THE LEGAL ENVIRONMENT OF BUSINESS
This page intentionally left blank
To the numerous students who appreciate the importance of developing their critical thinking skills for their personal growth and development

NANCY K. KUBASEK AND M. NEIL BROWNE

In memory of Professor Thomas Dunfee
of the Wharton School of Finance

BARTLEY A. BRENNAN
This page intentionally left blank
# Brief Contents

## PART ONE

**Introduction to the Law and the Legal Environment of Business**  1  
1 Critical Thinking and Legal Reasoning  2  
2 Introduction to Law and the Legal Environment of Business  15  
3 The American Legal System  33  
4 Alternative Tools of Dispute Resolution  70  
5 Constitutional Principles  99  
6 Cyberlaw and Business  134  
7 White-Collar Crime and the Business Community  160  
8 Ethics, Social Responsibility, and the Business Manager  202  
9 The International Legal Environment of Business  228  

## PART TWO

**Private Law and the Legal Environment of Business**  261  
10 The Law of Contracts and Sales—I  262  
11 The Law of Contracts and Sales—II  289  
12 The Law of Torts  309  
13 Product and Service Liability Law  342  
14 Law of Property: Real and Personal  372  
15 Intellectual Property  394  
16 Agency Law  413  
17 Law and Business Associations—I  434  
18 Law and Business Associations—II  453  

## PART THREE

**Public Law and the Legal Environment of Business**  477  
19 The Law of Administrative Agencies  478  
20 The Employment Relationship  499  
21 Laws Governing Labor–Management Relations  527  
22 Employment Discrimination  557  
23 Environmental Law  600  
24 Rules Governing the Issuance and Trading of Securities  629  
25 Antitrust Laws  680  
26 Laws of Debtor–Creditor Relations and Consumer Protection  721  

**APPENDIX A**  The Constitution Of the United States  763  
**APPENDIX B**  Uniform Commercial Code (2000 Official Text), Article 2  769  
**GLOSSARY**  783  
**INDEX**  797
This page intentionally left blank
Contents

PREFACE xxxi
ACKNOWLEDGMENTS xxxv
ABOUT THE AUTHORS xxxvii

PART ONE

Introduction to the Law and the Legal Environment of Business 1

1 Critical Thinking and Legal Reasoning 2
   The Importance of Critical Thinking 2
   A Critical Thinking Model 3

   United States of America v. Martha Stewart and Peter Bacanovic 4
   The Critical Thinking Steps 5
      Facts 5
      Issue 6
      Reasons and Conclusion 6
      Rules of Law 6
      Ambiguity 7
      Ethical Norms 7
      Analogies 7
      Missing Information 8

   Using Critical Thinking to Make Legal Reasoning Come Alive 9

   Legal Reasoning 10

   Applying the Critical Thinking Approach 13
   Assignment on the Internet 14
   On the Internet 14
   For Future Reading 14

2 Introduction to Law and the Legal Environment of Business 15
   Definition of the Legal Environment of Business 16
   Definition of Law and Jurisprudence 17
      Natural Law School 18
      Positivist School 19
      Sociological School 19
      American Realist School 20
      Critical Legal Studies School 20
      Feminist School 20
      Law and Economics School 21

   Sources of Law 21
      The Legislature as a Source of Statutory Law 21
      The Judicial Branch as a Source of Case Law 23
      The Executive Branch as a Source of Law 25
      Administrative Agencies as a Source of Law 25
Classifications of Law 26
  *Criminal Law and Civil Law* 26
  *Public and Private Law* 27
  *Substantive and Procedural Law* 27
  *Cyberlaw* 27

Global Dimensions of the Legal Environment of Business 28

Summary 28

Review Questions 28

Review Problems 29

Case Problems 29

Thinking Critically about Relevant Legal Issues 31

Assignment on the Internet 31

On the Internet 32

For Future Reading 32

3 The American Legal System 33

Jurisdiction 33
  *Original versus Appellate Jurisdiction* 33
  *Jurisdiction over Persons and Property* 34

*World-Wide Volkswagen Corp. v. Woodson, District Judge of Cook County* 35
  *Subject Matter Jurisdiction* 37

*West Virginia University Board of Governors for and on Behalf of West Virginia University v. Richard Rodriguez* 39

Venue 40

The Structure of the Court System 42
  *The Federal Court System* 42
  *State Court Systems* 42

The Actors in the Legal System and their Relationship to the Business Community 45
  *The Attorney* 45
  *The Judge* 46
  *The Jury* 48

The Adversary Process 49
  *Criticisms of the Adversary System* 49

Steps in Civil Litigation and the Role of Businesspersons 50
  *The Pretrial Stage* 50
  *The Trial* 55

*J.E.B. v. Alabama, ex rel. T.B.* 56
  *Appellate Procedure* 60
  *Class Actions* 62

Global Dimensions of the American Legal System 63

Summary 65

Review Questions 65

Review Problems 65

Case Problems 66

Thinking Critically about Relevant Legal Issues 68

Assignment on the Internet 68
## Alternative Tools of Dispute Resolution

### Negotiation and Settlement

Selection of a Mediator  
Common Uses of Mediation  
Advantages of Mediation  
Criticisms of Mediation

### Mediation

Selection of a Mediator  
Common Uses of Mediation  
Advantages of Mediation  
Criticisms of Mediation

### Arbitration

*Hall Street Associates, L.L.C. v. Mattel, Inc.*  
Methods of Securing Arbitration

*Southland Corp. v. Keating*

Selection of an Arbitrator  
Common Uses of Arbitration  
Problems with Arbitration

### Minitrials

Early Neutral Case Evaluation

### Summary Jury Trials

### Court-Annexed Alternative Dispute Resolution

Use of Court-Annexed ADR in the State and Federal Systems  
Differences between Court-Annexed and Voluntary ADR

### The Future of Alternative Dispute Resolution

### Global Dimensions of Alternative Dispute Resolution

*Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth*

### Summary

Review Questions  
Review Problems  
Case Problems  
Thinking Critically about Relevant Legal Issues  
Assignment on the Internet  
On the Internet  
For Future Reading

## Constitutional Principles

### The Constitution

Federalism  
Supremacy Clause  
Federal Preemption

Separation of Powers

*William Jefferson Clinton v. Paula Corbin Jones*

The Impact of the Commerce Clause on Business  
The Commerce Clause as a Source of Federal Authority
CONTENTS

6 Cyberlaw and Business 134
Cyberlaw and Business: How Law Changes as Society Changes 135
   The Flexibility of Law 135
   Changes in the Ways Courts Function 136
   Challenges to the Limits and Powers of Government 137
Intellectual Property Issues in Cyberspace 141
   Patents 141
   Trademarks 141
   Copyrights 142
A & M Records, Inc. v. Napster, Inc. 143
E-Commerce Issues 145
   Privacy 145
   Online Marketing 147
Centocor Inc. (Plaintiff-Appellant) v. Patricia Hamilton (Respondent) 147
   Cybersignatures 148
Employment Law Issues in Cyberspace 149
   Privacy versus Employment-at-Will 149
Michael A. Smyth v. the Pillsbury Co. 149
   Online Harassment 150
The War against Cybercrime 152
   Denial-of-Service Attacks 152
   Identity Theft 152
   Insider Trading 153
   Internet Gambling 154
White-Collar Crime and the Business Community 160
Crime and Criminal Procedure 163

Crime 163
Criminal Procedure 164

Distinguishing Features of White-Collar Crime 168
The Corporation as a Criminal 169
Arguments in Support of Corporate Liability 170
Arguments in Opposition to Corporate Liability 171
Imposition of Liability on Corporate Executives 171

United States v. Park 172
Imposition of Liability on Lower-Level Corporate Criminals 175
Factors Encouraging the Commission of White-Collar Crime 175
Sentencing of White-Collar Criminals 176

Common White-Collar Crimes 178
Bribery 179
Violations of Federal Regulations 179
Criminal Fraud 180

United States v. Gray 181
Larceny 183
Embezzlement 183
Computer Crimes 183

Prevention of White-Collar Crime 186

Federal Laws Used in the Fight Against White-Collar Crime 189
The Racketeer Influenced and Corrupt Organizations Act (RICO) 189
False Claims Act 189

Rockwell International Corp. v. United States 191
Sarbanes-Oxley Act 193
Whistleblower Protection Act 193

State Laws Used in the Fight Against White-Collar Crime 194

Global Dimensions of White-Collar Crime 195

Summary 196
Review Questions 196
Review Problems 196
Case Problems 197
Thinking Critically about Relevant Legal Issues 199
Assignment on the Internet 200
On the Internet 200
For Future Reading 201
<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>8</td>
<td>Ethics, Social Responsibility, and the Business Manager</td>
<td>202</td>
</tr>
<tr>
<td></td>
<td>Definition of Business Ethics and Social Responsibility</td>
<td>204</td>
</tr>
<tr>
<td></td>
<td>Business Ethics</td>
<td>204</td>
</tr>
<tr>
<td></td>
<td>The Social Responsibility of Business</td>
<td>204</td>
</tr>
<tr>
<td></td>
<td>In re Exxon Valdez</td>
<td>205</td>
</tr>
<tr>
<td></td>
<td>Theories of Ethical Thought</td>
<td>206</td>
</tr>
<tr>
<td></td>
<td>Consequential Theories</td>
<td>206</td>
</tr>
<tr>
<td></td>
<td>Deontological Theories</td>
<td>208</td>
</tr>
<tr>
<td></td>
<td>Humanist Theories</td>
<td>208</td>
</tr>
<tr>
<td></td>
<td>Codes of Ethics</td>
<td>208</td>
</tr>
<tr>
<td></td>
<td>Individual Codes of Ethics</td>
<td>208</td>
</tr>
<tr>
<td></td>
<td>Corporate Codes of Ethics</td>
<td>210</td>
</tr>
<tr>
<td></td>
<td>Industry Codes of Ethics</td>
<td>211</td>
</tr>
<tr>
<td></td>
<td>Professional Codes of Ethics</td>
<td>212</td>
</tr>
<tr>
<td></td>
<td>Bates v. State Bar of Arizona</td>
<td>214</td>
</tr>
<tr>
<td></td>
<td>Schools of Social Responsibility</td>
<td>216</td>
</tr>
<tr>
<td></td>
<td>Profit-Oriented School</td>
<td>216</td>
</tr>
<tr>
<td></td>
<td>Managerial School</td>
<td>219</td>
</tr>
<tr>
<td></td>
<td>Cooper Industries v. Leatherman Tool Group, Inc.</td>
<td>219</td>
</tr>
<tr>
<td></td>
<td>Institutional School</td>
<td>220</td>
</tr>
<tr>
<td></td>
<td>Professional Obligation School</td>
<td>220</td>
</tr>
<tr>
<td></td>
<td>Regulation School</td>
<td>221</td>
</tr>
<tr>
<td></td>
<td>Fog Cutter Capital Group v. Securities and Exchange Commission</td>
<td>221</td>
</tr>
<tr>
<td></td>
<td>Global Dimensions of Ethics and Social Responsibility</td>
<td>222</td>
</tr>
<tr>
<td></td>
<td>Code of Conduct for Transnational Corporations</td>
<td>222</td>
</tr>
<tr>
<td></td>
<td>Summary</td>
<td>223</td>
</tr>
<tr>
<td></td>
<td>Review Questions</td>
<td>223</td>
</tr>
<tr>
<td></td>
<td>Review Problems</td>
<td>223</td>
</tr>
<tr>
<td></td>
<td>Case Problems</td>
<td>224</td>
</tr>
<tr>
<td></td>
<td>Thinking Critically about Relevant Legal Issues</td>
<td>225</td>
</tr>
<tr>
<td></td>
<td>Assignment on the Internet</td>
<td>226</td>
</tr>
<tr>
<td></td>
<td>On the Internet</td>
<td>227</td>
</tr>
<tr>
<td></td>
<td>For Future Reading</td>
<td>227</td>
</tr>
<tr>
<td></td>
<td>The International Legal Environment of Business</td>
<td>228</td>
</tr>
<tr>
<td></td>
<td>Dimensions of the International Environment of Business</td>
<td>229</td>
</tr>
<tr>
<td></td>
<td>Political Dimensions</td>
<td>229</td>
</tr>
<tr>
<td></td>
<td>Economic Dimensions</td>
<td>230</td>
</tr>
<tr>
<td></td>
<td>Cultural Dimensions</td>
<td>231</td>
</tr>
<tr>
<td></td>
<td>Corruption and Trade</td>
<td>231</td>
</tr>
<tr>
<td></td>
<td>United States v. Kay</td>
<td>232</td>
</tr>
<tr>
<td></td>
<td>Legal Dimensions</td>
<td>234</td>
</tr>
<tr>
<td></td>
<td>Crosby v. National Foreign Trade Council</td>
<td>237</td>
</tr>
<tr>
<td></td>
<td>Methods of Engaging in International Business</td>
<td>238</td>
</tr>
<tr>
<td></td>
<td>Trade</td>
<td>238</td>
</tr>
<tr>
<td></td>
<td>International Licensing and Franchising</td>
<td>239</td>
</tr>
<tr>
<td></td>
<td>Foreign Direct Investment</td>
<td>240</td>
</tr>
</tbody>
</table>
CONTENTS

Competent Parties 278
Legal Object 279

Moore v. Midwest Distribution, Inc. 280

Contracts That Must Be in Writing 281

Contracts for the Sale of an Interest in Land 281
Contracts to Pay the Debts of Another 281
Contracts Not Performable in One Year 282
Sale of Goods of $500 or More 282

Iacono v. Lyons 282

Nonbusiness Contracts 283

Parol Evidence Rule 283

Third-Party Beneficiary Contracts and Assignment of Rights 284

Types of Third-Party Beneficiary Contracts 284
Assignment of Rights 284

Summary 285
Review Questions 286
Review Problems 286
Case Problems 286
Thinking Critically about Relevant Legal Issues 287
Assignment on the Internet 288
On the Internet 288
For Future Reading 288

11 The Law of Contracts and Sales—II 289

Methods of Discharging a Contract 290

Discharge by Performance 290

Plante v. Jacobs 290

Discharge by Mutual Agreement 292
Discharge by Conditions Precedent and Subsequent 293

Architectural Systems, Inc. v. Gilbane Building Co. 293

Discharge by Impossibility of Performance 294
Discharge by Commercial Impracticability 294

Facto v. Pantagis 295

Remedies for a Breach of Contract 296
Monetary Damages ("Legal" Remedies) 296

Shirley Parker v. Twentieth Century Fox Film Corp. 297

Arrowhead School District No. 75, Park County, Montana v. James A. Klyap, Jr. 298
Equitable Remedies 300
Remedies for Breach of a Sales Contract (Goods) 301

Fitl v. Strek 301

E-Contracts 302
E-Signatures 302

The Uniform Computer Information Transaction Act 303

Global Dimensions of Contract and Sales Law 304
Summary 305
Review Questions 305
12 The Law of Torts 309
The Goals of Tort Law 309
Damages Available in Tort Cases 310
  Compensatory Damages 310
  Nominal Damages 311
  Punitive Damages 311
BMW of North America, Inc. v. Gore, Jr. 312
Classifications of Torts 318
Intentional Torts 318
  Intentional Torts against Persons 318
Nemet Chevrolet, Ltd. v. Consumeraffairs.com, Inc. 321
Ellen Johnston v. One America Productions, Inc. 325
  Intentional Torts against Property 329
  Intentional Torts against Economic Interests 329
Negligent Torts 331
  Elements of Negligence 331
  Defenses to Negligence 333
Vicki Lynn Shultz v. Cheney School District No. 360 335
Strict Liability Torts 336
Global Dimensions of Tort Law 336
Summary 336
Review Questions 337
Review Problems 337
Case Problems 338
Thinking Critically about Relevant Legal Issues 340
Assignment on the Internet 340
On the Internet 341
For Future Reading 341

13 Product and Service Liability Law 342
Theories of Recovery in Product Liability Cases 343
  Negligence 343
Donna S. Riegel v. Medtronic, Inc. 350
  Strict Liability in Contract for Breach of Warranty 352
Williams v. Braum Ice Cream Store, Inc. 354
  Strict Liability in Tort 357
Welge v. Planters Lifesavers Co. 358
Susan Calles v. Scripto-Tokai Corp. et al. 360
  Liability to Bystanders 363
Market Share Liability 363
Law of Property: Real and Personal 372

Real Property 373
  Definition of Real Property 374
  Extent of Ownership 374

Interests in Real Property 374
  Fee Simple Absolute 375
  Conditional Estate 375
  Life Estate 375
  Future Interest 375
  Leasehold Estates 376
  Easements 376
  License 376
  Co-Ownership 377
  Condominiums and Cooperatives 377

Burton Stevens v. Elk Run Homeowners' Association, Inc. 378

Voluntary Transfer of Real Property 379
  Execution 380
  Delivery 382
  Acceptance 382
  Recording 382

Involuntary Transfer of Real Property 382
  Adverse Possession 382
  Condemnation 382


Restrictions on Land Use 385
  Restrictive Covenants 386
  Zoning 387
  Other Statutory Restrictions on Land Use 387

Personal Property 388
  Voluntary Transfer of Personal Property 388
  Involuntary Transfers of Personal Property 388
  Bailments 389

Global Dimensions of Property Law 389

Summary 390

Review Questions 390

Review Problems 391
Case Problems  391
Thinking Critically about Relevant Legal Issues  392
Assignment on the Internet  393
On the Internet  393
For Future Reading  393

15  Intellectual Property  394
Introduction to Intellectual Property  394
Trademarks  394
Toys “R” Us, Inc., v. Canarsie Kiddie Shop, Inc.  395
    Trade Dress  398
    Federal Trademark Dilution Act of 1995  398
Victor Moseley and Kathy Moseley et al., dba Victor’s Little Secret v. V Secret Catalogue, Inc. et al.  400
Trade Secrets  401
Patents  401
Copyrights  402
    Fair Use Doctrine  403
    Copyrights in the Digital Age  406
RealNetworks, Inc. v. DVD Control Copy Association, Inc., et al.  407
Global Dimensions of Intellectual Property Law  408
Summary  409
Review Questions  409
Review Problems  410
Case Problems  410
Thinking Critically about Relevant Legal Issues  411
Assignment on the Internet  412
On the Internet  412
For Future Reading  412

16  Agency Law  413
Definition and Types of Agency Relationships  414
    Definition of Agency  414
    Types of Agency Relationships  414
Alberty-Vélez v. Corporación de Puerto Rico  416
Creation of an Agency Relationship  418
    Expressed Agency or Agency by Agreement  418
    Agency by Implied Authority  418
Penthouse International v. Barnes  419
    Agency through Ratification by Principal  420
    Agency by Estoppel or Apparent Authority  420
Duties of Agents and Principals  420
    Principal’s Duties to Agent  420
    Agent’s Duties to Principal  421
CONTENTS

Cousins v. Realty Ventures, Inc. 421
Gossels v. Fleet National Bank 423

Principal’s and Agent’s Liability to Third Parties 424
   Contractual Liability 424

McBride v. Taxman Corp. 424
   E-Commerce: Intelligent Agents 425
   Liability of Disclosed, Partially Disclosed Principals, and Undisclosed Principals 426
   Liability of Undisclosed Principal 426
   Tort Liability 426
   Tort Liability and Negligence 426
   Criminal Liability 427

Termination of the Principal–Agent Relationship 427
   Termination by Agreement 427
   Termination by Operation of Law 427

Gaddy v. Douglass 428

Global Dimensions of Agency Law 429
   Japan 429
   European Union 429
   U.S. Agents Abroad 430

Summary 430
Review Questions 431
Review Problems 431
Case Problems 432
Thinking Critically about Relevant Legal Issues 432
Assignment on the Internet 433
On the Internet 433
For Future Reading 433

17 Law and Business Associations—I 434

Factors Influencing a Business Manager’s Choice of Organizational Form 436

Some Common Forms of Business Organization in the United States 436
   Sole Proprietorships 437
   General Partnerships 437

In re KeyTronics 439

Enea v. Superior Court of Monterey County 440
   Limited Partnerships and Limited Liability Limited Partnerships 444

Specialized Forms of Business Associations 445
   Joint Stock Company 445
   Syndicate 445
   Joint Venture 445
   Franchising 446

Global Dimensions of Business Associations 447
Summary 449
Review Questions 449
Law and Business Associations—II 453

The Corporation 453

Classification of Corporations 454

- Closely Held Corporation 454
- Publicly Held Corporation 455
- Multinational or Transnational Corporation 455
- Subchapter S Corporation 455
- Professional Corporation 455
- Nonprofit Corporation 456

Creation of Corporations 456

Financing of Corporations 456

- Debt Financing 456
- Equity Financing 457
- Consideration 459

Operation of Corporations 460

- The Role of the Shareholders 460
- The Role of the Board of Directors 462
- The Role of the Officers and Managers 462
- Fiduciary Obligations of Directors, Officers, and Managers 463

Beam v. Stewart 464

Smith v. Van Gorkom 466

Limited Liability Companies 469

- The Uniform Limited Liability Act 469
- LLC Characteristics 469

Creative Resource Management Inc. v. Soskin 469

- Creating a Limited Liability Company 470
- Duration of the LLC 471
- Financing of the LLC 471
- Control Considerations 471
- Tax Ramifications 471

Global Dimension of Corporations: A “Big Fat Greek” Bailout II 471

Summary 472

Review Questions 472

Review Problems 473

Case Problems 473

Thinking Critically about Relevant Legal Issues 474

Assignment on the Internet 475

On the Internet 475

For Future Reading 476
PART THREE
Public Law and the Legal Environment of Business 477

19 The Law of Administrative Agencies 478
Introduction to Administrative Law and Administrative Agencies 479
  Administrative Law 479
  Administrative Agencies 480
Creation of Administrative Agencies 481
Functions of Administrative Agencies 482
  Rulemaking 482
Massachusetts v. EPA 484
  Adjudication 485
Fox Television Stations, Inc. v. Federal Communications Commission 489
  Administrative Activities 490
Limitations on Administrative Agencies' Powers 490
  Statutory Limitations 490
  Institutional Limitations 490
State and Local Administrative Agencies 492
Vonage Holdings Corp. v. Minnesota Public Utilities Commission 493
Global Dimensions of Administrative Agencies 494
Summary 494
Review Questions 494
Review Problems 495
Case Problems 495
Thinking Critically about Relevant Legal Issues 497
Assignment on the Internet 497
On the Internet 498
For Future Reading 498

20 The Employment Relationship 499
Wage and Hour Laws 500
Unemployment Compensation 502
Cassandra Jenkins v. American Express Financial Corp. 504
Consolidated Omnibus Budget Reconciliation Act of 1985 505
Worker's Compensation Laws 505
  Coverage 505
  Recoverable Benefits 506
  The Claims Process 507
  Benefits of the Worker's Compensation System 507
The Family and Medical Leave Act of 1993 508
  Major Provisions 508
Rachael Schaar, Appellant v. Lehigh Valley Health Services, Inc.; Lehigh Valley Physicians Business Services, Inc. 509
  Remedies for Violations of the FMLA 511
Environmental Law 600
Alternative Approaches to Environmental Protection 601
Tort Law 601
Boomer et al. v. Atlantic Cement Co. 601
   Government Subsidies Approach 603
   Emission Charges Approach 603
   Marketable Discharge Permits Approach 603
   Direct Regulation Approach 604
The Environmental Protection Agency 604
The National Environmental Policy Act of 1970 606
   Threshold Considerations 606
   Content of the EIS 606
TOMAC v. Gale Norton 607
   Effectiveness of the EIS Process 608
Regulating Water Quality 609
   The Federal Water Pollution Control Act 609
   The Safe Drinking Water Act 609
Regulating Air Quality 610
Massachusetts v. Environmental Protection Agency 611
   The National Ambient Air Quality Standards 612
   New Source Review 613
   The Acid Rain Control Program 613
   Climate Change 614
Regulating Hazardous Waste and Toxic Substances 615
   The Resource Conservation and Recovery Act of 1976 616
   The Comprehensive Environmental Response, Compensation, and Liability Act of 1980, as Amended by the Superfund Amendment and Reauthorization Act of 1986 618
   The Toxic Substances Control Act of 1979 619
   The Federal Insecticide, Fungicide, and Rodenticide Act of 1972 619
The Pollution Prevention Act of 1990 620
   Business Aspects of Voluntary Pollution Prevention 621
   Sustainable Development 621
Global Dimensions of Environmental Regulation 621
   The Need for International Cooperation 621
   The Transnational Nature of Pollution 622
   The Global Commons 623
   Primary Responses of the United States 623
Summary 624
Review Questions 625
Review Problems 625
Case Problems 625
Thinking Critically about Relevant Legal Issues 627
Assignment on the Internet 628
On the Internet 628
For Future Reading 628
Rules Governing the Issuance and Trading of Securities 629
Introduction to the Regulation of Securities 630
Summary of Federal Securities Legislation 631
The Securities and Exchange Commission 633
Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 637
Oversight of Financial Problems by Regulatory Agencies 637
Risk Taking by Large Banks and Nonbanks 638
Executive Compensation 638
Too Big to Fail 638
Credit Rating Agencies 639
Derivatives 639
Consumer Protection 639
Exemptions 640
Regulation by Regulators 640
The Sarbanes-Oxley Act of 2002 641
Corporate Accountability 641
New Accounting Regulations 641
Criminal Penalties 642
The Securities Act of 1933 642
Definition of a Security 642
Securities and Exchange Commission v. Edwards 643
Registration of Securities under the 1933 Act 644
Securities and Transactions Exempt from Registration under the 1933 Act 647
Resale Restrictions 650
Liability, Remedies, and Defenses under the 1933 Securities Act 650
The Securities Exchange Act of 1934 653
Registration of Securities Issuers, Brokers, and Dealers 653
Disclosure: Compensation 656
Securities Markets 656
Proxy Solicitations 657
Tender Offers and Takeover Bids 659
Remedies and Defensive Strategies 660
Barbara Schreiber v. Burlington Northern, Inc. 660
Securities Fraud 663
Securities and Exchange Commission v. Texas Gulf Sulphur Co. 667
Liability and Remedies under the 1934 Exchange Act 669
The Wharf (Holdings) Limited v. United International Holdings, Inc. 670
Short-Swing Profits 670
State Securities Laws 672
E-Commerce, Online Securities Disclosure, and Fraud Regulation 672
Marketplace of Securities 672
E-Commerce and Fraud in the Marketplace 672
Global Dimensions of Rules Governing the Issuance and Trading of Securities 673
Legislation Prohibiting Bribery and Money Laundering Overseas 673
Antitrust Laws 680

Introduction to Antitrust Law 681
A Definition of Antitrust 681
Law and Economics: Setting and Enforcing Antitrust Policy 681
Goals of the Antitrust Statutes 683

Enforcement of and Exemptions from the Antitrust Laws 684
Enforcement 684
Exemptions 686

The Sherman Act of 1890 687
Section 1: Combinations and Restraints of Trade 687

Williamson Oil Co. v. Philip Morris, USA 689
Leegin Creative Leather Products, Inc. v. PSKS, Inc., dba Kay’s Kloset, Kay’s Shoes 693
Continental TV, Inc. v. GTE Sylvania 695
Section 2: Monopolies 698

Newcal Industries, Inc. v. Ikon Office Solutions 700
United States v. Microsoft Corporation 702

The Clayton Act of 1914 703
Section 2: Price Discrimination 704
Section 3: Tying Arrangements and Exclusive-Dealing Contracts 705
Section 7: Mergers and Acquisitions 705
Section 8: Interlocking Directorates 712

Other Antitrust Statutes 712
Federal Trade Commission Act of 1914 712
California Dental Association v. Federal Trade Commission 713
Bank Merger Act of 1966 714

Global Dimensions of Antitrust Statutes 714
Transnational Reach of U.S. Antitrust Legislation 714
Global Dimensions of U.S. Antitrust Laws 715
Enforcement 715

Summary 716
Review Questions 717
Review Problems 717
Case Problems 718
Thinking Critically about Relevant Legal Issues 719
Assignment on the Internet  719
On the Internet  720
For Future Reading  720

26  Laws of Debtor–Creditor Relations
and Consumer Protection  721
Debtor–Creditor Relations  722
  Rights of and Remedies for Creditors  723
  Rights and Remedies for Debtors  724
The Federal Bankruptcy Code and the Incorporation of the
Bankruptcy Abuse Prevention and Consumer Protection
Act of 2005  725
  History and Background  725
  Bankruptcy Management and Proceedings  725
  Chapter 7  729
In re Savage v. United State Bankruptcy  730
  Chapter 13  731
  Chapter 11  732
  Chapter 12  733
The Evolution of Consumer Law  735
  Economics  735
Federal Regulation of Business Trade Practices
and Consumer–Business Relationships  736
  The Federal Trade Commission: Functions, Structure,
  and Enforcement Powers  736
  Deceptive and Unfair Advertising  737
Federal Trade Commission v. Verity International, Ltd.  738
Federal Trade Commission v. QT, Inc.  739
  Consumer Legislation  741
Federal Laws Regulating Consumer Credit and Business Debt-Collection
Practices  744
  Truth-in-Lending Act  745
Household Credit Services, Inc. v. Pfenning  747
  Credit Card Accountability, Responsibility and Disclosure Act of
  2009  748
  The Electronic Fund Transfer Act  748
  A Plastic Society  749
  The Fair Credit Reporting Act  749
Safeco Insurance Co. v. Burr  750
  Identity Theft and Credit Ratings  752
  Equal Credit Opportunity Act  752
  The Fair Credit Billing Act  753
  The Fair Debt Collection Practices Act  754
Miller v. McCalla, Raymer Padrick and Clark, LLC  755
Dodd-Frank Act and Consumer Protection  756
State Consumer Legislation  757
  Uniform Consumer Credit Code  757
  Unfair and Deceptive Practices Statutes  757
  Arbitration of Disputes  758
Preface

The Legal Environment of Business: A Critical Thinking Approach, 6th edition, is exactly what its name implies: a comprehensive textbook that not only helps students develop a thorough understanding of the legal environment of business, but also enhances their ability to engage in critical thinking and ethical analysis. Students thus develop the knowledge and skills necessary to survive in an increasingly competitive global environment.

The initial motivation for this book was the authors’ perceptions that there was no legal environment book available that explicitly and adequately facilitated the development of students’ critical thinking skills. Nor was there a book that really integrated ethical analysis throughout the text.

Some people may argue that the traditional method of case analysis allows students to develop their critical thinking skills. The problem with this approach, however, is that it focuses only on the analytical skills, while ignoring the evaluative component that is really the essence of critical thinking; it also lacks an ethics component. To engage in critical thinking necessarily includes consideration of the impact of values on the outcome being considered.

The use of cases in the legal environment of business classroom, however, can provide an excellent opportunity for the development of students’ critical thinking abilities when the traditional case method is modified to emphasize development of these critical thinking skills. Additionally, as the students enhance their critical thinking skills, their understanding of the substance of the law also improves.

The following components of The Legal Environment of Business: A Critical Thinking Approach ensure that our goal of developing critically thinking students who understand the important concepts of business law and the legal environment of business is attained.

• An explicit critical thinking model developed by the author of the best-selling critical thinking textbook is set forth in the first chapter. An eight-step model has as its base the traditional method of case analysis, but adds crucial critical thinking questions that also incorporate ethical analysis. The steps are clearly explained, and students are encouraged to apply the steps to every case in the text.

• Additional critical thinking and ethical analysis questions incorporated at the beginning of each chapter and after selected cases. These additional questions help to reinforce the skills emphasized in the model.

• “Thinking Critically about Relevant Legal Issues” essays at the end of each chapter, which give students additional opportunities to develop their critical thinking skills. These essays, found at the end of each chapter, allow students to extend their use of their newly developed critical thinking skills beyond cases to the kinds of arguments they will encounter in their daily lives.

Other Points of Distinction

• Explicit links connecting the law to other disciplines. This text is the only legal environment book to respond to the call for more integration among courses in colleges of business. “Linking Law to Business” boxes explicitly state how the law in an area directly affects or is affected by a concept in one of the core areas of business, such as accounting, management, and marketing. These boxes appear in every chapter.
• **A balanced mix of classic and current cases.** This book contains many of the most significant classic and contemporary cases, including key U.S. Supreme Court decisions handed down as recently as 2008. Whenever possible, cases were chosen that not only demonstrated important concepts but also contained fact situations that would interest students.

• **Emphasis on the global environment.** Many of our students will be working in countries other than the United States, and U.S. companies will have many dealings with foreign companies. Thus, an understanding of the global environment is essential for today’s business student. This text emphasizes the importance of the global environment by using both the stand-alone and infusion approaches. Chapter 9 focuses explicitly on the global environment of business, and then we integrate global considerations into every chapter with our global dimensions sections and our “Comparative Law Corner,” which allows students to see how U.S. law compares to that of other nations around the world. The feature can also sensitize students to the idea that if something is not working well in our country, it might make sense to see how some other countries address similar issues. Examples include:
  - Eminent domain in Germany
  - The judicial system in Germany
  - Corporate speech in Canada
  - Unions in Sweden
  - Pollution controls in Japan

• **For Future Reading Feature.** We all want our students to become lifelong learners, and we especially want them to continue learning about the law. But how do they know where to go? This feature, found at the end of each chapter, provides a short list of books and articles related to the material in each chapter that interested students may read to learn more about the new areas of law they have just discovered.

### New to This Edition

• Reorganized business organizations materials. The coverage of forms of business organizations has been reorganized, and we have expanded our coverage of this area of law from one chapter into two.

• Expanded coverage of intellectual property to allow greater discussion of property issues. This topic now appears in the new intellectual property chapter.

• Introduction of changes in the law, especially in the securities area, brought about by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act incorporated into chapters 20, 21, 24, and 26.

• Updated cases. Cases in this edition have been significantly updated. We have retained the classic cases from the previous edition, as well as those that students find especially interesting or that do an exceptional job of illustrating an important point of law. All of the other cases have been replaced by more current cases that will be of greater interest to our students and that capture the most current changes in the law. Examples of new cases include:
  - *West Virginia University Board of Governors for and on behalf of West Virginia University, Plaintiff v. Richard Rodriguez* (Chapter 3)
  - *Hall Street Associates, L.L.C. v. Mattel, Inc.* (Chapter 4)
  - *Centocore, Inc. v. Patricia Hamilton* (Chapter 6)
• Case problems. Approximately one-third of the case problems from the fifth edition have been replaced with more current case problems.
• Revised “For Further Reading” sections. Suggested readings at the end of each chapter have been updated to emphasize more current legal issues.

For Instructors
We offer a variety of both print and electronic supplements to meet the unique teaching needs of each instructor. Electronic versions of the supplements that accompany this text are available for download by instructors only at our Instructor Resource Center, at www.pearsonhighered.com/irc.

• Instructor’s Manual
• Test Item File
• E-mail case updates. Adopters of the book may subscribe to a list that will provide regular case updates via e-mail, consisting of edited versions of newly decided cases, as well as suggestions for where they would fit in the text. To subscribe, just send an e-mail to Nancy Kubasek at nkubase@bgsu.edu and ask to be added to the CTLEB list.
• PowerPoints
This page intentionally left blank
Acknowledgments

The author would like to acknowledge, with thanks, the following reviewers of this text:

Robert Aalberts, University of Nevada, Las Vegas
Victor Alicea, Normandale Community College
Carlos Alsua, University of Alaska, Anchorage
S. Catherine Anderson, Queens University of Charlotte
Teddy Jack Armstrong, Carl Albert State College
Janie Blankenship, Del Mar College
William Bockanic, John Carroll University
Heidi Bulich, College of Business, Michigan State University
Kimble Byrd, Rowan University
Glenn Chappell, Coker College
William Christian, College of Santa Fe
Linda Christiansen, Indiana University Southeast
Patrick Cihon, Whitman School of Management, Syracuse University
Michael Costello, University of Missouri–St. Louis
Robert Cox, Salt Lake Community College
Jamey Darnell, Barton College
Regina Davenport, Pearl River Community College
Julia Derrick, Brevard Community College
Joseph Dworak, San Jose State University
Bruce Elder, University of Nebraska, Kearney
Gail Evans, University of Houston, Downtown
David Forsyth, ASU Polytechnic
Lucky Franks, Bellevue University
Samuel B. Garber, DePaul University
Rosario Girasa, Pace University
Van Graham, Gardner-Webb University
John Gray, Loyola College in Maryland
David Griffis, University of San Francisco
Jason Harris, Augustana College
Norman Hawker, Haworth College of Business, Western Michigan University
Richard Hunter, Seton Hall University
Marilyn Johnson, Mississippi Delta Community College
Nancy Johnson, Mt. San Jacinto Community College
Catherine Jones-Rikkers, Grand Valley State University
James Kelley, Notre Dame de Namur University
Lara Kessler, Grand Valley State University
Ernest King, University of Southern Mississippi
Audrey Wolfson Latourette, Richard Stockton College of New Jersey
Larry Laurent, McCoy College of Business, Texas State University
Marty Ludlum, Oklahoma City Community College
Vicki Luoma, Minnesota State University
Daniel Lykins, Oregon State University
Bryan Jon Maciewski, Fond du Lac Tribal and Community College
Maurice McCann, Southern Illinois University
George McNary, College of Business Administration, Creighton University
Don Miller-Kermani, Brevard Community College
David Missirian, Bentley College
Odell Moon, Victor Valley College
Henry Moore, University of Pittsburgh, Greensburg
Mark Muhich, Mesabi Range Community & Technical College
Kimber Palmer, Texas A&M International University
Steve Palmer, Eastern New Mexico University
Darka Powers, Northeastern Illinois University
Charles Radeline, St. Petersburg College
Linda Reid, University of Wisconsin–Whitewater
Bruce Rockwood, College of Business, Bloomsburg University
Robert Rowlands, Harrisburg Area Community College
Ira Selkowitz, University of Colorado at Denver and Health Sciences Center
Mary Sessom, Cuyamaca College
James Smith, Bellevue University
Craig Stilwell, Michigan State University
Pamela Stokes, Texas A&M–Corpus Christi
Keith Swim, Jr., Mays Business School, Texas A&M University
Harold Tepool, Vincennes University
Daphyne Saunders Thomas, James Madison University
David Torres, Angelo State University
Kyle Usre, Whitworth College
Deborah Walsh, Middlesex Community College
Joe Walsh, Lees-McRae College
Dalph Watson, Madonna University
Mary Ellen Wells, Alvernia College
John Whitehead, Kilgore College
John Williams, Northwestern State University
Levon Wilson, Georgia Southern University
Rob Wilson, Whitworth College
Andrew Yee, University of San Francisco
NANCY KUBASEK is a Professor of Legal Studies at Bowling Green State University, where she teaches the Legal Environment of Business, Environmental Law, and an Honors Seminar on Moral Principles. For eight years she team-taught a freshman honors seminar on critical thinking and values analysis. She has published another undergraduate textbook with Prentice Hall, *Environmental Law* (7th ed. 2010) and more than 75 articles. Professor Kubasek’s articles have appeared in such journals as the *American Business Law Journal*, the *Journal of Legal Studies Education*, the *Harvard Women’s Law Journal*, the *Georgetown Journal of Legal Ethics*, and the *Harvard Journal on Legislation*. She received her J.D. from the University of Toledo College of Law and her B.A. from Bowling Green State University.

Active in her professional associations, Professor Kubasek has served as president of the TriState Regional Academy of Legal Studies in Business, and president of the national professional association, the Academy of Legal Studies in Business (ALSB). Committed to helping students become excited about legal research, she organized the first Undergraduate Student Paper Competition of the ALSB’s Annual Meeting, an event that now provides an annual opportunity for students to present their original legal research at a national convention. She has also published several articles with students and has received her university’s highest award for faculty–student research. She states:

The most important thing that a teacher can do is to help his or her students develop the skills and attitudes necessary to become lifelong learners. Professors should help their students learn the types of questions to ask to analyze complex legal issues, and to develop a set of criteria to apply when evaluating reasons. If we are successful, students will leave our legal environment of business classroom with a basic understanding of important legal concepts, a set of evaluative criteria to apply when evaluating arguments that includes an ethical component, and a desire to continue learning.

To attain these goals, the classroom must be an interactive one, where students learn to ask important questions, define contexts, generate sound reasons, point out the flaws in erroneous reasoning, recognize alternative perspectives, and consider the impacts that their decisions (both now and in the future) have on the broader community beyond themselves.

BARTLEY A. BRENNAN is an Emeritus Professor of Legal Studies at Bowling Green State University. He is a graduate of the School of Foreign Service, Georgetown University (B.S. International Economics); the College of Law, State University of New York at Buffalo (J.D.); and Memphis State University (M.A. Economics). He was a volunteer in the United States Peace Corps, was employed by the Office of Opinions and Review of the Federal Communications Commission, and worked in the general counsel’s office of a private international corporation. Professor Brennan has received appointments as a visiting associate professor at the Wharton School, University of Pennsylvania, and as a Research Fellow at the Ethics Resource Center, Washington, D.C. He is the author of articles dealing with the Foreign Corrupt Practices Act of 1977, as amended; the business judgment rule; law and economics; and business ethics. He has published numerous articles in such journals as the *American Business Law Journal*, *University of North Carolina Journal of International Law*, and the *Notre Dame*
M. NEIL BROWNE is a Distinguished Teaching Professor of Economics and director of IMPACT, an Honors Residential Learning Community Centered Around the Principles of Intellectual Discovery and Moral Commitment, at Bowling Green State University. He received a J.D. from the University of Toledo and a Ph.D. from the University of Texas. He is the coauthor of seven books and more than a hundred research articles in professional journals. One of his books, *Asking the Right Questions: A Guide to Critical Thinking* (6th ed.), is a leading text in the field of critical thinking. His most recent book, *Striving for Excellence in College: Tips for Active Learning*, provides learners with practical ideas for expanding the power and effectiveness of their thinking. Professor Browne has been asked by dozens of colleges and universities to aid their faculty in developing critical thinking skills on their respective campuses. He also serves on the editorial board of the *Korean Journal of Critical Thinking*. In 1989, he was a silver medalist for the Council for the Advancement and Support of Education's National Professor of the Year award. Also, in 1989, he was named the Ohio Professor of the Year. He has won numerous teaching awards on both local and national levels. He states:

When students come into contact with conflicting claims, they can react in several fashions; my task is to enable them to evaluate these persuasive attempts. I try to provide them with a broad range of criteria and attitudes that reasonable people tend to use as they think their way through a conversation. In addition, I urge them to use productive questions as a stimulus to deep discussion, a looking below the surface of an argument for the assumptions underlying the visible component of the reasoning. The eventual objectives are to enable them to be highly selective in their choice of beliefs and to provide them with the greater sense of meaning that stems from knowing that they have used their own minds to separate sense from relative nonsense.
Introduction to the Law and the Legal Environment of Business

Part One introduces the concept of critical thinking that provides the framework for our study of the legal environment of business. In addition, we provide an overview of how the American legal system works. This overview requires us to understand alternative philosophies of law, alternative philosophies of ethics, how the constitutional foundations of our legal system work to resolve both criminal and civil disputes, and alternative methods of resolving disputes. Part One concludes with a discussion of white-collar crime, a major problem in the legal environment of business.
Critical Thinking and Legal Reasoning

- THE IMPORTANCE OF CRITICAL THINKING
- A CRITICAL THINKING MODEL
- THE CRITICAL THINKING STEPS
- USING CRITICAL THINKING TO MAKE LEGAL REASONING COME ALIVE
- APPLYING THE CRITICAL THINKING APPROACH

The Importance of Critical Thinking

Success in the modern business firm requires the development of **critical thinking skills**. Business leaders regularly list these skills as the core set of competencies needed in business. **Critical thinking** refers to the ability to understand what someone is saying and then to apply evaluative criteria to assess the quality of the reasoning offered to support the conclusion. Because they are under increasing competitive pressure, business and industry need managers with advanced thinking skills.1 Highlighting this need, a report by the U.S. Secretary of Education states that because “one of the major goals of business education is preparing students for the workforce, students and their professors must respond to this need for enhancing critical thinking skills.”2

Calls for improvements in critical thinking skills also come from persons concerned about business ethics: “Managers stand in need of sharp critical thinking skills that will serve them well [in tackling] ethical issues,” according to an editorial in *Management Accounting Quarterly*.3 As a future business manager, you will experience many ethical dilemmas: Where should our facilities be located? Whom should we hire? What are the boundaries of fair competition? What responsibilities do firms owe various stakeholders? All such questions require legal analysis and ethical understanding, guided by critical thinking.

The message is clear: Success in business today requires critical thinking skills, and there is no better context in which to develop them than in the study of the laws that affect business. Critical thinking skills learned in the legal environment of business course will be easily transferred to your eventual role as a manager, entrepreneur, or other business professional. The law develops through argument among various parties. Critical thinking about these arguments gives direction to the development of more effective law.

---

2 Id.
Legal reasoning is like other reasoning in some ways and different in others. When people, including lawyers and judges, reason, they do so for a purpose. Some problem or dilemma bothers them. The stimulus that gets them thinking is the issue. It is stated as a question because it is a call for action. It requires them to do something, to think about answers.

For instance, in our legal environment of business course, we are interested in such issues as:

1. Under the National Labor Relations Act, when are union organizers permitted to enter an employer’s property?
2. Do petroleum firms have liability for the environmental and economic effects of oil spills?
3. Must a business fulfill a contract when the contract is made with an unlicensed contractor in a state requiring that all contractors be licensed?

These questions have several possible answers. Which one should you choose? Critical thinking moves us toward better choices. Some of your answers could get you into trouble; others could advance your purpose. Each answer is called a conclusion. The conclusion is a position or stance on an issue.

Business firms encounter legal conclusions in the form of laws or court decisions. As businesses learn about and react to decisions or conclusions made by courts, they have two primary methods of response:

1. Memorize the conclusions or rules of law as a guide for future business decisions.
2. Make judgments about the quality of the conclusions.

This book encourages you to do both. What is unique about this text is its practical approach to evaluating legal reasoning. This approach is based on using critical thinking skills to understand and evaluate the law as it affects business.

There are many forms of critical thinking, but they all share one characteristic: They focus on the quality of someone’s reasoning. Critical thinking is active; it challenges each of us to form judgments about the quality of the link between someone’s reasons and conclusions. In particular, we will be focusing on the link between a court’s reasons and its conclusions.

A Critical Thinking Model

You will learn critical thinking by practicing it. This text will tutor you, but your efforts are the key to your skill as a critical thinker. Because people often learn best by example, we will introduce you to critical thinking by demonstrating it in a model that you can easily follow.

We now turn to a sample of critical thinking in practice. The eight critical thinking questions listed in Exhibit 1-1 and applied in the sample case that follows illustrate the approach you should use when reading cases to develop your critical thinking abilities.
As a citizen, entrepreneur, or manager, you will encounter cases like the one that follows. How would you respond? What do you think about the quality of Judge Cedarbaum’s reasoning?

**CASE 1-1**

United States of America v. Martha Stewart and Peter Bacanovic
United States District Court for the Southern District of New York, 2004
U.S. Dist. LEXIS 12538

Defendants Martha Stewart and Peter Bacanovic were both convicted of conspiracy, making false statements, and obstruction of an agency proceeding, following Stewart’s sale of 3,928 shares of ImClone stock on December 27, 2001. Stewart sold all of her ImClone stock after Bacanovic, Stewart’s stockbroker at Merrill Lynch, informed Stewart that the CEO of ImClone, Samuel Waksal, was trying to sell his company stock. On December 28, 2001, ImClone announced that the Food and Drug Administration (FDA) had not approved the company’s cancer-fighting drug Erbitux. Thereafter, the Securities and Exchange Commission (SEC) and the United States Attorney’s Office for the Southern District of New York began investigations into the trading of ImClone stock, including investigations of Stewart and Bacanovic. Following Stewart’s and Bacanovic’s criminal convictions, the defendants filed a motion for a new trial, alleging that expert witness Lawrence F. Stewart, director of the Forensic Services Division of the United States Secret Service, had committed perjury in his testimony on behalf of the prosecution. As the “national expert for ink analysis,” Lawrence Stewart testified about the reliability of defendant Bacanovic’s personal documents that contained information about Martha Stewart’s investments in ImClone.

**Judge Cedarbaum**

Rule 33 provides: “Upon the defendant’s motion, the court may vacate any judgment and grant a new trial if the interest of justice so requires.” However, “in the interest of according finality to a jury’s verdict, a motion for a new trial based on previously-undiscovered evidence is ordinarily ‘not favored and should be granted only with great caution.’” In most situations, therefore, “relief is justified under Rule 33 only if the newly-discovered evidence could not have been discovered, exercising due diligence, before or during trial, and that evidence ‘is so material and non-cumulative that its admission would probably lead to an acquittal.’”

But the mere fact that a witness committed perjury is insufficient, standing alone, to warrant relief under Rule 33. “Whether the introduction of perjured testimony requires a new trial initially depends on the extent to which the prosecution was aware of the alleged perjury. To prevent prosecutorial misconduct, a conviction obtained when the prosecution’s case includes testimony that was known or should have been known to be perjured must be reversed if there is any reasonable likelihood that the perjured testimony influenced the jury.” When the Government is unaware of the perjury at the time of trial, “a new trial is warranted only if the testimony was material and ‘the court [is left] with a firm belief that but for the perjured testimony, the defendant would most likely not have been convicted.’”

Since [United States v.] Wallach, the Second Circuit has noted that even when the prosecution knew a witness was committing perjury, “where independent evidence supports a defendant’s conviction, the subsequent discovery that a witness’s testimony at trial was perjured will not warrant a new trial.”

Defendants have failed to demonstrate that the prosecution knew or should have known of Lawrence’s perjury. However, even under the stricter prejudice standard applicable when the Government is aware of a witness’s perjury, defendants’ motions fail. There is no reasonable likelihood that knowledge by the jury that Lawrence lied about his participation in the ink tests and whether he was aware of a book proposal could have affected the verdict.

The verdict, the nature of Lawrence’s perjury, and the corroboration that Lawrence’s substantive testimony received from the defense’s expert demonstrate that Lawrence’s misrepresentations could have had no effect on defendants’ convictions.

First, the jury found that the Government did not satisfy its burden of proof on the charges to which Lawrence’s testimony was relevant. Defendants do not dispute that Bacanovic was acquitted of the charge of making and using a false document, and that none of the false statement and perjury specifications concerning the existence of the $60 agreement were found by the jury to have been proved beyond a reasonable doubt. . . . In other words, the jury convicted defendants of lies that had nothing to do with the $60 agreement. The outcome would have been no different had Lawrence’s entire testimony been rejected by the jury, or had Lawrence not testified at all.

Defendants argue that acquittal on some charges does not establish that the jury completely disregarded Lawrence’s testimony. They contend that the $60 agreement constituted Stewart and Bacanovic’s core defense and that the “@60” notation was evidence which supported that
defense; thus, to the extent that awareness of Lawrence’s perjury could have caused the jury to discredit his testimony and have greater confidence in the existence of the agreement and the validity of the notation, the jury would have been more willing to believe defendants’ version of the events.

This argument is wholly speculative and logically flawed. The existence of the $60 agreement would not have exonerated defendants. It would not have been inconsistent for the jury to find that defendants did make the $60 agreement, but that the agreement was not the reason for the sale. Defendants do not persuasively explain how knowledge of Lawrence’s lies could have made the jury more likely to believe that the agreement was the reason for the sale.

As an initial matter, defendants overstate the importance of the $60 agreement to this prosecution. That a $60 agreement was the reason for Stewart’s sale was only one of many lies defendants were charged with telling investigators to conceal that Stewart sold her stock because of Baganovic’s tip.

In addition to the substantial basis for concluding that the jury’s decision could not have been affected by the revelation of Lawrence’s misrepresentations, ample evidence unrelated to the $60 agreement or to Lawrence’s testimony supports defendants’ convictions.

The testimony of Faneuil, Perret, and Pasternak supports the jury’s determinations that Stewart lied when she told investigators that she did not recall being informed of Waksal’s trading on December 27.

Finally, Faneuil’s testimony supports the jury’s determination that Stewart lied when she claimed not to have spoken with Baganovic about the Government investigation into ImClone trading or Stewart’s ImClone trade (Specifications Six and Seven of Count Three). Faneuil stated that Baganovic repeatedly told him in January 2002 and afterward that Baganovic had spoken to Stewart and that everyone was “on the same page.”

But defendants fail to explain how the revelation of this perjury—if in fact it is perjury—could have affected the verdict. Defendants cannot escape the fact that the jury acquitted Baganovic of Count Five and both defendants of making false statements relating to the existence of the $60 agreement, and the fact that ample evidence supports the charges of which the jury convicted defendants.

Motion for a new trial denied.

First, review the eight steps of a critical thinking approach to legal reasoning in Exhibit 1-1. Throughout the book, we will call these the critical thinking questions. Notice the primary importance of the first four steps; their purpose is to discover the vital elements in the case and the reasoning behind the decision. Failure to consider these four foundational steps might result in our reacting too quickly to what a court or legislature has said. The rule here is: We should never evaluate until we first understand the argument being made.

The answers to these four questions enable us to understand how the court’s argument fits together and to make intelligent use of legal decisions. These answers are the necessary first stage of a critical thinking approach to legal analysis. The final four questions are the critical thinking component of legal reasoning. They are questions that permit us to evaluate the reasoning and to form our reaction to what the court decided.

You will develop your own workable strategies for legal reasoning, but we urge you to start by following our structure. Every time you read a case, ask yourself these eight questions. The remainder of this section will demonstrate the use of each of the eight steps. Notice that the order makes sense. The first four follow the path that best allows you to discover the basis of a particular legal decision; the next four assist you in deciding what you think about the worth of that decision.

The Critical Thinking Steps

FACTS

First we look for the most basic building blocks in a legal decision or argument. These building blocks provide the context in which the legal issue is to be resolved. Certain events occurred; certain actions were or were not taken; particular persons behaved or failed to behave in specific ways. We always wonder, what happened in this case? Let’s now turn our attention to the Stewart case:

1. Martha Stewart sold 3,928 shares of her ImClone stock on December 27, 2001.
2. On December 28, 2001, ImClone announced the FDA’s rejection of its new cancer-fighting drug, which caused the company’s stock to lose value.
3. Stewart and Bacanovic were convicted of conspiracy, making false statements, and obstruction of an agency proceeding.

4. Expert witness Lawrence Stewart was accused of perjuring himself in the testimony he gave prior to the defendants’ conviction.

5. According to a federal rule and case law, perjury of a witness could constitute grounds for a new trial.

**ISSUE**

In almost any legal conflict, finding and expressing the issue is an important step in forming a reaction. The issue is the question that caused the lawyers and their clients to enter the legal system. Usually, there are several reasonable perspectives concerning the correct way to word the issue in dispute.

1. In what instances may a court grant a new trial?
2. Does perjury of a witness mean that defendants should have a new trial?
3. Do the regulations in Rule 33 and relevant case law permit the defendants to have a new trial?

Do not let the possibility of multiple useful ways to word the issue cause you any confusion. The issue is certainly not just anything that we say it is. If we claim something is an issue, our suggestion must fulfill the definition of an issue in this particular factual situation.

**REASONS AND CONCLUSION**

Judge Cedarbaum held that the defendants should not have a new trial. This finding by Judge Cedarbaum is her conclusion; it serves as her answer to the legal issue. Why did she answer this way? Here we are calling for the **reasons**, explanations or justifications provided as support for a conclusion.

1. Under Rule 33 and relevant case law, perjury is not sufficient to justify a new trial, unless (a) the government knew about the perjury or (b) the perjured testimony was so material that without it the verdict would probably have resulted in acquittal of the defendants.
2. The defendants did not demonstrate that the government knew or should have known about the perjured testimony.
3. The jury would still have convicted the defendants apart from Lawrence’s testimony.
4. Defense experts agreed with Lawrence on the “most critical aspects of his scientific analysis.”

Let’s not pass too quickly over this very important critical thinking step. When we ask why of any opinion, we are showing our respect for reasons as the proper basis for any assertion. We want a world rich with opinions so we can have a broad field of choice. We should, however, agree with only those legal opinions that have convincing reasons supporting the conclusion. Thus, asking why is our way of saying, “I want to believe you, but you have an obligation to help me by sharing the reasons for your conclusion.”

**RULES OF LAW**

Judges cannot offer just any reasoning they please. They must always look back over their shoulders at the laws and previous court decisions that together provide a foundation for current and future decisions.
This particular case is an attempt to match the words of the Federal Rules of Criminal Procedure, specifically Rule 33, and its regulations with the facts in this instance. The court also references case law, specifically the Second Circuit’s ruling in United States v. Wallach. What makes legal reasoning so complex is that statutes and findings are never crystal clear. Judges and businesspeople have room for interpretive flexibility in their reasoning.

**AMBIGUITY**

The court’s reasoning rests on its implied assumptions about the meaning of several ambiguous words or phrases. (An ambiguous word is one capable of having more than one meaning in the context of these facts.) For instance, Judge Cedarbaum stated that Rule 33 permits the court to grant a new trial if the “interest of justice so requires.” But what is the “interest of justice”?

Does the interest of justice entail strict conformity to legal precedents? Or could the court’s reliance on certain precedents result in some form of injustice in the Stewart case? If we adopt the former definition, we would be more inclined to conclude that the judge’s denying the defendants’ motion for a new trial was consistent with the “interest of justice.” However, if the legislators who created Rule 33 intended a definition of “justice” that placed a stronger emphasis on judicial fairness, for example, perhaps we would be less supportive of Judge Cedarbaum’s decision.

Another illustration of important ambiguity in the decision is the court’s use of the term reasonable likelihood, referring to the probability that Lawrence’s alleged perjury could not have affected the jury’s verdict—but what degree of probability is a “reasonable likelihood”? Does this level of probability suggest that knowledge of Lawrence’s testimony could have affected the jury’s verdict? If we interpret “reasonable likelihood” as still including the possibility that knowledge of Lawrence’s perjury could have affected the jury, we might reach a conclusion that differs from the court’s decision. If we assume a definition of “reasonable likelihood” similar to “beyond a reasonable doubt,” however, we would be more inclined to agree with the judge’s decision. Hence, until we know what “reasonable likelihood” means, we cannot fairly decide whether the judge made the appropriate decision.

**ETHICAL NORMS**

The primary ethical norms that influence judges’ decisions are justice, stability, freedom, and efficiency. Judge Cedarbaum expresses herself as a defender of stability or order. (Here is a good place to turn to Exhibit 1-2 to check alternative definitions of stability.) She is unwilling to grant a new trial simply on the ground that one of the witnesses allegedly committed perjury. Instead of granting the defendants’ motion, Judge Cedarbaum elevates the “interest of according finality to a jury’s verdict,” even if the prosecution knew or should have known about the alleged perjury. Citing previous case law, she holds to those precedents that grant new trials only in rare instances.

**ANALOGIES**

Ordinarily, our examination of legal analogies will require us to compare legal precedents cited by the parties with the facts of the case we are examining. Those precedents are the analogies on which legal decision making depends. In this case, Judge Cedarbaum relies on several legal precedents as analogies for her ruling, including United States v. Wallach.

In this particular precedent, the Second Circuit held that even if the prosecution knew of a witness’s perjury, the court should not grant a new trial when
A judge’s allegiance to a particular ethical norm focuses our attention on a specific category of desired conduct. We have, or think we have, an understanding of what is meant by freedom and other ethical norms.

But do we? Ethical norms are, without exception, complex and subject to multiple interpretations. Consequently, to identify the importance of one of the ethical norms in a piece of legal reasoning, we must look at the context to figure out which form of the ethical norm is being used. The types of conduct called for by the term freedom not only differ depending on the form of freedom being assumed, but at times they can contradict each other.

As a future business manager, your task is to be aware that there are alternative forms of each ethical norm. Then a natural next step is to search for the form used by the legal reasoning so you can understand and later evaluate that reasoning.

The following alternative forms of the four primary ethical norms can aid you in that search.

<table>
<thead>
<tr>
<th>Ethical Norms</th>
<th>Forms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Freedom</td>
<td>To act without restriction from rules imposed by others</td>
</tr>
<tr>
<td></td>
<td>To possess the capacity or resources to act as one wishes</td>
</tr>
<tr>
<td>Security</td>
<td>To provide the order in business relationships that permits predictable plans to be effective</td>
</tr>
<tr>
<td></td>
<td>To be safe from those wishing to interfere with your property rights</td>
</tr>
<tr>
<td></td>
<td>To achieve the psychological condition of self-confidence such that risks are welcomed</td>
</tr>
<tr>
<td>Justice</td>
<td>To receive the product of your labor</td>
</tr>
<tr>
<td></td>
<td>To provide resources in proportion to need</td>
</tr>
<tr>
<td></td>
<td>To treat all humans identically, regardless of class, race, gender, age, and so on</td>
</tr>
<tr>
<td></td>
<td>To possess anything that someone else was willing to grant you</td>
</tr>
<tr>
<td>Efficiency</td>
<td>To maximize the amount of wealth in our society</td>
</tr>
<tr>
<td></td>
<td>To get the most from a particular input</td>
</tr>
<tr>
<td></td>
<td>To minimize costs</td>
</tr>
</tbody>
</table>

Independent evidence is sufficient to convict a defendant. The worth of this analogy depends on a greater understanding of independent evidence. In other words, what constitutes independent evidence? And is the strength of independent evidence in the Stewart case comparable to the independent evidence in Wallach? Or are there significant differences between the two cases such that the court’s reliance on Wallach is unwarranted in this case?

To feel comfortable with the analogy, we would need to be persuaded that the independent evidence in the Stewart case is similar to the independent evidence in the precedent, United States v. Wallach.

MISSING INFORMATION

In the search for relevant missing information, it is important not to say just anything that comes to mind. For example, where did the defendants eat Thanksgiving dinner? Anyone hearing that question would understandably wonder why it was asked. Ask only questions that would be helpful in understanding the reasoning in this particular case.

To focus on only relevant missing information, we should include with a request for additional information an explanation of why we want it. We have listed a few examples here for the Stewart case. You can probably identify others.
1. How well informed is Judge Cedarbaum with respect to the deliberations of the jury? If her understanding of the jurors’ preverdict discussions is very limited, the defendants’ request for a new trial might be more convincing, because Judge Cedarbaum repeatedly contends that jurors’ knowledge of Lawrence’s alleged perjury would not have affected the jurors’ decision.

2. Congress, as it does with any legislation, discussed the Rules of Criminal Procedure before passing them. Does that discussion contain any clues as to congressional intent with respect to the various conditions required for a defendant to receive a new trial? The answer would conceivably clarify the manner in which the court should apply Rule 33.

3. Are there examples of cases in which courts have examined fact patterns similar to those in the Stewart case but reached different conclusions about a new trial? The answer to this question would provide greater clarity about the appropriateness of using certain case precedents, thereby corroborating or undermining Judge Cedarbaum’s decision.

Many other critical thinking skills could be applied to this and other cases. In this book, we focus on the ones especially valuable for legal reasoning. Consistently applying this critical thinking approach will enable you to understand the reasoning in legal cases and increase your awareness of alternative approaches our laws could take to many problems you will encounter in the legal environment of business. The remaining portion of this chapter examines each of the critical thinking questions in greater depth to help you better understand the function of each.

Using Critical Thinking to Make Legal Reasoning Come Alive

Our response to an issue is a conclusion. It is what we want others to believe about the issue. For example, a court might conclude that an employee, allegedly fired for her political views, was actually a victim of employment discrimination and is entitled to a damage award. Conclusions are reached by following a path produced by reasoning. Hence, examining reasoning is especially important when we are trying to understand and evaluate a conclusion.

There are many paths by which we may reach conclusions. For instance, I might settle all issues in my life by listening to voices in the night, asking my uncle, studying astrological signs, or just playing hunches. Each method could produce conclusions. Each could yield results.

But our intellectual and legal tradition demands a different type of support for conclusions. In this tradition, the basis for our conclusions is supposed to consist of reasons. When someone has no apparent reasons, or the reasons don’t match the conclusion, we feel entitled to say, “But that makes no sense.” We aren’t impressed by claims that we should accept someone’s conclusion “just because.”

This requirement that we all provide reasons for our conclusions is what we mean, in large part, when we say we are going to think. We will ponder what the reasons and conclusion are and whether they fit together logically. This intense study of how a certain conclusion follows from a particular set of reasons occupies much of the time needed for careful decision making.

Persons trained to reason about court cases have a great appreciation for the unique facts that provoked a legal action. Those facts, and no others, provide the context for our reasoning. If an issue arises because environmentalists want to prevent an interstate highway from extending through a wilderness area, we want to know right away: What are the facts?

Legal reasoning encourages unusual and necessary respect for the particular factual situation that stimulated disagreement between parties. These fact patterns,
as we call them, bring the issue to our attention and limit the extent to which the court’s conclusion can be applied to other situations. Small wonder that the first step in legal reasoning is to ask and answer the question: What are the facts?

LEGAL REASONING

Step 1: What Are the Facts? The call for the facts is not a request for all facts, but only those that have a bearing on the dispute at hand. That dispute tells us whether a certain fact is pertinent. In some cases, the plaintiff’s age may be a key point; in another, it may be irrelevant.

Only after we have familiarized ourselves with the relevant legal facts do we begin the familiar pattern of reasoning that thoughtful people use. We then ask and answer the following question: What is the issue?

Step 2: What Is the Issue? The issue is the question that the court is being asked to answer. For example, courts face groups of facts relevant to issues such as the following:

1. Does Title VII apply to sexual harassment situations when the accused and the alleged victim are members of the same sex?
2. Does a particular merger between two companies violate the Sherman Act?
3. When does a governmental regulation require compensation to the property owner affected by the regulation?

As we pointed out earlier, the way we express the issue guides the legal reasoning in the case. Hence, forming an issue in a very broad or an extremely narrow manner has implications for the scope of the effect stemming from the eventual decision. You can appreciate now why parties to a dispute work very hard to get the court to see the issue in a particular way.

You will read many legal decisions in this book. No element of your analysis of those cases is more important than careful consideration of the issue at hand. The key to issue spotting is asking yourself: What question do the parties want the court to answer? The next logical step in legal analysis is to ask: What are the reasons and conclusion?

Step 3: What Are the Reasons and Conclusion? The issue is the stimulus for thought. The facts and the issue in a particular case get us to start thinking critically about legal reasoning, but the conclusion and the reasons for that conclusion put flesh on the bones of the court’s reaction to the legal issue. They tell us how the court has responded to the issue.

To find the conclusion, use the issue as a helper. Ask yourself: How did the court react to the issue? The answer is the conclusion. The reasons for that conclusion provide the answer to the question: Why did the court prefer this response to the issue rather than any alternative? One part of the answer to that question is the answer to another question: What are the relevant rules of law?

Step 4: What Are the Relevant Rules of Law? The fourth step in legal reasoning reveals another difference from general nonlegal reasoning. The issue arises in a context of existing legal rules. We do not treat each legal dispute as if it were the first such dispute in human history. On the contrary, society has already addressed similar disputes in its laws and court findings. It has already responded to situations much like the ones now before the court. The historical record of pertinent judicial decisions provides a rich source of reasons on which to base the conclusions of courts. These prior decisions, or legal precedents, provide legal rules to which those in a legal dispute must defer. Thus, the fourth step in legal reasoning requires a focus on those rules. These legal rules are what the parties
Step 5: Does the Legal Argument Contain Significant Ambiguity? Legal arguments are expressed in words, and words rarely have the clarity we presume. Whenever we are tempted to think that our words speak for themselves, we should remind ourselves of Emerson’s observation that “to be understood is a rare luxury.” Because it is couched in words, legal reasoning possesses elasticity. It can be stretched and reduced to fit the purpose of the attorney or judge.

As an illustration, a rule of law may contain the phrase public safety. At first glance, as with any term, some interpretation arises in our minds; however, as we continue to consider the extent and limits of public safety, we realize it is not so clear. To be more certain about the meaning, we must study the intent of the person making the legal argument. Just how safe must the public be before an action provides sufficient threat to public safety to justify public intervention?

As a strategy for critical thinking, the request for clarification is a form of evaluation. The point of the question is that we cannot agree with a person’s reasoning until we have determined what we are being asked to embrace.

What we are being asked to embrace and the reasoning behind it usually involve an ethical component. Therefore, an important question to ask is: What ethical norms are fundamental to the court’s reasoning?

Step 6: What Ethical Norms Are Fundamental to the Court’s Reasoning?
The legal environment of business is established and modified according to ethical norms. A norm is a standard of conduct, a set of expectations that we bring to social encounters. For example, one norm we collectively understand and obey is that our departures are ordinarily punctuated by “good-bye.” We may presume rudeness or preoccupation on the part of someone who leaves our presence without bidding us some form of farewell.

Ethical norms are special because they are steps toward achieving what we consider good or virtuous. Goodness and virtue are universally preferred to their opposites, but the preference has little meaning until we look more deeply into the meaning of these noble aims.

Conversations about ethics compare the relative merit of human behavior guided by one ethical norm or another. Ethical norms represent the abstractions we hold out to others as the most fundamental standards defining our self-worth and value to the community. For example, any of us would be proud to know that others see us as meeting the ethical norms we know as honesty, dependability, and compassion. Ethical norms are the standards of conduct we most want to see observed by our children and our neighbors.

The legal environment of business receives ethical guidance from many norms. Certain norms, however, play a particularly large role in legal reasoning. Consequently, we highlight what we will refer to as the four primary ethical norms: freedom, stability, justice, and efficiency. (See Exhibit 1-2 for clarification of these norms.) The interplay among these four provides the major ethical direction for the laws governing business behavior. As you examine the cases in this text, you may identify other ethical norms that influence judicial opinions. To discover the relevant ethical norm, we must infer it from the court’s reasoning. Courts often do not announce their preferred pattern of ethical norms, but the norms are there anyway, having their way with the legal reasoning. As critical thinkers, we want to use the ethical norms, once we find them, as a basis for evaluating the reasoning.
Another element used in arriving at legal conclusions is the device of reasoning by analogy. Part of the critical thinking process in the evaluation of a legal conclusion is another question: How appropriate are the legal analogies?

**Step 7: How Appropriate Are the Legal Analogies?** A major difference between legal reasoning and other forms of analysis is the heavy reliance on analogies. Our legal system places great emphasis on the law, as it has evolved from previous decisions. This evolutionary process is our heritage, the collective judgments of our historical mothers and fathers. We give them and their intellects our respect by using legal precedents as the major support structure for judicial decisions. By doing so, we do not have to approach each fact pattern with entirely new eyes; instead, we are guided by similar experiences that our predecessors have already studied.

The use of precedent to reach legal conclusions is so common that legal reasoning can be characterized as little but analogical reasoning. An analogy is a verbal device for transferring meaning from something we understand quite well to something we have just discovered and have, as yet, not understood satisfactorily. What we already understand in the case of legal reasoning is the precedent; what we hope to understand better is the current legal dispute. We call on precedent for enlightenment.

To visualize the choice of legal analogy, imagine that we are trying to decide whether a waitress or waiter can be required to smile for hours as a condition of employment. (What is artificial about such an illustration, as we hope you already recognize, is the absence of a more complete factual picture to provide context.) The employer in question asks the legal staff to find appropriate legal precedents. They discover the following list of prior decisions:

1. Professional cheerleaders can be required to smile within reason, if that activity is clearly specified at the time of employment.
2. Employees who interact regularly with customers can be required as a condition of employment to wear clothing consistent with practice in the trade.
3. Employers may not require employees to lift boxes over 120 pounds without the aid of a mechanical device, under the guidelines of the Employee Health Act.

Notice that each precedent has similarities to, but also major differences from, the situation of the waiter or waitress. To mention only a few:

- Is a smile more natural to what we can expect from a cheerleader than from a waiter or waitress?
- Were the restaurant employees told in advance that smiling is an integral part of the job?
- Is a smile more personal than clothing? Are smiles private, as opposed to clothing, which is more external to our identity?
- Is a plastered-on smile, held in place for hours, a serious risk to mental health?
- Is a potential risk from smiling as real a danger as the one resulting from physically hoisting huge objects?

The actual selection of precedent and, consequently, the search for appropriate analogies are channeled by the theory of logic that we find most revealing in this case. For example, if you see the requirement to smile as an invasion of privacy, you will likely see the second precedent as especially appropriate. Both the precedent and the case in question involve employment situations with close customer contact.

The differences, however, could be significant enough to reject that analogy. Do you see your clothing as part of your essence, in the same fashion as you
surely see the facial form you decide to show at any given moment? Furthermore, the second precedent contains the phrase consistent with practice in the trade. Would not a simple field trip to restaurants demonstrate that a broad smile is a pleasant exception?

As you practice looking for similarities and differences in legal precedents and the legal problem you are studying, you will experience some of the fun and frustration of legal reasoning within a business context. The excitement comes when you stumble on just the perfect, matching fact pattern; then, after taking a closer look, you are brought back to earth by those annoying analogical differences that your experience warns you are always present.

Ambiguity, ethical norms, and legal analogies are all areas in which legal arguments may be deficient; but even if you are satisfied that all those considerations meet your standards, there is a final question that must not be overlooked in your critical analysis of a conclusion: Is there relevant missing information?

Step 8: Is There Relevant Missing Information? When we ask about the facts of a case, we mean the information presented in the legal proceedings. We are, however, all quite aware that the stated facts are just a subset of the complete factual picture responsible for the dispute. We know we could use more facts than we have, but at some point we have to stop gathering information and settle the dispute.

You might not be convinced that the facts we know about a situation are inevitably incomplete; however, consider how we acquire facts. If we gather them ourselves, we run into the limits on our own experience and perceptions. We often see what we want to see, and we consequently select certain facts to file in our consciousness. Other facts may be highly relevant, but we ignore them. We can neither see nor process all the facts.

Our other major source of information is other people. We implicitly trust their intentions, abilities, and perspective when we take the facts they give us and make them our own. No one, however, gives us a complete version of the facts. For several reasons, we can be sure that the facts shared with us are only partial.

Armed with your awareness of the incompleteness of facts, what can you do as a future businessperson or employee to effectively resolve disagreements and apply legal precedents?

You can seek a more complete portrayal of the facts. Keep asking for detail and context to aid your thinking. For example, once you learn that a statute requires a firm to use the standard of conduct in the industry, you should not be satisfied with the following fact:

On 14 occasions, our firm attempted to contact other firms to determine the industry standards. We have bent over backwards to comply with the ethical norms of our direct competitors.

Instead, you will persist in asking probing questions designed to generate a more-revealing pattern of facts. Among the pieces of missing information you might ask for would be the extent and content of actual conversations about industry standards, as well as some convincing evidence that “direct” competitors are an adequate voice, representing “the industry.”

Applying the Critical Thinking Approach

Now that you have an understanding of the critical thinking approach, you are ready to begin your study of the legal environment of business. Remember to apply each of the questions to the cases as you read them.

After you become proficient at asking these questions of every case you read, you may find that you start asking these evaluative questions in other
contexts. For example, you might find that, when you read an editorial in the *Wall Street Journal*, you start asking whether the writer has used ambiguous terms that affect the quality of the reasoning, or you start noticing when important relevant information is missing. Once you reach this point, you are well on your way to becoming a critical thinker whose thinking skills will be extremely helpful in the legal environment of business.

**ASSIGNMENT ON THE INTERNET**

You have now been introduced to the critical thinking steps that create a working strategy to evaluate legal reasoning. In the same manner that you evaluated *United States of America v. Martha Stewart and Peter Bacanovic*, practice evaluating the legal reasoning in a case of your choosing.

Go to [www.law.cornell.edu](http://www.law.cornell.edu) for current legal issues and cases. Find a case of interest to you, and evaluate the reasoning using the critical thinking steps outlined in this chapter. The following Web sites on critical thinking may assist you in evaluating legal reasoning.

**FOR FUTURE READING**


Introduction to Law and the Legal Environment of Business

- DEFINITION OF THE LEGAL ENVIRONMENT OF BUSINESS
- DEFINITION OF LAW AND JURISPRUDENCE
- SOURCES OF LAW
- CLASSIFICATIONS OF LAW
- GLOBAL DIMENSIONS OF THE LEGAL ENVIRONMENT OF BUSINESS

This book is about the legal environment in which the business community operates today. Although we concentrate on law and the legal variables that help shape business decisions, we have not overlooked the ethical, political, and economic questions that often arise in business decision making. In this chapter, we are especially concerned with legal variables in the context of critical thinking, as outlined in Chapter 1. In addition, we examine the international dimensions of several areas of law. In an age of sophisticated telecommunication systems and computer networking, it would be naive for our readers to believe that, as citizens of a prosperous, powerful nation situated between two oceans, they can afford to ignore the rest of the world. Just as foreign multinational companies must interact with U.S. companies and government agencies, so must U.S. entities interact with regional and international trade groups and agencies of foreign governments.

The United States, Canada, and Mexico created the North American Free Trade Agreement (NAFTA) to lower trade barriers among themselves. In the Asian-Pacific Economic Cooperation (APEC) forum, the United States and 17 Pacific Rim nations are discussing easing barriers to trade and investments among themselves and creating a Pacific free trade zone extending from Chile to China. The European Union has added new member nations, bringing its total to 27. The World Trade Organization continues to lower trade barriers among the 144 nations that have joined it. No nation is an island unto itself today, and economic globalization is accelerating in the twenty-first century. (See Chapter 9 for a discussion of the global legal environment of business.)
This chapter serves as an introduction to the legal and ethical components of the business environment. You will learn about different schools of jurisprudence and about sources and classifications of law. In addition, this chapter offers the opportunity to practice the critical thinking skills you learned in Chapter 1. The following critical thinking questions will help you better understand the introductory topics discussed in this chapter.

1. Why should we be concerned with the ethical components of the legal environment of business? Why shouldn’t we just learn the relevant laws regarding businesses?
   Clue: Which critical thinking questions address the ethical components of the legal environment of business?

2. As you will soon discover, judges and lawyers often subscribe to a particular school of legal thought. Judges and lawyers, however, will probably not explicitly tell us which school of thought they prefer. Why do you think this knowledge might be beneficial when critically evaluating a judge’s reasoning?
   Clue: Think about why we look for missing information. Furthermore, why do we want to identify the ethical norms fundamental to a court’s reasoning?

3. You tell your landlord that your front door lock is broken, but he does not repair the lock. A week later, you are robbed. You decide to sue the landlord, and you begin to search for an attorney. As a legal studies student, you ask the potential lawyers what school of jurisprudence they prefer. Although you find a lawyer who prefers the same school of jurisprudence you prefer, your decision is not final. What else might you want to ask the lawyer?
   Clue: Think about the other factors that might affect a lawyer’s performance.

Definition of the Legal Environment of Business

The legal environment of business is defined in various ways. For our purposes, the study of the legal environment includes:

- The study of the legal reasoning, critical thinking skills, ethical norms, and schools of ethical thought that interact with the law.
- The study of the legal process and our present legal system, as well as alternative dispute resolution systems such as private courts, mediation, arbitration, and negotiation.
- The study of the administrative law process and the role of businesspeople in that process.
- The study of selected areas of public and private law, such as securities regulation, antitrust, labor, product liability, contracts, and consumer and environmental law. In each of these areas, we emphasize the processes by which business managers relate to individuals and government regulators.
- The examination of the international dimensions of the legal environment of law.

Our study of the legal environment of business is characterized by five features:

1. Critical thinking skills.
2. Legal literacy. A survey by the Hearst Corporation found that 50 percent of Americans believe that it is up to the criminally accused to prove their innocence, despite our common-law heritage that a person is presumed innocent until proven guilty. Only 41 percent were able to identify the then Chief Justice (Warren Burger) and the first female Supreme Court Justice
(Sandra Day O’Connor). Of those responding to the survey, 49.9 percent had served on a jury, and 31 percent were college graduates.

3. An understanding that the law is dynamic, not static. The chapters on discrimination law, securities regulation, antitrust law, and labor law in particular have had to be constantly updated during the writing of this book, because federal regulatory agencies issue new regulations, rules, and guidelines almost daily.

4. Real-world problems. You will be confronted with real, not theoretical, legal and ethical problems. As the great American jurist Oliver Wendell Holmes once pointed out, the law is grounded in experience. In reading the cases excerpted in this book, you will see how business leaders and others either were ignorant of the legal and ethical variables they faced or failed to consider them when making important decisions.

5. Interdisciplinary nature. Into our discussions of the legal environment of business we interweave materials from other disciplines that you either are studying now or have studied in the past, especially economics, management, finance, marketing, and ethics. You may be surprised to learn how often officers of the court (judges and attorneys) are obliged to consider material from several disciplines in making decisions. Your own knowledge of these other disciplines will be extremely helpful in understanding the content of this book.

The connections to other areas of business are so significant that we have chosen to highlight many of them in subsequent chapters of this book. As you are reading, you will encounter boxes entitled “Linking Law and Business.” These boxes contain material from other business disciplines that is related to the business law material you are studying. By highlighting these connections, we hope to provide greater cohesiveness to your education as a future business manager. As listed in Exhibit 2-1, there are a number of benefits to be gained by studying the legal environment of business.

Definition of Law and Jurisprudence

Jurisprudence is the science or philosophy of law, or law in its most generalized form. Law itself has been defined in different ways by scholarly thinkers. Some idea of the range of definitions can be gained from the following quote from a distinguished legal philosopher:

> We have been told by Plato that law is a form of social control; by Aristotle that it is a rule of conduct, a contract, an ideal of reason; by Cicero that it is the agreement of reason and nature, the distinction between the just and the unjust; by Aquinas that it is an ordinance of reason for the common good; by Bacon that certainty is the prime necessity of law; by Hobbes that law is the command of the sovereign; by Hegel that it is an unfolding or realizing of the idea of right.\(^1\)

---

2. Familiarizing yourself with the legal limits on business freedom.
3. Forming an alertness to potential misconduct of competitors.
4. Appreciating the limits of entrepreneurship.
5. Being able to communicate with your lawyer.
6. Making you a more fully informed citizen.
7. Developing an employment-related skill.
8. Exploring the fascinating complexity of business decisions.
10. Opening your eyes to the excitement of the law and business.

---

EXHIBIT 2-2
SCHOOLS OF JURISPRUDENCE

<table>
<thead>
<tr>
<th>School</th>
<th>Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Natural law school</td>
<td>Source of law is absolute (nature, God, or reason)</td>
</tr>
<tr>
<td>Positivist school</td>
<td>Source of law is the sovereign</td>
</tr>
<tr>
<td>Sociological school</td>
<td>Source of law is contemporary community opinion and customs</td>
</tr>
<tr>
<td>American realist school</td>
<td>Source of law is actors in the legal system and scientific analysis of their actions</td>
</tr>
<tr>
<td>Critical legal studies school</td>
<td>Source of law is a cluster of legal and nonlegal beliefs that must be critiqued to bring about social and political change</td>
</tr>
<tr>
<td>Feminist school</td>
<td>Jurisprudence reflects a male-dominated executive, legislative, and judicial system in which women's perspectives are ignored and women are victimized</td>
</tr>
<tr>
<td>Law and economics school</td>
<td>Classical economic theory and empirical methods are applied to all areas of law in order to arrive at decisions</td>
</tr>
</tbody>
</table>

The various ideas of law expressed in this passage represent different schools of jurisprudence. To give you some sense of the diversity of meaning the term *law* has, we will examine seven accepted schools of legal thought: (1) natural law, (2) positivist, (3) sociological, (4) American realist, (5) critical legal studies, (6) feminist, and (7) law and economics. Exhibit 2-2 summarizes the outstanding characteristics of each of these schools of jurisprudence.

**NATURAL LAW SCHOOL**

For adherents of the natural law school, which has existed since 300 B.C., law consists of the following concepts: (1) There exist certain legal values or value judgments (e.g., a presumption of innocence until guilt is proved); (2) these values or value judgments are unchanging because their source is absolute (e.g., nature, God, or reason); (3) these values or value judgments can be determined by human reason; and (4) once determined, they supersede any form of human law. Perhaps the most memorable statement of the natural law school of thought in this century was made by Martin Luther King, Jr., in his famous letter from a Birmingham, Alabama, city jail. Here is how he explained to a group of ministers why he had violated human laws that discriminated against his people:

> There are just laws and there are unjust laws. I would be the first to advocate obeying just laws. One has not only a legal but moral responsibility to obey just laws. Conversely, one has a moral responsibility to disobey unjust laws. I would agree with Saint Augustine that “an unjust law is no law at all.”

Now, what is the difference between the two? How does one determine when a law is just or unjust? A just law is a manmade code that squares with the moral law or the law of God. An unjust law is a code that is out of harmony with the moral law. To put it in the terms of Saint Thomas Aquinas, an unjust law is a human law that is not rooted in eternal and natural law. Any law that uplifts human personality is just. Any law that degrades human personality is unjust. All segregation statutes are unjust because segregation distorts the soul and damages the personality.

Let us turn to a more concrete example of just and unjust law. An unjust law is a code that a majority inflicts on a minority but that is not binding on the majority itself. This is difference made legal. In contrast, a just law is a code that a majority compels a minority to follow that it is willing to follow itself. This is sameness made legal.
Let me give another explanation. An unjust law is a code inflicted upon a minority which that minority had no part in enacting or creating because they did not have the unhampered right to vote.\(^2\)

Adherents of other schools of legal thought view King’s general definition of law as overly subjective. For example, they ask, “Who is to determine whether a manmade law is unjust because it is ‘out of harmony with the moral law’?” Or: “Whose moral precepts or values are to be included in the ‘moral law’?” The United States is a country of differing cultures, races, ethnic groups, and religions, each of which may hold or reflect unique moral values.

**POSITIVIST SCHOOL**

Early in the 1800s, followers of positivism developed a school of thought in opposition to the natural law school. Its chief tenets are (1) law is the expression of the will of the legislator or sovereign, which must be followed; (2) morals are separate from law and should not be considered in making legal decisions (thus, judges should not take into consideration extralegal factors such as contemporary community values in determining what constitutes a violation of law); and (3) law is a closed logical system in which correct legal decisions are reached solely by logic and the use of precedents (previous cases decided by the courts).

Disciples of the positivist school would argue that when the Congress of the United States has not acted on a matter, the U.S. Supreme Court has no power to act on that matter. They would argue, for example, that morality has no part in determining whether discrimination exists when a business pays workers differently on the basis of their sex, race, religion, or ethnic origin. Only civil rights legislation passed by Congress, and previous cases interpreting that legislation, should be considered. Laws of other nations should not be considered when U.S. courts must make decisions, as Justice Scalia of the United States Supreme Court has argued.

Positivism has been criticized by adherents of other schools of thought as too narrow and literal minded. Critics argue that the refusal to consider social, ethical, and other factors makes for a static jurisprudence that ill serves society.

**SOCIOLGICAL SCHOOL**

Followers of the sociological school propose three steps in determining law:

1. A legislator or a judge should make an inventory of community interests.
2. Judges and legislators should use this inventory to familiarize themselves with the community’s standards and mores.
3. The judge or legislator should rule or legislate in conformity with those standards and mores.

For those associated with this school of legal thought, human behavior or contemporary community values are the most important factors in determining the direction the law should take. This philosophy is in sharp contrast to that of the positivist school, which relies on case precedents and statutory law. Adherents of the sociological school seek to change the law by surveying human behavior and determining present community standards. For example, after a famous U.S. Supreme Court decision stating that material could be judged “obscene” on the basis of “contemporary community standards,” a mayor of a large city immediately went out and polled his community on what books and movies they thought were obscene. (He failed to get a consensus.)


Critics of the sociological school argue that this school would make the law too unpredictable for both individuals and businesses. They note that contemporary community standards change over time and, thus, the law itself would be changing all the time and the effects could harm the community. For example, if a state or a local legislature offered a corporation certain tax breaks as an incentive to move to a community and then revoked those tax breaks a few years later because community opinion on such matters had changed, other corporations would be reluctant to locate in that community.

**AMERICAN REALIST SCHOOL**

The American realist school, though close to the sociological school in its emphasis on people, focuses on the actors in the judicial system instead of on the larger community to determine the meaning of law. This school sees law as a part of society and a means of enforcing political and social values. In a book entitled *The Bramble Bush*, Karl Llewellyn wrote: “This doing of something about disputes, this doing it reasonably, is the business of the law. And the people who have the doing of it are in charge, whether they be judges, or clerks, or jailers, or lawyers, they are officials of the law. What these officials do about disputes is, to my mind, the law itself.”\(^4\) For Llewellyn and other American realists, anyone who wants to know about law should study the judicial process and the actors in that process. This means regular attendance at courthouses and jails, as well as scientific study of the problems associated with the legal process (e.g., plea bargaining in the courtroom).

Positivists argue that if the American realist definition of law were accepted, there would be a dangerous unpredictability to the law and legal decisions.

**CRITICAL LEGAL STUDIES SCHOOL**

As a contemporary extension of American legal realism, critical legal studies seeks to connect what happens in the legal system to the political–economic context within which it operates. Adherents of critical legal jurisprudence believe that law reflects a cluster of beliefs that convince human beings that the hierarchical relations under which they live and work are natural and must be accommodated. According to this school, this cluster of beliefs has been constructed by elitists to rationalize their dominant power. Using economics, mass communications, religion, and, most of all, law, members of society’s elite have constructed an interlocking system of beliefs that reinforces established wealth and privilege. Only by critiquing these belief structures, critical legal theorists believe, will people be able to break out of a hierarchical system and bring about democratic social and political change.

Traditional critics argue that the critical legal theorists have not developed concrete strategies to bring about the social and political changes they desire. Essentially, they have constructed only a negative position.

**FEMINIST SCHOOL**

There is a range of views as to what constitutes feminist jurisprudence. Most adherents of this school, believing that significant rights have been denied to women, advocate lobbying legislatures and litigating in courts for changes in laws to accommodate women’s views. They argue that our traditional common law reflects a male emphasis on individual rights, which at times is at odds with women’s views that the law should be more reflective of a “culture of caring.” To other adherents

of this school of jurisprudence, the law is a means of male oppression. For exam-
ple, some feminists have argued that the First Amendment, forbidding Congress
from making any laws abridging the freedom of speech, was authored by men and
is presently interpreted by male-dominated U.S. courts to allow pornographers to
make large profits by exploiting and degrading women.

Traditional critics of feminist jurisprudence argue that it is too narrow in scope
and that it fails to account for changes taking place in U.S. society, such as the in-
creasing number of women students in professional and graduate schools and their
movement into higher-ranking positions in both the public and private sectors.

**LAW AND ECONOMICS SCHOOL**

The law and economics school of jurisprudence started to evolve in the 1950s,
but has been applied with some rigor only for the past 30 years. It advocates us-
ing classical economic theory and empirical methods of economics to explain
and predict judges’ decisions in such areas as torts, contracts, property law, crim-
inal law, administrative law, and law enforcement. The proponents of the law
and economics school argue that most court decisions, and the legal doctrines
on which they depend, are best understood as efforts to promote an efficient
allocation of resources in society.

Critics of the school of law and economics argue that there are many schools
of economic thought, and thus no single body of principles governs economics.
For example, neo-Keynesians and classical market theorists have very different
views of the proper role of the state in the allocation of resources. A related crit-
icism is that this school takes a politically conservative approach to the legal so-
lution of economic or political problems. Liberals and others argue that it is a
captive of conservative thinkers.

**Sources of Law**

The founders of this country created in the U.S. Constitution three direct sources
of law and one indirect source (see Appendix A). The legislative branch (Article I)
is the maker or creator of laws; the executive branch (Article II) is the enforcer of
laws; and the judicial branch (Article III) is the interpreter of laws. Each branch
represents a separate source of law while performing its functions (Table 2-1). The
fourth (indirect) source of law is administrative agencies, which will be briefly dis-
cussed in this chapter and examined in detail in Chapter 19.

**THE LEGISLATURE AS A SOURCE OF STATUTORY LAW**

Article I, Section 1, of the U.S. Constitution states, “All legislative Powers herein
granted shall be vested in a Congress of the United States which shall consist of a
House and Senate.” It is important to understand the process by which a law
(called a *statute*) is made by the Congress, because this process and its results have
an impact on such diverse groups as consumers, businesspeople, taxpayers, and
unions. It should be emphasized that at every stage of the process, each of the
groups potentially affected seeks to influence the proposed piece of legislation
through lobbying. The federal legislative process described here (Exhibit 2-3) is
similar in most respects to the processes used by state legislatures, though state
constitutions may prescribe some differences.

**Steps in the Legislative Process**

**Step 1** A bill is introduced into the U.S. House of Representatives or
Senate by a single member or by several members. It is generally
referred to the committee of the House or Senate that has jurisdiction over the subject matter of the bill. (In most cases, a bill is simultaneously introduced into the Senate and House. Within each body, committees may vie with each other for jurisdictional priority.)

**Step 2** Let’s briefly follow through the House of Representatives a bill proposing to deregulate the trucking industry by doing away with the rate-making power of the Interstate Commerce Commission (ICC). This bill would be referred to the House Committee on Energy and Commerce, which, in turn, would refer it to the appropriate subcommittee.

**Step 3** The House subcommittee holds hearings on the bill, listening to testimony from all concerned parties and establishing a hearing record.

**Step 4** After hearings, the bill is “marked up” (drafted in precise form) and then referred to the subcommittee for a vote.

**Step 5** If the vote is affirmative, the subcommittee forwards the bill to the full House Energy and Commerce committee, which either accepts the subcommittee’s recommendation, puts a hold on the bill, or rejects it. If the House committee votes to accept the bill, it reports the bill to the full House of Representatives for a vote by all members.

---

**TABLE 2-1 WHERE TO FIND THE LAW**

<table>
<thead>
<tr>
<th>Levels of Government</th>
<th>Legislative Law</th>
<th>Executive Orders</th>
<th>Common Law/Judicial Interpretations</th>
<th>Administrative Regulations</th>
</tr>
</thead>
</table>
| Federal              | - United States Code (U.S.C.)  
- United States Statutes at Large (Stat.)  
- Title 3 of the Code of Federal Regulations  
- Codification of presidential proclamations and Executive Orders | - United States Reports (U.S.)  
- Supreme Court Reporter (S. Ct.)  
- Federal Reporter (F.2d, F.3d)  
- Federal Supplement (F.Supp., F.Supp. 2d)  
- Federal agency reports (titled by agency; e.g., F.C.C. Reports)  
- Regional reporters  
- State reporters | - Code of Federal Regulations (C.F.R.)  
- Federal Register (Fed. Reg.) |
| State                | - State code or state statutes (e.g., Ohio Revised Code Annotated, Baldwin’s)  
- Executive Orders of governors and proclamations | | - State administrative code or state administrative regulations |
| Local                | - Municipal ordinances | | - Municipality administrative regulations |

*Note: Databases (e.g., Westlaw and LexisNexis) online assist in finding all sources of law listed here.*
**Step 6** If the bill is passed by the House of Representatives and a similar bill is passed by the Senate, the bills go to a Senate–House Conference Committee to reconcile any differences in content. After compromise and reconciliation of the two bills, a single bill is reported to the full House and Senate for a vote.

**Step 7** If there is a final affirmative vote by both houses of Congress, the bill is forwarded to the president, who may sign it into law or veto it. When the president signs the bill into law, it becomes known as a *statute*, meaning it is written down and codified in the United States Code. In the event of a presidential veto, a two-thirds vote of the House and Senate membership is required to override the veto. If the president takes no action within 10 days of receiving the bill from Congress, the bill automatically becomes law without the president’s signature.

The single exception to this procedure occurs when Congress adjourns before the 10-day period has elapsed: In that case, the bill would not become law. It is said to have been “pocket-vetoed” by the president: The president “stuck the bill in a pocket” and vetoed it by doing nothing. With either type of veto, the bill is dead and can be revived only by being reintroduced in the next session of Congress, in which case the procedure begins all over again.

**The Judicial Branch as a Source of Case Law**

The federal courts and most state courts make up the judicial branch of government. They are charged by their respective constitutions with interpreting the constitution and statutory law on a case-by-case basis. Most case interpretations
are reported in large volumes called *reporters*. These constitute a compilation of our federal and state case law.

When two parties disagree about the meaning of a statute, they bring their case to court for the court to interpret. For example, when the bill to deregulate the trucking industry and take away the rate-making function of the ICC was signed by the president and became law, two parties could have disagreed about its meaning and asked the federal courts to interpret it. If the law had been challenged, the court would first have looked at the law’s legislative history to determine the intent of the legislature. This history can be found in the hearings held by the subcommittees and committees previously referred to, as well as any debates on the Senate and House floors. Hearings are published in the *U.S. Code Congressional News and Administrative Reports*, which may be ordered from the Government Printing Office or found in most university libraries in the government documents section. Debates on a bill are published in the daily *Congressional Record*, which may also be found in most university libraries.

The U.S. Supreme Court and most state supreme courts have the power of judicial review—that is, the power to determine whether a statute is constitutional. Although this power was not expressly provided for in the U.S. Constitution, the Supreme Court established it for the judiciary in the landmark case *Marbury v. Madison* (see Chapter 3 for a discussion of this case). The right of judicial review gives the U.S. Supreme Court the ultimate power to check the excesses of either the legislative or the executive branch.

Furthermore, this decision establishes case law precedents, which are followed by all federal and state courts. Thus, through its case-by-case interpretation of the Constitution and statutes, the U.S. Supreme Court establishes a line of authoritative cases on a particular subject that has to be followed by the lower courts, both federal and state. Similarly, state supreme courts establish precedents that must be followed by lower courts in their particular state systems.

### Case Law Precedents and the Internet

Decisions by state and federal appellate courts were (and to some extent still are) printed in volumes that were placed on (law) library shelves. Today, decisions are not always published as in the past; many are *unpublished* at the appellate level. (For example, only about 10 percent of California’s appellant’s decisions are published.) Many decisions are *posted* (published) to online databases (e.g., Westlaw or LexisNexis).

This has led to a debate as to whether these posted decisions should be given the same precedential value as published opinions in traditional volumes. In 2006, the United States Supreme Court announced that it would allow lawyers, judges, and other officers of the courts to cite (refer to) unpublished opinions of federal courts. *See* Rule 32.1 of the Federal Rules of Civil Procedure. However, this rule does not specify the weight that federal courts must give to unpublished opinions. Over time (often a lengthy time), we will learn about the weight to be given such opinions and their value as precedents.

### Restatements of the Law

Scholars writing in various areas of the law—including torts, contracts, agency, property, security, and conflicts of laws—have published summaries of the case law generally followed by the 50 states. The American Law Institute published these scholarly compilations. The Restatements are secondary sources, which in and of themselves may not have the force of law, but are often still relied upon by judges in making decisions.

---

5 5 U.S. (1 Branch) 137 (1803).
Throughout this text, you may see references to the Restatements (for example, the *Restatement (Second) of Contracts*). Over a number of years, the areas referred to here have been updated to the second or third edition as the case law has evolved.

**THE EXECUTIVE BRANCH AS A SOURCE OF LAW**

The executive branch is composed of the president, the president’s staff, and the cabinet, which is made up of the heads of each of the executive departments (e.g., the secretary of state, the secretary of labor, the secretary of defense, and the secretary of the treasury) and the counselor to the president. The Executive Office is composed of various offices, such as the Office of Management and Budget (OMB) and the Office of Personnel Management (OPM). The executive branch is a source of law in two ways.

**Treaty Making.** The president has the power, subject to the advice and consent of the Senate, to make treaties. These treaties become the law of the land, on the basis of the Supremacy Clause of the U.S. Constitution (Article VI), and supersede any state law. When President Carter entered into a treaty returning the Panama Canal Zone to the nation of Panama under certain conditions, it became the law of the land, and the treaty provisions superseded any federal or state laws inconsistent with the treaty.

**Executive Orders.** Throughout history, the president has made laws by issuing executive orders. For example, as we shall see in Chapter 19, President Reagan, by virtue of an executive order, ruled that all executive federal agencies must do a cost-benefit analysis before setting forth a proposed regulation for comment by interested parties. President Truman, by executive order, directed the secretary of commerce to seize all the nation’s steel mills to prevent a strike in this essential industry during the Korean War. President Johnson issued Executive Order No. 11246 requiring government contractors to set out an affirmative action plan for hiring and promoting minorities and women. (This executive order is discussed in Chapter 22.)

The executive order as a source of law is also used by state governors to deal with emergencies and budget functions. Often, a governor will call out the National Guard or, in some states, implement particular aspects of the budget by executive order. For example, a governor may order a freeze on the hiring of employees in the state university system or order an across-the-board cut in budgets in all state departments.

**ADMINISTRATIVE AGENCIES AS A SOURCE OF LAW**

Less well known as a source of law are the federal regulatory agencies, among which are the Securities and Exchange Commission (SEC), the Federal Trade Commission (FTC), the Equal Employment Opportunity Commission (EEOC), and the Occupational Safety and Health Administration (OSHA). Congress has delegated to these agencies the authority to make rules governing the conduct of business and labor in certain areas. This authority was delegated because it was thought to be in the public interest, convenience, and necessity. Because each of the agencies must notify the public of proposed rulemaking and set out a cost-benefit analysis, all proposed and final rules can be found in the *Federal Register*.

Administrative agencies constitute what many have called a fourth branch of government. They exist at the state and local levels as well. (See Chapter 19 on administrative law).
Classifications of Law

Besides statutory law made by the legislative branch and case law resulting from judicial interpretation of constitutions and statutes, there are several other classifications of law that are necessary to an understanding of the legal environment of business.

CRIMINAL LAW AND CIVIL LAW

Criminal law comprises those federal and state statutes that prohibit wrongful conduct such as arson, rape, murder, extortion, forgery, and fraud. The purposes of criminal law are punitive (punishing offenders by imprisonment or fines), rehabilitative (rehabilitating offenders), and restitutive (making restitution to victims). The plaintiff in a criminal case is the United States, State X, County X, or City X, representing society and the victim against the defendant, who is most likely to be an individual but may also be a corporation, partnership, or single proprietorship. The plaintiff must prove beyond a reasonable doubt that the defendant committed a crime.

Crimes are generally divided into felonies and misdemeanors. In most states, felonies are serious crimes (e.g., rape, arson, and criminal fraud) that are punishable by incarceration in a state penitentiary. Misdemeanors are less serious crimes (e.g., driving while intoxicated) that are usually punishable by shorter periods of imprisonment in a county or city jail or by fines. An act that is a misdemeanor in one state could be a felony in another state. White-collar felonies and misdemeanors are discussed in Chapter 7.

Civil law comprises federal and state statutes governing litigation between two private parties. Neither the state nor the federal government is represented in most civil cases (exceptions will be pointed out in future chapters). Rather than prosecutors, there are plaintiffs, who are usually individuals or businesses suing other individuals or businesses (the defendants) to obtain compensation for an alleged breach of a private duty. For example, A, a retailer, enters into a contract with B, a manufacturer, who agrees to supply A with all the bicycles of a certain brand that the retailer can sell. A advertises and sales exceed all expectations. B refuses to ship any more bicycles, and A's customers sue him for reneging on the rain check he gave them. In turn, A sues B for breach of contract. A must show by a preponderance of evidence (a lower standard of proof than the “beyond a reasonable doubt” standard that prevails in criminal cases) that B is liable (legally obligated) to fulfill the contract. Note that A is not seeking to put B in prison or to fine B. A is seeking only to be compensated for his advertising costs, his lost sales, and what it may cost him in lawyers' fees, court costs, and damage to settle with his customers (Table 2-2).

<table>
<thead>
<tr>
<th></th>
<th>Civil Law</th>
<th>Criminal Law</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Parties</strong></td>
<td>Individual or corporate plaintiff (in most cases) versus Individual or corporate defendant (in most cases)</td>
<td>County, city, state, or federal prosecutor versus Individual or corporate defendant (in most cases)</td>
</tr>
<tr>
<td><strong>Purpose</strong></td>
<td>Compensation</td>
<td>Punishment</td>
</tr>
<tr>
<td></td>
<td>Deference-deterrence</td>
<td>Deference-deterrence</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Rehabilitation</td>
</tr>
<tr>
<td><strong>Burden of proof and sanctions</strong></td>
<td>Preponderance of evidence</td>
<td>Beyond a reasonable doubt</td>
</tr>
<tr>
<td></td>
<td>Monetary damages</td>
<td>Imprisonment</td>
</tr>
<tr>
<td></td>
<td>Equitable terms</td>
<td>Fines</td>
</tr>
</tbody>
</table>
PUBLIC AND PRIVATE LAW

Public law deals with the relationship of government to individual citizens. Constitutional law, criminal law, and administrative law fit this classification. Constitutional law (discussed in Chapter 5) comprises the basic principles and laws of the nation as set forth in the U.S. Constitution. It determines the powers and obligations of the government and guarantees certain rights to citizens. Examples of questions that fall under constitutional law: Does an individual citizen have a Sixth Amendment right to counsel when stopped by a police officer, taken into custody, and interrogated? Is it cruel and unusual punishment under the Eighth Amendment to electrocute a person when that person has been found guilty of certain crimes, such as first-degree murder or killing a police officer in the line of duty? We have already touched on criminal law (which is discussed more fully in Chapter 7).

Administrative law (examined in Chapter 19) covers the process by which individuals or businesses can redress grievances against regulatory agencies such as the FTC and the SEC. It prevents the agencies from acting in an arbitrary or capricious manner and from extending their power beyond the scope that Congress has given them. For example, when the Federal Communications Commission (FCC) ruled that cable television corporations had to set aside so many channels for access by any public group that requested time, the courts reversed this FCC rule, deciding that it was beyond the agency’s authority and in violation of a provision of the Federal Communications Act. Administrative law also covers the process whereby government agencies represent individuals or classes of individuals against business entities—for example, when the EEOC represents individuals alleging discrimination in pay under the provisions of the Civil Rights Act of 1964.

Private law is generally concerned with the enforcement of private duties between individuals, between an individual and a business, or between two businesses. Contracts, torts, and property law fall under this classification. Note that the government is not a concerned party in most private law cases.

SUBSTANTIVE AND PROCEDURAL LAW

Substantive Law. Substantive law creates and regulates legal rights. For example, the rules of contract law (set out for your study in Chapters 10 and 11) determine whether an agreement between two parties is binding and, thus, an enforceable contract.

Procedural Law. Procedural law sets forth the rules for enforcing substantive rights in a court of law. In effect, procedural law defines the manner by which one obtains a remedy in a court of law. For example, when there is a possible breach of contract, the plaintiff will have to file a complaint indicating the basis for the suit, and the defendant will set forth an answer responding to the complaint, indicating why the defendant should not have to compensate the plaintiff.

CYBERLAW

Over the past 15 years, the use of the Internet to carry out commercial transactions has brought about a body of law that is largely traditional in the above categories, but often unique to cyberspace communication. Cyberlaw is not really a new type of law, but rather traditional categories (e.g., private law—contracts and torts) applied to a relatively new form of communication (online). Many chapters in this text include discussions of cyberlaw. Chapter 6 is dedicated to cyberlaw applications. In Chapters 10 and 11 on the law of contracts and sales,
we have dedicated parts of each chapter to online applications. Chapters 7 and 12 deal with white-collar crime and the law of torts, and are further examples of the application of traditional law to online situations. Those prepared to enter business today need to know traditional laws and their application when dealing with cyberlaw issues.

**Global Dimensions of the Legal Environment of Business**

At the beginning of this chapter, we stated that managers need to be aware of the impact of international variables on their business. As of the year 2004, approximately 30 percent of all jobs in the United States depended on exports, and in the view of many experts, that percentage will soon rise to 50 percent. Additionally, many jobs are being outsourced to other countries by American corporations for cost purposes. Trade treaties will make the international dimensions of the legal environment of business increasingly important to U.S. firms. Throughout this book, therefore, we discuss the international dimensions of product liability, tort, contracts, labor, securities, and antitrust law, as well as ethics whenever appropriate. For example, current U.S. securities laws include the Foreign Corrupt Practices Act of 1977 (FCPA), as amended in 1988. If the laws of Country X do not forbid bribery in order to obtain a $10 million contract to build an oil pipeline, should U.S. companies be constrained by the FCPA prohibitions against such bribery? Ethical and cultural relativists would say no: “When in Rome, do as the Romans do.” Normative ethical theorists, such as rule utilitarians, would say yes, arguing that rules agreed upon by the world community, or a preponderance of its members, cannot be compromised by a particular situation. They would point out that both the United Nations’ Multinational Code and the laws of most of the UN member states prohibit bribery.

**SUMMARY**

The study of the legal environment of business includes the study of legal reasoning, critical thinking skills, and ethical norms; the legal and administrative law processes; selected areas of public and private law; and relevant international law. Jurisprudence is the science or philosophy of law, or law in its most generalized form. The major schools of jurisprudence are natural law, positivism, sociological, American realism, critical legal studies, feminism, and law and economics.

The three direct sources of law are the legislative (statutory), judicial (case law), and executive (executive orders) branches of government. Administrative agencies, which promulgate regulations and rules, constitute the fourth (indirect) source of law. The international dimensions of law include legal, financial, economic, and ethical variables that have an impact on business decision making.

**REVIEW QUESTIONS**

2-1 Contrast the natural law school’s definition of law with that of the positivist school.

2-2 Explain how the critical legal studies and the feminist schools of jurisprudence are similar.

2-3 Describe how the executive branch of government is a source of law.

2-4 What is the difference between statutory law and case law? Explain.

2-5 If the president vetoes a bill passed by Congress, is there any way the bill can become law? Explain.

2-6 Distinguish between the pairs of terms in each of these three classifications of law:
   a. public law, private law
   b. civil law, criminal law
   c. felonies, misdemeanors
REVIEW PROBLEMS

2-7 Three men are trapped in a cave with no hope of rescue and no food. They roll dice to determine who will be killed and eaten by the others so that some may survive. The two survivors are unexpectedly rescued 10 days later and tried for murder. Judge A finds them guilty, saying that the unjustifiable killing of another is against the homicide laws of State X. He bases his decision solely on statutory law and case precedents interpreting the law. To which school of legal thought does Judge A belong? Explain.

2-8 Basing his decision on the same set of facts as given in Problem 2-7, Judge B rules that the survivors are not guilty because they were cut off from all civilized life, and in such a situation, the laws of nature apply, not manmade laws. To which school of legal thought does Judge B belong? Explain.

2-9 Basing her decision on the same set of facts as given in Problem 2-7, Judge C rules that the two survivors are not guilty because, according to a scientific survey of the community by a professional polling organization, the public believes that the survivors’ actions were defensible. To which school of legal thought does Judge C belong? Explain.

2-10 Imagine that you were a judge in the case set forth in Problem 2-7. How would you decide the case? On the basis of the reasons for your decision, explain which legal philosophy you think you hold.

2-11 Madison and his adult son lived in a house owned by Madison. At the request of the son, Marshall painted the house. Madison did not authorize the work, but he knew that it was being done and raised no objection. However, Madison refused to pay Marshall, arguing that he had not contracted to have the house painted.

Marshall asked his attorney if Madison was legally liable to pay him. The attorney told Marshall that, in their state, several appellate court opinions had established that when a homeowner allows work to be done on his home by a person who would ordinarily expect to be paid, a duty to pay exists. The attorney stated that, on the basis of these precedents, it was advisable for Marshall to bring a suit to collect the reasonable value of the work he had done. Explain what the attorney meant by precedent and why the fact that precedent existed was significant.

CASE PROBLEMS

2-13 In 2006, Myspace, an Internet Web site for young adult social networking, was sued by the Universal Music Group, Inc., for copyright infringement. Basically, Myspace was allowing users to upload musical content such as videos and songs to their profiles. Myspace was somewhat protected under a federal law that makes such practices illegal only if the copyright holder actually complains and the content is not subsequently removed from the site. Universal Music Group brought suit in an effort to change that law and claimed that such practices were still copyright infringement. Were the practices of Myspace copyright infringement? How would a judge’s legal philosophy affect how he or she would rule in this case? UMG Recordings Inc. v. Myspace, Inc., 526 F. Supp. 2d 1046; U.S. Dist. LEXIS 91179 (C.D. Cal. 2007).

2-14 Three same-sex couples who are residents of Vermont have lived together in committed relationships for a period. Two of the couples have raised children together. All three couples applied for marriage licenses and were refused a license on the ground that they were ineligible under the state marriage laws. Plaintiffs sought a declaratory judgment that the refusal to issue them a license violated the marriage statutes and the Vermont constitution. They argued that it violated the Common Benefits Clause of the Vermont constitution, which provides “[t]hat government is, or ought to be instituted for the common benefit, protection, and security of the people, nation, or community, and not for the particular emolument or advantage of a single person, family, or set of persons, who are part of that community . . . .” They argued that in not having access to a civil marriage
PART ONE • Introduction to the Law and the Legal Environment of Business

license, they are denied many legal benefits and protections, including coverage under a spouse’s medical, life, and disability insurance; hospital visitation and other medical decision-making privileges; and spousal support. Argue whether Vermont’s marriage license law violates the same-sex couples’ rights under the Vermont constitution. Which school of jurisprudence would you apply in your reasoning? Baker v. State of Vermont, 170 Vt. 194; 744 A.2d 864; 1999 Vt. LEXIS 406.

2-15 Margaret Beattie was seriously injured in an automobile accident in Delaware and was rendered a quadriplegic following the accident. She filed suit against her husband for damages, alleging that his negligence was the cause of her injuries. Because the Beatties had substantial liability insurance, Margaret would have received a large sum in damages if she had been able to establish her case. Unfortunately for her, Delaware follows the precedent of not allowing one spouse to sue the other spouse in tort. Should this precedent prevent Margaret from being allowed to sue her husband for damages in this case? Beattie v. Beattie, 630 A.2d 1096 (Del. 1993).

2-16 The United States age discrimination law protects individuals beginning at the age of 40. However, this law has specific requirements regarding whether an employer or the employee determines whether age-related factors were involved with a termination or layoff. Prior to this case, the employer who let go an individual 40 years of age or more had the burden of saying the separation was based on a reasonable factor unrelated to age. However, during this case in 2008, 28 individuals at or above the age of 40 were laid off, and in turn sued the employer for age discrimination. These individuals argued that instead of the employer having the burden, and thus being able to argue that there was a reasonable factor unrelated to age, the individuals being let go should have the burden. This way, the individuals would then be able to argue in court that there was no “reasonable” factor other than age involved in the individuals’ terminations from their jobs. In this case, did the Supreme Court agree with the individuals? Currently, who has the burden in such cases, the employer or the employees? *Meacham v. Knolls Atomic Power Laboratory*, 552 U.S. 1306, 128 S. Ct. 1764, 170 L. Ed. 2d 558; 2008 U.S. LEXIS 3090; 76 U.S.L.W. 3554 (2008).

2-17 A&M Records, plaintiffs, are in the business of the commercial recording, distribution, and sale of copyrighted musical compositions and sound recordings. It filed suit against Napster Inc. (Napster) as a contributory and vicarious copyright infringer. Napster operates an online service for “peer-to-peer file sharing” (www.Napster.com) so that users can, free of charge, download recordings via the Internet through a process known as “ripping,” which is the downloading of digital MP3 files. MP3 is the abbreviated term for audio recordings in a digital format known as MPEG-3. Napster’s online service provides a search vehicle for files stored on others’ computers and permits the downloading of the recordings from the hard drives of other Napster users. Napster provides technical support as well as a chat room for users to exchange information. The result is that users, who register and have a password through Napster, could download single songs and complete CDs or albums via the peer-to-peer file sharing. The district court granted a preliminary injunction to the plaintiffs, enjoining Napster from “engaging in, or facilitating others in copying, downloading, uploading, transmitting, or distributing plaintiffs’ copyrighted musical compositions and sound recordings, protected by either federal or state law, without express permission of the rights owner.” Who won? *A&M Records v. Napster*, 239 F.3d 1004 (9th Cir. 2001).

2-18 In 2007, two fair housing groups in California sued a Web site that helps people find roommates, called Roommate.com. The housing groups alleged that the Web site was in clear violation of the Fair Housing Act. Apparently, the Web site violated the act because the Web site allowed users to discriminate among people and who individuals were able to live with based on religion, sexual preference, gender, and so on. However, the Web site argued that its practices were protected under the Communication Decency Act. In other words, the Web site stated that the users were freely describing their own wants, and not the views or opinions of the Web site itself. However, the court took note that the Web site provided menus for users to choose preferences among religions, race, gender, and the like. How did the court decide in this case? Explain how the legal philosophy one adheres to would make one more or less supportive of the court’s ruling. *Fair Housing Council of San Fernando Valley v. Roommate.com LLC*, 521 F.3d 1157; 2008 U.S. App. LEXIS 7066 (9th Cir. 2008).
Although there is debate over the various schools of jurisprudence, not all options are of equal merit. In that the law is meant to offer protection and to guide society, not all philosophies can best achieve this desired outcome. To have a just legal system, laws must be based on absolute principles that provide clarity in the prescribed rules to follow, as well as justice in the result of following the laws. Therefore, the natural law school best provides for the maintenance of law, order, and justice in society.

One advantage of the natural law school is the acknowledgment of the black-and-white nature of legal issues. When someone commits a crime and harms another, one party is wrong and the other is harmed because of the wrong. Certain actions, such as murder, are simply wrong acts that are never permissible. The natural law school of jurisprudence readily recognizes moral absolutes and seeks to create a legal system around these absolutes, ultimately strengthening the resulting laws. Good and evil exist, and natural law sides with the good against the evil.

The basis in moral absolutes grounds natural law in the pursuit of the right and the good. These moral absolutes exist and are available to those who study and think about what is right and just. People, by considering these moral absolutes, can come up with the naturally right code of conduct, and make laws to ensure that people will live up to this naturally right code of conduct. No other school of jurisprudence adequately tells people the proper way to conduct their lives. After all, the role of the law is to maintain peace and justice in society by creating the laws that best channel people toward following right actions and avoiding wrong actions. Only an application of natural law jurisprudence can guide society for the good of all.

In addition to prescribing proper conduct for citizens, law grounded in moral absolutes can avoid subjective approaches to laws. A quick review of almost any legal issue will demonstrate that judges and lawyers do not always agree upon what a law means. When laws are firmly grounded in moral absolutes, however, the subjective element of the law is removed. No longer would judges need to ponder over what a law means and when it applies. Instead, judges would have to look at the law and determine the relevant moral truth the law upholds or on which the law is based. By enforcing the moral absolutes underlying the law, judges would no longer apply their subjective beliefs to laws, and instead would create a more consistent and predictable legal system.

1. How would you frame the issue and conclusion of this essay?
2. What is the primary ethical norm underlying the author’s argument?
3. Does the argument contain significant ambiguity in the reasoning?
   **Clue:** Which word or phrases could have multiple meanings, where changing the meaning used either strengthens or weakens the argument?
4. Write an essay that someone who holds an opinion opposite to that of the essay author might write.
   **Clue:** How might reasonable people disagree with the author’s conclusion?

This chapter introduces you to seven different schools of jurisprudence, each with distinct elements. Yet, the various schools also share a number of similarities that often blur the lines separating one from the other. Using the Internet, research at least two of the schools of jurisprudence discussed here to go beyond the information provided in this chapter. Then apply the critical thinking skills highlighted in Chapter 1 to compare the two schools you researched. How are they similar? How are they different?

For example, if you wanted to compare the critical legal studies school to the feminist school, you could begin by visiting this page on critical legal theory: [www.law.cornell.edu/topics/critical_theory.html](http://www.law.cornell.edu/topics/critical_theory.html). Then visit a site exploring the feminist school; one such site can be found at [www.law.cornell.edu/topics/feminist_jurisprudence.html](http://www.law.cornell.edu/topics/feminist_jurisprudence.html). The following sites may also be of use in better understanding theories of jurisprudence.
FOR FUTURE READING


The American Legal System

- JURISDICTION
- VENUE
- THE STRUCTURE OF THE COURT SYSTEM
- THE ACTORS IN THE LEGAL SYSTEM AND THEIR RELATIONSHIP TO THE BUSINESS COMMUNITY
- THE ADVERSARY PROCESS
- STEPS IN CIVIL LITIGATION AND THE ROLE OF BUSINESSPERSONS
- GLOBAL DIMENSIONS OF THE AMERICAN LEGAL SYSTEM

We are all subject to both state and federal laws. Under our dual court system, all lawsuits must be brought in either the federal or the state court system. In some cases, an action may be brought in either. Thus, it is important that those in the business community understand how the decisions are made as to which court system can resolve their grievances. This chapter first considers the principles that determine which court system has the power to hear various types of cases and then examines in greater detail the structure of the two basic divisions of our dual court system. Next, it focuses on the primary actors who play major roles in our litigation process. Finally, it examines the philosophy behind our American legal system and traces the procedures that must be followed when using one of our courts.

Jurisdiction

The concept of jurisdiction is exceedingly simple, yet at the same time exceedingly complex. At its simplest level, jurisdiction is the power of the courts to hear a case and render a decision that is binding on the parties. Jurisdiction is complex, however, because there are several types of jurisdiction that a court must have if it is to hear a case.

**ORIGINAL VERSUS APPELLATE JURISDICTION**

Perhaps the simplest type of jurisdiction to understand is the distinction between original and appellate jurisdiction, which refers to the role the court plays in the judicial hierarchy. A court of original jurisdiction, usually referred to as a trial court, has the power to initially hear and decide a case. It is in the court of original jurisdiction that a case originates; hence its name.

A court with appellate jurisdiction has the power to review a previously made decision to determine whether the trial court erred in making its initial decision.
in personam jurisdiction
Jurisdiction over the person; the power of a court to render a decision that affects the legal rights of a specific person.

plaintiff
Party on whose behalf the complaint is filed.

defendant
Party against whom an action is being brought.

complaint
The initial pleading in a case that states the names of the parties to the action, the basis for the court's subject matter jurisdiction, the facts on which the party's claim is based, and the relief that the party is seeking.

summons
Order by a court to appear before it at a certain time and place.

service
Providing the defendant with a summons and a copy of the complaint.

JURISDICTION OVER PERSONS AND PROPERTY

Before the court can render a decision affecting a person, the court must have in personam jurisdiction (jurisdiction over the person). In personam jurisdiction is the power to render a decision affecting the specific persons before the court. When a person files a lawsuit, that person, called the plaintiff, gives the court in personam jurisdiction over him or her. By filing a case, the plaintiff is asking the court to make a ruling affecting his or her rights. The court must acquire jurisdiction over the party being sued, the defendant, by serving him or her with a copy of the plaintiff's complaint and a summons. The complaint, discussed in more detail later in this chapter, is a detailed statement of the basis for the plaintiff's lawsuit and the relief being sought. The summons is an order of the court notifying the defendant of the pending case and telling him or her how and when to respond to the complaint.

Personal service, whereby a sheriff or other person appointed by the court hands the summons and complaint to the defendant, has been the traditional method of service. Today, other types of service are more common. Residential service may be used, whereby the summons and complaint are left by the representative of the court with a responsible adult at the home of the defendant. Certified mail or, in some cases, ordinary mail are also used to serve defendants. Once the defendant has been properly served, the court has in personam jurisdiction over him or her and may render a decision affecting his or her legal rights, regardless of whether the defendant responds to the complaint.

When one thinks about how the rules of service would apply to a suit against a corporation, the question arises: How do you serve a corporation? The legal system has solved this question. Most states require that corporations appoint an agent for service when they are incorporated. This agent is a person who has been given the legal authority to receive service for the corporation. Once the agent has been served, the corporation is served. In most states, service on the president of the corporation also constitutes service on the corporation.

A court's power is generally limited to the borders of the state in which it is located. So, traditionally, a defendant had to be served within the state in which

CRITICAL THINKING ABOUT THE LAW

Our American legal system can seem confusing at first. Using your critical thinking skills to answer the following questions as you read this chapter will help you understand how our legal system operates.

1. Critical thinkers recognize that ambiguous words—words that have multiple possible meanings—can cause confusion. Sam boldly asserts that the court of common pleas has jurisdiction over Jones v. Smith, while Clara asserts equally strongly that the court of common pleas does not have jurisdiction over the case. Explain the ambiguity that allows these two apparently contradictory statements to both be true.

   Clue: Is it possible for a court to have one type of jurisdiction and not another?

2. Our legal system contains numerous procedural requirements. Which of the primary values is furthered by these requirements?

   Clue: Review the four primary values described in Chapter 1.

3. Many say that the adversary system is consistent with the American culture. What value that is furthered by our adversary system is important to our culture?

   Clue: Can you go beyond the four primary values described in Chapter 1 and think of any other important values?
the court was located in order for the court to acquire jurisdiction over the person of the defendant. This restriction imposed severe hardships when a defendant who lived in one state entered another state and injured the plaintiff. If the defendant never again entered the plaintiff’s state, the plaintiff could bring an action against the defendant only in the state in which the defendant lived. Obviously, this restriction would prevent many legitimate actions from being filed.

To alleviate this problem, most states enacted long-arm statutes, which enable the court to serve a defendant outside the state as long as the defendant has engaged in certain acts within the state. Those acts vary from state to state, but most statutes include such acts as committing a tort within the state or doing business within the state. The following case demonstrates the application of such a statute.

CASE 3-1

World-Wide Volkswagen Corp. v. Woodson,
District Judge of Cook County
Supreme Court of the United States 444 U.S. 286 (1980)

Mr. and Mrs. Robinson, the plaintiffs in the original case, filed a product liability action against defendant World-Wide Volkswagen in a state court in Oklahoma to collect compensation for damages they incurred as a result of an accident involving an automobile they had purchased in New York. The defendants in that case, the retailer and the wholesaler of the car, were both New York corporations.

Defendants claimed that the Oklahoma court could not exercise jurisdiction over them because they were nonresidents and they lacked sufficient “minimum contacts” with the state to be subject to its in personam jurisdiction.

The trial court rejected defendant petitioner’s claims. The Oklahoma Supreme Court likewise rejected their claims, and so they petitioned the U.S. Supreme Court. Note that the case that went to the Supreme Court is against the trial court, because the issue on appeal is whether the trial court acted properly in asserting jurisdiction.

Justice White

The issue before us is whether, consistently with the Due Process Clause of the Fourteenth Amendment, an Oklahoma court may exercise in personam jurisdiction over a nonresident automobile retailer and its wholesale distributor in a products liability action, when the defendants’ only connection with Oklahoma is the fact that an automobile sold in New York to New York residents became involved in an accident in Oklahoma.

As has long been settled, and as we reaffirm today, a state court may exercise personal jurisdiction over a nonresident defendant only so long as there exist “minimum contacts” between the defendant and the forum State. The concept of minimum contacts, in turn, can be seen to perform two related, but distinguishable, functions. It protects the defendant against the burdens of litigating in a distant or inconvenient forum. And it acts to ensure that the States, through their courts, do not reach out beyond the limits imposed on them by their status as coequal sovereigns in a federal system.

The protection against inconvenient litigation is typically described in terms of “reasonableness” or “fairness.” We have said that the defendant’s contacts with the forum State must be such that maintenance of the suit “does not offend ‘traditional notions of fair play and substantial justice.’"

The limits imposed on state jurisdiction by the Due Process Clause, in its role as a guarantor against inconvenient litigation, have been substantially relaxed over the years. This trend is largely attributable to a fundamental transformation in the American economy.

Today many commercial transactions touch two or more States and may involve parties separated by the full continent. With this increasing nationalization of commerce has come a great increase in the amount of business conducted by mail across state lines. At the same time modern transportation and communication have made it much less burdensome for a party sued to defend himself in a State where he engages in economic activity.

Nevertheless, we have never accepted the proposition that state lines are irrelevant for jurisdictional purposes, nor could we, and remain faithful to the principles of interstate federalism embodied in the Constitution.

Applying these principles to the case at hand, we find in the record before us a total absence of those affiliating circumstances that are a necessary predicate to any exercise of state court jurisdiction. Petitioners carry on no activity whatsoever in Oklahoma. They close no sales and perform no services there. They avail themselves of none
of the privileges and benefits of Oklahoma law. They solicit no business there either through salespersons or through advertising reasonably calculated to reach the State; nor does the record show that they regularly sell cars at wholesale or retail to Oklahoma customers or residents or that they indirectly, through others, serve or seek to serve the Oklahoma market. In short, respondents seek to base jurisdiction on one isolated occurrence and whatever inferences can be drawn therefrom: The fortuitous circumstance that a single Audi automobile sold in New York to New York residents happened to suffer an accident while passing through Oklahoma.

It is argued, however, that because an automobile is mobile by its very design and purpose it was "foreseeable" that the Robinsons' Audi would cause injury in Oklahoma. Yet "foreseeability" alone has never been a sufficient benchmark for personal jurisdiction under the Due Process Clause.

If foreseeability were the criterion, a local California tire retailer could be forced to defend in Pennsylvania when a blowout occurs there; a Wisconsin seller of a defective automobile jack could be hauled before a distant court for damage caused in New York; or a Florida soft-drink concessionaire could be summoned to Alaska to account for injuries happening there.

This is not to say, of course, that foreseeability is wholly irrelevant. But the foreseeability that is critical to due process analysis is not the mere likelihood that a product will find its way into the forum State. Rather, it is that the defendant’s conduct and connection with the forum State are such that he should reasonably anticipate being hauled into court there. When a corporation “purposefully avails itself of the privilege of conducting activities within the forum State,” it has clear notice that it is subject to suit there and can act to alleviate the risk of burdensome litigation by procuring insurance, passing the expected costs on to customers, or, if the risks are too great, severing its connection with the State. Hence, if the sale of a product of a manufacturer or distributor such as Audi or Volkswagen is not simply an isolated occurrence but arises from the efforts of the manufacturer or distributor to serve directly or indirectly the market for its product in other States, it is not unreasonable to subject it to suit in one of those States if its allegedly defective merchandise has there been the source of injury to its owner or to others.

But there is no such or similar basis for Oklahoma jurisdiction over World-Wide or Seaway in this case. Seaway’s sales are made in Massena, New York. World-Wide’s market, although substantially larger, is limited to dealers in New York, New Jersey, and Connecticut. There is no evidence of record that any automobiles distributed by World-Wide are sold to retail customers outside this tristate area. It is foreseeable that the purchasers of automobiles sold by World-Wide and Seaway may take them to Oklahoma. But the mere “unilateral activity of those who claim some relationship with a nonresident defendant cannot satisfy the requirement of contact with the forum State.”

Reversed in favor of World-Wide Volkswagen Corporation

Contrast the facts in the foregoing case with those in the 2004 case of Snowe v. Harrah’s Entertainment, Inc., in which the court came to a contrary decision. In Snowe, the defendant, a California resident, filed a class action suit against Harrah’s and other Nevada casino operators, in a California state court, alleging unfair competition, breach of contract, and false advertising. The trial court dismissed the suit for lack of personal jurisdiction. The California Court of Appeals overturned the dismissal, explaining that when the court was deciding whether it could exercise its jurisdiction over a nonresident, it must consider (1) the burden on the defendant of defending an action in the forum; (2) the forum state's interest in adjudicating the dispute; (3) the plaintiff’s interest in obtaining relief; (4) judicial economy; and (5) the states’ shared interest in furthering fundamental substantive social policies. In finding that there were sufficient minimum contacts with the state of California to justify exercising jurisdiction, the court cited the facts that the hotels and casinos (1) purposefully directed advertising at California residents, (2) conducted business with some residents by an interactive Web site, and (3) solicited and received the patronage of California residents.

In Rem Jurisdiction. If a defendant has property within a state, the plaintiff may seek to bring the action directly against the property rather than against the owner. For example, if a Michigan defendant owned land in Idaho on which taxes had not been paid for 10 years, the state could bring an action to recover those taxes. The Idaho court would have in rem jurisdiction over the property and, in an in rem proceeding, could order the property sold to pay the taxes.

Such proceedings are often used when the owner of the property cannot be located for personal service.

**SUBJECT MATTER JURISDICTION**

One of the most important types of jurisdiction is subject matter jurisdiction, the power of the court to hear certain kinds of cases. Subject matter jurisdiction is extremely important because if a judge renders a decision in a case over which the court does not have subject matter jurisdiction, the decision is void or meaningless. The parties cannot give the court subject matter jurisdiction. It is granted by law, as described in the subsequent sections.

At the beginning of this chapter, you learned that the United States has a dual court system, comprised of both a state and a federal system. The choice of the system in which to file a case is not purely a matter of deciding which forum is most convenient or which judge would be most sympathetic. Subject matter jurisdiction determines which court may hear the case. When you think about the concept of subject matter jurisdiction, it is easiest to think of it in two steps. First, within which court system does the case fall? Once you know which court system has jurisdiction over the case, you then need to ask whether there is a special court within that system that hears that specific type of case. When asking which court system has subject matter jurisdiction, there are three possible answers: state jurisdiction, exclusive federal jurisdiction, or concurrent federal jurisdiction (Exhibit 3-1).

**State Jurisdiction.** The state court system has subject matter jurisdiction over all cases not within the exclusive jurisdiction of the federal court system. Only a very limited number of cases fall within the exclusive jurisdiction of the federal courts. Consequently, almost all cases fall within the state court jurisdiction. Suits for breach of contract, product liability actions, and divorces are just a few of the types of cases falling within the state court system's jurisdiction.

**Exclusive Federal Jurisdiction.** A few types of cases may be heard only in the federal courts. Such cases are within the exclusive jurisdiction of the federal court system. If these cases were tried in a state court, any decision rendered by the state court system

---

**EXHIBIT 3-1**

**SUBJECT MATTER JURISDICTION**

- **Exclusive Federal Jurisdiction**
  - Admiralty
  - Bankruptcy
  - Copyrights, Trademarks, Patents
  - Claims against the U.S. Government
  - Claims Arising under Statutes Providing for Exclusive Federal Jurisdiction
  - Federal Criminal Prosecutions

- **Concurrent Jurisdiction**
  - Federal Question
  - Diversity of Citizenship

- **State Court Jurisdiction**
  - All Cases Not under Exclusive Federal Jurisdiction

**subject matter jurisdiction**
The power of a court to render a decision in a particular type of case.

**state court jurisdiction**
Applies to cases that may be heard only in the state court system.
judge would be void. Cases that fall within the exclusive jurisdiction of the federal courts include such matters as admiralty, bankruptcy, federal criminal prosecutions, claims against the United States, and claims arising under those federal statutes that include a provision for exclusive federal jurisdiction. Many of these latter cases are of particular concern to businesspeople. For example, one statute that gives exclusive jurisdiction to the federal court system is the National Environmental Policy Act, discussed in Chapter 23. Cases brought under this act must be filed in a federal district court.

**Concurrent Federal Jurisdiction.** Many cases may be heard in either a federal or a state court. These cases are said to fall within the federal court’s concurrent jurisdiction, meaning that both court systems have jurisdiction, so the plaintiff may file in the trial court of either system. There are two types of such cases. The first are federal question cases. If a case requires an interpretation of the U.S. Constitution, a federal statute, or a federal treaty, it is said to involve a federal question and may be heard in either state or federal court. Many people make the mistake of thinking that when a person believes his or her rights under the federal Constitution have been violated, the case must go to the federal courts. They are wrong. Such a case involves a federal question and is, therefore, within the concurrent jurisdiction of both court systems.

The second means by which a case may fall within the federal court’s concurrent jurisdiction is through diversity of citizenship. If the opponents in a case are from different states, there is said to be diversity of citizenship. The diversity must be complete. If any two parties on opposing sides reside in the same state, diversity is lost. For example, if the plaintiff is an Ohio resident and one of the defendants lives in Michigan and the other in Indiana, diversity exists. If, however, an Ohio plaintiff is bringing an action against a Michigan defendant and an Ohio defendant, there is not complete diversity and therefore no concurrent federal jurisdiction. When the basis for federal jurisdiction is diversity of citizenship, an amount in excess of $75,000 must be in controversy.

When a case falls within the federal court’s concurrent jurisdiction because of either a federal question or diversity of citizenship, the suit may be filed in either state or federal court. If the case is filed in state court, the defendant has a right of removal, which means that he or she may have the case transferred to federal court. All the defendant has to do is file a motion with the court asking to exercise his or her right of removal. Thereupon, the case must be transferred to federal court; the judge has no discretion but must comply with the request.

The right of removal arises only when the case is filed in state court; there is no right of removal to state court. As a result, whenever a case is under concurrent jurisdiction, if either party wants the case heard in federal court, it will be heard there.

Why should both parties have the right to have such a case heard in federal court? In certain cases, a party may fear local prejudice in a state court. Juries for a state court are generally drawn from the county in which the court is located. The juries for federal district courts are drawn from the entire district, which encompasses many counties. Juries in state court are, therefore, usually more homogeneous than those in a district court. One problem that this homogeneity may present to the out-of-state corporate defendant occurs when the county in which the court is located is predominantly rural. If the case involves an injury to a member of this rural community, the defendant may feel that the rural jurors would be more sympathetic to the local injured party, whereas jurors drawn from a broader area, including cities, may be more likely to view the victim less sympathetically. City residents are also more likely to work for a corporation, and thus may not regard corporations as unfavorably as might rural residents.
Some people also believe that federal judges are better qualified to hear cases that involve a federal question, because they have more experience in resolving questions that require an interpretation of federal statutes. Finally, if a party anticipates that it may be necessary to appeal the case to the U.S. Supreme Court, bringing the case first in a federal district court may save one step in the appeals process.

When one party wishes to have the case tried in federal court and the other prefers state court, the issue of whether the case is within the concurrent jurisdiction of the federal courts sometimes arises. The following case provides an illustration of such a situation.

**CASE 3-2**

*West Virginia University Board of Governors for and on Behalf of West Virginia University v. Richard Rodriguez*

United States District Court for the Northern District of West Virginia

543 F. Supp. 2d 526; 2008 U.S. Dist. LEXIS 13137

In December 2007, the University of Michigan paid a West Virginia University [WVU] football coach, Rich Rodriguez, to leave his current position and instead coach at Michigan. As a result, WVU brought suit against Rodriguez in state court. Basically, Rodriguez had just made a contract with WVU stating that if he left his coaching position at WVU within one year of his signing date, he would owe the university $4 million. He ended up leaving the university within that time frame. However, what is most interesting is that although the case was settled six months later, for the majority of the time that the case was in existence it was embroiled in a bitter dispute over whether the case fell under concurrent federal or state jurisdiction.

In response to the university's filing of the case, Rodriguez filed a motion to move the case to a federal court. Once the case was removed to the federal court, WVU filed a motion to remand the case back to state court. WVU argued that there simply was no federal jurisdiction over the subject matter because a federal court hears disputes between individuals who are citizens of different states, and WVU was not a "citizen" of West Virginia. Instead, WVU was an "arm" of the state. In other words, WVU was not a citizen of the state but a part of the state itself. WVU further argued that Rodriguez also had changed his status to a citizen of Michigan at the time the suit was filed, solely to be able to go to federal court.

**Judge Bailey**

**II. The University Does Not Have Significant Autonomy from the State**

A review of the statutes and case law regarding West Virginia University and its Board of Governors demonstrates that, while the Board of Governors has great latitude in the day to day operations of the University, it can hardly be said to be autonomous. Among the ties to the state are the following:

1. Twelve of the eighteen members of the Board of Governors are appointed by the Governor of the state with the advice and consent of the state senate. Each member is required to take an oath as prescribed by Section five, Article IV of the Constitution of West Virginia.

2. A member of the Board of Governors appointed by the Governor may only be removed “for official misconduct, incompetence, neglect of duty or gross immorality and then only in the manner prescribed by law for the removal of the state elective officers by the Governor.”

3. The University has no power to tax.

4. Moneys may only be withdrawn from University accounts via a check issued by the state treasurer.

5. Checks may only be issued upon requisition by the University to the state auditor.

6. All property of the University is property of the state.

7. Employees of the University are state employees and are provided with the benefit of the West Virginia Public Employees Grievance Procedure.

8. Salaries for classified employees of the University are set by state statute.

9. The schedule of all tuition and fees charged by the University must be certified to the Legislative Auditor.

10. The Board of Governors is charged with direction of the preparation of a budget request to the legislature for the University.

11. The University must obtain the approval of the Secretary of Education and the Arts to transfer amounts between items of appropriation.

12. The University must submit copies of its annual audited financial statements to the Legislative Oversight Commission and the Joint Committee on Government and Finance.

The defendant argues that the fact that this case was filed by private counsel rather than by the state Attorney General is an indication that the University is not an arm of
the state. The defendant overlooks West Virginia Code § 18B-2A-4(y), which provides as follows:

> Notwithstanding any other provision of this code to the contrary, [the Board of Governors may] acquire legal services that are necessary, including representation of the governing boards, their institutions, employees and officers before any court or administrative body. The counsel may be employed either on a salaried basis or on a reasonable fee basis. In addition, the governing boards may, but are not required to, call upon the Attorney General for legal assistance and representation as provided by law.

Based upon the foregoing, this Court is of the opinion that the University is not significantly autonomous from the State of West Virginia.

IV. State Law Clearly Defines the University as an Arm of the State

Decisions of the West Virginia Supreme Court of Appeals make it abundantly clear that West Virginia deems West Virginia University to be an arm of the state. Syllabus Point 1 of University of West Virginia Board of Trustees v. Graf holds: “The Board of Governors of West Virginia University is a State agency, and, as such, is an arm of the State and, under Article VI, Section 35 of the Constitution of West Virginia, is immune from suit to enforce payment of a claim against such board.”

Syllabus Point 2 of State ex rel. Bd. of Govs. of W. Va. Univ. v. Sims holds that “[b]y legislative fiat, Code, 18-11-1, as amended by Chapter 73, Acts of the Legislature, 1947, and Section 1-a, Chapter 89, Acts of the Legislature, 1947, the board of governors of West Virginia University is a public and governmental body and as such is an arm of the State . . . .”

Based upon the foregoing, this Court holds that West Virginia University and its Board of Governors are arms and alter egos of the State of West Virginia and, therefore, are not citizens for purposes of 28 U.S.C. § 1332.

Motion granted in favor of WVU.

**CRITICAL THINKING ABOUT THE LAW**

Understandably, courts must have rules about when they will hear a case and when they will not. Parties to a legal action often search for avenues whereby they can acquire access to particular courts. The courts are watchful that jurisdiction has not been “created” by methods that are contrived. In this case, the court had to acknowledge that it did not have the same “citizen of state” definition for a university as for the defendant.

1. What reasoning could lead a court to presume that a university would be a citizen of a state?
2. If the status were changed from a university existing as an “arm” of the state to its being a “citizen” of the state, what effect would the change have on a case such as WVU v. Rodriguez?

**Venue**

Subject matter jurisdiction should not be confused with venue. Once it is determined which court system has the power to hear the case, venue determines which of the many trial courts in that system is appropriate. Venue, clearly prescribed by statute in each state, is a matter of geographic location. It is usually based on the residence of the defendant, the location of the property in dispute, or the location in which the incident out of which the dispute arose occurred. When there are multiple defendants who reside in various geographic locations, the party filing the lawsuit may usually choose from among the various locales.

If the location of the court in which the case is filed presents a hardship or inconvenience to one of the parties, that person may request that the case be moved under the doctrine of forum non conveniens, which simply means that the location of the trial court is inconvenient. The judge in the case will consider the party’s request and decide whether to grant the party’s request. Unlike the right of removal, the request for change of venue is granted at the judge’s discretion. There will usually be a hearing on the issue of whether the judge should grant the motion, because the plaintiff generally files the case in a particular court for a reason and will, therefore, be opposed to the defendant’s motion.
One example of a case in which a party sought to have the trial location changed due to *forum non conveniens* is *Ex parte Kia Motors America, Inc.* In this case, four people were riding in Florida in a 1998 Kia Sephia that was involved in a high-speed car accident; the car was forced from the road, caught fire, and burned. Three of the four passengers did not survive. The families of the deceased sued Kia for product liability and negligence, among other claims, in the Alabama courts. Kia filed a motion for *forum non conveniens* to have the case moved to Florida, stating that the car was purchased in Florida, the deceased were residents of Florida, the claims were to be tried according to Florida law, and 25 of the witnesses were also Florida residents. The Supreme Court of Alabama ruled that the motion for *forum non conveniens* was appropriate and the case should be moved to Florida.

### TECHNOLOGY AND THE LEGAL ENVIRONMENT

#### The Internet and In Personam Jurisdiction

Is the sponsor of a Web site that can be visited from every state subject to in personam jurisdiction in every state? As long as the sponsor is not conducting any business or trying to reach customers in a state, many courts have held that mere access to the Web site is not sufficient to grant in personam jurisdiction. One case that illustrates this point involved two organizations that both used the name Carefirst. Carefirst of Maryland, a nonprofit insurance company, accused Carefirst Pregnancy Center (CPC), a Chicago-based nonprofit organization, of trademark infringement. Carefirst of Maryland operated a Web site from which the company promoted its products to consumers who are located primarily in the mid-Atlantic region, with the majority of its consumers living in Maryland. CPC also operated a Web site, which was accessible anywhere in the world, for the purpose of promoting its services for women with pregnancy-related crisis and to generate donations for the organization. CPC’s operations were confined almost entirely to the state of Illinois.

Since CPC began using the name Carefirst, the Chicago-based organization received only one donation from a Maryland resident via the company’s Web site. From 1991 to 2001, CPC claimed that only 0.0174 percent of its donations came from Maryland residents. The only means through which CPC has contact with Maryland residents is CPC’s Web site. Therefore, a district court in Maryland and the appellate court both dismissed the case for lack of personal jurisdiction, concluding that even though CPC’s Web site could be contacted from anywhere, its purpose was to provide information about the organization and solicit donations primarily from Illinois residents. Although the court noted that the donations received from Maryland residents were negligible, the court also held that CPC made no effort to target Maryland donors. Furthermore, the court observed that CPC had no agents, employees, or offices located in Maryland. Hence, there was not sufficient contact with Maryland to support personal jurisdiction.

If the potential defendant, however, is actively trying to do business in other states via a Web site, the outcome of a case may be different. For example, in *Gator.com Corp v. L.L. Bean, Inc.*, the Ninth Circuit Court of Appeals held that L.L. Bean was subject to in personam jurisdiction in California. Gator.com, a company that develops software for consumers who make online purchases, also created pop-up coupons that would appear on L.L. Bean’s Web site for L.L. Bean’s competitors, such as Eddie Bauer. In response to its receiving a cease-and-desist letter from L.L. Bean, Gator.com sought a declaratory judgment that its actions were not illegal according to state and federal laws. L.L. Bean filed a motion to dismiss, after which a district court in California ruled that the court did not have in personam jurisdiction. The Ninth Circuit reversed on appeal, noting that 6 percent of L.L. Bean’s $1 billion in annual sales is attributable to California customers. The court also observed that L.L. Bean “targets” California consumers with its direct e-mail solicitations, and by maintaining a highly interactive Web site, from which numerous California customers make online purchases and interact with L.L. Bean sales representatives. The Ninth Circuit found these e-mail solicitations and Web-site services to California consumers to be sufficient minimum contacts for in personam jurisdiction.

You will learn more about the impact of the Internet on jurisdictional issues when you read Chapter 6.

---

*b 341 F.3d 1072 (9th Cir. 2002).  

2 881 So. 2d 396 (Ala. 2003).
The Structure of the Court System

As noted previously, our system has two parallel court structures, one federal system and one state system. Because of subject matter jurisdiction limitations, one often does not have a choice as to the system in which to file the case. Once a case is filed in a system, it will stay within that system, except for appeals to the U.S. Supreme Court. The following sections set forth the structure of the two systems. As you will see, they are indeed very similar. Their relationship is illustrated in Exhibit 3-2.

THE FEDERAL COURT SYSTEM

Federal Trial Courts. As you already know, trial courts are the courts of original jurisdiction. In the federal court system, the trial courts are the U.S. district courts. The United States is divided into 96 districts, and each district has at least one trial court of general jurisdiction. General jurisdiction means that the court has the power to hear cases involving a wide variety of subject matter and that it is not limited in the types of remedies it can grant. All cases to be heard in the federal system are filed in these courts, except those cases for which Congress has established special trial courts of limited jurisdiction.

Trial courts of limited jurisdiction in the federal system are limited in the type of cases they have the power to hear. Special federal trial courts of limited jurisdiction have been established for bankruptcy cases; claims against the U.S. government; and copyright, patent, and trademark cases. In an extremely limited number of cases, the U.S. Supreme Court also functions as a trial court of limited jurisdiction. Such cases include controversies between two or more states and suits against foreign ambassadors.

Intermediate Courts of Appeal. The second level of courts in the federal system is made up of the U.S. circuit courts of appeal. The United States is divided into 12 geographic areas, including the District of Columbia, each of which has a circuit court of appeals. Exhibit 3-2 illustrates this division. There is also a federal circuit court of appeals and a United States Veterans’ Court of Appeals. Each circuit court of appeals hears appeals from all of the district courts located within its geographic area. These courts also hear appeals from administrative agencies located within their respective circuits. In some cases, appeals from administrative agencies are heard by the Federal Circuit Court of Appeals. The Veterans’ Court of Appeals hears appeals of benefits decisions made by the Veterans Administration.

Court of Last Resort. The U.S. Supreme Court is the final appellate court in the federal system. In a limited number of instances, discussed in the last section of this chapter, the U.S. Supreme Court also hears cases from the court of last resort in a state system. As previously noted, the U.S. Supreme Court also functions as a trial court in a limited number of cases. The federal court system is illustrated in Exhibit 3-3.

STATE COURT SYSTEMS

There is no uniform state court structure because each state has devised its own court system. Most states, however, follow a general structure similar to that of the federal court system.

State Trial Courts. In state court systems, most cases are originally filed in the trial court of general jurisdiction. As in the federal system, state trial courts of general jurisdiction are those that have the power to hear all the cases that would be tried in the state court system, except those cases for which special trial courts
EXHIBIT 3-3
THE STRUCTURE OF THE COURT SYSTEM
of limited jurisdiction have been established. These trial courts of general jurisdiction are distributed throughout each state, usually by county. The names of these courts vary from state to state but are usually called courts of common pleas or county courts. New York uniquely calls its trial courts of general jurisdiction supreme courts. In some states, these courts may have specialized divisions, such as domestic relations or probate.

Most states also have trial courts of limited jurisdiction. These courts are usually limited in the remedies they may grant. Some may not issue injunctions or orders for specific performance. A common court of limited jurisdiction in most states is the small claims court, which may not grant damage awards in excess of specified amounts. Some courts of limited jurisdiction are limited to certain types of cases, such as traffic cases. Some criminal courts of limited jurisdiction may be limited to hearing misdemeanors. It is difficult to generalize about these courts because they vary so much from state to state. The main distinction between trial courts of general and limited jurisdiction, however, is that the former hear almost all types of cases that are filed in the state system and are unlimited in the remedies they can provide, whereas the latter hear only a particular type of case or may award only limited remedies.

Intermediate Courts of Appeal. Intermediate courts of appeal, analogous to the federal circuit courts of appeal, exist in approximately half the states. These courts usually have broad jurisdiction, hearing appeals from courts of general and limited jurisdictions, as well as from state administrative agencies. The names of these courts also vary by state. They may be called courts of appeal or superior courts.

Courts of Last Resort. In almost all cases filed in the state court system, the last appeal is to the state court of last resort. This court is frequently called the supreme court. In some states, it is known as the court of appeals. In approximately half of the states, it is the second court to which an appeal can be made; in the remaining states, it is the only appellate court.

The Actors in the Legal System and Their Relationship to the Business Community

THE ATTORNEY

An understanding of the structure of the legal system would be incomplete without an awareness of the primary actors within the system. The party with whom businesspersons usually have the most frequent contact is the attorney. Although the exact qualifications for being an attorney vary from state to state, most require that an attorney have a law degree, have passed the state’s bar examination, and be of high moral character. Attorneys are the legal representatives of the parties before the court. Some corporations have full-time attorneys, referred to as in-house counsel. Other corporations send all their legal work to an outside law firm. Many larger businesses have in-house counsel and also use outside counsel when a problem arises that requires a specialist.

Attorney–Client Privilege. The attorney can provide effective representation only when he or she knows all the pertinent facts of the case. The businessperson who withholds information from his or her attorney may cause irreparable harm if the hidden facts are revealed by the opposing side in court. To encourage client honesty, the attorney–client privilege was established. This privilege provides that information furnished in confidence to an attorney, in conjunction with a legal matter, may not be revealed by that attorney without permission from the client. There is, however, an important exception to this rule. If the lawyer
knows that the client is about to commit a crime, the lawyer may reveal confidential information in order to prevent the commission of that crime. Revealing such information, however, is not required of the attorney; it is simply allowed. This protection also extends to the attorney’s work product under what is known as the work-product doctrine. Work product includes both formal and informal documents prepared by the attorney in conjunction with a client’s case.

One of the problems arising out of use of the attorney–client privilege in the corporate setting is the definition of the client. The client is the corporation, but the communication sought to be protected is that between the attorney and upper-, middle-, or lower-level employees of the corporation. In such cases, the corporate attorney usually tries to rely on the work-product doctrine to protect the information that he or she has gathered from employees, especially when such information is in the form of written communications. Such an approach has generally been successful, but the courts have not yet precisely defined the parameters of the attorney–client privilege and the work-product doctrine as they apply to the corporate setting.

Additional Functions of the Attorney. Attorneys are probably best known for representing clients in litigation, but they also provide many other services for business clients. Attorneys represent their clients not only in courtroom litigation but also before administrative boards. Attorneys may be called on to represent their corporate clients in negotiations with labor unions or with other firms.

Corporate attorneys also serve as advisors or counselors, reviewing proposed corporate activities and advising management of legal problems that may arise as a result of such activities. In-house counsel familiar with the various activities of the firm are often in the best position to fulfill this role. Thus, businesspersons should attempt to establish a good working relationship with in-house counsel, using them as a resource whenever legal issues arise. Managers should not assume that they know all the legal ramifications of all the business activities in which they engage. Most in-house counsel would prefer to be consulted before an activity is undertaken rather than after it results in a legal problem.

Finally, the attorney may serve as a draftsperson, drawing up contracts, deeds, the corporate charter, securities registration statements, and all other legal documents needed by the corporation. Thus, it is clear that the attorney is one actor in the American legal system who is of special importance to the business manager.

THE JUDGE

The role of the judge is especially important in our legal system. The judge’s function depends on whether he or she is a trial or appellate court judge. A trial court judge presides over the trial, making sure the case is heard with reasonable speed; rules on all motions made in the case; and decides all questions of law. One of the most crucial functions of the trial court judge is ruling on whether evidence is admissible. A judge’s failure or refusal to admit certain items into evidence may determine the outcome of a case, and a judge’s ruling on any particular piece of evidence may subsequently become the basis for the appeal of an unfavorable decision. If the parties waive their rights to a jury trial, or if they are not entitled to a jury, the judge also decides the facts in the case and renders a decision accordingly. A single judge presides over each case.

Appellate judges serve on panels. They review lower-court cases to determine whether errors of law were committed by the lower courts. Their review consists primarily of reading the transcript of the trial, reading written arguments by counsel for both parties, and sometimes hearing oral arguments from both parties’ attorneys.

State court judges are usually elected, although some are appointed, whereas federal court judges are appointed by the president with the advice and consent of the Senate. This appointment process is a good example of how the legislative
and executive branches serve as checks on each other. The president has the
greatest role because he makes the nomination, but he cannot choose just any-
one. The president will usually select a list of potential nominees who will then
be rated by a committee of the American Bar Association. The bar association
looks at the nominees’ legal experience and reads their written opinions and
published articles in an attempt to ensure that only the most qualified candidates
will be named to the federal bench. The Senate also scrutinizes the list and gives
the president some idea, in advance, of whether the various potential nominees
have a high likelihood of being confirmed.

Once the president actually makes a nomination, the Senate judiciary sub-
committee holds formal hearings on the nominee’s fitness for office. After the
hearings, the full Senate votes on the nomination. Although the president gen-
erally tries to nominate someone with an ideological background to his own, if
the Senate is dominated by the opposite political party, a nominee who has too
strong an ideology is not likely to be confirmed. In recent years, the appoint-
ment process has become familiar to most Americans as the hearings on
Supreme Court nominees have been televised. Federal court judges serve for
life, whereas state court judges generally serve definite terms, the length of
which varies from state to state.

There is a lot of debate over whether judges should be appointed for life or
elected for specific terms. The rationale behind appointment for life is that it takes
the politics out of the judicial process. A judge will be selected based on his or
her credentials as opposed to the quality of his or her campaign skills or the size
of the campaign budget. Once in office, the judge is free to make honest deci-
sions without having to worry about the impact of any decision on reelection.

Of course, this independence is just what makes some people prefer elected
judges. They point out that the members of every other branch of government are
elected and are, therefore, forced to represent the will of the people; they argue that
judges should represent the people no less than members of the other branches.

**The Power of Judicial Review.** One very important power that judges have is
the power of *judicial review*, that is, the power to determine whether a law
passed by the legislature violates the Constitution. Any law that violates the Con-
stitution must be struck down as null and void. The justices of the U.S. Supreme
Court are the final arbiters of the constitutionality of our statutory laws.

This power of judicial review was not explicitly stated in the Constitution.
Rather, it was established in the classic 1803 case of *Marbury v. Madison*,\(^3\)
wherein the Supreme Court stated:

> It is emphatically the province and duty of the judicial department to say what
> the law is. Those who apply the rule to particular cases must of necessity
> expound and interpret that rule. If two laws conflict with each other, the courts
> must decide which of these conflicting rules governs the case. This is of the very
> essence of judicial duty.

When individual justices exercise this power of judicial review, they do so
with different philosophies and attitudes. Their philosophies can have a power-
ful effect on how they make decisions. One distinction frequently made with re-
spect to judicial philosophies is the difference between a judge who believes in
*judicial activism* and one who believes in *judicial restraint*.

A judge who believes in *judicial restraint* believes that the three branches
are coequal, and the judiciary should refrain from determining the constitution-
ality of an act of Congress unless absolutely necessary, to keep from interfering
in the congressional sphere of power. These judges tend to believe that social,

---

\(^3\) 5 U.S. 137 (1805).
economic, and political change should result from the political process, not from judicial action. They consequently give great deference to actions of the state and federal legislatures.

Those who believe in judicial restraint are much less likely to overturn an existing precedent. They tend to focus much more on the facts than on questioning whether the law should be changed. They tend to uphold lower-court decisions unless those decisions are clearly wrong on the facts.

In contrast, judicial activists tend to see a need for the courts to take an active role in encouraging political, economic, and social change, because the political process is often too slow to bring about necessary changes. They believe that constitutional issues must be decided within the context of today’s society and that the framers meant for the Constitution to be an evolving document.

Judicial activists are much less wedded to precedent and are more result oriented. They are much more likely to listen to arguments about what result is good for society. Activist judges have been responsible for many social changes, especially in the civil rights area.

**THE JURY**

The jury is the means by which citizens participate in our judicial system. It had its roots in ancient Greek civilization, and it is often seen as the hallmark of democracy. A jury is a group of individuals, selected randomly from the geographic area in which the court is located, who will determine questions of fact. There are two types of juries: petit and grand.

**Petit Juries.** Businesspersons are primarily concerned with petit juries. These juries serve as the finders of fact for trial courts. Though originally composed of 12 members, most juries in civil cases are allowed to have fewer members in many jurisdictions. Traditionally, jury decisions had to be unanimous. Today, however, more than half the jurisdictions no longer require unanimity in civil cases. This change in the jury system has been made primarily to speed up trial procedures.

An important decision to be made by any corporate client and his or her attorney is whether to have a jury. In any civil action in which the plaintiff is seeking a remedy at law (money damages), a jury may hear the case. If both parties to the case agree, however, the jury may be waived, and a judge decides the facts of the case. There is no hard-and-fast rule about when a businessperson should opt for a jury, but a few factors should frequently be considered. One is the technical nature of the case. If the matter is highly technical, a judge may be able to decide the case more fairly, especially if that judge has expertise in the area in dispute. Another factor is the emotional appeal of the case. If the opponent’s arguments in the case may have strong emotional appeal, a judge may render a fairer decision.

**Grand Juries.** Grand juries are used only in criminal matters. The Fifth Amendment requires that all federal prosecutions for “infamous” crimes (including all federal offenses that carry a term of imprisonment in excess of one year) be commenced with an indictment (a formal written accusation of the commission of a crime, which must be made before a defendant can be tried for the crime) by a grand jury. This jury hears evidence presented by the prosecutor and determines whether there is enough evidence to justify charging a defendant. The prudent business manager who carefully heeds the advice of an attorney should not be faced with a potential indictment by a grand jury. Increasingly, however, corporate managers are facing criminal charges for actions taken to benefit their corporate employers. Such cases are discussed in Chapter 7.
The Adversary Process

Our system of litigation is accurately described as an adversary system. In an adversarial system, a neutral factfinder, such as a judge or jury, hears evidence and arguments presented by both sides and then makes an objective decision based on the facts and the law as presented by the proponents of each side. Strict rules govern the types of evidence that the factfinder may consider.

Theoretically, the adversary system is the best way to bring out the truth, because each side will aggressively seek all the evidence that supports its position. Each side attempts to make the strongest possible argument for its position.

CRITICISMS OF THE ADVERSARY SYSTEM

Many people criticize this system. They argue that because each side is searching only for evidence that supports its position, a proponent who discovers evidence helpful to the other side will not bring such evidence to the attention of the court. This tendency to ignore contrary evidence prevents a fair decision—one based on all the available evidence—from being rendered.

Another argument of the critics is that the adversary process is extremely time-consuming and costly. Two groups of “investigators” are seeking the same evidence. Thus, there is a duplication of effort that lengthens the process and unnecessarily increases the cost.

Others argue that the adversary system, as it functions in this country, is unfair. Each party in the adversarial process is represented by an attorney. Having the most skillful attorney is a tremendous advantage. The wealthier a party is, the better the attorney she or he can afford to hire; hence, the system unjustifiably favors the wealthy.

Law professor Marc Galanter has written an interesting critique of our adversary system that has generated a lot of discussion. He argues that, given the structure of our system, certain parties tend to have a distinct advantage. Galanter divides litigants into two groups: the repeat players (RPs), those who are engaged in similar litigations over time; and the one-shotters (OSs), those who have only occasional recourse to the courts. RPs would typically be large corporations, financial institutions, landlords, developers, government agencies, and prosecutors. Typical OSs would be debtors, employees with grievances against their employers, tenants, and victims of accidents.

According to Galanter, the RPs have a distinct advantage over the OSs in litigation. Because of their experience, RPs are better prepared for trial; they know what kinds of records to keep and how to structure transactions so that they will have an advantage in court. RPs will have developed expertise in the area and will have access to specialists. They will have low “start-up costs” for a case because they have been through it before. RPs will have developed helpful informal relationships with those at the courthouse. RPs know the odds of success better because of their experience and can use that knowledge to calculate whether to settle. Finally, RPs can litigate for favorable rulings or for an immediate outcome.

Thus, in a typical case involving an RP and an OS, the RP has a distinct advantage. Some people believe this advantage is significant enough to prevent our current system from dispensing justice in these cases.

---

Steps in Civil Litigation and the Role of Businesspersons

THE PRETRIAL STAGE

Every lawsuit is the result of a dispute. Business disputes may result from a breach of contract, the protested firing of an employee, or the injury of a consumer who uses the corporation’s product. This section focuses on dispute resolution in this country under the adversary system. It examines the procedure used in a civil case, the stages of which are outlined in Exhibit 3-4. The rules that govern such

EXHIBIT 3-4
ANATOMY OF A CIVIL LAWSUIT

1. Plaintiff files complaint, which is served on defendant along with summons.
2. Defendant files answer, counterclaim, and/or motion to dismiss.
3. Plaintiff may file a reply to defendant’s counterclaim.
4. Plaintiff or defendant may file a motion for judgment on the pleadings or motions for preliminary relief.
5. Discovery occurs, including interrogatories, requests for production of documents, and depositions.
6. Plaintiff or defendant may file a motion for summary judgment.
7. Pretrial conference is held.
8. The trial occurs. The plaintiff’s case is presented, followed by the defendant’s case.
9. In a trial by jury, the judge instructs the jury; they recess to make their findings, and then return their verdict.
10. After a jury trial, the losing party may file a posttrial motion, such as motion for a new trial or a motion for a judgment notwithstanding the verdict.
11. The judge hands down the judgment.
12. Losing party may appeal judgment of the trial court.
proceedings are called the rules of civil procedure. There are federal rules of civil procedure, which apply in all federal courts, as well as state rules, which apply in the state courts. Most of the state rules are based on the federal rules.

**Informal Negotiations.** For the businessperson involved in a dispute, the first step is probably to discuss the dispute directly with the other party. When it appears that the parties are not going to be able to resolve the problem themselves, the businessperson will then discuss the dispute with an attorney. It is important that the attorney be given all relevant information, even if it does not make the businessperson look good. The more relevant facts the attorney has, the better the attorney’s advice will be. Together, the attorney and the client may be able to resolve the dispute informally with the other party.

**Initiation of a Legal Action.** Once a party decides that an informal resolution is not possible, the parties enter what is often called the pleading stage of the lawsuit. **Pleadings** are papers filed by a party in court and then served on the opponent. The basic pleadings are the complaint, the answer, the counterclaim, and the motion to dismiss. Exhibit 3-5 provides an illustration of a typical

**EXHIBIT 3-5**

**COMPLAINT**

THE COURT OF COMMON PLEAS
OF LUCAS COUNTY, OHIO

_Pam Streets, Plaintiff v. Daniel Lane, Defendant_

COMPLAINT FOR NEGLIGENCE
Case No. ____________

Now comes the plaintiff, Pam Streets, and, for her complaint, alleges as follows:

1. Plaintiff, Pam Streets, is a citizen of Lucas County, in the state of Ohio, and Defendant, Daniel Lane, is a citizen of Lucas County in the state of Ohio.
2. On December 1, 1987, the Plaintiff was lawfully driving her automobile south on Main Street in Toledo, Ohio.
3. At approximately 4:00 p.m., on December 1, 1987, the Defendant negligently ran a red light on Starr Avenue, and as a result crashed into Plaintiff’s car.
4. As a result of the collision, the Plaintiff suffered lacerations to the face and a broken leg, incurring $10,000 in medical expenses.
5. As a result of the above described collision, her car was damaged in the amount of $12,000.
6. As a result of the foregoing injuries, the Plaintiff was required to miss eight weeks of work, resulting in a loss of wages of $2,400.

WHEREFORE, Plaintiff demands judgment in the amount of $24,400, plus costs of this action.

Sam Snead
Attorney for Plaintiff
124 East Broadway
Toledo, OH 43605

JURY DEMAND

Plaintiff demands a trial by jury in this matter.

Sam Snead
Attorney for Plaintiff
complaint. The attorney of the businessperson who feels that he or she has been wronged initiates a lawsuit by filing a complaint in the appropriate court. A complaint is a document that states the names of the parties to the action, the basis for the court's subject matter jurisdiction, the facts on which the party's claim is based, and the relief that the party is seeking. Remember that the party on whose behalf the complaint is filed is the plaintiff, and the defendant is the party against whom the action is being brought.

In determining the appropriate court in which to file the complaint, the attorney must determine which court has subject matter jurisdiction over the case. Once that determination has been made, the attorney must ascertain the proper venue for the case. The means used by the attorney to determine subject matter jurisdiction and venue were discussed earlier in this chapter.

**Service of Process.** Once the complaint is filed, the court serves a copy of the complaint and a summons on the defendant. The reader should remember that service is the procedure used by the court to ensure that the defendant actually receives a copy of the summons and the complaint. Service of process gives the court in personam jurisdiction over the defendant and provides the notice of the charges required by the defendant’s due process rights.

**Defendant’s Response.** Once the defendant has been properly served, he or she files an answer and possibly a counterclaim. The answer is a response to the allegations in the plaintiff’s complaint. The answer must admit, deny, or state that the defendant has no knowledge about the truth of each of the plaintiff's allegations. The answer may also contain affirmative defenses, which consist of facts that were not stated in the complaint that would provide justification for the defendant's actions and a legally sound reason to deny relief to the plaintiff. These defenses must be stated in the answer. If they are not raised in the answer, the court may choose not to allow these defenses to be raised later. The defendant is required to plead his or her affirmative defenses in the answer in order to give the plaintiff notice of all the issues that will be raised at the trial.

As an illustration, two affirmative defenses to a breach-of-contract action might be that the plaintiff procured the defendant’s signature on the contract through fraud and that the contract was illegal because its enforcement would result in a violation of the antitrust laws. As another example, suppose that a manufacturer is being sued because the plaintiff was injured by the manufacturer’s negligently produced defective product. The defendant manufacturer might raise the affirmative defense of contributory negligence, arguing that the plaintiff’s injury would not have occurred if the plaintiff had not also been negligent. Notice the use of an affirmative defense in the sample answer in Exhibit 3-6. It is important that the businessperson who is being sued immediately try to think of any potential affirmative defenses that might excuse his or her actions.

Upon receiving the complaint, a defendant may believe that even if all of the plaintiff’s factual allegations were true, the plaintiff would still not be entitled to a favorable judgment. In that situation, the defendant may file a **motion to dismiss**. No factual issues are being debated, so the judge accepts the facts as stated by the plaintiff and makes a ruling on the legal questions in the case. Judges are generally not receptive to such motions, granting them only when it appears beyond doubt that the plaintiff can prove no set of facts, in support of his or her claim, that would entitle him or her to relief.

If the defendant believes that he or she has a cause of action against the plaintiff, this will be included as a **counterclaim**. The form of a counterclaim is just like that of a complaint. The defendant states the facts supporting his or her claim and asks for the relief to which he or she feels entitled. Exhibit 3-6 also contains a counterclaim.

If the defendant files a counterclaim, the plaintiff generally files a reply. A **reply** is simply an answer to a counterclaim. In the reply, the plaintiff admits,
denies, or states that he or she is without knowledge of the truth of the facts asserted by the defendant in the counterclaim. Any affirmative defenses that are appropriate must be raised in the reply.

**Pretrial Motions.** The early pleadings just described serve to establish the legal and factual issues of the case. Once these issues have been established, either the plaintiff or the defendant may file a motion designed to bring the case to an early conclusion or to gain some advantage for the party filing the motion. A *motion* is simply a party’s request for the court to do something. A party may request, or move, that the court do almost anything pertaining to the case, such as a motion for some form of temporary relief until a decision has been rendered. For example, if a suit is brought over the right to a piece of property, the court may grant a motion prohibiting the current possessor of that property from...
sitting it. A party may file a motion to proceed in forma pauperis, which is a motion to proceed without payment of fees if the party feels it has good reasons for why the court should allow the case to proceed even if it does not have the money to pay the fees up front (the assumption being that after successful suit the party will be able to pay the fees. As noted earlier, a defendant may believe that even if everything the plaintiffs plead in their complaint were true, there would still be no legitimate basis for a lawsuit. In such a situation, the defendant may file a motion to dismiss.

Many of the really frivolous lawsuits that are filed are dismissed in response to pretrial motion. For example, in 2007, Jehovah J. God, Jesus J. Christ, the Jehovah Witness Foundation Inc., and William E. Moore filed a $9 million lawsuit against the University of Arizona, arguing that the university was using God’s autobiography, the Bible, without paying him royalties. In dismissing the case upon hearing of the motion to proceed in forma pauperis, the court said that the allegations were “both fanciful and factually frivolous,” a finding that is made when the facts alleged rise to the level of the irrational or wholly incredible, whether or not there are judicially recognized facts available to contradict them.5

When a party files any motion with the court, a copy is always sent to the opposing attorney. That attorney may respond to the motion, usually by requesting that the judge deny the motion. In many cases, the judge will simply rule on the motion, either granting or denying it. In some cases, the judge may hold a hearing at which the two sides orally present arguments.

**Discovery.** Once the initial pleadings and motions have been filed, the parties gather information from each other through discovery. As a result of discovery, each party should have knowledge of most of the facts in the case. This process is supposed to prevent surprises from occurring in the courtroom.

At this stage, the businessperson is frequently asked by his or her attorney to respond to the opponent’s discovery requests. There are a number of tools of discovery. One of the most common is interrogatories, which are a series of written questions that are sent to the opposing party, who must truthfully answer them under oath. The interrogatories are frequently accompanied by a request to admit certain facts. The attorney and the client work together to answer these interrogatories and requests for admission of facts.

Another discovery tool is the request to produce documents or other items. Unless the information requested is privileged or is irrelevant to the case, it must be produced. Photographs, contracts, written estimates, and forms that must be filed with governmental agencies are among the items that may be requested. One party may also request that the other party submit to a mental or physical examination. This motion will be approved only when the party’s mental or physical health is at issue in the case.

Finally, testimony before trial may be obtained by the taking of a deposition. At a deposition, a witness is examined under oath by attorneys. A court reporter (stenographer) records every word spoken by the attorneys and witnesses. The testimony is usually transcribed so that both parties have a written copy. If a businessperson is to be deposed in a case, it is very important that he or she and the attorney talk extensively about what kinds of questions may come up at the deposition and how such questions are to be answered. The party who requested the deposition is not only seeking information, but is also laying the groundwork for identifying any inconsistencies that may arise between a person’s testimony at the deposition and in court. If such inconsistencies exist, they will be brought to the attention of the factfinder and may result in a loss of credibility for the courtroom testimony.

Depositions may also be used when a potential witness is old or ill and may die before the trial. They are useful if witnesses may be moving or for some other reason may not be available at the time of the trial.

Parties must comply with discovery requests, or the court may order that the facts sought to be discovered be deemed admitted. Thus, it is important that the businessperson involved in litigation produce for the attorney all requested discovery material. An attorney who feels that certain material should not be discovered makes arguments about its lack of relevance to the case, but if the court disagrees, the information must be supplied.

**Pretrial Conference.** If the judge finds that questions of fact do exist, he or she usually holds a pretrial conference. This is an informal meeting of the judge with the lawyers representing the parties. At this meeting, they try to narrow the legal and factual issues and work out a settlement if possible. When a lawsuit begins, there are many conflicting assertions as to what events actually led up to the lawsuit. Questions about what actually happened are referred to as *questions of fact.* Many times, as a result of discovery, parties come to agree on most of the facts. Remaining factual disputes may often be resolved at the conference. Then the only questions left are how to apply the law to the facts and what damages, if any, to award.

By the time of the pretrial conference, the businessperson should have determined the limits on any settlement to which he or she is willing to agree and should have communicated those limits to his or her attorney, who may be able to reach a settlement at the conference. Judges frequently try very hard to help the parties reach agreement before trial. If no settlement can be reached, the attorneys and the judge discuss the administrative details of the trial, its length, the witnesses, and any pretrial stipulations of fact or law to which the parties can agree.

**THE TRIAL**

Once the pretrial stage has concluded, the next step is the trial. As stated previously, if the plaintiff is seeking a legal remedy (money damages), he or she usually entitled to a jury trial. The judge is the factfinder when an equitable remedy (an injunction or other court order) is being sought or the parties have waived their right to a jury. For example, when a plaintiff in a product liability action requests a judgment for $10,000 in medical expenses, he or she would be seeking a legal remedy and would be entitled to a jury trial. However, a plaintiff seeking an injunction, under the antitrust laws, to prohibit two defendant corporations from merging would be requesting an equitable remedy and thus would not be entitled to a jury. It is important for the business manager to determine at the outset whether a jury is desirable, because a jury must be demanded in the complaint.

The stages of the trial are (1) jury selection, (2) the opening statements, (3) the plaintiff’s case, (4) the defendant’s case, (5) the conference on jury instructions, (6) closing arguments, and (7) posttrial motions.

**Jury Selection.** An important part of a jury trial is the selection of the jury. A panel of potential jurors is selected randomly from a list of citizens. In the federal court system, voter lists are used. In a process known as *voir dire,* the judge or the attorneys, or both, question potential jurors to determine whether they could render an unbiased opinion in the case.

When a juror’s response to a question causes an attorney to believe that this potential juror cannot be unbiased, the attorney will ask that the potential juror be removed “for cause.” For example, in an accident case, a potential juror might reveal that he had been in a similar accident, or the potential juror may have filed a similar lawsuit against one of the defendant’s competitors five years ago. Attorneys are given an unlimited number of challenges for *voir dire* Process whereby the judge and/or the attorneys question potential jurors to determine whether they will be able to render an unbiased opinion in the case.
cause. In most states, each attorney is allowed to reject a minimal number of potential jurors without giving a reason. These rejections are called peremptory challenges.

The legitimate rationale for “peremptories” is that they recognize and accommodate (to a certain extent) a lawyer’s “gut reaction” to a potential juror who does not say anything that technically reveals a bias. Nevertheless, there has been some abuse of peremptories in the past. One potential source of abuse was to use peremptories to discriminate against certain classes of people, such as by race or gender.

In 1986, in the case of *Batson v. Kentucky,* the U.S. Supreme Court ruled that prosecutors could not use race-based peremptory challenges in criminal cases. Subsequently, the Supreme Court extended the ban to the use of race-based challenges by either party in civil cases. Several unsuccessful attempts were made to extend the prohibition to challenges based on gender. Finally, in 1994, the Court in the following case extended the equal protection guarantee to cover gender.

**CASE 3-3**

**J.E.B. v. Alabama, ex rel. T.B.**

Supreme Court of the United States

511 U.S. 127 (1994)

On behalf of T.B., the unwed mother of a minor child, the State of Alabama filed a complaint for paternity and child support against J.E.B. A panel of 12 males and 24 females was called by the court as potential jurors. After the court removed three individuals for cause, only 10 males remained. The state used its peremptory challenges to remove nine male jurors and J.E.B. removed the tenth, resulting in an all-female jury. The court rejected J.E.B.’s objection to the gender-based challenges, and the jury found J.E.B. to be the father.

J.E.B. appealed to the court of appeals, who affirmed the trial court’s decision that the Equal Protection Clause does not prohibit gender-based challenges. The Alabama Supreme Court denied certiorari, and J.E.B. then appealed to the U.S. Supreme Court.

**Justice Blackmun**

Today we reaffirm what should be axiomatic: Intentional discrimination on the basis of gender by state actors violates the Equal Protection Clause, particularly where, as here, the discrimination serves to ratify and perpetuate invidious, archaic, and overbroad stereotypes about the relative abilities of men and women.

Discrimination on the basis of gender in the exercise of peremptory challenges is a relatively recent phenomenon. Gender-based peremptory strikes were hardly practicable for most of our country’s existence, since, until the 20th century, women were completely excluded from jury service.

Many States continued to exclude women from jury service well into the present century, despite the fact that women attained suffrage upon ratification of the Nineteenth Amendment in 1920.

Despite the heightened scrutiny afforded distinctions based on gender, respondent argues that gender discrimination in the selection of the petit jury should be permitted, though discrimination on the basis of race is not. Respondent suggests that “gender discrimination in this country . . . has never reached the level of discrimination” against African-Americans, and therefore gender discrimination, unlike racial discrimination, is tolerable in the courtroom.

While the prejudicial attitudes toward women in this country have not been identical to those held toward racial minorities, the similarities between the experiences of racial minorities and women, in some contexts, “overpower those differences.” Certainly, with respect to jury service, African-Americans and women share a history of total exclusion.

Discrimination in jury selection, whether based on race or on gender, causes harm to the litigants, the community, and the individual jurors who are wrongfully excluded from participation in the judicial process. The litigants are harmed by the risk that the prejudice which motivated the discriminatory selection of the jury will infect the entire proceedings. The community is harmed by the State’s participation in the perpetuation of invidious group stereotypes and the inevitable loss of confidence in our judicial system that state-sanctioned discrimination in the courtroom engenders.

---

When state actors exercise peremptory challenges in reliance on gender stereotypes, they ratify and reinforce prejudicial views of the relative abilities of men and women. Because these stereotypes have wreaked injustice in so many other spheres of our country’s public life, active discrimination by litigants on the basis of gender during jury selection “invites cynicism respecting the jury’s neutrality and its obligation to adhere to the law.”

In recent cases we have emphasized that individual jurors themselves have a right to nondiscriminatory jury selection procedures.

As with race-based *Batson* claims, a party alleging gender discrimination must make a prima facie showing of intentional discrimination before the party exercising the challenge is required to explain the basis for the strike. When an explanation is required, it need not rise to the level of a “for cause” challenge; rather, it merely must be based on a juror characteristic other than gender, and the proffered explanation may not be pretextual.

Equal opportunity to participate in the fair administration of justice is fundamental to our democratic system. It reaffirms the promise of equality under the law—that all citizens, regardless of race, ethnicity, or gender, have the chance to take part directly in our democracy. When persons are excluded from participation in our democratic processes solely because of race or gender, this promise of equality dims, and the integrity of our judicial system is jeopardized.

In view of these concerns, the Equal Protection Clause prohibits discrimination in jury selection on the basis of gender, or on the assumption that an individual will be biased in a particular case for no reason other than the fact that the person happens to be a woman or happens to be a man. As with race, the “core guarantee of equal protection, ensuring citizens that their State will not discriminate . . ., would be meaningless were we to approve the exclusion of jurors on the basis of such assumptions, which arise solely from the jurors’ [gender].”

*Reversed and remanded in favor of Defendant, J.E.B.*

**Justice Scalia, Dissenting**

Today’s opinion is an inspiring demonstration of how thoroughly up-to-date and right-thinking we Justices are in matters pertaining to the sexes, and how sternly we disapprove the male chauvinist attitudes of our predecessors. The price to be paid for this display—a modest price, surely—is that most of the opinion is quite irrelevant to the case at hand. The hasty reader will be surprised to learn, for example, that this lawsuit involves a complaint about the use of peremptory challenges to exclude men from a petit jury. To be sure, petitioner, a man, used all but one of his peremptory strikes to remove women from the jury (he used his last challenge to strike the sole remaining male from the pool), but the validity of his strikes is not before us. Nonetheless, the Court treats itself to an extended discussion of the historic exclusion of women not only from jury service, but also from service at the bar (which is rather like jury service, in that it involves going to the courthouse a lot). All this, as I say, is irrelevant since the case involves state action that allegedly discriminates against men.

The Court also spends time establishing that the use of sex as a proxy for particular views or sympathies is unwise and perhaps irrational. The opinion stresses the lack of statistical evidence to support the widely held belief that, at least in certain types of cases, a juror’s sex has some statistically significant predictive value as to how the juror will behave. This assertion seems to place the Court in opposition to its earlier Sixth Amendment “fair cross-section” cases. (“Controlled studies . . . have concluded that women bring to juries their own perspectives and values that influence both jury deliberation and result.”)

Of course the relationship of sex to partiality would have been relevant if the Court had demanded in this case what it ordinarily demands: that the complaining party have suffered some injury. Leaving aside for the moment the reality that the defendant himself had the opportunity to strike women from the jury, the defendant would have some cause to complain about the prosecutor’s striking male jurors if male jurors tend to be more favorable towards defendants in paternity suits. But if men and women jurors are (as the Court thinks) fungible, then the only arguable injury from the prosecutor’s “impermissible” use of male sex as the basis for his peremptories is injury to the stricken juror, not to the defendant. Indeed, far from having suffered harm, petitioner, a state actor under precedents, has himself actually inflicted harm on female jurors. The Court today presumably supplies petitioner with a cause of action by applying the uniquely expansive third-party standing analysis of according petitioner a remedy because of the wrong done to male jurors. Insofar as petitioner is concerned, this is a case of harmless error if there ever was one; a retrial will do nothing but divert the State’s judicial and prosecutorial resources, allowing either petitioner or some other malefactor to go free.

The core of the Court’s reasoning is that peremptory challenges on the basis of any group characteristic subject to heightened scrutiny are inconsistent with the guarantee of the Equal Protection Clause. That conclusion can be reached only by focusing unrealistically upon individual exercises of the peremptory challenge, and ignoring the totality of the practice. Since all groups are subject to the peremptory challenge (and will be made the object of it), depending upon the nature of the particular case, it is hard to see how any group is denied equal protection.

Even if the line of our later cases guaranteed by today’s decision limits the theoretically boundless *Batson* principle to race, sex, and perhaps other classifications subject to heightened scrutiny, much damage has been done. It has been done, first and foremost, to the peremptory challenge system, which loses its whole character when (in order to defend against “impermissible stereotyping” claims) “reasons” for strikes must be given. The right of peremptory challenge “is,” as Blackstone says, “an arbitrary and capricious right; and it must be exercised with full freedom, or it fails of its full purpose.”

And damage has been done, secondarily, to the entire justice system, which will bear the burden of the expanded quest for “reasoned peremptories” that the Court demands. The extension of *Batson* to sex, and almost certainly beyond, will provide the basis for extensive collateral litigation . . . Another consequence, as I have
PART ONE
Introduction to the Law and the Legal Environment of Business

The voir dire process has changed significantly over the years, and to many lawyers, a successful voir dire is the essential element in winning a case. Jury selection today has become a “science,” and in most cases involving large potential judgments, at least one side, and often both, use a professional jury selection service. An example of one such service is Litigation Sciences, a firm established in 1979. By 1989, 10 years later, the firm claimed to have handled more than 900 cases, with a win figure of 90 to 95 percent. It employed a full-time staff of more than 100, and the average cost of its services was approximately $200,000, although some cases ran into the millions.7 Its clients include both major law firms and corporations.

Some of the services include identifying demographic data to help lawyers build a profile of the ideal juror, helping design questions for the lawyers to ask during voir dire, and providing such post–voir dire services as mock juries and shadow juries.

A **mock jury** is a body of individuals whose demographic makeup matches that of the actual jury. The lawyers practice their case before the mock jury to find out how receptive the “jurors” are to their arguments and how the mock jurors relate to the witnesses. Lawyers can gain valuable information about what they need to change before actually presenting the case. Depending on how much money a client has, lawyers may go through multiple “trials” before a mock jury.

A **shadow jury** again matches the demographics of the real jury, but the shadow jury actually sits in the courtroom during the trial. They “deliberate” at the end of each day, so the lawyer has an ongoing idea of how the case is faring. The shadow jury's deliberations may let a lawyer know when damage has been done to the case that should be repaired. After the trial is finished, the shadow jury deliberates for a predetermined, brief period. Their “verdict” then helps the lawyer decide whether to try to settle the case before the jury comes back with a verdict. (Remember, the parties can agree to settle at any time until the judge hands down the final decision in the case.)

You can see from this brief discussion how valuable a jury selection service can be. You can also see why many argue that such services should not be allowed. After all, they give a tremendous advantage to the client with more money to spend on the trial.

**Opening Statements.** Once a jury has been impaneled, or selected, the case begins with the opening statements. Each party’s attorney explains to the judge and the jury what facts he or she intends to prove, the legal conclusions to which these facts will lead, and how the case should be decided.

**Plaintiff’s Case.** The plaintiff then presents his or her case, which consists of examining witnesses and presenting evidence. The procedure for each witness

---

The reasoning in Case 3-3 is played out with *Batson v. Kentucky* standing tall and visible in the background. The legal system reinforces our ethical preference for order. The resulting dependability of our legal rules serves as a guide for business decisions, facilitating the many transactions required by modern business.

Nevertheless, the courts recognize that rules must evolve as our social needs and understandings change. Hence, the courts must struggle with achieving a balance between order and flexibility. *J.E.B.* provides an opportunity to use our critical thinking skills to see this tension in action.

1. **What facts in our society have become more visible such that Justice Blackmun feels it appropriate to expand the application of *Batson*?**

   **Clue:** What about our history makes Blackmun’s reasoning less likely to have been the basis for a Supreme Court decision in 1950?

2. **Justice Blackmun disagrees with the respondent concerning the comparative “level of discrimination” experienced by nonwhites and women. Legal reasoning frequently contains phrases like *level of discrimination* that require some numerical determination—but recognize that clear numbers measuring such a level are hard to come by. As critical thinkers, you can often see soft spots in reasoning by asking, “Now, how are they measuring that concept?” Could you help Justice Blackmun measure “level of discrimination” by suggesting what data might be useful for this determination?**

   **Clue:** Start with the number of people potentially affected, the probability that they would be affected, and the extent of the harm.

3. **Justice Scalia does not categorically disagree with extension of *Batson*. What facts would have had to be different for Scalia to have concurred with the majority?**

   **Clue:** Find the section in his dissent in which he explains the inadequacies in the majority’s reasoning.

is the same. First, the plaintiff’s attorney questions the witness in what is called *direct examination*. The plaintiff’s lawyer asks questions designed to elicit from the witnesses facts that support the plaintiff’s case. The opposing counsel may then cross-examine the witness, but may ask only questions pertaining to the witness’s direct examination. The purpose of cross-examination is often to “poke holes” in the witness’s testimony or to reduce the credibility of the witness. The plaintiff’s attorney then has the opportunity for *redirect examination* to repair any damage done by the cross-examination. The opposing counsel then has a last opportunity to cross-examine the witness to address facts brought out in redirect examination. This procedure is followed for each of the plaintiff’s witnesses.

Immediately following the plaintiff’s case, the defendant may make a motion for a directed verdict. In making such a motion, the defendant is stating to the court that even if all the plaintiff’s factual allegations are true, the plaintiff has not proved his or her case. For example, as will be discussed in Chapter 12, to prove a case of negligence, the plaintiff must prove that the defendant breached his or her duty to the plaintiff, causing compensable injury. If the plaintiff offers no evidence of any compensable injury, then there can be no judgment for the plaintiff. In such a case, a motion for a directed verdict would be granted, and the case would be dismissed. Such motions are rarely granted, because the plaintiff usually introduces some evidence of every element necessary to establish the existence of his or her case.

A motion for a directed verdict also may be made by either party after the presentation of the defendant’s case. The party filing the motion (the moving party) is saying that even if the judge looks at all the evidence in the light most favorable to the other party, it is overwhelmingly clear that the only decision the jury could come to is that the moving party is entitled to judgment in his or her favor.
**Defendant's Case.** If the defendant's motion for a directed verdict is denied, the trial proceeds with the defendant's case in chief. The defendant's witnesses are questioned in the same manner as were the plaintiff's, except that it is the defendant's attorney who does the direct and redirect examinations, and the plaintiff's attorney is entitled to cross-examine the witnesses.

**Conference on Jury Instructions.** If the case is being heard by a jury, the attorneys and the judge then retire for a conference on jury instructions. *Jury instructions* are the court's explanation to the jury of what legal decision they must make if they find certain facts to be true. Each attorney presents to the judge the set of jury instructions he or she feels will enable the jury to accurately apply the law to the facts. Obviously, each attorney tries to state the law in the manner most favorable to his or her client. The judge confers with the attorneys regarding their proposed instructions and then draws up the instructions for the jury.

**Closing Arguments.** The attorneys' last contact with the jury then follows, as they present their closing arguments. The party who has the burden of proof, the plaintiff, presents the first closing argument; the defendant's closing argument follows. Finally, the plaintiff is entitled to a *rebuttal*. The judge then reads the instructions to the jury, and the jurors retire to the jury room to deliberate. When they reach a decision, the jurors return to the courtroom, where their verdict is read.

**Posttrial Motions.** The party who loses has a number of options. A motion for a judgment notwithstanding the verdict may be made. This motion is a request for the judge to enter a judgment contrary to that handed down by the jury on the ground that, as a matter of law, the decision could only have been different from that reached by the jury. For example, if a plaintiff requests damages of $500 but introduces evidence of only $100 in damages, the jurors cannot award the plaintiff the $400 for unsubstantiated damages. If they do so, the defendant would file a motion for a judgment notwithstanding the verdict. Alternatively, the dissatisfied party may file a motion for a new trial, on the ground that the verdict is clearly against the weight of the evidence. If neither of these motions is granted and the judge enters a judgment in accordance with the verdict, the losing party may appeal the decision.

**APPELLATE PROCEDURE**

As explained earlier, the court to which the case is appealed depends on the court in which the case was originally heard. If a case was heard in a federal district court, it is appealed to the U.S. Circuit Court of Appeals for the geographic region in which the district court is located. If heard in a state trial court, the case is appealed to that state’s intermediate appellate court or, if none exists, to the state’s final appellate court.

To appeal a case, the losing party must allege that a prejudicial error of law occurred during the trial. A *prejudicial error* is one that is so substantial that it could have affected the outcome of the case. For example, the judge may have ruled as admissible in court certain evidence that had a major impact on the decision, when that evidence was legally inadmissible. Or the party may argue that the instructions the judge read to the jury were inaccurate and resulted in a misapplication of the law to the facts.

When a case is appealed, there is not a new trial. The attorney for the appealing party (the *appellant*) and the attorney for the party who won in the lower court (the *appellee*) file *briefs*, or written arguments, with the court of appeals. They also generally present oral arguments before the appeals court. The court considers these arguments, reviews the record of the case, and renders a decision. The decisions of the appellate court can take a number of forms. The court
may accept the decision of the lower court and affirm that decision. Alternatively, the appellate court may conclude that the lower court was correct in its decision, except for granting an inappropriate remedy, and so it will modify the remedy. If the appellate court decides that the lower court was incorrect in its decision, that decision will be reversed. Finally, if the appeals court feels that an error was committed, but it does not know how that error would have affected the outcome of the case, it will remand the case to the lower court for a new trial.

Although the appeals procedure may sound relatively simple compared with the initial trial procedure, appeals require a great deal of work on the part of the attorneys. They are consequently expensive. Thus, when deciding whether to appeal, the businessperson must consider how much money he or she wishes to spend. If a judgment is rendered against a businessperson, it may be less expensive to pay the judgment than to appeal.

Another factor to consider when one is deciding whether to appeal is the precedential value of the case. The case may involve an important issue of law that a party hopes may be decided in her or his favor by an appeals court. If she or he anticipates similar suits arising in the future, it may be important to get a favorable ruling, and if the case appears to be strong, an appeal may be desirable.

Appellate courts, unlike trial courts, are usually composed of a bench of at least three judges. There are no juries. The decision of the appeals court is determined by the majority of the judges. One of the judges who votes with the majority records the court’s decision and their reasons in what is called the majority opinion. These have precedential value; they are used by judges to make future decisions and by attorneys in advising their clients as to the appropriate course of behavior in similar situations. If any of the judges in a case agrees with the ultimate decision of the majority but for different reasons, he or she may write a concurring opinion, stating how this conclusion was reached. Finally, the judge or judges disagreeing with the majority may write dissenting opinions, giving their reasons for reaching a contrary conclusion. Dissenting opinions may be cited in briefs by attorneys arguing that the law should be changed. Dissents may also be cited by an appellate judge who decides to change the law.

For most cases, only one appeal is possible. In some states in which there is both an intermediate and a superior court of appeals, a losing party may appeal from the intermediate appellate court to the state supreme court. In a limited number of cases, a losing party may be able to appeal from a state supreme court or a federal circuit court of appeals to the U.S. Supreme Court.

**Appeal to the U.S. Supreme Court.** Every year, thousands of individuals attempt to have their appeals heard by the U.S. Supreme Court. The Court hears, however, only about 80 cases every year on average. When a party wishes to have its case heard by the highest court in the nation, it files a petition with the Court, asking it to issue a writ of certiorari, which is an order to the lower court to send the record of the case to the Supreme Court.

As you may guess from the number of cases heard by the Supreme Court, very few writs are issued. The Justices review the petitions they receive and will issue a writ only when at least four Justices vote to hear the case. The Court is most likely to issue a writ when (1) the case presents a substantial federal question that has not yet been addressed by the Supreme Court; (2) the case involves a matter that has produced conflicting decisions from the various circuit courts of appeal and is, therefore, in need of resolution; (3) a state court of last resort holds that a federal law is invalid or upholds a state law that has been challenged as violating federal law; or (4) a federal court has ruled that an act of Congress is unconstitutional.

It is often difficult to predict whether the Court will hear a case. In the first instance in the preceding list, for example, a federal question is simply an issue...
arising under the federal Constitution, treaties, or statutes. Substantiality is more difficult to define. If the decision would affect a large number of people or is likely to arise again if not decided, it may be considered substantial. Sometimes, however, a case may in fact involve a very important federal question of statutory interpretation, yet the Supreme Court may believe that the problem was unclear drafting by Congress, and so it may choose not to hear the case in anticipation of an amendment of the federal statute whose interpretation is at issue. If the Supreme Court refuses to hear a case, this refusal has no precedential effect.

CLASS ACTIONS

In discussing the stages of civil litigation, we have been talking as if there were only one plaintiff and one defendant, but multiple parties may join as plaintiffs and multiple parties may be named or joined as defendants. For example, if a person gets injured using a defective product, he or she would probably sue both the manufacturer and the retailer.

There is a special kind of case, however, in which the plaintiff is not a single party, or even a few parties, but rather a large group of individuals who may not even know each other but who all share a common complaint against the defendant. This kind of case is referred to as a class action. For example, all of the shareholders of a corporation may want to sue a member of the board of directors. One of the most common class actions involves product liability cases, situations in which numerous people injured by the same product join together to sue the manufacturer of that product. Other kinds of cases that may give rise to class action suits include discrimination claims and antitrust claims. Sometimes, people come together to bring a class action because their individual claims are so small that separate litigation really is not feasible; when all the claims are combined, though, the amount is large enough that it will be profitable for a lawyer to take the case.

Some see class actions as efficient because, instead of all the individuals filing and trying individual cases based on the same issue, all of the claims can be dealt with in one action. This efficiency seems even more significant when complex issues are involved and the costs of trial preparation are high. When a class action is brought, the case is usually filed in the name of one or two of the parties and all others who are similarly situated. The named plaintiffs in the case have to pay all the court costs, including the costs of finding the names and addresses of everyone in the class and notifying them.

The first step in a class action suit, which differentiates it from other suits, is certification of the class. The court will review the claims to ensure that all the named plaintiffs indeed share a common interest that can adequately be raised by the named plaintiffs. Defendants will often challenge the certification of the class, knowing that if the class does not get certified, the named plaintiffs may not have the resources to bring their cases as separate, individual actions.

Once the class has been certified, the parties often enter into settlement negotiations. The court will approve a classwide settlement only if it is fair and equitable and benefits the entire class, not just the named plaintiffs and their lawyers. Once a settlement has been approved by the court, it legally satisfies the claims of all the class members.

In an effort to reform class action lawsuits, Congress passed, and President Bush signed, the Class Action Fairness Act of 2005. The Class Action Fairness Act had several intended goals. First, it sought to limit the enormous legal fees attorneys representing plaintiff classes frequently receive as part of their service. Second, the act was written to allow the defendants in class action lawsuits to have greater access to federal courts. Finally, the act was intended to
As part of the new regulations on attorney fees, attorneys now receive compensation based on the actual amount class members claim as compensation, rather than on the gross sum awarded to the plaintiff class. In addition, the court must first approve the award the plaintiff class members are to receive to ensure that the award does not violate the defendants’ due process rights. If the attorney’s fees are not to be determined by the amount of the award, the attorney’s compensation is to be limited to actual time spent working on the case.

Moving beyond attorney’s fees, the Class Action Fairness Act changes the requirements for diversity of citizenship in class actions, as well as the general requirements for federal jurisdiction. The act provides federal courts with jurisdiction over any class action where there is partial diversity of citizenship; that is, if any of the class members is a citizen of a different state than any of the defendants, the federal courts have jurisdiction. The federal courts also have jurisdiction whenever any plaintiff or defendant is a foreign state or the citizen of a foreign state. These new requirements under the act allow more class actions to fall within federal jurisdiction and make it much harder for plaintiffs to pursue their actions in state courts. Business defendants are typically happy with this last change, as they tend to face smaller awards in federal courts than in state courts.

Despite the greater access to federal courts, the act also allows federal courts some discretion in accepting jurisdiction. A district court can choose not to accept jurisdiction over a class action if between one-third and two-thirds of the plaintiff class members and the primary defendants are citizens of the same state. There are also two situations in which the federal court has no choice regarding jurisdiction. When fewer than one-third of the plaintiff class members are residents of the same state as the primary defendants, then the class action will be subjected to federal jurisdiction. If more than two-thirds of the plaintiff class members are residents of the same state as the primary defendants, however, there will be no federal jurisdiction in the case.

As mentioned previously, the act contains a number of provisions that are intended to protect the interest of the individual plaintiff class members. For example, the act forbids any settlement that would result in a net loss to the class members. That is, class members cannot accept a settlement that does not cover their damages, unless the court decides that other, nonmonetary benefits are valuable enough to outweigh the net monetary loss. In addition, class members cannot be awarded different monetary amounts based upon their geographical location. All class members, barring differences in their actual damages, are awarded the same monetary amount.

**Global Dimensions of the American Legal System**

This chapter has focused on the American legal system. With the growth of multinational corporations and trade among nations, Americans may increasingly become involved in disputes in foreign nations, and foreigners will increasingly become involved in disputes with Americans and American corporations.

When parties make international agreements, they can incorporate as a term of the agreement their choice of which nation’s court will hear any disputes arising under the agreement. Because of differences between the U.S. litigation system and others, it is important to compare the procedures in each country before choosing a forum. For example, in Japan, there is no procedure comparable to discovery, so parties go to trial not knowing what evidence the other side has.
PART ONE • Introduction to the Law and the Legal Environment of Business

LINKING LAW AND BUSINESS

Management

In your management class, you may have learned about a concept known as cost-benefit analysis. This idea is defined as the process by which managers weigh the benefits or revenues of a particular activity in comparison to the costs of performing the action. Usually, managers will decide to pursue an action if the benefits outweigh the costs.

Managers or other decision makers can effectively come to a conclusion as to which alternative to pursue only after the options have been evaluated. Management texts often state that there are three basic steps decision makers should follow in this evaluation: (1) Estimate, as accurately as possible, the potential effects of each of the possible actions. (2) Assign probabilities to each of the expected effects of each decision if the idea were implemented. (3) Compare the possible effects of each alternative decision and the probabilities of each. Meanwhile, consideration should be given to organizational objectives. After taking these three steps, managers will have a better understanding about the benefits and risks of alternative decisions. Therefore, it is hoped that they will be able to understand which choice will be most advantageous to the organization.

A cost-benefit analysis can also be done when a businessperson is faced with the decision of whether to appeal a court decision. The businessperson should examine the costs of the appellate procedures, the probability of the outcome in the appeals court, and the time involved with the appeals process. Thereafter, the businessperson can choose the course that will potentially be most beneficial.

COMPARATIVE LAW CORNER

The Judicial System in Germany

The United States and Germany are major trading partners and have many similarities, but the German judicial system is very different from the American judicial system. German law is based on a civil-law tradition rather than a common-law tradition. The United States has a common-law system, which relies on precedents set by previous cases to rule on current cases. German judges make decisions based on the country’s extensive civil codes, rather than previous decisions. German judges are not elected as many American judges are; instead, most are appointed for life, after a probationary period.

The judicial system is a federal system, as in the United States, but German courts are separated by field. The ordinary courts hear most criminal and civil cases, each specialty courts (for labor, patents, social, administrative, and fiscal issues) hears cases related to its individual area, and constitutional courts hear cases involving constitutional issues. The courts all have local, land (state), and federal levels. The highest court in Germany is the Bundesverfassungsgericht, the Federal Constitutional Court, which deals only with constitutional issues, unlike the U.S. Supreme Court. Each specialty court has its own highest court of appeals, such as the Federal Court of Germany for the ordinary courts.

Germany does not have any jury trials; all cases are heard by a judge or a panel of judges. Also, the judges are the primary questioners of witnesses. Lawyers can question witnesses after the judges have finished. This legal factfinding method differs from the American method of examination and cross-examination.

With the increase in trade, many foreigners now purchase American goods. Because of differences between court systems, many citizens of foreign countries who have allegedly been injured by U.S. corporations prefer to sue in the United States. In Japan, for example, there are no contingency fees, and an injured plaintiff must pay his or her lawyer’s fees up front, at a cost of 8 percent of the proposed recovery plus nonrefundable court costs. Also, in Japan, there are no class actions.
Our American legal system is really composed of two systems: a federal system and a state system. When one has a legal dispute, subject matter jurisdiction determines which court system will hear the case. Almost all cases fall within the state court’s jurisdiction. Only the limited number of cases within the exclusive jurisdiction of the federal courts do not. A case may be heard in either court when there is concurrent jurisdiction. Concurrent jurisdiction exists when (1) the case involves a federal question, or (2) there is diversity of citizenship between the plaintiff and the defendant. Besides having subject matter jurisdiction, a court must also have in personam jurisdiction and proper venue to hear a case.

Cases are filed in courts of original jurisdiction. In the state system, these courts are usually called the courts of common pleas or county courts. In the federal system, the courts of original jurisdiction are called the district courts. In the state system, state courts of appeals and state supreme courts have appellate jurisdiction. Depending on the state, there may be either one or two levels of appeal. In the federal system, cases are appealed to the circuit court of appeals and then to the U.S. Supreme Court.

Cases are guided through the courts by attorneys. Juries act as finders of fact in trials. Judges resolve questions of law and, in bench trials, also serve as finders of fact.

There are four basic stages in a lawsuit. (1) In the pretrial stage, there are (a) informal negotiations, (b) pleadings, (c) pretrial motions, (d) discovery, and (e) a pretrial conference. (2) Next comes the trial, with (a) jury selection, (b) opening statements, (c) the plaintiff’s case, (d) the defendant’s case, (e) jury instructions, and (f) closing arguments. (3) Third are the posttrial motions, which may include a motion for a judgment notwithstanding the verdict or a motion for a new trial. (4) The final stage is the appellate stage, during which the party who lost at the trial appeals the case.

### REVIEW QUESTIONS

3-1 Identify the different types of jurisdiction and explain why each is important.

3-2 Explain the two situations that cause the state and federal courts to have concurrent jurisdiction.

3-3 What is venue?

3-4 What is the relationship between federal district courts and courts of common pleas?

3-5 What is the attorney-client privilege and what is the rationale for its existence?

3-6 Explain the importance of the work-product doctrine.

### REVIEW PROBLEMS

3-7 Jacobson, a Michigan resident, sued Hasbro Corporation for negligence after one of Hasbro’s truck drivers fell asleep and ran his semi off the road and into Jacobson’s house, causing structural damage of approximately $80,000. Hasbro has small plants in Michigan, Ohio, and Indiana. The company is incorporated in Illinois and has its central offices there. Jacobson files his case in the state court in Michigan. Hasbro files a motion for removal, which Jacobson contests, arguing that the case does not fall within the concurrent jurisdiction of the federal courts. Should the case be transferred? Why or why not?

3-8 Bill, a white male, is charged with spousal abuse. His attorney uses his peremptory challenges to remove all white females from the jury. The prosecution objects. Was there any impropriety in the jury selection process?

3-9 Marx Corporation is incorporated in the state of Delaware, but all of the firm’s business is conducted within the state of New York. Sanders, a Delaware resident, is injured by one of Marx Corporation’s products and subsequently files suit against Marx Corporation in Delaware state court. Marx files a motion to dismiss...
the case on the ground that Delaware cannot assert jurisdiction over the corporation because it does not conduct business in Delaware; it is incorporated there only because it gained certain legal advantages from incorporating in that state. Explain why the Delaware state court system does or does not have jurisdiction over this case.

3-10 Carson is a resident of Clark County, Nevada. He sued Stevens, a resident of Washoe County, Nevada, for injuries he received in an accident that took place in Washoe County. Carson filed the case in Clark County. Can Stevens get the case moved to Washoe County? How would he try to do so?

3-11 Attorney Fox represented Davis in a number of drunk driving cases. Davis shows up at Fox’s office to discuss having the attorney draw up a will for him. The attorney recognizes that Davis is clearly intoxicated. The attorney offers to pay for a cab to take Davis home, but he refuses the offer. Fox’s secretary suggests that he call the state highway patrol. If Fox calls the highway patrol, is he violating the attorney-client privilege? Why or why not?

3-12 Watson brought a negligence case against the PrescripShun Drug Store to recover damages for injuries he received from falling on the wet floor of the store. He believed that the store was negligent for marking the floor with only a small sign that said “Slippery When Wet.” The trial court refused to let Watson introduce evidence that after his fall the store started marking wet floors with cones and a large sign saying, “Caution—Floor Is Wet and Slippery.” Watson lost in the trial court and lost his appeals to the state appeals court and state supreme court. Will he be able to appeal to the U.S. Supreme Court? Why or why not?

CASE PROBLEMS

3-13 In 2007, an Alabama court ordered a father to pay $600 for monthly postminority educational support. Ten months later, in December of that year, the mother brought the father to court because the father was not paying the educational support. He also had not shown up for the court hearing, and was therefore in contempt of court. However, the father argued that under Ala. R. Civ. P. 60(b), he did not have to make the payments because his attorney did not tell him about the court hearing. The rule he cited could have protected him because the rule provides relief for a defendant based on “mistake, inadvertence, surprise, or excusable neglect.” Unfortunately for the father, the rule also states that an appeal must be made four months after the original order; the father in this case made the appeal ten months later. Thus, due to the missed deadline, the court would have no jurisdiction over the case. Nevertheless, the appellant court then considered taking the father’s appeal under a subsection of the 60(b) rule, 60(b)(6). This section states that an order may be undone for “any . . . reason justifying relief.” This subsection also contains a time limit more ambiguous than four months, stating that “[the appeal] only has to be brought within a ‘reasonable time.’” Was the father’s appeal successful? Did the court determine whether it had jurisdiction over the case? Noll v. Noll, 2010 Ala. Civ. App. LEXIS 32.

3-14 Wallace R. Brown hired Jeffrey Thaler, an attorney with Berman & Simmons, to represent him in an effort to recover damages for three of his commercial fishing vessels that suffered from an oil spill. During the time of representation, Thaler moved from Berman & Simmons to Bernstein, Shur, Sawyer & Nelson (BSSN). Unhappy with Thaler’s work, Brown filed a complaint with the superior court against Thaler, Berman & Simmons, and BSSN, seeking damages. Brown used certified mail to send the summons and complaint to the defendants. According to Maine law, to complete service by mail, (1) the summons and complaint must be mailed to the person to be served; (2) the served documents must be accompanied by a notice and acknowledgment form and a prepaid envelope to be returned to the sender with the signed acknowledgment form; and (3) the signed acknowledgment form must be filed with the court. None of the defendants acknowledged service, and they filed suit to dismiss Brown’s claims for lack of proper notification. The court dismissed Brown’s claim. If you were Brown, what could you have done to ensure that proper service was made? Brown v. Thaler, 880 A.2d 1113 (Me. 2005).

3-15 A debtor who had defaulted on a student loan asked a bankruptcy court to decide that the student-loan principal was fully paid. The court made a determination about the student-loan principal, determining the debtor still owed what was due on the student loan. However, the court also decided that postpetition interest was to be awarded, and collection costs were to be denied. Subsequently, the Educational Credit Management Corporation appealed this decision, claiming that the court lacked jurisdiction over postpetition interest and collection costs because the court was a bankruptcy court. In other words, postpetition interest and collection costs did not fall
under United States Code Title 11 (over which the bankruptcy court had jurisdiction) or 28 U.S.C. § 1334(a) or (b) (over which the bankruptcy court also had jurisdiction). Furthermore, the Credit Management Corporation argued that a bankruptcy proceeding is completely unrelated to collection costs and postpetition interest. Do you think the Credit Management Corporation’s appeal was successful? Was the decision of the first court reversed? Educational Credit Management Corp. v. Kirkland, 600 F.3d 310; 2010 U.S. App. LEXIS 5212 (4th Cir. 2010).

3-16 Joseph Hazel, a tractor-trailer operator for R & D Transport, was involved in a car accident while working. Hazel’s tractor-trailer struck a vehicle in which A.H., a minor, was a passenger. The accident occurred in Dearborn County, and Hazel’s residence and R & D Transport’s principal place of business are in Hendricks County. Sarah Richardson, suing for herself and as the guardian of A.H., filed suit in Porter County where they resided. Richardson sued, in part, for damages to “orthotic devices [and] clothing” for A.H. that were normally kept in Porter County. Hazel and R & D filed a motion to have the case transferred to either Hendricks County or Dearborn County. What is the proper venue for the trial? R & D Transport, Inc. v. A.H., 859 N.E.2d 352 (Ind. 2006).

3-17 Prior to his becoming governor of California, Arnold Schwarzenegger resided as a citizen of California. Schwarzenegger brought suit against Fred Martin Motors, an Ohio-based car dealer, in a California district court. Schwarzenegger claimed that Fred Martin advertised his used cars in the Akron Beacon Journal, a locally owned Ohio newspaper, while inappropriately using Schwarzenegger’s photograph as the “Terminator,” thereby constituting an alleged violation of Schwarzenegger’s right to publicity. Fred Martin regularly purchased imported automobiles from California, but he dealt only with their representatives in Illinois and New Jersey. In addition, Fred Martin relied on the services of a California-based marketing company to implement direct-mail advertisements. Explain why the state court in California can or cannot exercise personal jurisdiction over the defendant. Schwarzenegger v. Fred Martin Motors, 374 F.3d 797 (9th Cir. 2004).

3-18 An engineer had formerly been involved with manufacturing nuclear reactor parts that were to be put onto U.S. Navy vessels. However, he was fired after superiors heard he had been complaining to coworkers about quality control problems he felt he had observed. Such complaints were determined by his superiors as likely breaking the company’s Navy contract. Subsequently, the engineer was fired. The engineer then brought suit against the company for wrongful discharge in 2005. However, he brought the suit in a federal court. His reasoning for suing the company in a federal court was that the firing violated two federal statutes. Specifically, both statutes banned the submission of untrue claims to the military or federal government. Generally, these statutes concern fraud in government contracting, although the engineer felt that his firing could be loosely linked to government statutes. A wrongful discharge suit, however, is generally subject to state law. Therefore, the company attempted to move the suit from the federal court to a state court, arguing that the federal court had absolutely no jurisdiction over the case. Was the case moved to a state court, or did the federal court want to hear the case because the firing could be loosely tied to federal statutes? Eastman v. Marine Mechanical Corp., 438 F.3d 544; 2006 U.S. App. LEXIS 3530 (6th Cir. 2006).

3-19 In 2009, several freelance writers filed a class action lawsuit against publishers, claiming that the publishers had, without permission, reproduced certain works. In other words, the publishers had committed copyright infringement. With the first court’s approval, a settlement was reached between the two parties. However, the writers subsequently decided that they were unhappy with the settlement and appealed. The second court considered whether the federal court had actually had jurisdiction over the case. The second court ultimately determined that federal law (14 USC § 411(a)) takes away federal jurisdiction if a copyright holder has not registered a work prior to suing for copyright infringement. Thus, the second court reversed the original decision and the settlement did not stand. The case was then brought to the U.S. Supreme Court. The Supreme Court tried to determine whether the failure of a copyright holder was enough to actually take jurisdiction over the case away from a federal court. How do you think the Supreme Court ruled? Should the federal court have had jurisdiction over the case even if the copyright holders failed to register a work prior to the case? Elsevier, Inc., et al., v. Muchnick et al., 130 S. Ct. 1237, 176 L. Ed. 2d 18; 2010 U.S. LEXIS 2202 (2010).

3-20 Arnold Holloway was convicted of first-degree murder and sentenced to death. During the voir dire for the case, the prosecutor used 12 peremptory strikes, 11 of which were used to remove African-Americans. Holloway, an African-American, challenged the prosecutor’s use of the peremptory challenges as being purposeful discrimination on the basis of race. Did the court of appeals overturn Holloway’s conviction? Why or why not? Holloway v. Horn, 355 F.3d 707 (3d Cir. 2004).
THINKING CRITICALLY ABOUT RELEVANT LEGAL ISSUES

The Election of Judges

Despite a lack of consensus among legal commentators, there is a clear answer to the debate about whether judges should be elected or appointed. America is a democracy; it is only right that the American people should get to elect all judges. Like the legislative and executive branches of government, the judicial branch functions to provide services to the American people. Those very people deserve to elect their judges just as they elect members of Congress and the president. One of the keys to democracy is having a responsible and responsive government. Judges will be neither responsible nor responsive unless they must face the American people periodically and ask for their votes.

Part of holding judges accountable for their legal decisions is not only choosing to elect or reelect them, but also having the ability to remove a judge who is not performing his duty adequately. The American people should have the option of removing judges who fail to uphold the standards and morals of the community. Accordingly, allowing voters to have recall elections would further prevent judges from engaging in undue judicial activism. Judges who are appointed for life terms are beholden to no one; that life tenure challenges the very essence of democracy.

Sometimes a judge’s ideology or judicial philosophy will change over time; this change affects the decisions the judge will make. When a judge changes her decision-making process, she is no longer staying true to why she was elected in the first place. One way to fix unexpected changes is to have periodic elections for judges. These elections will help to keep judges consistent in their rulings and interpretations, while also preventing surprises for the American people who elected the judges in the first place.

By having elections, out-of-touch judges who do not reflect the current social climate can be removed in favor of judges who are in touch with the American people. This last point has the added benefit of possibly bringing younger people to the bench, thus opening up the possibility for a wider group of Americans to shape the law.

1. How would you frame the issue and conclusion of this essay?
2. What ethical norms does the author primarily rely on in arguing for why judges should be elected?
3. Part of being a critical thinker is avoiding the temptation to dichotomize (look at everything as an either-or situation) and to look for other reasonable alternatives. Does the author engage in any dichotomous thinking? If so, what are other reasonable alternatives?

   Clue: What either-or situations does the author create, and are there third and fourth possibilities?
4. Write an essay that someone who holds an opinion opposite to that of the essay author might write.

   Clue: What other ethical norms could influence an opinion on this issue?

ASSIGNMENT ON THE INTERNET

As you learned in this chapter, the question of jurisdiction determines whether a court has the power to render a meaningful decision. The growth of Internet commerce, however, brings additional jurisdictional questions and concerns that have yet to be resolved. Use the Web site library.findlaw.com/1999/Jan/1/241482.html to familiarize yourself with the interactive and passive-use distinctions made in cases of Internet jurisdiction.

Next, apply this distinction to the case of Barton Southern Co., Inc. v. Manhole Barrier Systems, Inc. and JFC Co., 318 F. Supp. 2d 1174 (N.D. Ga. 2004), which can be found using findlaw.com or through the LexisNexis database. Does the interactive/passive distinction help resolve the issue of jurisdiction in this case? Why or why not?
ON THE INTERNET

www.allbusiness.com/legal/961805-1.html This Web site contains an article discussing the difficulties of and possible ways in which businesses can seek to obtain in personam jurisdiction over foreign “cybersquatters.” Cybersquatters are people in other countries who have bought up popular domain names and are using them for their own personal gain and to the detriment of the owner of the products with the purchased domain names.

writ.news.findlaw.com/amar/20040220.html In his column, Vikram David Amar discusses some problems with juries as well as possible changes to the jury selection process that might improve juries.

www.litigationresources.com/HomePage/tabid/681/Default.aspx Litigation Resources is a company that offers business and legal professionals many tools and services they might need to ease the litigation process.

www.martindale.com This is the site of the Martindale-Hubble Law Directory, which provides information about lawyers and law firms. Typical entries include area of special expertise, address, and telephone number.

www.lexisone.com/legalresearch/legalguide/codes_statutes/federal_rules_of_civil_procedure.htm This site will lead you to a number of sites that contain the Federal Rules of Civil Procedure in a variety of formats.

www.lawresearch.com/v2/statute/statstat.htm Go to this page to find a link to your state’s constitution, statutes, and rules of civil procedure.

www.supremecourtus.gov/about/about.html This site provides a wealth of information about the U.S. Supreme Court.

FOR FUTURE READING


Alternative Tools of Dispute Resolution

- Negotiation and Settlement
- Mediation
- Arbitration
- Minitrials
- Early Neutral Case Evaluation
- Private Trials
- Summary Jury Trials
- Court-Annexed Alternative Dispute Resolution
- The Future of Alternative Dispute Resolution
- Global Dimensions of Alternative Dispute Resolution

Pacific Gas and Electric Company (PG & E) was faced with six disputes stemming from the crash of a helicopter that hit one of its electrical lines. Officials at PG & E knew that they were facing the expensive and time-consuming litigation process described in Chapter 3. They were aware that a trial would take about two years to wind its way through the court system, with litigation costs of $300,000 if the matter was settled before the trial and double that amount if the case was tried through to a verdict. Instead, the case was resolved within 10 months, and legal fees and administrative costs were kept to around $20,000.¹

Like a growing number of would-be litigants who see the trial process as unwieldy, time-consuming, and expensive, PG & E decided to consider resolving its dispute outside the court, through what is often referred to as alternative dispute resolution (ADR). Many judges now encourage the increased use of these alternatives to litigation, which include (1) negotiation and settlement, (2) mediation, (3) arbitration, (4) minitrials, (5) early neutral case evaluation, (6) private trials, (7) summary jury trials, and (8) court-annexed alternative dispute resolution. The ADR method that PG & E successfully opted for was mediation.

These options are becoming so common that many law and some business schools now offer courses covering alternative dispute resolution methods. In the business world, 600 of the nation’s largest corporations have signed a pledge

not to sue another corporation before first trying to resolve the conflict out of court. Nearly every state court has some ADR program in place.

Almost all of these alternative methods share certain advantages over litigation. First, they are generally less expensive. For example, PG&E shifted toward an aggressive litigation-alternative approach in 1988, and found that by 1993, its legal department’s operation costs, including legal fees, had fallen by 9 percent. The amount it paid out in judgments and settlements during that time fell by 25 percent. Second, most ADR methods are more convenient for the participants: They are less time-consuming, and the formal-hearing times and places can be set to accommodate the parties. Admittedly, it is difficult to estimate the time required by a given ADR case. Studies of private commercial arbitration cases, however, have shown that the average time lag from filing date to the decision date is 145 days. Third, the persons presiding over the resolution process can be chosen by the parties, and, in many cases, they are chosen because they are more familiar with the subject matter of the dispute than a randomly assigned judge would be.

These alternatives may also prevent adverse publicity, which could be ruinous to a business. Imagine how much better Denny’s image might be, for example, without the adverse publicity it received as a result of litigation over charges of discrimination! Similarly, these alternatives preserve confidentiality, which may be extremely important when a company’s trade secrets are involved. A lot of information that a firm might wish to keep from its competitors could come out in a lawsuit but would not be subject to public disclosure if the matter was settled through an ADR method. Another related potential advantage might be that the immediate case could be resolved through ADR without a precedent being set. Finally, the less adversarial ADR methods might also help to preserve the relationship between the parties, who often desire to continue doing business with one another. In the following sections, we will examine the most important ADR methods in greater detail. From these discussions, future businesspersons should gain some awareness of typical situations in which each of these alternatives may be preferable to litigation.

Negotiation and Settlement

The oldest, and perhaps the simplest, alternative to litigation is negotiation and settlement. Negotiation and settlement is a process by which the parties to

**CRITICAL THINKING ABOUT THE LAW**

Why would one want to use an alternative method for dispute resolution? Alternative dispute resolution seems to be advantageous compared with the traditional method of litigation for several reasons. For example, ADR methods are less time-consuming than litigation. The following questions will help you learn to think critically about alternative dispute resolution.

1. What reasons are offered to suggest that ADR is advantageous compared with litigation?
   **Clue:** Reread the introductory section.

2. What primary ethical norms underlie the reasons given to suggest that ADR is advantageous?
   **Clue:** Examine the reasons given in response to Question 1. Consider the list of ethical norms given in Chapter 1. For example, ADR methods are less time-consuming. Which ethical norm is being upheld with this reason?

---

a dispute come together informally, either with or without their lawyers, and attempt to resolve their dispute. No independent or neutral third party is involved.

To successfully negotiate a settlement, each party must, in most cases, give up something in exchange for getting something from the other side. Almost all lawyers will attempt to negotiate a settlement before taking a case to trial or before adopting a more formal type of dispute resolution method. Attempts at negotiation and settlement are so common that we often do not even consider negotiation as an alternative to litigation.

**Mediation**

A key advantage to the negotiation and settlement method is that it is not as adversarial as litigation; many would like to resolve their disputes through negotiation and settlement to help preserve their relationship. If this informal process does not work, however, the least adversarial of the formal methods of dispute resolution is mediation.

**Mediation** is a process in which the two disputants select a party, usually one with expertise in the disputed area, to help them reconcile their differences. It is sometimes characterized as a creative and collaborative process involving joint efforts of the mediator and the disputants. Mediation primarily differs from litigation and arbitration (which we discuss next) in that the mediator makes no final decision. She or he is simply a facilitator of communication between disputing parties.

Even though different mediators use different techniques, their overall goals are the same. They try to get the disputants to listen to each other’s concerns and understand each other’s arguments with the hope of eventually getting the two parties communicating. Once the parties are talking, the mediator attempts to help them decide how to solve their problem. The agreed-upon resolution should be “fair, equitable,” and “based upon sufficient information.”

Although there is no guarantee that a decision will be reached through mediation, when a decision is reached the parties generally enter into a contract that embodies the terms of their settlement. Skilled mediators will attempt to help the parties to draft agreements that reflect the principles underlying mediation; that is, the agreement should not attempt to assess blame either implicitly or explicitly, but should reflect mutual problem solving and consensual agreement. If one party does not live up to the terms of the settlement, he or she can then be sued for breach of contract. Often, however, the parties are more likely to live up to the terms of the agreement than they are to obey a court order, because they were the ones who reached the agreement. The agreement is their own idea of how to resolve the dispute, not some outsider’s solution.

If the mediation is not successful and the parties subsequently take their dispute to arbitration or litigation, nothing that was said during mediation can be used by either party at a later proceeding. Whatever transpires during the mediation is confidential.

**SELECTION OF A MEDIATOR**

Mediators are available from several sources. In any community, you will be able to find organizations offering mediation services by looking in the Yellow Pages or online. Often the local bar association or Better Business Bureau offers mediation services. A governmental organization, the Federal Mediation and Conciliation Service (FMCS), also provides mediation services, as do national private services such as JAMS Resolution Services, which has locations across the country and can be found on the Internet. A person in need of mediation services can...
also find a mediator by going to a site such as Mediate.com, which contains a mediator directory for mediators in the United States and abroad. The state in which one resides may also have a professional organization that can provide a list of recognized mediators, such as California’s Academy of Professional Neutrals.

One factor to consider when selecting a mediator is what type of background he or she has. Some companies use only former judges, whereas others use judges, lawyers, and nonlawyers as mediators. There is, not surprisingly, a lot of contention over who makes the best mediator. Many people prefer judges because of their legal knowledge, but others say that judges are too ready to make a decision because they spend most of their careers making decisions.

**COMMON USES OF MEDIATION**

Perhaps the best-known use of mediation is in collective bargaining disputes. Under the National Labor Relations Act, before engaging in an economic strike to achieve better wages, hours, or working conditions under a new collective bargaining agreement, a union must first contact the FMCS and attempt to mediate contract demands.

Mediation is also used increasingly to resolve insurance claim disputes and commercial contract problems. More and more frequently, a mediation clause is being included in commercial contracts in conjunction with a standard arbitration clause. Under such clauses, only if mediation is unsuccessful do the parties then submit the dispute to arbitration. Going through both of these processes is still generally less time-consuming and expensive than litigation, especially when one considers the drawn-out discovery process.

Some argue that mediation should play a greater role in employment disputes. Often such disputes arise out of miscommunication, and mediation helps to open the lines of communication. A wide variety of creative remedies might be applicable to the employment situation. In fact, JAMS/Endispute offers three basic employment dispute options: standard mediation, streamlined mediation, and a mediation–arbitration combination.

A growing area for mediation is in the resolution of environmental disputes. Many advocate the use of mediation for environmental matters because the traditional dispute resolution methods are designed to handle a problem between two parties, whereas environmental disputes often involve multiple parties. Mediation can easily accommodate multiple parties. Environmental matters are often likely to involve parties who will have to deal with one another in the future, so preservation of their relationship is of utmost importance. For example, you might have a dispute over a new development in which a local citizen group, a developer, the municipality, and an environmental interest group all have concerns. Mediation could theoretically resolve their problems in a way that would prevent greater problems in the future. Mediation also offers the potential for creative solutions, which are often needed for environmental disputes.

**ADVANTAGES OF MEDIATION**

The primary advantage of mediation is that, because of its nonadversarial nature, it tends to preserve the relationship between the parties to a greater extent than would a trial or any of the other alternatives to litigation. Because the parties are talking to each other, rather than talking about each other and trying to make the other “side” look bad, there is less of the bitterness that often results from a trial. Parties will almost always come away from a trial with increased hostility toward the other side, whereas even if the parties cannot resolve their differences completely, they almost always leave mediation with a little better understanding of each other’s positions. Thus, mediation is increasingly being used in cases in which the parties will have an ongoing relationship once the immediate dispute is settled.
Another important advantage to mediation is its ability to find and implement creative solutions. Because the parties are not searching for a decision in their favor or an award of money damages, they are more open to finding some sort of creative solution that may allow both parties to receive some benefit from the situation. Finally, as with other ADR methods, mediation is usually less expensive and less time-consuming than litigation. It is difficult to measure precisely how successful mediation is, however, because settlements are not made public.

CRITICISMS OF MEDIATION

The process of mediation has its critics. They argue that the informal nature of the process represses and denies certain irreconcilable structural conflicts, such as the inherent strife between labor and management. They also argue that this informal process tends to create the impression of equality between the disputants when no such equality exists. The resultant compromise between unequals is an unequal compromise, but it is clothed in the appearance of equal influence.

The mediation process can also arguably be abused. A party who believes that he or she will ultimately lose a dispute may enter the mediation process in bad faith, dragging the process out as long as possible.

Arbitration

One of the most well known alternatives to litigation, arbitration, is the resolution of a dispute by a neutral third party outside the judicial setting. According to a 2010 survey by the American Bar Association Litigation Section Task Force on Alternative Dispute Resolution, 78 percent of surveyed lawyers said arbitration was more efficient than litigation, while 56 percent said it was more cost effective.4 The arbitration hearing is similar to a trial, but there is no prehearing discovery phase, although in some cases an arbitrator may allow limited amounts of discovery. In addition, the stringent rules of evidence applicable in a trial are generally relaxed. Each side presents its witnesses and evidence and has the opportunity to cross-examine its opponent’s witnesses. The arbitrator frequently takes a much more active role in questioning the witness than would a judge. If the arbitrator wants more information, he or she generally does not hesitate to ask for that information from witnesses.

Ordinarily, no official record of the arbitration hearing is made. Rather, the arbitrator and each of the parties usually take their own notes of what happens. The parties and the arbitrator, however, may agree to have a stenographer record the proceedings at the expense of the parties. Although attorneys may represent

---

parties in arbitration, legal counsel is not required; individuals may represent themselves or have nonlawyers represent them. For example, in a labor dispute (discussed in Chapter 20) the union may be represented by one of its officers. In addition to the oral presentation, in some cases, the arbitrator may request written arguments from the parties. These documents are called arbitration briefs.

The arbitrator usually provides a decision for the parties within 30 days of the hearing. In many states, this deadline is mandated by statute. The arbitrator's decision is called the award, even if no monetary compensation is ordered. The award does not have to state any findings of fact or conclusions of law, nor must the arbitrator cite any precedent for the decision or give any reasons. He or she must only resolve the dispute. However, if the arbitrator hopes to continue to be selected by parties and function in that role, he or she should provide reasons for the decision.

For a number of reasons, the arbitrator's decision is much more likely to be a compromise than a decision handed down by a court. First, the arbitrator is not as constrained by precedent as are judges. An arbitrator is interested in resolving a factual dispute, not in establishing or strictly applying a rule of law. Second, the arbitrator may be more interested than a judge in preserving an ongoing relationship with the parties. A compromise is much more likely to achieve this result than is a clear win-or-lose decision. Finally, because an arbitrator frequently decides cases in a particular area, he or she wants to maintain a reputation of being fair to both sides. For example, a person who focuses on labor arbitrations would not want to gain a reputation as being prolabor or promanagement.

The decision rendered by the arbitrator is legally binding. In some cases, such as labor cases, a decision may be appealed to the district court, but there are few such appeals. Of the more than 25,000 labor cases decided by arbitrators each year, fewer than 200 are challenged.

The policy of deferring to the arbitrator's decision applies to disputes in areas other than labor contracts. Unless there is a clear showing that the arbitrator's decision is contrary to law or there was some defect in the arbitration process, the decision will be upheld. Section 10 of the Federal Arbitration Act, the federal law enacted to encourage the use of arbitration, sets forth the four grounds on which the arbitrator's award may be set aside:

1. The award was the result of corruption, fraud, or other "undue means."
2. The arbitrator exhibited bias or corruption.
3. The arbitrator refused to postpone the hearing despite sufficient cause, refused to hear evidence pertinent and material to the dispute, or otherwise acted to substantially prejudice the rights of one of the parties.
4. The arbitrator exceeded his or her authority or failed to use such authority to make a mutual, final, and definite award.

The United States Supreme Court reiterated and reinforced its desire to limit the ability of the judiciary to overturn arbitrators' decisions in the following case.

**Case 4-1**

**Hall Street Associates, L.L.C. v. Mattel, Inc.**

_United States Supreme Court of the United States_ **552 U.S. 576 (2008)**

Mattel was leasing a property to Hall Street Associates. Hall Street sued Mattel on the ground that Mattel illegally terminated the lease. Hall Street additionally demanded compensation for what it said were necessary “environmental cleanup costs.” Although the court decided in favor of Mattel on the termination issue, the parties made an agreement to arbitrate the environmental cleanup issue. Both parties determined that the court could modify the arbitration
award as it saw fit. In other words, the court would be granted expanded judicial review of the arbitration award. After the arbitrator decided in favor of Hall Street, the court dismissed the arbitration award on the ground that the decision was based on errors of law. Subsequently, the arbitrator instead decided in favor of Mattel. This time, the court let the second decision of the arbitrator stand. However, a second court reversed the decision, stating that the scope of judicial review permitted by the Federal Arbitration Act (FAA) did not encompass the actions of the earlier court. In other words, the earlier court should not have had the power to dismiss or modify the arbitration award. The case was appealed to the Supreme Court.

Justice Souter

“. . . Congress enacted the FAA to replace judicial indisposition to arbitration with a national policy favoring [it] and plac[ing] arbitration agreements on equal footing with all other contracts.” As for jurisdiction over controversies touching arbitration, the Act does nothing, being “something of an anomaly in the field of federal-court jurisdiction” in bestowing no federal jurisdiction but rather requiring an independent jurisdictional basis (providing for action by a federal district court “which, save for such [arbitration] agreement, would have jurisdiction under title 28”). But in cases falling within a court’s jurisdiction, the Act makes contracts to arbitrate “valid, irrevocable, and enforceable,” so long as their subject involves “com- mercial.” And this is so whether an agreement has a broad reach or goes just to one dispute, and whether enforcement is sought in state court or federal. . . .

The Act also supplies mechanisms for enforcing arbitration awards: a judicial decree confirming an award, an order vacating it, or an order modifying or correcting it. An application for any of these orders will get streamlined treatment as a motion, obviating the separate contract action that would usually be necessary to enforce or tinker with an arbitral award in court. Under the terms of § 9, a court “must” confirm an arbitration award “unless” it is vacated, modified, or corrected “as prescribed” in §§ 10 and 11. Section 10 lists grounds for vacating an award, while § 11 names those for modifying or correcting one. . . .

The Courts of Appeals have split over the exclusiveness of these statutory grounds when parties take the FAA shortcut to confirm, vacate, or modify an award, with some saying the recitations are exclusive, and others regarding them as mere threshold provisions open to expansion by agreement. As mentioned already, when this litigation started, the Ninth Circuit was on the threshold side of the split, from which it later departed en banc in favor of the exclusivity view, which it followed in this case. We now hold that §§ 10 and 11 respectively provide the FAA’s exclusive grounds for expedited vacatur and modification. . . .

[It makes more sense to see the three provisions, §§ 9–11, as substantiating a national policy favoring arbitration with just the limited review needed to maintain arbitration's essential virtue of resolving disputes straightforward. Any other reading opens the door to the full-bore legal and evidentiary appeals that can “rende[r] informal arbitration merely a prelude to a more cumbersome and time-consuming judicial review process,” and bring arbitration theory to grief in postarbitration process. . . .

We do not know who, if anyone, is right, and so cannot say whether the exclusivity reading of the statute is more of a threat to the popularity of arbitrators or to that of courts. But whatever the consequences of our holding, the statutory text gives us no business to expand the statutory grounds. . . .

In holding that §§ 10 and 11 provide exclusive regimes for the review provided by the statute, we do not purport to say that they exclude more searching review based on authority outside the statute as well. The FAA is not the only way into court for parties wanting review of arbitration awards: they may contemplate enforcement under state statutory or common law, for example, where judicial review of different scope is arguable. But here we speak only to the scope of the expeditious judicial review under §§ 9, 10, and 11, deciding nothing about other possible avenues for judicial enforcement of arbitration awards. . . .

Although we agree with the Ninth Circuit that the FAA confines its expedited judicial review to the grounds listed in 9 U.S.C. §§ 10 and 11, we vacate the judgment and remand the case for proceedings consistent with this opinion. It is so ordered.

Judgment vacated and case remanded.

Case Questions

1. What does it mean for a court to be able to vacate or modify an arbitration award, rather than the two parties being limited to an arbitrator’s decision?

Clue: What would be the effect on cooperation of the parties in an arbitration case if they both knew that courts are eager to vacate or modify an arbitration decision?

2. Why would the FAA want to limit a court’s power over an arbitration award?

Clue: Look at the various advantages of arbitration when compared to court resolution of disputes.

Methods of Securing Arbitration

Arbitration may be secured voluntarily, or it may be imposed on the parties. The first voluntary means of securing arbitration is by including a binding arbitration clause in a contract. Such a clause provides that all or certain disputes arising under the contract are to be settled by arbitration. The clause should also include the means by which the arbitrator is to be selected. More than 95 percent of the collective bargaining agreements in force today have some provision for arbitration.5

Any controversy, dispute, or claim of whatever nature arising out of, in connection with, or in relation to the interpretation, performance, or breach of this agreement, including any claim based on contract, tort, or statute, shall be resolved, at the request of any party to this agreement, by final and binding arbitration conducted at a location determined by the arbitrator in (City), (State), administered by and in accordance with the existing rules of Practice and Procedure of Judical Arbitration & Mediation Services, Inc. (J.A.M.S.), and judgment upon any award rendered by the arbitrator may be entered by any state of federal court having jurisdiction thereof.

Exhibit 4-1 contains a sample binding arbitration clause that could be included in almost any business contract.

If their contract contains no binding arbitration clause, the parties may secure arbitration by entering into a submission agreement, an example of which is provided in Exhibit 4-2. This contract can be entered into at any time. It is a written contract stating that the parties wish to settle their dispute by arbitration. Usually, it specifies the following conditions:

- How the arbitrator will be selected
- The nature of the dispute
- Any constraints on the arbitrator’s authority to remedy the dispute
- The place where the arbitration will take place
- A time by which the arbitration must be scheduled

Usually, both parties declare their intent to be bound by the arbitrator’s award.

If the parties have entered into a submission agreement or have included a binding arbitration clause in their contract, they will be required to resolve their disputes through arbitration. Both federal and state courts must defer to arbitration if the contract in dispute contains a binding arbitration clause. This constraint was mandated by the U.S. Supreme Court in the following case.

**CASE 4-2**

**Southland Corp. v. Keating**

Supreme Court of the United States


Plaintiffs, a group of individuals who ran 7-Eleven stores franchised by the Southland Corporation, sued the defendant corporation for breach of contract, fraud, and violation of the California Franchise Investment Law. The defendant responded by filing a motion to compel arbitration because their contract included a clause stating that any claim or controversy related to the agreement would be settled by arbitration in accordance with the rules of the AAA. The trial court held that the fraud and breach-of-contract claims should be arbitrated but that the cause of action (or claim) filed under the state franchise law should be litigated. The California Court of Appeals held that all claims should be subject to arbitration. The court stated that to allow the state franchise law claim to be litigated would be to contravene the Federal Arbitration Act, which withdraws from the courts claims covered by an arbitration clause. The California Supreme Court reversed the decision of the court of appeals and reinstated the trial court’s decision. The defendant corporation appealed to the U.S. Supreme Court.

**Chief Justice Burger**

The California Franchise Investment Law provides that “Any condition, stipulation or provision purporting to bind any person acquiring any franchise to waive compliance with any provision of the law or any rule or order hereunder is void.”
The California Supreme Court interpreted this statute to require judicial consideration of claims brought under the state statute and accordingly refused to enforce the parties’ contract to arbitrate such claims. So interpreted, the California Franchise Investment Law directly conflicts with Section 2 of the Federal Arbitration Act and violates the Supremacy Clause.

In enacting Section 2 of the Federal Act, 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. The Federal Arbitration Act provides:

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

Congress has thus mandated the enforcement of arbitration agreements.

We discern only two limitations on the enforceability of arbitration provisions governed by the Federal Arbitration Act: they must be part of a written maritime contract or a contract “evidencing a transaction involving commerce” and such clauses may be revoked upon “grounds as exist at law or in equity for the revocation of any contract.” We see nothing in the act indicating that the broad principle of enforceability is subject to any additional limitations under State law.

The Federal Arbitration Act rests on the authority of Congress to enact substantive rules under the Commerce Clause. The Court examined the legislative history of the act and concluded that the statute “is based upon . . . the incontestable federal foundations of ‘control over interstate commerce and over admiralty.’”

We reaffirmed our view that the Arbitration Act “creates a body of federal substantive law” and expressly stated what was implicit—the substantive law the act created was applicable in state and federal court.

Although the legislative history is not without ambiguities, there are strong indications that Congress had in mind something more than making arbitration agreements enforceable only in the federal courts. The House Report plainly suggests the more comprehensive objectives: “The purpose of this bill is to make valid and enforceable agreements for arbitration contained in contracts involving interstate commerce or within the jurisdiction or admiralty, or which may be the subject of litigation in the Federal courts.”

The broader purpose can also be inferred from the reality that Congress would be less likely to address a problem whose impact was confined to federal courts than a problem of large significance in the field of commerce. The Arbitration Act sought to “overcome the rule of equity, that equity will not specifically enforce any arbitration agreement.”

And because the overwhelming proportion of all civil litigation in this country is in the state courts, we cannot believe Congress intended to limit the Arbitration Act to disputes subject only to federal court jurisdiction. Such an interpretation would frustrate Congressional intent to place “an arbitration agreement . . . upon the same footing as other contracts, where it belongs.”

In creating a substantive rule applicable in state as well as federal courts, Congress intended to foreclose state legislative attempts to undercut the enforceability of arbitration agreements. We hold that Section 31512 of the California Franchise Investment Law violates the Supremacy Clause.

Reversed in favor of Defendant, Southland Corporation.

CRITICAL THINKING ABOUT THE LAW

By now, you realize that legal reasons have degrees of quality, reliability, and acceptability. A claim is not valid simply because reasons are given for its truth or merit.

The following questions, pertaining to Case 4-2, will refresh your appreciation of this point.

1. Crucial to the Court’s reasoning is its claim that Congress intended the Federal Arbitration Act’s authority to extend to the state courts. What evidence does the Court provide for this claim?

Clue: Reread the section that begins with this claim.

2. Having answered Question 1, you now know that the Court relies to some extent on the legislative history of the act to support its position. What are the dangers with this type of evidence?

Clue: Think about your own personal history. Have your intentions always been expressed in a form that everyone who knew you could interpret accurately?
American Arbitration Association

SUBMISSION TO DISPUTE RESOLUTION

The named parties hereby submit the following dispute for resolution under the _________________________ Rules of the American Arbitration Association:

Procedure Selected: ❑ Binding Arbitration ❑ Mediation Settlement ❑ Other ______________________

(Descr) FOR INSURANCE CASES ONLY:

Policy Number ______________________ to ______________________ Applicable Policy Limits ______________________

Effective Dates Location Claim Number: ______________________

Date of Incident ______________________ Insured: ______________________

Name(s) of Claimant(s) Check if a Minor Amount Claimed

☐ ☐ ☐

Nature of Dispute and/or Injuries Alleged (attach additional sheets if necessary):

Place of Hearing: ___________________________________________________________________________

We agree that, if binding arbitration is selected, we will abide by and perform any award rendered hereunder and that a judgment may be entered on the award.

To Be Completed by the Parties

Name of Party

Address

City, State, and ZIP Code

Telephone Fax

Signature†

Name of Party’s Attorney or Representative

Address

City, State, and ZIP Code

Telephone Fax

Signature†

Name of Party

Address

City, State, and ZIP Code

Telephone Fax

Signature†

Name of Party’s Attorney or Representative

Address

City, State, and ZIP Code

Telephone Fax

Signature†

Name of Party

Address

City, State, and ZIP Code

Telephone Fax

Signature†

Name of Party’s Attorney or Representative

Address

City, State, and ZIP Code

Telephone Fax

Signature†

Please file three copies with the AAA.

* If you have a question as to which rules apply, please contact the AAA.
† Signatures of all parties are required for arbitration.

EXHIBIT 4-2
SAMPLE SUBMISSION AGREEMENT

Source: Reproduced with permission of the American Arbitration Association, 140 West 51st Street, New York, NY 10020.

The U.S. Supreme Court had the opportunity to reexamine its holding in Southland v. Keating in 1995 when it agreed to hear the case of Allied-Bruce-Terminix Cos. v. Dobson. In that case, Mr. Gibbs and a termite exterminator had entered into a termite control contract that included a clause providing that all disputes under the contract would be settled exclusively by arbitration. Dobson had purchased Gibbs’s house and took over the contract. When Allied-Bruce-Terminix was unable to fulfill the terms of the contract, Dobson filed suit in court, asking the state to uphold a state law invalidating predispute arbitration clauses. The state’s highest court upheld the state law, saying that the Federal Arbitration Act did not apply to this case because the parties did not contemplate any interstate transaction under the contract. On the appeal before the U.S. Supreme Court, 20 state attorneys general signed an amicus curiae (friend of the

When Clear Channel became Diane Ignazio’s employer, they required her to enter into an arbitration agreement with Clear Channel. Both parties waived their right to sue for any claim covered by the agreement and agreed to enter into final and binding arbitration. Section 10B, however, allowed either party to bring an action in court to set aside the award “where the standard of review will be the same as that applied by an appellate court reviewing a decision of a trial court sitting without a jury.”

Ignazio was terminated on October 7, 2003, and she filed an action against Clear Channel asserting claims of age and sex discrimination, retaliation, and wrongful termination of employment in violation of public policy. Clear Channel filed a motion to stay the action pending arbitration, as
Ignazio’s claims fell under the arbitration agreement. The trial court granted the motion to stay. Ignazio appealed. The court of appeals found that section 10B violated Ohio arbitration laws (Ohio Rev. Code ch. 2711) by allowing too great a standard of judicial review, rendering any arbitration award not final and binding. An agreement that did not provide for a final and binding decision could not be classified as an arbitration agreement. The appeals court reversed the judgment of the trial court and remanded to allow Ignazio’s lawsuit to proceed. Clear Channel appealed to the Ohio Supreme Court.

Justice Stratton

The issue before us is whether a clause in an arbitration agreement that provides for greater judicial review of an award than is permitted under R.C. Chapter 2711 renders the entire agreement unenforceable, or whether the offensive clause may be severed and the remainder of the agreement enforced.

Nevertheless, for purposes of this appeal, the parties do not dispute that the second sentence in Section 10B provides for a standard of review that is not permitted under Ohio’s arbitration laws. We must decide whether the sentence in Section 10B is fundamental to the overall meaning of the agreement, or whether it may be severed so that the remainder of the agreement may be given effect. Whether a part of a contract may be severed from the remainder “depends generally upon the intention of the parties, and this must be ascertained by the ordinary rules of construction.”

The arbitration agreement in this case expressly provides, “Should any provision of this Agreement be found to be unenforceable, such portion will be severed from the Agreement and the remaining portions shall remain in full force and effect.” We presume the intent of the parties from the language employed in the contract. Clearly, the parties contemplated and provided for severing a provision that was unenforceable and giving effect to the remaining provisions.

Severing only the second sentence of Section 10B will not modify or alter the remainder of the provision for enforcing an arbitration award. The agreement still requires the parties to arbitrate disputes. Severing does not modify or change the terms of the agreement for demanding and conducting the arbitration process. The agreement continues to provide a means of enforcement in that “[e]ither party may bring an action in any court of competent jurisdiction to compel arbitration under this Agreement and to enforce an arbitration award.” R.C. 2711.09, 2711.10, and 2711.11 permit a party to challenge the arbitration agreement in certain circumstances. If the phrase is severed, the only difference will be that a party may not seek to have a court review the award using the same standard of review as an appellate court. Therefore, this single phrase in one sentence of a multipage agreement does not alter the fundamental nature of the agreement.

Furthermore, severing the offending provision and enforcing the remainder of the agreement is consistent with this state’s strong public policy in favor of arbitration. The law favors and encourages arbitration as a means of resolving disputes.

Therefore, we hold that the offending provision in this agreement does not fundamentally alter the otherwise valid and enforceable provisions of the agreement. Based on the express severability clause and Ohio’s strong public policy in favor of arbitration of disputes, the second sentence of Section 10B is severed from the agreement, and the remaining provisions of the agreement are to be given full force and effect. Following arbitration, the parties may seek to confirm, vacate, or modify the award in court or otherwise challenge the process as provided by law.

Judgment reversed in favor of Appellants, Clear Channel.

CRITICAL THINKING ABOUT THE LAW

Courts tend to hold parties to the bargain they make in a contract. In the contract in this particular case, specific language supports the idea that under certain conditions, a clause can be severed from the contract without affecting the enforceability of the rest of the contract.

1. What are the reasons for this decision? How does the attitude of the courts toward arbitration serve as a reason in this instance?
   Clue: Ask yourself, “What grounds did the court provide to substantiate its conclusion?”

2. Why do the parties care whether the clause is severed? What ethical norms support the court’s reasoning?
   Clue: What happens if the court rules that the clause cannot be severed from the contract?

Although in the foregoing case the court decided to sever the section of the agreement that was incompatible with state law, other courts have found arbitration agreements with objectionable sections to be entirely unenforceable. For example, the Fourth Circuit Court of Appeals refused to enforce an agreement between Hooters Restaurant and one of its waitresses to settle all employment disputes through arbitration, because the court found that the rules for arbitration under the agreement were “so one-sided that their only possible purpose is to
undermine the neutrality of the proceeding. Some of the more objectionable rules incorporated in the agreement included the following:

- The employee had to provide notice of the specifics of the claim, but Hooters did not need to file any type of response to these specifics or notify the claimant of what kinds of defenses the company planned to raise.
- Only the employee had to provide a list of all fact witnesses and a brief summary of the facts known to each.
- Although the employee and Hooters could each choose an arbitrator from a list and those arbitrators would then select a third to create the arbitration panel that would hear the dispute, Hooters alone selected the arbitrators on the list.
- Only Hooters had the right to widen the scope of arbitration to include any matter, whereas the employee was limited to those raised in her or his notice.
- Only Hooters had the right to record the arbitration. Only Hooters had the right to sue to vacate or modify an arbitration award because the arbitration panel exceeded its authority. Only Hooters could cancel the agreement to arbitrate or change the arbitration rules.

If you think about these conditions, each of them individually seems inherently unfair. When you consider their impact as a group, it is easy to see why the court refused to uphold the agreement.

As increasing numbers of employers began incorporating mandatory, binding arbitration clauses in their employment contracts, a question arose as to whether certain statutory rights, such as the right to not be discriminated against on the basis of age, sex, race, religion, color, or national origin, were so important that one could not contract away one’s ability to protect those rights through litigation. The U.S. Supreme Court addressed that issue in the case of *Gilmer v. Interstate/Johnson Lane Corp.* Gilmer was a 62-year-old securities broker who sued his employer under the Age Discrimination in Employment Act (ADEA) when he was terminated. The employer argued that Gilmer had to submit his age discrimination claim to arbitration because as part of his application to be a securities representative with the New York Stock Exchange, he had signed an agreement to arbitrate “any claim, dispute, or controversy” arising between himself and Interstate.

The high court upheld the binding arbitration clause, noting that the employee was not agreeing to give up any statutory rights; instead, the employee was simply agreeing to resolve disputes involving those rights through arbitration. The court had no problem with such a waiver of the employee’s right to sue to enforce his statutory rights, as long as the employee understood that the binding arbitration clause also encompassed statutory rights.

The initial impact of this ruling was to increase the use of mandatory arbitration agreements in employment contracts in all industries. In fact, about 100 large companies soon moved to follow the securities industry’s policy. Some courts and the Equal Employment Opportunity Commission, however, became increasingly concerned about whether arbitration agreements that had to be accepted as a condition of employment were really voluntary. On July 10, 1997, the EEOC issued a policy statement saying that the mandatory “arbitration of discrimination claims as a condition of employment are [sic] contrary to the fundamental principles of employment discrimination laws.” The EEOC chairman stated that the agency strongly supported agreements to arbitrate once a dispute

---

had arisen, but did not believe that a prospective employee could make a voluntary agreement to arbitrate future disputes as part of a “take it or leave it” contract of employment. In 2003, however, in *EEOC v. Luce, Forward, Hamilton & Scripps*, the Ninth Circuit\(^\text{11}\) cleared the way for the inclusion of mandatory arbitration clauses in employment agreements. The court held that federal civil rights claims can be the subject of mandatory arbitration agreements, and an employer can require all employees to sign such an agreement as a condition of employment.

Thus, an employer need not provide its employees with a choice in statutory discrimination disputes. However, the Supreme Court recently upheld the EEOC’s right to seek remedies in discrimination cases, even when a binding arbitration agreement exists to settle all employment-related disputes. In *EEOC v. Waffle House, Inc.*,\(^\text{12}\) an employee brought suit against his employer, claiming that he was unlawfully discharged after he had a seizure at work. With regard to the defendant’s allegations that this discharge violated the Americans with Disabilities Act, the Supreme Court ruled that the EEOC could seek statutory remedies, including “victim-specific” relief, back pay, compensatory damages, and punitive damages. In the year after this case was handed down, the EEOC settled a case by agreeing to allow an employer to require employees to sign a mandatory arbitration agreement as long as the employees were notified of their right to still file a charge with the EEOC that the agency might wish to pursue.

In 1997, the National Association of Securities Dealers changed its policy to allow employees to choose between entering into private arbitration agreements with their employer or reserving the right to file a claim in state or federal court. Nevertheless, the trend in many industries is toward an increasing use of binding arbitration clauses in employment agreements. After all, the EEOC files suit in less than 1 percent of the charges it receives each year. Hence, even if an employee wants to litigate for statutory discrimination, the likelihood that the EEOC will represent him or her is very small. To avoid any chance of an arbitration clause being challenged by an employee wishing to bring a lawsuit under a civil rights statute, the binding arbitration clause should be drafted in such a way as to make it clear that the employee knew he or she was agreeing to arbitrate all disputes arising out of the employment situation, including statutory rights.

If the binding arbitration clause is contained in an agreement between the employer and the union, and individuals under the agreement are giving up their rights to sue for statutory violations, the agreement to arbitrate statutory disputes must be even more explicit; it must be clear and unmistakable. In *Wright v. Universal Maritime Service*,\(^\text{13}\) the U.S. Supreme Court said that “[t]he right to a federal judicial forum is of sufficient importance to be protected against a less-than-explicit union waiver in a CBA [collective bargaining agreement]. The CBA in this case does not meet that standard. Its arbitration clause is very general, providing for arbitration of ‘[m]atters under dispute’—which could be understood to mean matters in dispute under the contract. And the remainder of the contract contains no explicit incorporation of statutory antidiscrimination requirements.” Thus, an employer wishing to avoid litigation of allegations of civil rights violations must be even more careful in crafting the binding arbitration clause when it is a union that is waiving its members’ rights.

Binding arbitration clauses, however, are included not only in employment agreements, but also sometimes in consumer and business-to-business contracts. For instance, in *Eagle v. Fred Martin Motor Co.*,\(^\text{14}\) plaintiff Lisa Eagle sued Fred Martin Motors, alleging that the defendant violated the Consumer Sales Practices

\(^{11}\) 345 F. 3d 742 (9th Cir. 2003).
\(^{12}\) 534 U.S. 279 (2002).
\(^{13}\) 525 U.S. 70 (1998).
\(^{14}\) 157 Ohio App. 3d 150 (2004).
Act, after the plaintiff’s new car repeatedly stalled and experienced other mechanical problems that the dealer failed to fix. After Eagle filed suit, Fred Martin Motors moved to compel arbitration in accordance with a binding arbitration clause that was included in the sales agreement. The common pleas court granted the defendant’s motion, and Eagle appealed, claiming that the arbitration agreement was unconscionable.

The appellate court reversed the common pleas court’s decision. Explaining that consumer transactions should be subject to closer scrutiny, the judge claimed that the agreement was substantively unconscionable because the agreement included excessive filing fees, especially for the plaintiff, who earned only about $14,000 per year. The judge stated that the binding arbitration clause was procedurally unconscionable because the preprinted purchase contract was an adhesion contract, in the sense that the plaintiff had no actual choice about the terms of arbitration. Furthermore, the judge cited several additional factors relating to procedural unconscionability, including allegations that the dealer’s sales representative hurried through the purchasing papers with the plaintiff, the plaintiff was not made aware of the binding arbitration clause during the purchase (nor did the plaintiff know what arbitration meant), and the arbitration clause did not mention the excessive costs. Considering the plaintiff’s limited educational and economic background, the judge agreed that these two factors were also relevant to his conclusion that the arbitration clause was procedurally unconscionable. Hence, the court ruled that the binding arbitration clause was substantively and procedurally unconscionable and therefore, unenforceable. See Exhibit 4-3 for a list of points to consider to ensure that any mandatory arbitration clause you draft will not be struck down as unconscionable.

In addition to the two voluntary means of securing arbitration, state law may mandate the process for certain types of conflicts. For instance, in some states, public employees must submit collective bargaining disputes to binding arbitration. In other states, disputes involving less than a certain amount of money automatically go to arbitration.

**SELECTION OF AN ARBITRATOR**

Once the decision to arbitrate has been made, an arbitrator must be selected. Arbitrators are generally lawyers, professors, or other professionals. They are frequently selected on the basis of their special expertise in some area. If the parties have not agreed on an arbitrator before a dispute, they generally use one of two sources for selecting one: the Federal Mediation and Conciliation Services, a government agency; or the AAA, a private, nonprofit organization founded in 1926, whose stated purpose is “to foster the study of arbitration in all of its aspects, to perfect its techniques under arbitration law, and to advance generally

---

**EXHIBIT 4-3**

**DRAFTER’S CHECKLIST**

Checklist for Insuring That a Mandatory Arbitration Clause Is Not Unconscionable

- The contract is not a contract of adhesion, that is, one where the consumer could not meaningfully negotiate the inclusion and terms of the mandatory arbitration clause.
- The mandatory arbitration clause and its provisions are not buried in fine print.
- The provisions of the clause do not unduly favor the interests of drafter of the contract.
- The provisions of the clause do not impose significant costs on the consumer.
- The provisions of the clause do not include a confidentiality requirement (which may make it difficult for consumers to share information).
- The provisions do not limit the ability of the consumer to obtain punitive damages.
the science of arbitration for the prompt and economical settlement of disputes.” Its slogan is “Speed, Economy, and Justice.” It currently employs more than 8,000 arbitrators and mediators worldwide, of whom 1,100-plus are bilingual or multilingual and collectively speaking more than 40 languages. The parties may also turn to one of the private arbitration services.

When the disputants contact one of these agencies, they receive a list of potential arbitrators along with a biographical sketch of each. The parties then jointly select an arbitrator from the list. Once the arbitrator has been selected, the parties and the arbitrator agree on the time, date, and location of the arbitration. They also agree on the substantive and procedural rules to be followed in the arbitration. Regardless of whether the arbitrator is selected through the AAA, the FMCS, or some private association, he or she will be subject to the Arbitrator’s Code of Ethics (Exhibit 4-4). Organized by canons of ethics, the code is designed to ensure that arbitrators perform their duties diligently and in good faith, thereby maintaining public confidence in the arbitration process. Exhibit 4-4 sets out the seven canons of the Arbitrator’s Code of Ethics.

COMMON USES OF ARBITRATION

As noted earlier, arbitration is frequently used to resolve grievances under collective bargaining agreements. It is so frequently used in these cases that it is sometimes identified primarily as a means for resolving labor disputes. Furthermore, it is not used only in traditional labor disputes; we are increasingly seeing it used in disputes over athletes’ salaries. For example, salary arbitration made headlines when the Washington Nationals baseball player Brian Bruney went to arbitration in an attempt to increase his salary to $1.85 million for 2010, but the Washington Nationals argued for a salary of $1.5 million.15

---

**EXHIBIT 4-4**

THE ARBITRATOR’S CODE OF ETHICS

| CANON 1 | • An arbitrator will uphold the integrity and fairness of the arbitration process. |
| CANON 2 | • If the arbitrator has an interest or relationship that is likely to affect his or her impartiality or that might create an appearance of partiality or bias, it must be disclosed. |
| CANON 3 | • An arbitrator, in communicating with the parties, should avoid impropriety or the appearance of it. |
| CANON 4 | • The arbitrator should conduct the proceedings fairly and diligently. |
| CANON 5 | • The arbitrator should make decisions in a just, independent, and deliberate manner. |
| CANON 6 | • The arbitrator should be faithful to the relationship of trust and confidentiality inherent in that office. |
| CANON 7 | • In a case where there is a board of arbitrators, each party may select an arbitrator. That arbitrator must ensure that he or she follows all the ethical considerations in this type of situation. |

However, arbitration is also used to resolve a much broader range of issues: insurance and uninsured motorist claims, construction disputes, securities, real estate, intellectual property, and other commercial disputes. For example, many consumer complaints are now being handled through arbitration sponsored by Better Business Bureaus (BBBs) in more than 100 cities. Under the BBBS’ National Consumer Arbitration Program, which has been in effect since 1972, the consumer first files a complaint with the BBB, whose representative attempts to negotiate a solution between the consumer and the business. If negotiation fails, the consumer and the business representative sign a submission agreement specifying the disputed issues. They then select an arbitrator from a panel of five trained volunteers from the local community. After the hearing (at which the parties are usually not represented by counsel), the arbitrator has 10 days to render a decision.

Another area that is seeing an increasing use of arbitration is technology disputes. In 2003, the AAA handled technology-related claims that totalled more than $1 billion. The average claim was $1.2 million, and the average counter-claim $2.3 million.

The National Consumer Arbitration Program is limited in that arbitrators cannot award damages beyond the value of the product in question. They cannot, for example, award punitive damages or damages for personal injuries suffered as a result of a defective product. Despite these limitations, this program provides an excellent forum for disputes that often would not be resolved in court, because the cost of litigation would probably exceed or come close to the amount of the damage award. The use of arbitration in consumer cases is further discussed in Chapter 26.

As mentioned in the previous section, another area in which arbitration is increasingly being used is in employment disputes. Other areas in which arbitration is prevalent include malpractice cases, environmental disputes, community disputes and elections, and commercial contract conflicts. It is also being increasingly used to handle insurance liability claims arising from accidents.

**PROBLEMS WITH ARBITRATION**

Despite the growing use of arbitration, the process does not escape criticism, especially from the securities industry. From 1991, when the U.S. Supreme Court affirmed the authority of the securities industry to do so, until 1997, securities firms required that employees who execute, buy, or sell orders at brokerages or investment banks take all their employment disputes—including allegations of race, sex, and age discrimination—to arbitration instead of to court.

According to a study by the General Accounting Office (GAO), these disputes are most likely to be filed by women and minorities. They are also the cases most likely to be heard by white males over the age of 60. Only 11 percent of arbitrators are female, and fewer than 1 percent are Asian or black. Arbitrators in the securities industry come from the New York Stock Exchange and the National Association of Securities Dealers. Most are retired or semiretired executives or professionals, so they frequently lack expertise in discrimination matters.

Although not criticizing the fairness of the outcome in any particular case, the GAO did recommend that the industry appoint as arbitrators in discrimination cases people who had some knowledge about discrimination. They also recommended that the industry track the outcome of discrimination cases and establish criteria to keep individuals with records of regulatory violations or other disciplinary actions from becoming arbitrators. Finally, the report expressed concern over the lack of regularized Securities and Exchange Commission (SEC) oversight of the arbitration process in general, including the thousands of broker-customer disputes arbitrated each year. The GAO asked the
SEC to establish a regular cycle of reasonably frequent reviews of all securities arbitrations, which the SEC has agreed to do.

The trend toward greater use of compulsory arbitration in employment and termination cases concerns some lawyers and legal scholars, because they believe that such a requirement erodes workers’ rights. Thus, an employee who is subject to mandatory arbitration gives up the right to a public trial, the ability to get an injunction to stop unlawful practices, and the right to bring a class action suit.

Another potential problem is the arbitrator’s background. For example, although about half of the AAA’s arbitrators are lawyers, often an arbitrator is merely someone with expertise in the area in which the dispute arose. He or she may be solving a legal dispute without any real understanding of the applicable law.

A related problem is that if more employers (and other institutions) turn to mandatory arbitration, arbitration may start to become more and more like litigation. Those forced to give up their day in court may start pressing for their “due process” rights in arbitration. They may also argue that arbitrators should be allowed to grant the same remedies as courts. Ultimately, arbitration proceedings could be burdened with the same kinds of formalities that plague litigation—that is, the same disadvantages that gave rise to ADR in the first place.

Some also question the absence of written opinions. Without such opinions, legal precedents cannot develop to reflect changing circumstances. Finally, there is a question of whether the public interest is harmed by allowing an industry to use arbitration to “hide” its disputes from the public. If, for example, a bank required all billing disputes to be handled by arbitration, the public would never know if that bank was continually making overbilling errors. If such cases went to court, the public would be informed about the bank practices and inefficiencies. In addition, of course, firms that are secure in the knowledge that their operations will not be publicized are more likely to be lax than are firms that know they are subject to public scrutiny.

**Minitrials**

A relatively new means of resolving commercial disputes, probably first used in the United States in 1977 to resolve a dispute between TRW and Telecredit, is the minitrial. A minitrial is presided over by a neutral adviser, but the settlement authority resides with senior executives of the disputing corporations. Lawyers for each side make a presentation of the strengths and weaknesses of their respective positions. The adviser may be asked to give his or her opinion as to what the result would be if the case went to trial. The corporate executives then meet, without their attorneys, to discuss settlement options. Once they reach a settlement, they can make it binding by entering into a contract that encompasses the terms of the settlement.

The use of a minitrial before resorting to arbitration or litigation may be provided for in a contractual clause. One modification of the minitrial is to give the neutral adviser the authority to settle the case if the corporate executives cannot agree on a means of resolving the dispute within a given period of time.

The minitrial is seen by some as more desirable than arbitration when the disputes involve complex matters that may be better understood by parties directly involved in the contract than by an outside arbitrator. The process also requires intensive, direct communication between the disputants, which may help them better understand the other party’s position and thus may ultimately help their relationship. Minitrials, in some instances, also have the advantage of being less costly than arbitration. For example, the Army Corps of Engineers settled several cases through the use of minitrials, including one trial that involved...
Early Neutral Case Evaluation

Early neutral case evaluation is similar to a minitrial. In early neutral case evaluation, parties select a neutral third party and explain their respective positions to this neutral party, who then evaluates the strengths and weaknesses of their cases. This evaluation guides the parties in reaching a settlement.

Private Trials

In several states, legislation now permits private trials in which cases are tried by a referee selected and paid by the disputants. These referees are empowered by statute to render legally binding judgments. Referees usually need not have any special training, but they are frequently retired judges—hence the disparaging reference to this ADR method as “rent-a-judge.” The time and place of the trial are set by the parties at their convenience. Cases may be tried in private, a provision that ensures confidentiality.

On hearing the case, the referee states findings of facts and conclusions of law in a report with the trial court. The referee’s final judgment is entered with the clerk when the report is filed. Any party who is dissatisfied with the decision can move for a new trial before the trial court judge. If this motion is denied, the party can appeal the final judgment.

Until recently, private trials did not involve juries. Private jury trials, however, are now offered by a small number of private firms, most notably JAMS/Endispute.


---


17 Id.
Jurors in these cases tend to be slightly better educated than the typical jury, and many will have served on several previous private juries. Whether having “semi-professional” jurors serving on many cases perverts the idea of a “jury of one’s peers” is currently being debated.

Like other forms of ADR, private trials are subject to criticisms. Many people, for example, are concerned that the use of private trials may lead to the development of a two-tier system of justice. Disputants with sufficient resources will be able to channel their disputes through an efficient, private system; everyone else will have to resolve their complaints through a slower, less-efficient public system. Similarly, critics suggest that as wealthier individuals and corporations opt for the private courts, they will be less willing to channel their tax dollars into the public system. With less funding, the public system will then become even less effective. Finally, there is the same question that was raised with respect to arbitration: whether the public interest is harmed by allowing an industry to use private trials to “hide” its disputes from the public.

**Summary Jury Trials**

Originating in a federal district court in Cleveland, Ohio, in 1983, as a way to clean up an overcrowded docket, summary jury trials are today used in many state and federal courts across the nation for that purpose. The primary advantage of a summary jury trial is that it lasts only one day. The judge first instructs a jury on the law. Each side then has a limited amount of time to make an opening statement and present a summary of the evidence it would have presented at a regular trial.

The jury, which is usually composed of no more than six people, then retires to reach a verdict. The verdict, however, is only advisory, although jurors are usually not aware that their decision does not have a binding effect.

Immediately after receiving the verdict, the parties retire to a settlement conference. Roughly 95 percent of all cases settle at this point. If the parties do not settle, the case is then set for trial. If a case goes to trial, nothing from the summary trial is admissible as evidence.

**Court-Annexed Alternative Dispute Resolution**

**USE OF COURT-ANNEXED ADR IN THE STATE AND FEDERAL SYSTEMS**

In an attempt to relieve the overburdened court systems and in partial recognition of the success of voluntary ADR, many state and federal jurisdictions are mandating that disputants go through some formal ADR process before certain types of cases may be brought to trial. It is difficult to generalize about the use of ADR in the court system, however, because practices vary from jurisdiction to jurisdiction, and even from court to court, as courts experiment with a broad range of programs and approaches. Some courts mandate ADR; others make it voluntary. Some refer almost all civil cases to ADR; others target certain cases by subject matter or by amount of controversy.

In the federal system, for example, in 1984, some federal district courts began adopting programs for mandatory, nonbinding arbitration of disputes involving amounts of less than $100,000. The subsequent passage of the Alternative Dispute Resolution Act of 1998 required all federal district courts to have an ADR program along with a set of rules regarding this program. Under these mandatory programs, less than 10 percent of the cases referred to arbitration end up going to trial. When Congress enacted the ADR Act of 1998, Congress did not create any programs for
appellate courts, because all federal circuit courts had already implemented ADR programs. The one exception is the Federal Circuit, which hears cases of more specific and complex subject matter and, therefore, only suggests that parties discuss settlements before a trial. Nevertheless, ADR programs appear to be successful at the appellate level. For example, the Court of Appeals in the Ninth Circuit, like most courts at the appellate level, offers opposing parties an opportunity to reach a settlement during the appeals process. Relying primarily on mediation, the Ninth Circuit settled 739 cases in 2000, returning only 98 for additional litigation.

More than half of the states have enacted legislation authorizing ADR in the courts or have established statewide task forces to develop ADR programs, and probably every state has at least one court that has experimented with some form of ADR. Mediation is the form of ADR most commonly used, in part because of the informality of proceedings, the greater emphasis on cooperation over competition, and the larger amount of control that lawyers and parties have over their cases.

The aggressiveness with which a state encourages the use of ADR methods varies a great deal. For instance, Florida courts mandate the highest degree of ADR; these courts referred about 113,000 claims to ADR proceedings in 2001. In some states, such as Missouri, however, a completely voluntary approach is used. Courts are simply required to provide all parties with a notice of the availability of ADR services and names and addresses of persons or agencies able to provide such services. Although such a casual approach is criticized on the ground that few people will voluntarily use such services, defenders point out that if people choose ADR, their commitment to the process will be stronger than if they are forced into it and, therefore, it is more likely to work. Many states have adopted programs that require parties to take certain types of cases either to mandatory nonbinding arbitration or to mediation. In fact, at least 28 states require arbitration or mediation for certain kinds of cases or for cases under a particular monetary amount. Only when the parties cannot reach an agreement through mediation or when one party disagrees with the arbitrator’s decision will the court hear the case.

New Jersey is one example of a state that requires nonbinding arbitration. For two decades, New Jersey courts have required all civil suits involving vehicular accidents to be sent to arbitration. In 2000, the requirements were extended to include most claims involving personal injury, contracts, and commercial disputes. Consequently, New Jersey experienced a 75 percent increase in the number of arbitration claims filed each year. In Minnesota, parties must consult with each other and decide within 45 days of filing a case which form of ADR they would like to use. Their decision is reported to the court. If the parties cannot agree, or the judge disagrees with their selection, a conference with the judge is held and the judge then orders participants to use a particular ADR method.

Similarly, in the Western District of Missouri, approximately one-third of litigants must select a form of ADR to use. If the litigants cannot decide, an administrator of the court will meet with the parties and their lawyers and make a decision for them.

Some state systems also use ADR at the appellate level. South Carolina was the first state to do so. Under its system, arbitration at the appellate level is optional, but once arbitration has been selected, the decision of the arbitrator is binding.

**DIFFERENCES BETWEEN COURT-ANNEXED AND VOLUNTARY ADR**

**Arbitration.** Probably the major difference between court-annexed arbitration and voluntary arbitration is that, in most cases, the court-mandated arbitration is not binding on the parties. If either party objects to the outcome, the case will
go to court for a full trial. As you remember from earlier sections of this chapter, the outcome of voluntary arbitration is binding. The right of a dissatisfied party to reject a court-mandated arbitration decision is really necessary, however, to preserve the disputants’ due process rights. The government cannot take away a person’s right to his or her day in court in the interests of streamlining the justice system.

Of course, a person who chooses to go forward with a trial after rejecting an arbitrator’s decision may still be penalized to some extent in a number of states. In some systems, a party that rejects an arbitrator’s decision and does not receive a more favorable decision from the trial court may be forced to pay the opposing counsel’s court fees. In other systems, that party may be required to pay the costs of the arbitration or other court fees.

Another difference between court-mandated and voluntary arbitration lies in the rules of evidence, which are generally more relaxed in arbitration than in litigation. A few states do treat evidence in court-mandated arbitration in this same relaxed fashion, either allowing almost any evidence to be admitted regardless of whether it would be admissible in court, or allowing the arbitrator to decide what evidence is admissible. In most states, however, the same rules of evidence apply to court-annexed arbitration as apply to trials.

**Mediation.** The primary difference between court-mandated mediation and voluntary mediation is in the attitudes of the parties toward the process. In voluntary mediation, the parties are likely to enter the mediation process with a desire to work out an agreement; in court-ordered mediation, they are much more likely to view mediation as simply a hurdle to go through before the trial. Although some have tried to challenge the power of the courts to mandate some form of ADR, the courts have generally upheld this power. For example, in 2002, the First Circuit Court of Appeals, in the case of *In re Atlanta Pipe Corp.*, held that the district court had inherent power to require the parties to participate in nonbinding mediation and to share the costs.18

**The Future of Alternative Dispute Resolution**

You are already familiar with some of the problems associated with each of the ADR methods. You should also be aware of some of the concerns raised about the overall increase in the use of ADR.

First, some legal scholars are concerned about whether a dispute resolution firm can be truly unbiased when one of the parties to the dispute is a major client of the dispute resolution provider. For example, if a major insurance company includes a binding arbitration clause in all its contracts and specifies that JAMS/Endispute will provide the arbitrator, it may be tempting for JAMS/Endispute to favor the insurance company to try to ensure that it will continue to benefit from the firm’s business in the future. The more intense the competition among ADR providers, the more tempted the providers may be to favor large firms.

Another issue raised by some critics is whether it is fair for consumers to be coerced into an ADR forum and thereby forced to give up their right to a trial, especially when (1) they may be much more likely to get a higher award from a jury than from an arbitrator; and (2) they may find themselves having “agreed” to arbitration not really voluntarily but because of a clause stuck in a purchase agreement that they failed to read. Despite these concerns, however, interest in ADR continues to grow, and there is no reason to think this growth will end in the near future. During 2000, the AAA handled nearly 200,000 cases through ADR, more than double the number of cases handled in 1998.

---

18 304 F. 3d 135 (1st Cir. 2002).
Global Dimensions of Alternative Dispute Resolution

Internationally, alternative dispute resolution methods are highly favored. Seventy-three countries currently belong to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, commonly referred to as the New York Convention. The primary function of this treaty is to ensure that an arbitration award made in any of the signatory countries is enforceable in the losing party’s country. Defenses to enforcement that are allowed under the treaty include: one of the parties to the contract lacked the legal capacity to enter into a contract, the losing party did not receive proper notice of the arbitration, or the arbitrator was acting outside the scope of his or her authority in making the award.

The Lok Adalat system has a lot of support in India. It takes a large burden off the court system, and it gives people too poor to afford legal fees a chance to recover damages. There are no fees for the Lok Adalat and if a court fee has already been paid, it will be refunded if the case is settled through the Lok Adalat. The process is less formal than a court proceeding and the rules of procedure and evidence are not strictly applied.

International organizations, such as the World Bank, have offered some criticisms of the Lok Adalat system, however. Because the system is village-level, traditional prejudices against women and other underprivileged groups sometimes influence the rulings. Also, there has been evidence that some parties are abusing the Lok Adalat system, using it to delay resolution to get the injured party to abandon its claim.

The Lok Adalat system is an interesting innovation in ADR mechanisms, and it does have many benefits, but it also has drawbacks and can be misused, just like ADR mechanisms in the United States.

**Case 4-4**

**Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth**

*United States Supreme Court 473 U.S. 614 (1985)*

**Plaintiff** Mitsubishi, a Japanese corporation, and Chrysler International, a Swiss corporation, formed a joint venture, Mitsubishi Motors, to distribute worldwide motor vehicles manufactured in the United States and bearing Mitsubishi and Chrysler trademarks. Defendant Soler Chrysler-Plymouth, a dealership incorporated in Puerto Rico, entered into a distributorship agreement with Mitsubishi that included a binding arbitration clause. When Soler began having difficulty selling the requisite number of cars, it first asked Mitsubishi to delay shipment...
of several orders and then subsequently refused to accept liability for its failure to sell vehicles under the contract.

Plaintiff Mitsubishi filed an action to compel arbitration. The district court ordered arbitration of all claims, including the defendants’ allegations of antitrust violations. The court of appeals reversed in favor of the defendant. The plaintiff, Mitsubishi, appealed to the U.S. Supreme Court.

**Justice Blackmun**

We granted certiorari primarily to consider whether an American court could enforce an agreement to resolve antitrust claims by arbitration when that agreement arises from an international transaction. Soler reasons that because it falls within a class [for] whose benefit the federal and local antitrust laws were passed, the clause cannot be read to contemplate arbitration of these statutory claims.

We do not agree, for we find no warrant in the Arbitration Act for implying in every contract a presumption against arbitration of statutory claims. The “liberal federal policy favoring arbitration agreements,” manifested by the act as a whole, is at bottom a policy guaranteeing the enforcement of private contractual arrangements: the act simply “creates a body of federal substantive law establishing and regulating the duty to honor an agreement to arbitrate.”

There is no reason to depart from these guidelines where a party bound by an arbitration agreement raises claims founded on statutory rights. Of course, courts should remain attuned to well-supported claims that the agreement to arbitrate resulted from the sort of fraud or overwhelming economic power that would provide grounds “for the revocation of any contract.” But, absent such compelling considerations, the act itself provides no basis for disfavoring agreements to arbitrate statutory claims.

By agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute, it only submits to their resolution in an arbitral, rather than a judicial, forum. It trades the procedures and opportunity for review of the courtroom for the simplicity, informality, and expedition of arbitration.

We now turn to consider whether Soler’s antitrust claims are nonarbitrable even though it agreed to arbitrate them. . . . [W]e conclude that concerns of international comity, respect for the capacities of foreign and transnational tribunals, and sensitivity to the need of the international commercial system for predictability in the resolution of disputes require that we enforce the parties’ agreement, even assuming that a contrary result would be forthcoming in a domestic context.

There is no reason to assume at the outset of the dispute that international arbitration will not provide an adequate mechanism. To be sure, the international arbitral tribunal owes no prior allegiance to the legal norms of particular states; hence, it has no direct obligation to vindicate their statutory dictates. The tribunal, however, is bound to effectuate the intentions of the parties. Where the parties have agreed that the arbitral body is to decide a defined set of claims that includes, as in these cases, those arising from the application of American antitrust law, the tribunal therefore should be bound to decide that dispute in accord with the national law giving rise to the claim.

As international trade has expanded in recent decades, so too has the use of international arbitration to resolve disputes arising in the course of that trade. The controversies that international arbitral institutions are called upon to resolve have increased in diversity as well as in complexity. Yet the potential of these tribunals for efficient disposition of legal disagreements arising from commercial relations has not yet been tested. If they are to take a central place in the international legal order, national courts will need to “shake off the old judicial hostility to arbitration,” and also their customary and understandable unwillingness to cede jurisdiction of a claim arising under domestic law to a foreign or transnational tribunal. To this extent, at least, it will be necessary for national courts to subordinate domestic notions of arbitrability to the international policy favoring commercial arbitration.

Accordingly, we “require this representative of the American business community to honor its bargain,” . . . by holding this agreement to arbitrate “enforce[able] in accord with the explicit provisions of the Arbitration Act.”

[As to the issue of arbitrability] Reversed and remanded in favor of the Plaintiff, Mitsubishi.

**SUMMARY**

As the burden on our court system increases, many disputants are turning to alternative ways of resolving disputes. These alternatives include (1) negotiation and settlement, (2) arbitration, (3) mediation, (4) minitrials, (5) early neutral case evaluation, (6) private trials, and (7) summary jury trials.

Which, if any, alternative is best for an individual depends on the situation. The primary benefits that come from these alternatives, in varying degrees, include (1) less publicity, (2) less time, (3) less expense, (4) more convenient proceedings, and (5) a better chance to have a reasonable relationship with the other disputant in the future.

Alternative dispute resolution also has its critics. Some of their concerns are that compulsory ADR may force parties to give up their “day in court,” that a party who consistently procures ADR services from one firm will end up with a “neutral” that is biased toward that party, and that we will end up with a two-tier system of justice—an efficient private system and an overburdened public one.
PART ONE • Introduction to the Law and the Legal Environment of Business

REVIEW QUESTIONS

4-1 Explain why the use of ADR is increasing.
4-2 When will a judge overturn an arbitrator’s decision?
4-3 Explain how to secure arbitration as a means of resolving a dispute.
4-4 Why are some people opposed to the growing use of arbitration?
4-5 What are the basic obligations of an arbitrator, according to the Arbitrator’s Code of Ethics?
4-6 Identify the factors that would lead a disputant to favor mediation as a dispute resolution method.

REVIEW PROBLEMS

4-7 McGraw and Duffy have a contract that includes a binding arbitration clause. The clause provides for arbitration of any dispute arising out of the contract. The clause also provides that the arbitrator is authorized to award damages of up to $100,000 in any dispute arising out of the contract. McGraw allegedly breaches the contract. Duffy seeks arbitration, and the arbitrator, given the willfulness of the breach and the magnitude of its consequences, awards Duffy $150,000 in damages. Would a court uphold the award? Why or why not?

4-8 Sam and Mary enter into a contract that does not include a provision for arbitration. Mary wants to arbitrate the dispute, but Sam believes that arbitration is not possible because there is no binding arbitration clause in the contract. How can the parties secure arbitration?

4-9 Howard and Hannah decide to resolve a contract dispute through arbitration. They select their arbitrator through a private service. The arbitrator returns a significant award for Howard. The weekend after receiving a notice of the award, Hannah finds out from one of Howard’s coworkers that, although the arbitrator and Howard acted as if they did not know each other, they had actually been college roommates. Does Hannah have any basis for getting the award set aside?

4-10 Eloise is hired as a pharmacist and signs an employment agreement that includes a provision stating that she will submit any employment disputes to arbitration. After being on the job for three years, she is denied a promotion that she feels she deserved. She files a sex discrimination charge with the EEOC and a lawsuit in the federal district court. The employer files a motion to compel arbitration. Will Eloise be forced to arbitrate her claims? Why or why not?

4-11 Boxley Corporation and Eberly Corporation have a contract dispute before an arbitrator. Eberly wants to present evidence of prior contract disputes the two have had, but the arbitrator refuses to receive that evidence, saying it is not relevant to the alleged breach of contract at issue before him. When Boxley receives an award from the arbitrator that entitles it to significant damages from Eberly, the latter appeals the arbitrator’s decision on the ground that the excluded evidence would have changed the outcome. Why is Eberly likely or unlikely to have the award overturned?

4-12 Marshall files a complaint against S.A. & E., a brokerage firm registered with the Securities and Exchange Commission. The complaint alleges a violation of the Securities Exchange Act by engaging in fraudulent excessive trading. S.A. & E. files a motion to dismiss the case because Marshall had signed a customer agreement that included in its terms a promise to submit all disputes arising regarding their accounts to arbitration. Marshall argues that, owing to the egregious nature of S.A. & E’s conduct, Marshall should be entitled to his day in court and the binding arbitration clause should be nullified. Why will the court grant or deny S.A. & E’s motion?

CASE PROBLEMS

4-13 Olshan Foundation Repair Company did foundation stabilization work for Remigio and Martha Ayala. As part of the contract, both parties signed a binding arbitration agreement. When the Ayalas sued Olshan for breach of contract, fraud, negligence, and violations of the Deceptive Trade Practices Act, alleging that their foundation had failed, Olshan moved to compel arbitration. The trial court granted the motion and the parties moved to begin arbitration with the AAA. Later, the Ayalas were informed that their half of the arbitration would cost more than $33,000. The Ayalas renewed their objection to arbitration, asserting that the excessive costs made the arbitration agreement unconscionable. Olshan argued that the
arbitration treated both sides fairly (they split the costs evenly), which negated the unconscionability argument. The trial court denied Olshan’s motion to compel arbitration, and Olshan appealed. The appeals court also found the arbitration agreement unconscionable, and denied Olshan’s motion to compel arbitration. What reasons did the court give for finding the arbitration agreement unconscionable? Olshan Foundation Repair Co. v. Ayala, 180 S.W.3d 212 (Tex. Ct. App. 2005).

4-14 After the plaintiff had been employed by AGF for 20 years, the company announced that continued employment with the firm was dependent upon agreement to arbitrate all future employment disputes through the new Employee Dispute Resolution (EDR) program. A document was given to all employees explaining the program and containing the statement “continuing employment with AGF means that you agree to resolve employment related claims against the company . . . through this process.” When the plaintiff was fired two years after this document was distributed, she sued the employer for violating her leave rights under the Family and Medical Leave Act. AGF filed a motion to compel arbitration, which was denied by the district court. When AGF appealed, do you believe the denial was upheld or denied? Why or why not? Seawright v. American General Financial Services, Inc., 507 F.3d 967 (6th Cir. 2007).

4-15 The plaintiffs-appellants were 23 individuals who were employees of Seagull Energy. The plaintiffs comprised virtually all of the employees of the Operations and Construction Group (O&C Group), a division of Seagull. Seagull had adopted a Management Stability Plan (the Plan) in 1995, which provided that employees involuntarily terminated within two years after a “change in control,” such as a merger, would receive specified severance benefits. It provided that disputes under the Plan should be submitted to arbitration.

After a merger, the plaintiffs did not timely receive severance benefits pursuant to the terms of the Plan, so they each filed a claim with the Ocean Organization and Compensation Committee (the Committee), which was also the named fiduciary with the power to administer the Plan and review claims. It was primarily composed of outside directors and Senior Ocean executives. The Committee based its decision on a packet of information, including a denial letter drafted by the company’s general counsel. The Committee met for one hour and decided to deny benefits.

The plaintiffs filed suit in Texas state district court. Ocean removed to federal court and then moved the district court to compel arbitration. The district court ordered “plaintiffs’ claims” to be arbitrated. The parties agreed on an arbitrator and submitted the case. The arbitrator entered a 42-page opinion awarding the plaintiffs benefits under the Plan totaling some $1.5 million plus $75,000 attorney fees and 6 percent preaward interest and 10 percent postaward interest.

Ocean then filed an application to vacate the award in the district court, arguing that the arbitrator had exceeded his authority by reviewing the merits of the Plan and its amendments. The plaintiffs’ statement of claim had clearly presented to the arbitrator all of the issues decided by the arbitrator. The defendant never objected to any of the issues submitted to arbitration by the plaintiffs until after the arbitrator decided against the defendant.

The district court vacated the award, finding that the arbitrator had “exceeded his powers, misunderstood the law, and misread the documents.”

The plaintiffs appealed, asserting that the district court improperly applied a de novo standard of review and ignored the considerable deference due arbitration awards. Ocean argued that the arbitrator exceeded his powers by reviewing the merits of the Plan and its amendments. On appeal, was the district court order to vacate the arbitration award upheld? Why or why not? Harold A. Kergosien, et al. v. Ocean Energy, Inc., 376 F.3d 377; 2004 WI 2451351 (5th Cir. 2004).

4-16 In 2009, a hairstylist and makeup artist named Rita Ragone brought suit against her employer for sexual harassment. She worked for Atlantic Video, ESPN. Her contract stated that all sexual harassment claims would be subject to arbitration and not a court trial. In fact, Ragone was hired on the condition that she sign the contract containing the arbitration provision. The provision specifically said that her claims would be submitted to one arbitrator, and that the arbitrator’s decision would be binding.

Ragone wanted to dismiss the arbitration provision. However, the court could waive the provision only if it was unconscionable. Ragone argued that three clauses were unconscionable: Specifically, she must file the claim within 90 days instead of the usual 300 days, the losing party would pay all attorneys fees, and there was no right to a jury trial. Do you think these three clauses are unconscionable? How do you think the court decided? Ragone v. Atlantic Video, 2010 U.S. App. LEXIS 3018 (2d Cir. Feb. 17, 2010).

4-17 Howard Wein had an agreement with property owner Jack Morris regarding payment of a commission for bringing possible future tenants to view Morris’s property. Allegedly, Morris himself eventually found tenants directly and leased his properties without acknowledging or paying Wein. Wein in turn brought suit against Morris, claiming that their
agreement was illegally terminated and his business relationships with the possible tenants were interfered with. However, the commission agreement between Wein and Morris contained arbitration clauses. Both Wein and Morris went to court and, although the litigation lasted five years, neither party ultimately favored arbitration. However, the judge (ignoring the objections of both parties) demanded arbitration and dismissed the lawsuit. Both parties then engaged in arbitration and Wein was awarded his commissions. Subsequently, Morris appealed, stating that the court’s decision regarding arbitration ought to be reversed because both parties had waived their right to arbitration. How do you think the court responded to Morris’s appeal? Does the arbitration still stand even though the parties originally waived arbitration? Wein v. Morris, 388 N.J. Super 640 (App. Div. 2006).

4-18 Ally Cat LLC bought a condo from Chauvin, the seller of the unit. A Home Owners Limited Warranty document, containing an arbitration provision, was transferred to Ally Cat. However, the document did not specifically state that the signer of the document had to comply with the terms of the document. The document alternatively meant that the signer (or purchaser of the condo) was simply acknowledging that the document and condo had been received. In other words, under Kentucky law, the document did not qualify as a binding arbitration agreement. If the document did qualify under Kentucky law, Ally Cat would be forced to resolve disputes through arbitration and Kentucky courts would have jurisdiction to enforce the arbitration. Therefore, when Ally Cat attempted to bring Chauvin to court for damages, how do you think the court resolved the dispute? Did the parties have to settle through arbitration? Ally Cat LLC, et al, v. Chauvin et al., 274 S.W.3d 451; 2009 Ky. LEXIS 10 (Ky. 2009).

4-19 Kevin Janda entered into a cell phone service agreement with T-Mobile USA. Janda and Singh asserted that T-Mobile charged a “Universal Service Fund Fee” and/or a “Regulatory Cost Recovery Fee,” which was not required by law and was not included in the advertised cost. Also, T-Mobile supposedly billed minutes in billing periods other than when the call was made, and improperly charged for roaming, long distance, and nights and weekends that were supposed to be free. The service agreement said, in small, bold font, that the signatory agreed to all terms and conditions and that all disputes were subject to mandatory arbitration with more information to be found on the back of the agreement. The agreement required a waiver of all class action rights. The contract included this provision: “an arbitrator may not award relief in excess of or inconsistent with the provisions of the Agreement . . . or award lost profits, punitive, incidental or consequential damages or any other damages other than the prevailing party’s direct damages,” as well as this provision: “[e]ach party agrees to pay the fees and costs of its own counsel . . . at the arbitration,” which seems to limit the plaintiff to attorney fees that amount to less than what he is allowed to recover. Singh and Janda argued that the contract was unconscionable, and they should not be required to arbitrate. The U.S. District Court found that the contract was unconscionable. What reasoning did the court use to come to that decision? Janda v. T-Mobile, 2006 U.S. Dist. LEXIS 15748 (N.D. Cal., Mar. 17, 2006).

4-20 Steven Gorelick and Haim Gvritzman, professors at Stanford University, created a new method of extracting volatile organic compounds from groundwater (NoVOCs technology). They granted the patent right to Stanford in exchange for one-sixth each of the royalty payments. After a series of transfers and acquisitions of stock and licenses, the company EG&G held a license to use the NoVOCs technology with an agreement to pay Gorelick installment payments of $3,000 for every well drilled with NoVOCs technology. Their agreement included an arbitration agreement that excluded patent invalidity or infringement, and that held the arbitrator’s decision final and nonappealable. EG&G was bought by MACTEC, which transferred all of EG&G’s responsibilities to MACTEC, including the payments for drilling NoVOCs wells. MACTEC developed a similar and partly overlapping technology and renegotiated its contract with Gorelick to $1,500 per well drilled. When MACTEC terminated its license with Stanford to use the NoVOCs technology, it ceased paying Gorelick. Gorelick filed a demand for arbitration.

The arbitrator awarded Gorelick approximately $4.5 million, based partly on the discovery of many wells for which Gorelick had not received payment. MACTEC filed for review before a federal district court. The district court found the arbitrator’s award to be proper, and therefore upheld the award. MACTEC appealed to the Tenth Circuit Court of Appeals. Gorelick argued that the nonappealability clause in the arbitration agreement prevented the court of appeals from having jurisdiction over the case. Do you think the court agreed to hear the case? Why? MACTEC, Inc. v. Gorelick, 427 F.3d 821 (10th Cir. 2005).
THINKING CRITICALLY ABOUT RELEVANT LEGAL ISSUES

Arbitration in the Malpractice Arena

Recently, a group of New Jersey gynecologists have come under fire for requiring their patients to sign a binding arbitration agreement before treating them. The agreement waived the patients’ rights to a jury trial and limited the amount of damages they could be awarded. The use of binding arbitration agreements has grown in recent years, and they are desperately needed in the field of medicine.

Malpractice insurance for doctors has become unreasonably expensive because of frivolous lawsuits that award plaintiffs huge damages. These lawsuits are especially a problem in the fields of obstetrics and gynecology. Consequently, many doctors avoid obstetrics and gynecology, and those doctors who remain in this field are forced to charge more for their care to pay for their insurance. Obstetrics and gynecology are crucial areas in medicine and the shortage of obstetricians and gynecologists poses a major threat to the health of American women.

The arbitration agreement is beneficial for both doctor and patient. Arbitration agreements limit the award a patient can receive, which helps to keep insurance rates down and lowers the cost of care for all patients. Arbitration is faster and less expensive for plaintiffs than a lawsuit. Arbitration also allows patients to recover damages much more quickly than a lawsuit, and although the damages are limited, arbitration avoids the many appeals that larger punitive damages generate.

Some have questioned the legality of these doctor-patient arbitration agreements. Binding arbitration agreements between doctor and patient are no different from those between employer and employee, which the Supreme Court ruled are completely legal in *Gilmer v. Interstate/Johnson Lane Corp*. The court ruled that Gilmer’s age discrimination suit was subject to compulsory arbitration because of the employment agreement he signed and that the employment agreement requiring arbitration was valid. Therefore, a binding arbitration agreement between doctor and patient is valid.

Just as an employee does not have to accept employment if she does not like the offered contract, a patient does not have to be treated by that doctor if she does not like the doctor’s terms. There is, however, no reason a patient should have a problem with an arbitration agreement. It helps lower costs for both doctors and patients and speeds up the process for everyone involved. Not only should doctor-patient arbitration agreements be upheld as legal, they should be encouraged.

1. How would you frame the issue and conclusion of this essay?
2. What ethical norms would cause the author of this essay to take this position?
   **Clue:** Look at the ethical norms discussed in Chapter 1.
3. What legal analogy is used to support the author’s argument? How appropriate is that legal analogy?
4. Write an essay that someone who holds an opinion opposite to that of the essay author might write.
   **Clue:** What other ethical norms could influence an opinion on this issue?

ASSIGNMENT ON THE INTERNET

After reading this chapter, you should have an understanding about the advantages and disadvantages of ADR. Using the Internet, find a private mediation and arbitration firm, such as National Arbitration and Mediation. Visit its Web site (www.namadr.com) and create a list of questions you would want to ask before hiring its services by applying the information in this chapter and your critical thinking skills.

What kind of problems might be associated with this company’s process? Where do its mediators or arbitrators come from? What qualities would you look for in choosing a mediator or arbitrator? What are the advantages of using this company? What are the disadvantages?

Now that you have evaluated one ADR firm, make a comparison to another firm that you found on the Internet (e.g., www.resolvenmydispute.com). What distinguishes one firm from the other? Why would you choose one and not the other? What factors affect your answer? When would you forgo ADR and use the court system?
ON THE INTERNET

www.adrr.com This ADR site contains substantial online materials for ADR and particularly for mediation.
www.odr.info/ This site has information on online dispute resolution.
www.calbar.ca.gov/state/calbar/calbar_generic.jsp?cid=11373&id=19728 This Web site has recent ADR cases from California.
www.adr.org This is the home page of the American Arbitration Association.
www.dr.bbb.org/ The Better Business Bureau’s dispute resolution page.
www.law.cornell.edu/uscode/9 The Federal Arbitration Act can be found at this Web site.

FOR FUTURE READING


Constitutional Principles

- THE CONSTITUTION
- FEDERALISM
- SEPARATION OF POWERS
- THE IMPACT OF THE COMMERCE CLAUSE ON BUSINESS
- THE TAXING AND SPENDING POWERS OF THE FEDERAL GOVERNMENT
- THE IMPACT OF THE AMENDMENTS ON BUSINESS

Fiercely independent, highly individualistic, and very proud of their country would be a good characterization of Americans. Many say there is no place they would rather live than the United States. Much of their pride stems from a belief that they have a strong Constitution, which secures for all individuals their most fundamental rights. Most people, however, are not aware of precisely what their constitutional rights are or of how to go about enforcing those rights. This chapter provides the future business manager with basic knowledge of the constitutional framework of our country, as well as an overview of the significant impact of some of the constitutional provisions on the legal environment of business.

The Constitution

The Constitution provides the legal framework for our nation. The articles of the Constitution set out the basic structure of our government and the respective roles of the state and federal governments. The Amendments to the Constitution, especially the first 10, were primarily designed to establish and protect individual rights.

Federalism

Underlying the system of government established by the Constitution is the principle of federalism, which means that the authority to govern is divided between two sovereigns or supreme lawmakers. In the United States, these two sovereigns are the state and federal governments. Federalism allocates the power to control local matters to local governments. This allocation is embodied in the U.S. Constitution. Under the Constitution, all powers that are neither given exclusively to the federal government nor taken from the states are reserved to the states. The federal government has only those powers granted to it in the Constitution. Therefore, whenever federal legislation that affects business is passed, the question of the source of authority for that regulation always arises. The Commerce Clause is the predominant source of authority for the federal regulation of business, as we will see later.
The Constitution secures numerous rights for U.S. citizens. If we did not have these rights, our lives would be very different. Furthermore, businesses would be forced to alter their practices because they would not enjoy the various constitutional protections. As you will soon learn, various components of the Constitution, such as the Commerce Clause and the Bill of Rights, offer guidance and protection for businesses. The following questions will help sharpen your critical thinking about the effects of the Constitution on business.

1. One of the basic elements in the Constitution is the separation of powers in the government. What ethical norm would guide the framers’ thinking in creating a system with a separation of powers and a system of checks and balances?
   
   **Clue:** Consider what might happen if one branch of government became too strong.

2. If the framers of the Constitution wanted to offer the protection of unrestricted speech to citizens and businesses, what ethical norm would they view as most important?
   
   **Clue:** Return to the list of ethical norms in Chapter 1. Which ethical norm might the framers view as least important in protecting unrestricted speech?

3. Why should you, as a future business manager, be knowledgeable about the basic protections offered by the Constitution?
   
   **Clue:** If you were ignorant of the constitutional protections, how might your business suffer?

In some areas, the state and federal governments have concurrent authority; that is, both governments have the power to regulate the matter in question. This situation arises when authority to regulate in an area has been expressly given to the federal government by the Constitution. In such cases, a state may regulate in the area as long as its regulation does not conflict with any federal regulation of the same subject matter. A conflict arises when a regulated party cannot comply with both the state and the federal laws at the same time. When the state law is more restrictive, such that compliance with the state law is automatically compliance with the federal law, the state law will usually be valid. For example, as discussed in Chapter 23, in many areas of environmental regulation, states may impose much more stringent pollution-control standards than those imposed by federal law.

### SUPREMACY CLAUSE

The outcome of conflicts between state and federal laws is dictated by the **Supremacy Clause**. This clause, found in Article VI of the Constitution, provides that the Constitution, laws, and treaties of the United States constitute the supreme law of the land, “any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.” This principle is known as the principle of federal supremacy: Any state or local law that directly conflicts with the federal Constitution, laws, or treaties is void. Federal laws include rules promulgated by federal administrative agencies. Exhibit 5-1 illustrates the application of the Supremacy Clause to state regulation.

### FEDERAL PREEMPTION

The Supremacy Clause is also the basis for the doctrine of **federal preemption**. This doctrine is used to strike down a state law that, although it does not directly conflict with a federal law, attempts to regulate an area in which federal legislation is so pervasive that it is evident that the U.S. Congress wanted only federal regulation in that general area. It is often said in these cases that federal law “preempts the field.” Cases of federal preemption are especially likely to arise in matters
Does the state law directly conflict with a federal law?

If yes, the state law is invalid under the Supremacy Clause.

If no, does the state law attempt to regulate in an area where federal law is so pervasive that it appears that Congress intended only federal regulation in that area?

If yes, the state law is invalid under the doctrine of federal preemption.

If no, the state law is valid.

EXHIBIT 5-1
APPLICATION OF THE SUPREMACY CLAUSE TO STATE REGULATION

Does the state law directly conflict with a federal law?

If yes, the state law is invalid under the Supremacy Clause.

If no, does the state law attempt to regulate in an area where federal law is so pervasive that it appears that Congress intended only federal regulation in that area?

If yes, the state law is invalid under the doctrine of federal preemption.

If no, the state law is valid.

pertaining to interstate commerce, such as when a local regulation imposes a substantial burden on the flow of interstate commerce through a particular state. This situation is discussed in some detail in the section on the Commerce Clause.

Separation of Powers

The U.S. Constitution, in its first three articles, establishes three independent branches of the federal government, each with its own predominant and independent power. These three are the legislative, executive, and judicial branches. Each branch was made independent of the others and was given a separate sphere of power to prevent any one source from obtaining too much power and consequently dominating the government.

The doctrine of separation of powers calls for Congress, the legislative branch, to enact legislation and appropriate funds. The president is commander-in-chief of the armed forces and is also charged with ensuring that the laws are faithfully executed. The judicial branch is charged with interpreting the laws in the course of applying them to particular disputes. No member of one branch owes his or her tenure in that position to a member of any other branch; no branch can encroach on the power of another. This system is often referred to as being a system of checks and balances; that is, the powers given to each branch operate to keep the other branches from being able to seize enough power to dominate the government. Exhibit 5-2 provides a portrait of this system.

EXHIBIT 5-2
SYSTEM OF CHECKS AND BALANCES
Despite this delicate system of checks and balances, on numerous occasions a question has arisen as to whether one branch was attempting to encroach on the domain of another. This situation arose in an unusual context: a sexual harassment charge against President Bill Clinton.

**CASE 5-1**

**William Jefferson Clinton v. Paula Corbin Jones**

Supreme Court of the United States 520 U.S. 681 (1997)

Plaintiff Paula Jones filed a civil action against defendant (sitting) President Bill Clinton, alleging that he made “abhorrent” sexual advances. She sought $75,000 in actual damages and $100,000 in punitive damages.

Defendant Clinton sought to dismiss the claim on the ground of presidential immunity, or, alternatively, to delay the proceedings until his term of office had expired.

The district court denied the motion to dismiss and ordered discovery to proceed, but it also ordered that the trial be stayed until the end of Clinton’s term. The court of appeals affirmed the denial of the motion to dismiss and reversed the stay of the trial. President Clinton appealed to the U.S. Supreme Court.

**Justice Stevens**

Petitioner’s principal submission—that “in all but the most exceptional cases,” the Constitution affords the President temporary immunity from civil damages litigation arising out of events that occurred before he took office—cannot be sustained on the basis of precedent.

Only three sitting presidents have been defendants in civil litigation involving their actions prior to taking office. Complaints against Theodore Roosevelt and Harry Truman had been dismissed before they took office; the dismissals were affirmed after their respective inaugurations. Two companion cases arising out of an automobile accident were filed against John F. Kennedy in 1960 during the Presidential campaign. After taking office, he unsuccessfully argued that his status as Commander in Chief gave him a right to a stay. The motion for a stay was denied by the District Court, and the matter was settled out of court. Thus, none of those cases sheds any light on the constitutional issue before us.

The principal rationale for affording certain public servants immunity from suits for money damages arising out of their official acts is inapplicable to unofficial conduct. In cases involving prosecutors, legislators, and judges we have repeatedly explained that the immunity serves the public interest in enabling such officials to perform their designated functions effectively without fear that a particular decision may give rise to personal liability.

That rationale provided the principal basis for our holding that a former president of the United States was “entitled to absolute immunity from damages liability predicated on his official acts.” Our central concern was to avoid rendering the President “unduly cautious in the discharge of his official duties.”

This reasoning provides no support for an immunity for unofficial conduct. . . . “[T]he sphere of protected action must be related closely to the immunity’s justifying purposes.” But we have never suggested that the President, or any other official, has an immunity that extends beyond the scope of any action taken in an official capacity.

Moreover, when defining the scope of an immunity for acts clearly taken within an official capacity, we have applied a functional approach. “Frequently our decisions have held that an official’s absolute immunity should extend only to acts in performance of particular functions of his office.” Petitioner’s strongest argument supporting his immunity claim is based on the text and structure of the Constitution. The President argues for a postponement of the judicial proceedings that will determine whether he violated any law. His argument is grounded in the character of the office that was created by Article II of the Constitution and relies on separation-of-powers principles.

As a starting premise, petitioner contends that he occupies a unique office with powers and responsibilities so vast and important that the public interest demands that he devote his undivided time and attention to his public duties. He submits that—given the nature of the office—the doctrine of separation of powers places limits on the authority of the Federal Judiciary to interfere with the Executive Branch that would be transgressed by allowing this action to proceed.

We have no dispute with the initial premise of the argument. We have long recognized the “unique position in the constitutional scheme” that this office occupies.

It does not follow, however, that separation-of-powers principles would be violated by allowing this action to proceed. The doctrine of separation of powers is concerned with the allocation of official power among the three coequal branches of our Government. The Framers “built into the tripartite Federal Government . . . a self-executing safeguard against the encroachment or aggrandizement of one branch at the expense of the other.” Thus, for example, the Congress may not exercise the judicial power to revise final judgments, or the executive power to manage an airport.

. . . [I]n this case there is no suggestion that the Federal Judiciary is being asked to perform any function that might in some way be described as “executive.” Respondent is merely asking the courts to exercise their core Article III jurisdiction to decide cases and controversies. Whatever the outcome of this case, there is no possibility
that the decision will curtail the scope of the official powers of the Executive Branch. The litigation of questions that relate entirely to the unofficial conduct of the individual who happens to be the President poses no perceptible risk of misallocation of either judicial power or executive power.

Rather than arguing that the decision of the case will produce either an aggrandizement of judicial power or a narrowing of executive power, petitioner contends that—as a by-product of an otherwise traditional exercise of judicial power—burdens will be placed on the President that will hamper the performance of his official duties. We have recognized that “[e]ven when a branch does not arrogate power to itself . . . the separation-of-powers doctrine requires that a branch not impair another in the performance of its constitutional duties.” As a factual matter, petitioner contends that this particular case—as well as the potential additional litigation that an affirmance of the Court of Appeals judgment might spawn—may impose an unacceptable burden on the President’s time and energy and thereby impair the effective performance of his office.

Petitioner’s predictive judgment finds little support in either history or the relatively narrow compass of the issues raised in this particular case. If the past is any indicator, it seems unlikely that a deluge of such litigation will ever engulf the presidency. As for the case at hand, if properly managed by the District Court, it appears to us highly unlikely to occupy any substantial amount of petitioner’s time.

Of greater significance, petitioner errs by presuming that interactions between the Judicial Branch and the Executive, even quite burdensome interactions, necessarily rise to the level of constitutionally forbidden impairment of the Executive’s ability to perform its constitutionally mandated functions. Separation of powers does not mean that the branches “ought to have no partial agency in, or no control over the acts of each other.” The fact that a federal court’s exercise of its traditional Article III jurisdiction may significantly burden the time and attention of the Chief Executive is not sufficient to establish a violation of the Constitution. Two long-settled propositions . . . support that conclusion.

First, we have long held that when the President takes official action, the Court has the authority to determine whether he has acted within the law. Perhaps the most dramatic example of such a case is our holding that President Truman exceeded his constitutional authority when he issued an order directing the Secretary of Commerce to take possession of and operate most of the Nation’s steel mills, in order to avert a national catastrophe.1

Second, it is also settled that the President is subject to judicial process in appropriate circumstances. We . . . held that President Nixon was obligated to comply with a subpoena commanding him to produce certain tape recordings of his conversations with his aides. As we explained, “neither the doctrine of separation of powers, nor the need for confidentiality of high-level communications, without more, can sustain an absolute, unqualified presidential privilege of immunity from judicial process under all circumstances.”

Sitting Presidents have responded to court orders to provide testimony and other information with sufficient frequency that such interactions between the Judicial and Executive Branches can scarcely be thought a novelty. President Ford complied with an order to give a deposition in a criminal trial, and President Clinton has twice given videotaped testimony in criminal proceedings.

“[I]t is settled law that the separation-of-powers doctrine does not bar every exercise of jurisdiction over the President of the United States.” If the Judiciary may severely burden the Executive Branch by reviewing the legality of the President’s official conduct, and if it may direct appropriate process to the President himself, it must follow that the federal courts have power to determine the legality of his unofficial conduct. The burden on the President’s time and energy that is a mere by-product of such review surely cannot be considered as onerous as the direct burden imposed by judicial review and the occasional invalidation of his official actions. We therefore hold that the doctrine of separation of powers does not require federal courts to stay all private actions against the President until he leaves office.

Reversed in part. Affirmed in part in favor of Respondent, Jones.

COMMENT: After this case was sent back for trial on the merits, the case was ultimately dismissed on April 1, 1998, on a motion for summary judgment on the ground that the plaintiff’s allegations, even if true, failed to state a claim of criminal sexual assault or sexual harassment. It is ironic that despite the high court’s claim that the case would be “highly unlikely to occupy any substantial amount of the petitioner’s time,” matters arising out of this case managed to occupy so much of the president’s time and become such a focus of a media frenzy that many people were calling for the media to reduce coverage of the issues so the president could do his job.2

Finance

The principle behind the separation of powers in government is also modeled in another realm of business. In your accounting class, you learned that internal controls are the policies and procedures used to create a greater assurance that the objectives of an organization will be met. One feature of internal controls is the separation of duties. This feature calls for the functions of authorization, recording, and custody to be exercised by different individuals. The likelihood of illegal acts by employees is reduced when the responsibility of completing a task is dependent on more than one person. If there are three people responsible for carrying out a particular task, then each person acts as a deterrent to the other two in regard to the possibility of embezzlement by one or more employees. Therefore, the chance of dishonest behavior is minimized when employees act as a check on the other employees involved in striving to meet organizational objectives.


Cases like Jones v. Clinton are not common. The reason is not that each branch generally operates carefully within its own sphere of power. Rather, the explanation lies in the fact that because it is difficult to determine where one branch’s authority ends and another’s begins, each branch rarely challenges the power of its competing branches. The powers of each branch were established so that, although the branches are separate and independent, each branch still influences the actions of the others and there is still a substantial amount of interaction among them.

The Impact of the Commerce Clause on Business

THE COMMERCE CLAUSE AS A SOURCE OF FEDERAL AUTHORITY

The primary powers of Congress are listed in Article I of the Constitution. It is important to remember that Congress has only limited legislative power. Congress possesses only that legislative power granted to it by the Constitution. Thus, all acts of Congress not specifically authorized by the Constitution or necessary to accomplish an authorized end are invalid.

The Commerce Clause provides the basis for most of the federal regulation of business today. This clause empowers the legislature to “regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.” Early in our history, the Supreme Court was committed to a laissez-faire ideology, an ideology that was grounded in individualism. A narrow interpretation of the Commerce Clause means that only a limited amount of trade or exchange can be regulated by Congress.

Under the Court’s initial narrow interpretation, the Commerce Clause was interpreted to apply only to the transportation of goods. Manufacturing of goods, even of goods that were going to be sold in another state, was not considered to have a direct effect on interstate commerce and, thus, was not subject to federal regulation. Businesses conducted solely in one state were similarly excluded from the authority of Congress. Under this restrictive interpretation, numerous federal regulations, such as laws attempting to regulate the use of child labor in manufacturing plants, were struck down.

During the 1930s, the Supreme Court’s interpretation of the Commerce Clause was broadened to allow a greater scope for federal regulations. In *NLRB v. Jones & Laughlin Steel Corp.*,\(^4\) for example, the Court said that:

*Although activities may be intrastate in character when separately considered, if they have such a close and substantial relationship to interstate commerce that their control is essential or appropriate to protect that commerce from burdens or obstructions, Congress cannot be denied the power to exercise that control.*

Over the next several decades, the Supreme Court continued to expand Congress’s power under the Commerce Clause to regulate intrastate activities that affect interstate commerce. For example, in *Perez v. United States*,\(^5\) loan-sharking, conducted on a local basis, was deemed to affect interstate commerce because of its connection to organized crime on a national scale, as the funds from loan-sharking help to pay for crime across the United States. According to the subsequent ruling in *International House of Pancakes v. Theodore*,\(^6\) a locally owned and operated franchise located near two interstates and three hotels qualifies the restaurant as related to interstate commerce and thus subject to the Americans with Disabilities Act. This expansive view continued with *United States v. Lake*,\(^7\) in which the court ruled that a locally operated coal mine that sells its coal locally and buys its supplies locally can still be subjected to federal regulations (Federal Mine Safety and Health Act) because the local activities of all coal mines help to influence the interstate market for coal.

As these cases illustrate, during most of the twentieth century, almost any activity, even if purely intrastate, could be regulated by the federal government if it substantially affected interstate commerce. The effect may be direct or indirect, as the U.S. Supreme Court demonstrated in the classic 1942 case of *Wickard v. Filburn*,\(^8\) when it upheld federal regulation of the production of wheat on a farm in Ohio that produced only 239 bushels of wheat solely for consumption on the farm. The Court’s rationale was that even though one wheat farmer’s activities might not matter, the combination of a lot of small farmers’ activities could have a substantial impact on the national wheat market. This broad interpretation of the Commerce Clause has made possible much of the legislation covered in other sections of this book.

Since the mid-1990s, however, the Supreme Court has appeared to be scrutinizing congressional attempts to regulate based on the Commerce Clause a little more closely. In the 1995 case of *United States v. Lopez*,\(^9\) the U.S. Supreme Court found that Congress had exceeded its authority under the Commerce Clause when it passed the Gun-Free School Zone Act, a law that banned the possession of guns within 1,000 feet of any school. The Court found the statute to be unconstitutional because Congress was attempting to regulate in an area that had “nothing to do with commerce, or any sort of economic enterprise.” At first, commentators did not see this case, decided in a 5–4 vote, as a major shift in the Supreme Court’s Commerce Clause interpretation. As the Court’s ruling in *Brzonkala v. Morrison*\(^10\) demonstrates, however, *Lopez* may indeed have indicated that the courts are going to look more closely at congressional attempts to regulate interstate commerce, an action that seems consistent with the high court’s increasing tendency to support greater power for states in conflicts between the state and federal governments. In *Morrison*, the Court ruled that the

---

\(^4\) 301 U.S. 1 (1937).
\(^7\) 985 F.2d 265 (6th Cir. 1995).
\(^8\) 317 U.S. 111 (1942).
\(^10\) 529 U.S. 598 (2000).
Violence Against Women Act, which Congress justified through its Commerce Clause power, was unconstitutional. Despite the rulings in *Lopez* and *Morrison*, however, the following case, *Gonzales v. Raich*, shows that the Court may not be categorically opposed to an expansion of congressional power through the Commerce Clause.

**CASE 5-2**

**Gonzales v. Raich**

Supreme Court of the United States 545 U.S. 1 (2005)

In 1996, California voters passed the Compassionate Use Act of 1996, which allowed seriously ill residents of the state to have access to marijuana for medical purposes. Angel Raich and Diane Monson are California residents who were using medical marijuana pursuant to their doctors’ recommendations for their serious medical conditions.

County deputy sheriffs and federal Drug Enforcement Administration (DEA) agents investigated Raich’s and Monson’s use of medical marijuana. Although Raich and Monson were found to be in compliance with the state law, the federal agents seized and destroyed their cannabis plants.

Raich and Monson brought suit against the attorney general of the United States and the head of the DEA, seeking injunctive and declaratory relief prohibiting the enforcement of the federal Controlled Substances Act (CSA) to the extent it prevents them from possessing, obtaining, or manufacturing cannabis for their personal medical use. The district court denied respondents’ motion for a preliminary injunction. A divided panel of the court of appeals for the Ninth Circuit reversed and ordered the district court to enter a preliminary injunction. The United States appealed.

**Justice Stevens**

Respondents in this case do not dispute that passage of the CSA, as part of the Comprehensive Drug Abuse Prevention and Control Act, was well within Congress’ commerce power. Nor do they contend that any provision or section of the CSA amounts to an unconstitutional exercise of congressional authority. Rather, respondents’ challenge is actually quite limited; they argue that the CSA’s categorical prohibition of the manufacture and possession of marijuana as applied to the intrastate manufacture and possession of marijuana for medical purposes pursuant to California law exceeds Congress’ authority under the Commerce Clause.

[There are] three general categories of regulation in which Congress is authorized to engage under its commerce power. First, Congress can regulate the channels of interstate commerce. Second, Congress has authority to regulate and protect the instrumentalities of interstate commerce and persons or things in interstate commerce. Third, Congress has the power to regulate activities that substantially affect interstate commerce. Only the third category is implicated in the case at hand.

Our case law firmly establishes Congress’ power to regulate purely local activities that are part of an economic “class of activities” that have a substantial effect on interstate commerce. As we stated in *Wickard v. Filburn*, 114 U.S. 317 (1915), “even if appellee’s activity be local and though it may not be regarded as commerce, it may still, whatever its nature, be reached by Congress if it exerts a substantial economic effect on interstate commerce.” We have never required Congress to legislate with scientific exactitude. When Congress decides that the “total incidence” of a practice poses a threat to a national market, it may regulate the entire class.

Our decision in *Wickard* is of particular relevance. In *Wickard*, we upheld the application of regulations promulgated under the Agricultural Adjustment Act of 1938, which were designed to control the volume of wheat moving in interstate and foreign commerce in order to avoid surpluses and consequent abnormally low prices. The regulations established an allotment of 11.1 acres for Filburn’s 1941 wheat crop, but he sowed 23 acres, intending to use the excess by consuming it on his own farm. Filburn argued that even though we had sustained Congress’ power to regulate the production of goods for commerce, that power did not authorize “federal regulation [of] production not intended in any part for commerce but wholly for consumption on the farm.” Justice Jackson’s opinion for a unanimous Court rejected this submission. He wrote:

*The effect of the statute before us is to restrict the amount which may be produced for market and the extent as well to which one may forestall resort to the market by producing to meet his own needs. That appellee’s own contribution to the demand for wheat may be trivial by itself is not enough to remove him from the scope of federal regulation where, as here, his contribution, taken together with that of many others similarly situated, is far from trivial.*

*Wickard* thus establishes that Congress can regulate purely intrastate activity that is not itself “commercial,” in that it is not produced for sale, if it concludes that failure to regulate that class of activity would undercut the regulation of the interstate market in that commodity.

The similarities between this case and *Wickard* are striking. Like the farmer in *Wickard*, respondents are cultivating, for home consumption, a fungible commodity for
which there is an established, albeit illegal, interstate market. Just as the Agricultural Adjustment Act was designed “to control the volume [of wheat] moving in interstate and foreign commerce in order to avoid surpluses . . . ” and consequently control the market price, a primary purpose of the CSA is to control the supply and demand of controlled substances in both lawful and unlawful drug markets. In *Wickard*, we had no difficulty concluding that Congress had a rational basis for believing that, when viewed in the aggregate, leaving home-consumed wheat outside the regulatory scheme would have a substantial influence on price and market conditions. Here too, Congress had a rational basis for concluding that leaving home-consumed marijuana outside federal control would similarly affect price and market conditions.

More concretely, one concern prompting inclusion of wheat grown for home consumption in the 1938 Act was that rising market prices could draw such wheat into the interstate market, resulting in lower market prices. The parallel concern making it appropriate to include marijuana grown for home consumption in the CSA is the likelihood that the high demand in the interstate market will draw such marijuana into that market. While the diversion of homegrown wheat tended to frustrate the federal interest in stabilizing prices by regulating the volume of commercial transactions in the interstate market, the diversion of homegrown marijuana tends to frustrate the federal interest in eliminating commercial transactions in the interstate market in their entirety. In both cases, the regulation is squarely within Congress’ commerce power because production of the commodity meant for home consumption, be it wheat or marijuana, has a substantial effect on supply and demand in the national market for that commodity.

Nonetheless, respondents suggest that *Wickard* differs from this case in three respects: (1) the Agricultural Adjustment Act, unlike the CSA, exempted small farming operations; (2) *Wickard* involved a “quintessential economic activity”—a commercial farm—whereas respondents do not sell marijuana; and (3) the *Wickard* record made it clear that the aggregate production of wheat for use on farms had a significant impact on market prices. Those differences, though factually accurate, do not diminish the precedential force of this Court’s reasoning.

The fact that Wickard’s own impact on the market was “trivial by itself” was not a sufficient reason for removing him from the scope of federal regulation. That the Secretary of Agriculture elected to exempt even smaller farms from regulation does not speak to his power to regulate all those whose aggregated production was significant, nor did that fact play any role in the Court’s analysis. Moreover, even though Wickard was indeed a commercial farmer, the activity he was engaged in—the cultivation of wheat for home consumption—was not treated by the Court as part of his commercial farming operation.

In assessing the scope of Congress’ authority under the Commerce Clause, we stress that the task before us is a modest one. We need not determine whether respondents’ activities, taken in the aggregate, substantially affect interstate commerce in fact, but only whether a “rational basis” exists for so concluding. Given the enforcement difficulties that attend distinguishing between marijuana cultivated locally and marijuana grown elsewhere, and concerns about diversion into illicit channels, we have no difficulty concluding that Congress had a rational basis for believing that failure to regulate the intrastate manufacture and possession of marijuana would leave a gaping hole in the CSA. Thus, as in *Wickard*, when it enacted comprehensive legislation to regulate the interstate market in a fungible commodity, Congress was acting well within its authority to “make all Laws which shall be necessary and proper” to “regulate Commerce . . . among the several States.” That the regulation ensnares some purely intrastate activity is of no moment. As we have done many times before, we refuse to excise individual components of that larger scheme.

*Reversed and remanded* in favor of Attorney General Gonzalez.

**CRITICAL THINKING ABOUT THE LAW**

Analogies are a standard method for creating a link between the case at hand and legal precedent. *Wickard v. Filburn* is a long-established precedent. The court’s reasoning in Case 5-2 is that the use of medical marijuana by the plaintiffs is sufficiently similar to the facts in *Wickard* to rely on this precedent.

1. **What are the similarities between the case at hand and *Wickard***?
   
   **Clue:** Try to make a large list of similarities. Later after you have made a large list, think about the logic the analogy is trying to support. Eliminate those similarities that do not assist that logic because they are not relevant to an assessment of the quality of the analogy.

2. **Are there significant differences that the Court ignores or downplays?**
   
   **Clue:** First think about the purpose this analogy is serving. Then think about the differences in the facts for this case and the facts for *Wickard*. 

---
Although the current Supreme Court seems to prefer greater regulatory power for states, *Gonzales v. Raich* and another recent case stand as examples in which the Supreme Court upheld congressional acts on the basis of the Commerce Clause. In *Pierce County v. Guillen*,11 the Supreme Court held that the Hazard Elimination Program was a valid exercise of congressional authority under the Commerce Clause. This program provided funding to state and local governments to improve conditions of some of their most unsafe roads. To receive federal funding, however, state and local governments were required to regularly acquire information about potential road hazards. The state and local governments were reluctant to avail themselves of the program for fear that the information they acquired to receive funding would be used against them in lawsuits based on negligence. To alleviate these fears, Congress amended the program, allowing state and local governments to conduct engineering surveys without publicly disseminating the acquired information, even for discovery purposes in trials.

Following his spouse’s death in an automobile accident, Ignacio Guillen sued Pierce County and sought information related to previous accidents at the intersection where his wife died. The county argued that such information was protected under the provisions of the Hazard Elimination Program. Reversing the appellate court’s holding that Congress exceeded its powers when amending the act, the Supreme Court concluded that the amended act was valid under the Commerce Clause. The Supreme Court reasoned that Congress had a significant interest in assisting local and state governments in improving safety in the channels of interstate commerce, the interstate highways. The Court validated Congress’s belief that state and local governments would be more likely to collect relevant and accurate information about potential road hazards if those governments would not be required to provide such information in discovery. Hence, the Supreme Court held that the amended act of Congress was valid on the basis of the Commerce Clause.

Despite the Court’s ruling in *Pierce County v. Guillen*, many Supreme Court commentators had thought that the Court’s turn toward a more restrictive interpretation of the Commerce Clause would lead the Court to rule that Congress cannot justify regulating states’ decisions regarding medical marijuana through the Commerce Clause. Instead, Justice Stevens distinguished *Gonzales v. Raich* from *United States v. Lopez* and *Brzonkala v. Morrison*, explaining that the federal regulations at issue in *Lopez* and *Morrison* were not related to economic activity, even understood broadly, and thus in both cases Congress had overstepped its bounds. Raich’s activities, however, did involve economic activity, even if it is the economic activity of an illegal, controlled substance. Exhibit 5-3 offers a summary of a number of Commerce Clause cases the Supreme Court has decided since *Lopez*. One inference a person could draw after examining the cases in Exhibit 5-3 is that the Court is willing to limit congressional power but not necessarily in every instance where such restriction is possible.

**THE COMMERCE CLAUSE AS A RESTRICTION ON STATE AUTHORITY**

Because the Commerce Clause grants authority to regulate commerce to the federal government, a conflict arises over the extent to which granting such authority to the federal government restricts the states’ authority to regulate commerce. The courts have attempted to resolve the conflict over the impact of

---

<table>
<thead>
<tr>
<th>Case</th>
<th>Summary</th>
<th>Significance of the Case</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>Reno v. Condon</em>, 528 U.S. 141 (2000)</td>
<td>Supreme Court upheld the Driver Privacy Protection Act (DPPA), which prevented intentional disclosure of personal information obtained by the Department of Motor Vehicles (DMV) about another person.</td>
<td>The personal information of drivers, and the subsequent sale of said information, was deemed to be a valid part of interstate commerce and thus within Congress’s regulatory reach.</td>
</tr>
<tr>
<td><em>United States v. Morrison</em>, 529 U.S. 598 (2000)</td>
<td>Congressional law that added a federal civil penalty to gender-motivated crimes was ruled to be unconstitutional.</td>
<td>Under its Commerce Clause power, Congress cannot regulate gender-motivated violence that is in no way economic activity.</td>
</tr>
<tr>
<td><em>Solid Waste Agency of Northern Cook County v. United States Army Corps of Engineers</em>, 531 U.S. 159 (2001)</td>
<td>An abandoned sand-and-gravel pit that had subsequently been filled with water forming an intrastate body of water was deemed out of the regulatory reach of Congress and the Army Corps of Engineers, which sought to regulate the water under the Clean Water Act through Congress’s Commerce Clause power.</td>
<td>The Supreme Court effectively limited Congress’s power to regulate intrastate waterways through the elimination of the Migratory Bird Rule provision of the Clean Water Act.</td>
</tr>
<tr>
<td><em>Pierce County v. Guillen</em>, 537 U.S. 129 (2003)</td>
<td>The federal Hazard Elimination Program, which requires states to collect information regarding dangerous roadways, contains a provision that prevents the data from being used as evidence in state or federal courts. The Supreme Court ruled that the protection does not violate Congress’s Commerce Clause powers.</td>
<td>Although not expanding Congress’s Commerce Clause powers per se, the Court’s ruling did not limit the power Congress has over the regulation of roadways and the dissemination of information regarding the safety of roadways.</td>
</tr>
<tr>
<td><em>Gonzales v. Raich</em>, 545 U.S. 1 (2005)</td>
<td>The California medicinal marijuana laws were ruled to violate the Constitution’s Commerce Clause, as Congress has the power to regulate illegal drugs.</td>
<td>Congress’s Commerce Clause power includes the ability to regulate illegal substances, whereas states do not have a reciprocal ability to do so.</td>
</tr>
<tr>
<td><em>Granholm v. Heald</em>, 544 U.S. 460 (2005)</td>
<td>New York and Michigan state laws that allow in-state wineries to ship wine directly to consumers, but that prohibit out-of-state wineries from engaging in the same practice, were ruled to unconstitutionally violate the Commerce Clause by discriminating against interstate commerce.</td>
<td>The 21st Amendment, which ended prohibition, does not allow states to interfere with interstate commerce associated with the sale of wine.</td>
</tr>
<tr>
<td><em>American Trucking Association, Inc. v. Michigan Public Service Commission</em>, 545 U.S. 429 (2005)</td>
<td>The Supreme Court ruled that a flat $100 fee that Michigan imposed on all in-state truck deliveries did not discriminate against interstate commerce and thus did not violate the Commerce Clause.</td>
<td>State regulations that apply to in-state and out-of-state groups equally do not violate the Commerce Clause.</td>
</tr>
<tr>
<td><em>Rapanos v. United States</em>, 126 S. Ct. 2208 (2006)</td>
<td>The expanded use of the term <em>navigable waters</em> by the Army Corps of Engineers in order to regulate an increased number of waterways violates Congress’s Commerce Clause powers.</td>
<td>The Supreme Court greatly restricted Congress’s ability to regulate waterways under the Clean Water Act, thus diminishing Congress’s Commerce Clause authority.</td>
</tr>
<tr>
<td><em>United Haulers Association, Inc. v. Oneida-Herkimer Solid Waste Management Authority</em>, 127 S. Ct. 1786 (2007)</td>
<td>State flow control ordinances regulating solid waste disposal that favor an in-state public facility were upheld, as they do not violate the Commerce Clause.</td>
<td>When state laws validly favor a public facility, and consequently treat in-state and out-of-state businesses the same, there is no unconstitutional interference with interstate commerce.</td>
</tr>
</tbody>
</table>
the Commerce Clause on state regulation by distinguishing between regulations of commerce and regulations under the state police power. **Police power** means the residual powers retained by the state to enact legislation to safeguard the health and welfare of its citizenry. When the courts perceived state laws to be attempts to regulate interstate commerce, these laws would be struck down; however, when the courts found state laws to be based on the exercise of the state police power, the laws were upheld.

Since the mid-1930s, whenever states have enacted legislation that affects interstate commerce, the courts have applied a two-pronged test. First, they ask: Is the regulation rationally related to a legitimate state end? If it is, then they ask: Is the regulatory burden imposed on interstate commerce outweighed by the state interest in enforcing the legislation? If it is, the state’s regulation is upheld. The following case provides an illustration of the Court’s examination of a state law that was ultimately found not to unconstitutionally interfere with interstate commerce.

**CASE 5-3**

United Haulers Association, Inc. v. Oneida-Herkimer Solid Waste Management Authority

Supreme Court of the United States 127 S. Ct. 1786 (2007)

In 1989, the Oneida-Herkimer Solid Waste Management Authority (Authority) and Oneida and Herkimer Counties entered into a solid waste management agreement, under which the Authority agreed to manage all solid waste within the counties. The Authority collected “tipping fees” to cover its operating and maintenance costs, but these fees were significantly higher than typical open-market fees. In addition to landfill transportation and solid waste disposal, the fees enabled the Authority to provide recycling of 33 kinds of materials, as well as composting, household hazardous waste disposal, and a number of other services.

The counties enacted “flow control” ordinances requiring that all solid waste generated within the counties be delivered to the Authority’s processing sites. Under the ordinance, private haulers had to obtain a permit from the Authority to collect waste in the counties. United Haulers, a trade association made up of solid waste management companies and haulers operating in Oneida and Herkimer Counties, brought suit alleging that the flow control laws violate the Commerce Clause by discriminating against interstate commerce. The district court ruled in favor of the haulers, but the Second Circuit reversed and remanded. After further proceedings, the Second Circuit’s previous ruling in favor of the counties stood. The Second Circuit’s ruling was in opposition to an opinion given by the Sixth Circuit in *National Solid Wastes Management Association v. Daviess County*, 434 F.3d 898 (6th Cir. 2006), so the Supreme Court agreed to hear the case.

**II**

**A**

The Commerce Clause provides that “Congress shall have Power . . . to regulate Commerce with foreign Nations, and among the several States.” Although the Constitution does not in [its] terms limit the power of States to regulate commerce, we have long interpreted the Commerce Clause as an implicit restraint on state authority, even in the absence of a conflicting federal statute.

To determine whether a law violates this so-called “dormant” aspect of the Commerce Clause, we first ask whether it discriminates on its face against interstate commerce. In this context, “discrimination” simply means differential treatment of in-state and out-of-state economic interests.
that benefits the former and burdens the latter.” Discriminatory laws motivated by “simple economic protectionism” are subject to a “virtually per se rule of invalidity,” which can only be overcome by a showing that the State has no other means to advance a legitimate local purpose.

B

[T]he haulers argue vigorously that the Counties’ ordinances discriminate against interstate commerce under Carbone. In Carbone, the town of Clarkstown, New York, hired a private contractor to build a waste transfer station. According to the terms of the deal, the contractor would operate the facility for five years, charging an above-market tipping fee of $81 per ton; after five years, the town would buy the facility for one dollar. The town guaranteed that the facility would receive a certain volume of trash per year. To make good on its promise, Clarkstown passed a flow control ordinance requiring that all nonhazardous solid waste within the town be deposited at the transfer facility.

This Court struck down the ordinance, holding that it discriminated against interstate commerce by “hoarding solid waste, and the demand to get rid of it, for the benefit of the preferred processing facility.” The dissent pointed out that all of this Court’s local processing cases involved laws that discriminated in favor of private entities, not public ones. According to the dissent, Clarkstown’s ostensibly private transfer station was “essentially a municipal facility,” and this distinction should have saved Clarkstown’s ordinance because favoring local government is by its nature different from favoring a particular private company. The majority did not comment on the dissent’s public–private distinction.

As the Second Circuit explained, “in Carbone the Justices were divided over the fact of whether the favored facility was public or private, rather than on the import of that distinction.” Carbone cannot be regarded as having decided the public–private question.

C

Unlike private enterprise, government is vested with the responsibility of protecting the health, safety, and welfare of its citizens. These important responsibilities set state and local government apart from a typical private business.

Given these differences, it does not make sense to regard laws favoring local government and laws favoring private industry with equal skepticism. As our local processing cases demonstrate, when a law favors in-state business over out-of-state competition, rigorous scrutiny is appropriate because the law is often the product of “simple economic protectionism.” Laws favoring local government, by contrast, may be directed toward any number of legitimate goals unrelated to protectionism. Here the flow control ordinances enable the Counties to pursue particular policies with respect to the handling and treatment of waste generated in the Counties, while allocating the costs of those policies on citizens and businesses according to the volume of waste they generate.

We hold that the Counties’ flow control ordinances, which treat in-state private business interests exactly the same as out-of-state ones, do not “discriminate against interstate commerce” for purposes of the dormant Commerce Clause.

D

The counties’ flow control ordinances are properly analyzed under the test set forth in Pike v. Bruce Church, Inc., 397 U.S. 137 (1970), which is reserved for laws “directed to legitimate local concerns, with effects upon interstate commerce that are only incidental.” Under the Pike test, we will uphold a nondiscriminatory statute like this one “unless the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits.”

[The ordinances] increase recycling in at least two ways, conferring significant health and environmental benefits upon the citizens of the Counties. First, they create enhanced incentives for recycling and proper disposal of other kinds of waste. Solid waste disposal is expensive in Oneida-Herkimer, but the Counties accept recyclables and many forms of hazardous waste for free, effectively encouraging their citizens to sort their own trash. Second, by requiring all waste to be deposited at Authority facilities, the Counties have markedly increased their ability to enforce recycling laws. If the haulers could take waste to any disposal site, achieving an equal level of enforcement would be much more costly; if not impossible. For these reasons, any arguable burden the ordinances impose on interstate commerce does not exceed their public benefits.

Affirmed in favor of Oneida-Herkimer Solid Waste Management.

CRITICAL THINKING ABOUT THE LAW

1. Chief Justice Roberts’s opinion relies on drawing several legal analogies to compare and contrast United Haulers with other cases. What are the legal analogies Roberts makes? Are the legal analogies appropriate?

   **Clue:** Are the facts of the various cases Roberts discusses similar to those in United Haulers? Are there relevant differences in the fact patterns?

2. What ethical norm is responsible for Chief Justice Roberts’s reasoning?

   **Clue:** What ethical norms might someone who disagrees with Roberts hold?
Another example of a state statute that has been upheld is Chicago’s ban on the use of spray paint in the city. Paint retailers challenged the statute, arguing that it could have caused $55 million in lost sales over the next 6 years for spray paint retailers. The U.S. Court of Appeals eventually found the law to be constitutional. The state had a legitimate interest in trying to clean up graffiti, and it did not “discriminate against interstate commerce” nor violate the Commerce Clause. The appeals court reversed the previous ruling and allowed Chicago’s enactment of this ordinance to remain intact.12 Despite the rulings in the United Haulers and Chicago cases, it is not necessarily easy to craft a state statute that affects interstate commerce that will be upheld. Frequently, the courts will find that state legislation that impinges upon interstate commerce in some way is an unconstitutional interference with interstate commerce. The cases described in Table 5-1 further illustrate how the courts attempt to determine when a state statute that affects interstate commerce will be upheld.

### Table 5-1 Recent Cases Considering State Statutes

<table>
<thead>
<tr>
<th>Case</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Black Star Farms v. Oliver, 600 F.3d 1225 (9th Cir., 2010)</td>
<td>The state of Arizona developed a scheme of regulating wine sales whereby suppliers sell wine to wholesalers, who then sell the wine to retailers, who sell wine to the public. Exceptions to this distribution scheme were made for (1) small wineries that produce no more than 20,000 gallons of wine annually, who are allowed to sell directly to the public, and (2) direct shipments to consumers who visit a winery and request, in person, that purchased winery be shipped to their address. A winery that produces 35,000 bottles a year challenged the state scheme as unconstitutionally interfering with interstate commerce, thus violating the dormant Commerce Clause.</td>
</tr>
<tr>
<td>Family Winemakers of California, et al. v. Jenkins, 592 F.3d 1(2010)</td>
<td>Massachusetts passed a statute allowing only “small” wineries, defined as those producing 30,000 gallons or less of grape wine a year, to obtain a “small winery shipping license” that allows them to sell their wines in Massachusetts in three ways: by shipping directly to consumers, through wholesaler distribution, and through retail distribution. All of Massachusetts’s wineries, and some out-of-state wineries, are “small” wineries. “Large” wineries, those producing more than 30,000 gallons per year, and which are all located out of state, must choose between relying upon wholesalers to distribute their wines in-state or applying for a “large winery shipping license” to sell directly to Massachusetts consumers. They cannot, by law, use both methods to sell their wines in Massachusetts, and they cannot sell wines directly to retailers under either option. A group of California winemakers and Massachusetts residents challenged the statute as violating the dormant commerce clause, and sought an injunction against its enforcement.</td>
</tr>
<tr>
<td>Cachia v. Islamorada, 542 F.3d 839 (11th Cir., 2008)</td>
<td>Islamadora, Florida passed an ordinance prohibiting “formula restaurants” (chain restaurants) from operating within its jurisdiction. When the plaintiff was prohibited by the ordinance from selling his coffee shop to a Starbucks, he challenged the ordinance as unconstitutional interfering with interstate commerce.</td>
</tr>
<tr>
<td>Cavel International, Inc. v. Madigan, 500 F.3d 551 (7th Cir., 2007)</td>
<td>The Illinois legislature amended the state’s Horse Meat Act to make it illegal for anyone in Illinois to slaughter a horse and sell its meat for human consumption. Because most of the horse meat was shipped overseas, it was a ban on exporting. Cavel Industries stood to lose a lot of money if the amendment were enforced, so they sought an injunction prohibiting enforcement of the amendment, arguing that the amendment placed an undue burden on interstate commerce.</td>
</tr>
</tbody>
</table>

---

12 National Paint & Coatings Association et al. v. City of Chicago, 45 F.3d 1124 (7th Cir. 1995).
The Taxing and Spending Powers of the Federal Government

Article I, Section 8, of the Constitution gives the federal government the “Power to lay and collect Taxes, Duties, Imports and Excises.” The taxes laid by Congress, however, must be uniform across the states. In other words, the U.S. government cannot impose higher taxes on residents of one state than another.

Although the collection of taxes is essential for the generation of revenue needed to provide essential government services, taxes can be used to serve additional functions. For example, the government may wish to encourage the development of certain industries and discourage the development of others, so it may provide tax credits for firms entering the favored industries. As long as the “motive of Congress and the effect of its legislative action are to secure revenue for the benefit of the general government,” the tax will be upheld as constitutional. The fact that it also has what might be described as a regulatory impact will not affect the validity of the tax.

Article I, Section 8, also gives Congress its spending power by authorizing it to “pay the Debts and provide for the common Defence and general Welfare of the United States.” Just as Congress can indirectly use its power to tax to achieve certain social welfare objectives, it can do the same with its spending power. For example, the U.S. Supreme Court in 1987 upheld the right of Congress to condition the states’ receipt of federal highway funds on their passing state legislation making 21 the legal drinking age.

Taxation of the Internet?

The rapid rise in Internet commerce has many states wondering how they will collect their fair share of sales taxes. According to the U.S. Department of Commerce, Internet retail sales have continued to increase. U.S. retail e-commerce sales reached almost $142 billion in 2008, up from a revised $137 billion in 2007—an annual gain of 3.3 percent. From 2002 to 2008, retail e-sales increased at an average annual growth rate of 21.0 percent, compared with 4.0 percent for total retail sales. Although Internet sales constituted only 3.7 percent of overall retail sales in the United States during 2009, advocates of taxes on Internet sales insist that states are losing a considerable amount of revenue each year.

Currently, states are only allowed to require a business to submit sales tax payments if the business has a store or distribution center in the state. Otherwise, states are prohibited from collecting sales taxes, although residents are supposed to report the taxes on personal income tax returns. In addition to the e-commerce business, increased access to the Internet has some clamoring for a use tax on Internet access, in addition to a sales tax on Internet purchases.

In 1998, Congress approved the Internet Tax Freedom Act, which established a moratorium on Internet taxes until November 2001. The 1998 bill provided a grandfather clause that allowed several states to continue levying taxes on Internet access if those taxes were established before the Internet Tax Freedom Act was passed. In November 2001, Congress extended the moratorium for two more years to allow for more discussion and research on the effects of the ban on state governments.

In September 2003, the House of Representatives passed the Internet Tax Nondiscrimination Act (H.R. 49), a bill designed to replace the Internet Tax Freedom Act that would have expired in November 2003 with a permanent ban on taxes on Internet purchases.

---

a U.S. Census Bureau, E-Stats, May 27, 2010; access to these statistics is available at http://www.census.gov/econ/estats/2008/2008reportfinal.pdf.

Internet access and a permanent extension of the moratorium on multiple and discriminatory taxes on electronic commerce. On April 29, 2004, the Senate passed a different version of the Internet Tax Nondiscrimination Act (S. 150) that extended the moratorium on Internet taxes until November 2007. The Senate bill was a compromise between supporters of a permanent Internet tax ban and a group of senators who questioned how a permanent ban would affect state and local budgets.

The final version of the legislation, signed into law by President Bush on December 3, 2004, had two different grandfather exemptions. States that taxed Internet service before October 1, 1998, were allowed to continue their taxes until November 1, 2007, whereas states that taxed Internet service before October 1, 2003, were allowed to continue their taxes until November 1, 2005. The law banned all other states from imposing Internet taxes from November 1, 2003, to November 1, 2007.

In 2007, Congress and the president extended the act until November 1, 2014, with the Internet Tax Nondiscrimination Act.

The Impact of the Amendments on Business

The first 10 amendments to the U.S. Constitution, known as the Bill of Rights, have a substantial impact on governmental regulation of the legal environment of business. These amendments prohibit the federal government from infringing on certain freedoms that are guaranteed to individuals living in our society. The Fourteenth Amendment extends most of the provisions in the Bill of Rights to the behavior of states, prohibiting their interference in the exercise of those rights. Many of the first 10 amendments have also been held to apply to corporations because corporations are treated, in most cases, as “artificial persons.” The activities protected by the Bill of Rights and the Fourteenth Amendment are not only those that occur in one’s private life, but also those that take place in a commercial setting. Several of these amendments have a significant impact on the regulatory environment of business, and they are discussed in the remainder of this chapter.

**The First Amendment**

The First Amendment guarantees freedom of speech and of the press. It also prohibits abridgment of the right to assemble peacefully and to petition for redress of grievances. Finally, it prohibits the government from aiding the establishment of a religion and from interfering with the free exercise of religion.

Although we say these rights are guaranteed, they obviously cannot be absolute. Most people would agree that a person does not have the right to yell “Fire!” in a crowded theater. Nor does one’s right of free speech extend to making false statements about another that would be injurious to that person’s reputation. Because of the difficulty in determining the boundaries of individual rights, a large number of First Amendment cases have been decided by the courts.

Not surprisingly, student speech has given rise to a number of free speech cases. For example, in *Tinker v. Des Moines Independent School District*, the Court ruled that a school policy that prohibited students from wearing antiwar armbands was unconstitutional because the students’ message was political and was not disruptive to normal school activities. In *Tinker*, the Court famously stated that students do not “shed their constitutional rights . . . at the schoolhouse gate.” Subsequently, the Court ruled in *Bethel School District No. 403 v. Fraser* that speech that would otherwise be protected can be restricted within the

---

15 Id. at 506.
school context. Fraser gave a speech at a school assembly that contained a graphic and extended sexual metaphor. The Court held that, although the speech would have been protected if given in the public forum, the fact that the speech was delivered at school allowed for administrators to censor the speech and restrict Fraser’s right to give the speech. Most recently, relying upon their rulings in *Tinker* and *Fraser,* the Court ruled in *Morse v. Frederick* that student speech advocating drug use during a school function can constitutionally be restricted. *Morse v. Frederick* is the much-discussed “Bong Hits 4 Jesus” case. The Court determined that the “Bong Hits 4 Jesus” banner clearly advocated drug use, and because the poster was displayed at a school function, the students responsible could be punished. Furthermore, the banner did not portray a political or religious message and thus was not protected speech.

Attempts to regulate new technologies also raise First Amendment issues. For example, Congress passed the Communications Decency Act of 1996 (CDA) to protect minors from harmful material on the Internet; however, the U.S. Supreme Court found that provisions of the CDA that criminalized and prohibited the “knowing” transmission of “obscene or indecent” messages to any recipient under age 18 by means of telecommunications devices or through the use of interactive computer services were content-based blanket restrictions on freedom of speech. Because these provisions of the statute were too vague and overly broad, repressing speech that adults have the right to make, these provisions were found to be unconstitutional.

After the Supreme Court held that the CDA was unconstitutional, Congress responded by passing the Child Online Protection Act (COPA), which imposed a $50,000 fine and 6 months imprisonment on individuals who posted material for commercial purposes that was harmful to minors. Web sites that required individuals to submit a credit card number or some other form of age verification, however, were not in violation of the act. Nevertheless, the Supreme Court ruled that this act was also unconstitutional, as the provisions of the act likely violated the First Amendment. The Court reasoned that COPA was not narrowly tailored to meet a compelling governmental interest, and the regulations were not the least restrictive methods of regulating in this area, as filtering programs could more easily restrict minors’ access to obscene material than criminal penalties.

Congress also passed the Child Internet Protection Act (CIPA), requiring libraries to implement filtering software to prevent minors from accessing pornography or other obscene and potentially harmful material. Libraries that did not comply with the provisions of CIPA would not receive federal funding for Internet access. In *United States v. American Library Association,* numerous libraries and Web-site publishers brought suit, claiming that the CIPA was unconstitutional. Reversing the district court’s decision that the act was unconstitutional because it violated the First Amendment, the Supreme Court ruled in a split decision that the act was constitutional. Although six Justices ruled that the act was not unconstitutional, there was greater disagreement about the Court’s opinion. The majority reasoned that the act did not violate an individual’s First Amendment rights, as libraries are afforded broad discretion about the kinds of materials they may include in their collections. In other words, a library is not a public forum in the traditional sense.

An interesting issue that has arisen on many campuses is whether so-called hate speech, derogatory speech directed at members of another group, such as another race, is unprotected speech that can be banned. Thus far, hate-speech

---

codes on campuses that were challenged as unconstitutional have been struck down by state courts or federal appeals courts, although the issue has not yet reached the Supreme Court. Hate speech is a serious issue that affects more than 1 million students every year, prompting 60 percent of universities to ban verbal abuse and verbal harassment and 28 percent of universities to ban advocacy of an offensive viewpoint.\(^1\) Because universities are often viewed as breeding grounds for ideas and citizen development, courts have not looked favorably on limits to speech on campuses.

The international community has been quicker to call hate speech unprotected speech than the United States, with a declaration from the United Nations and laws in several countries passed years ago.\(^2\) In October 22, 2009, however, the House and Senate passed the federal Matthew Shepard and James Byrd, Jr. Hate Crime Prevention Statute, and on October 28, 2009, President Obama signed the legislation.\(^3\) Under the law, a hate crime is defined as a crime of violence that is motivated by hatred of the group to which the victim belongs. Protected groups are those based on race, color, religion, national origin, gender, disability, sexual orientation, and gender identity.

**Corporate Commercial Speech.** Numerous cases have arisen over the extent to which First Amendment guarantees are applicable to corporate commercial speech. The doctrine currently used to analyze commercial speech is discussed in the following case.

---

### CASE 5-4

**Central Hudson Gas & Electric Corp. v. Public Service Commission of New York**  
Supreme Court of the United States 447 U.S. 557 (1980)

Plaintiff Central Hudson Gas and Electric Corporation filed an action against Public Service Commission of New York to challenge the constitutionality of a regulation that completely banned promotional advertising by the utility but permitted “informational” ads—those designed to encourage shifting consumption from peak to nonpeak times. The regulation was upheld by the trial court. On appeal by the utility, the New York Court of Appeals sustained the regulation, concluding that governmental interests outweighed the limited constitutional value of the commercial speech at issue. The utility appealed.

**Justice Powell**

The Commission’s order [enforcing the regulation’s advertising ban] restricts only commercial speech, that is, expression related solely to the economic interests of the speaker and its audience. The First Amendment, as applied to the States through the Fourteenth Amendment, protects commercial speech from unwarranted governmental regulation. Commercial expression not only serves the economic interest of the speaker, but also assists consumers and furthers the societal interest in the fullest possible dissemination of information. In applying the First Amendment to this area, we have rejected the “highly paternalistic” view that government has complete power to suppress or regulate commercial speech. Even when advertising communicates only an incomplete version of the relevant facts, the First Amendment presumes that some accurate information is better than no information at all. Nevertheless, our decisions have recognized “the ‘common sense’ distinction between speech proposing a commercial

---

\(^1\) Timothy C. Shiell, *Campus Hate Speech on Trial* 2, 49 (Lawrence: University Press of Kansas, 1998).
\(^2\) Id. at 32.
transaction, which occurs in an area traditionally subject to
government regulation, and other varieties of speech.”

The Constitution therefore accords a lesser protection to
commercial speech than to other constitutionally guar-
anteed expression. The protection available for particular
commercial expression turns on the nature both of the ex-
pression and of the governmental interests served by its
regulation. Two features of commercial speech permit reg-
ulation of its content. First, commercial speakers have ex-
tensive knowledge of both the market and their products.
Thus, they are well situated to evaluate the accuracy of
their messages and the lawfulness of the underlying activ-
ity. In addition, commercial speech, the offspring of eco-

onomic self-interest, is a hardy breed of expression that is
not “particularly susceptible to being crushed by over-

broad regulation.”

If the communication is neither misleading nor related
to unlawful activity, the government’s power is more cir-
cumscribed. The State must assert a substantial interest to
be achieved by restrictions on commercial speech. More-
over, the regulatory technique must be in proportion to
that interest. The limitation on expression must be de-
signed carefully to achieve the State’s goal. Compliance
with this requirement may be measured by two criteria.
First, the restriction must directly advance the state inter-
est involved; the regulation may not be sustained if it
provides only ineffective or remote support for the gov-
ernment’s purpose. Second, if the governmental interest
could be served as well by a more limited restriction on
commercial speech, the excessive restrictions cannot
survive.

The second criterion recognizes that the First Amend-
ment mandates that speech restrictions be “narrowly
drawn.” The regulatory technique may extend only as far
as the interest it serves. The State cannot regulate speech
that poses no danger to the asserted state interest, nor
can it completely suppress information when narrower
restrictions on expression would serve its interest as
well. In commercial speech cases, then, a four-part analy-

sis has developed. At the outset, we must determine
whether the expression is protected by the First Amend-
ment. For commercial speech to come within that provi-
sion, it at least must concern lawful activity and not be
misleading. Next, we ask whether the asserted govern-
mental interest is substantial. If both inquiries yield posi-
tive answers, we must determine whether the regulation
directly advances the governmental interest asserted and
whether it is not more extensive than is necessary to
serve that interest.

The Commission does not claim that the expression at
issue is inaccurate or relates to unlawful activity. Yet the
New York Court of Appeals questioned whether Central
Hudson’s advertising is protected commercial speech. Be-
cause appellant holds a monopoly over the sale of elec-
tricity in its service area, the state court suggested that the
Commission’s order restricts no commercial speech of any
worth.

In the absence of factors that would distort the decision
to advertise, we may assume that the willingness of a busi-

ness to promote its products justifies belief that consumers
are interested in the advertising. Since no such extraordi-
nary conditions have been identified in this case, appel-
lant’s monopoly position does not alter the First Amend-
ment’s protection for its commercial speech.

The Commission offers two state interests as justifica-
tions for the ban on promotional advertising. The first
concerns energy conservation. Any increase in demand
for electricity—during peak or off-peak periods—means
greater consumption of energy. The Commission argues
that the State’s interest in conserving energy is sufficient
to support suppression of advertising designed to in-
crease consumption of electricity. In view of our coun-
try’s dependence on energy resources beyond our con-

rol, no one can doubt the importance of energy con-


servation. Plainly, therefore, the state interest asserted is
substantial.

We come finally to the critical inquiry in this case:
whether the Commission’s complete suppression of
speech ordinarily protected by the First Amendment is no
more extensive than necessary to further the State’s inter-
est in energy conservation. The Commission’s order
reaches all promotional advertising, regardless of the im-
pact of the touted service on overall energy use. But the
energy conservation rationale, as important as it is, cannot
justify suppressing information about electric devices or
services that would cause no net increase in total energy
use. In addition, no showing has been made that a more
limited restriction on the content of promotional advertis-
ing would not serve adequately the State’s interests.

Appellant insists that but for the ban, it would advertise
products and services that use energy efficiently. These in-
clude the “heat pump,” which both parties acknowledge to
be a major improvement in electric heating, and the use of
electric heat as a “backup” to solar and other heat sources.
Although the Commission has questioned the efficiency of
electric heating before this Court, neither the Commis-

sion’s Policy Statement nor its order denying rehearing
made findings on this issue. The Commission’s order pre-

vents appellant from promoting electric services that
would reduce energy use by diverting demand from less-
efficient sources, or that would consume roughly the same
amount of energy as do alternative sources. In neither
situation would the utility’s advertising endanger conser-
vation or mislead the public. To the extent that the
Commission’s order suppresses speech that in no way
impairs the State’s interest in energy conservation, the
Commission’s order violates the First and Fourteenth
Amendments and must be invalidated.

The Commission also has not demonstrated that its in-
terest in conservation cannot be protected adequately by
more limited regulation of appellant’s commercial ex-
pression. To further its policy of conservation, the Com-
mision could attempt to restrict the format and content
of Central Hudson’s advertising. It might, for example,
require that the advertisements include information
about the relative efficiency and expense of the offered
service, both under current conditions and for the fore-
seeable future.

Reversed in favor of Plaintiff, Central Hudson.
In Case 5-4, the Court had to balance government interests in energy efficiency, as well as fair and efficient pricing, with the conflicting constitutional value of Central Hudson’s right to free commercial speech. Having affirmed the validity of government’s substantial interests in regulating the utility company, the Court sought to determine whether these interests could have been sufficiently served with more limited restrictions. Because this determination is of central importance to the Court’s reversal of the earlier court’s judgment, it will be the focus of the questions that follow.

1. What primary ethical norm is implicit in the legal requirement that regulations on commercial speech be of the most limited nature possible in carrying out the desired end of advancing the state’s substantial interest?
   Clue: Review the four primary ethical norms. You want to focus not on the government regulation but on the rationale for limits on that regulation.

2. What information missing from the Court’s opinion must you, as a critical thinker, know before being entirely satisfied with the decision?
   Clue: You want to focus on the issue about which the Public Service Commission and Central Hudson have conflicting viewpoints. What information would you want to know before accepting the soundness of the Court’s judgment in resolving this conflict?

The test set forth in *Central Hudson* was reaffirmed by the U.S. Supreme Court in two decisions handed down in the summer of 1995, when it applied the test in *Rubin v. Coors Brewing Co.*\(^\text{24}\) and *Florida Bar v. Went for It and John T. Blakely.*\(^\text{25}\) In the first case, Coors challenged a regulation of the Federal Alcohol Administration Act that prohibited beer producers from disclosing the beer’s alcohol content. The Court found that the government’s interest in suppressing “strength wars” among beer producers was “substantial” under the *Central Hudson* test, but held that the ban failed to meet the asserted government interest and be no more extensive than necessary to serve that interest.

A restriction that passed the *Central Hudson* test was the Florida ethics rule upheld in the *Went for It* case. The rule requires lawyers to wait 30 days before sending targeted direct-mail solicitation letters to victims of accidents or disasters. The high court found a substantial interest both in protecting the privacy and tranquility of victims and their loved ones against invasive and unsolicited contact by lawyers and in preventing the erosion of confidence in the profession that such repeated invasions have caused. The bar association had established, by unrebutted survey data, that Floridians considered immediate postaccident direct-mail solicitation to be an invasion of victims’ privacy that reflects poorly on lawyers. The Court also found that the ban’s scope was reasonably well tailored to meet the stated objectives. It was limited in duration, and there were other ways for injured Floridians to learn about the availability of legal services during the time period set by the ban. Thus, the ban was upheld as directly advancing the asserted legitimate interest in a manner no more extensive than necessary to serve that interest.

The U.S. Supreme Court once again reaffirmed and applied the four-part test of *Central Hudson* in the case of *Lorillard Tobacco Co. et al., v. Thomas F. Reilly.*\(^\text{26}\) a case challenging Massachusetts’s comprehensive set of regulations regarding cigarette, cigar, and smokeless tobacco advertising and distribution. The


\(^{26}\) 533 U.S. 525 (2001).
high court found that Massachusetts’s outdoor-advertising regulations that prohibited smokeless tobacco or cigar advertising within 1,000 feet of a school or playground violated the First Amendment because they failed the fourth part of the Central Hudson test. The Court reasoned as follows:

Their broad sweep indicates that the Attorney General did not “carefully calculate[ed] the costs and benefits associated with the burden on speech imposed.” The record indicates that the regulations prohibit advertising in a substantial portion of Massachusetts’ major metropolitan areas; in some areas, they would constitute nearly a complete ban on the communication of truthful information. This substantial geographical reach is compounded by other factors. “Outdoor” advertising includes not only advertising located outside an establishment, but also advertising inside a store if visible from outside. Moreover, the regulations restrict advertisements of any size, and the term advertisement also includes oral statements. The uniformly broad sweep of the geographical limitation and the range of communications restricted demonstrate a lack of tailoring. The governmental interest in preventing underage tobacco use is substantial, and even compelling, but it is no less true that the sale and use of tobacco products by adults is a legal activity. A speech regulation cannot unduly impinge on the speaker’s ability to propose a commercial transaction and the adult listener’s opportunity to obtain information about products. The Attorney General has failed to show that the regulations at issue are not more extensive than necessary.27

In that same case, the high court also struck down regulations prohibiting placement of indoor, point-of-sale advertising of smokeless tobacco and cigars lower than 5 feet from the floor of a retail establishment located within 1,000 feet of a school or playground because they failed both the third and fourth steps of the Central Hudson analysis. The Court found that the five-foot rule did not seem to advance the goals of preventing minors from using tobacco products and curbing demand for that activity by limiting youth exposure to advertising, because not all children are less than five feet tall, and those who are can look up and take in their surroundings. In the case, the Court overruled the circuit court’s finding that the regulations met the four-part test of Central Hudson, so it clearly is not always easy to know how the test is going to be applied.28

Corporate Political Speech. Not all corporate speech is considered commercial speech. Sometimes, for example, corporations might spend funds to support political candidates or referenda. At one time, states restricted the amount of advertising firms could engage in because of a fear that, with their huge assets, corporations’ speech on behalf of a particular candidate or issue would drown out other voices. In the 1978 case of First National Bank of Boston v. Bellotti,29 however, the U.S. Supreme Court struck down a state law that prohibited certain corporations from making contributions or expenditures influencing voters on any issues that would not materially affect the corporate assets or business. Stating that “the concept that the government may restrict speech of some elements of our society in order to enhance the relative voice of others is wholly foreign to the First Amendment,” the high court ruled that corporate political speech should be protected to the same extent as the ordinary citizen’s political speech.

The ability of the government to regulate corporate political speech was further restricted in 2010 by the landmark decision in Citizens United v. Federal Election Commission.30 By a 5–4 vote, the majority ruled that the corporate funding
of independent political broadcasts in candidate elections cannot be limited under the First Amendment, thus finding political spending to be a form of protected speech. The decision struck down a provision of a 2002 campaign financing law that prohibited all corporations, both for-profit and not-for-profit, and unions from broadcasting “electioneering communications,” which were defined as “a broadcast, cable, or satellite communication that mentioned a candidate within 60 days of a general election or thirty days of a primary.” Arguably, this decision paved the way for the 2010 midterm election setting a record for midterm election spending, with an estimated $3.8 billion being spent.31

Our discussion of the First Amendment has focused on its effect on people’s ability to speak, but just as the First Amendment may also prevent the government from prohibiting speech, the Amendment may also prevent the government from compelling individuals to express certain views or from compelling certain individuals to pay subsidies for speech to which they object. This protection is illustrated by the 2001 case of United States Department of Agriculture v. United Foods, Inc.,32 in which the Court struck down a governmental assessment against mushroom growers that was used primarily for generic advertising to promote mushroom sales. The mushroom producer who challenged the assessment wanted to be able to promote his mushrooms as different from other producers’ mushrooms and, hence, did not want to be forced to help fund generic advertising that promoted the idea that all mushrooms were good. The Supreme Court agreed, stating that “First Amendment values are at serious risk if the government can compel a citizen or group of citizens to subsidize speech on the side that it favors.”33

33 Id. at 411.

---

Corporate Speech in Canada

As the limits on political speech made by corporations in the United States have been expanded, Canada has been tightening its regulations. The recent Federal Accountability Act in Canada bans contributions by corporations, trade unions, and associations. This act signals a change in policy by eliminating the exception that allowed annual contributions of $1,000 to various political entities.

The law also tightens the limits on individual contributions, but not to the extent of a total ban. This reveals a difference in the treatment of corporations and people in Canada, despite the fact that corporations are considered juristic persons under Canadian law, just as they are in the United States. Although there are differences in the restrictions on individual and corporate speech in the United States, the recent trend in Supreme Court rulings has been to eliminate the differences between individual and corporate speech. Canada’s Conservative government seems to be taking the opposite approach and restricting political speech for corporations.
THE FOURTH AMENDMENT

The Fourth Amendment protects the right of individuals to be secure in their persons, their homes, and their personal property. It prohibits the government from conducting unreasonable searches of individuals and seizing their property to use as evidence against them. If such an unreasonable search and seizure occurs, the evidence obtained from it cannot be used in a trial.

An unreasonable search and seizure is basically one conducted without the government official's having first obtained a warrant from the court. The warrant must specify the items sought, and this requirement is strictly enforced, as Supreme Court case from 2004 illustrates. In Grob v. Ramirez, the high court ruled that a search warrant was invalid on its face when it utterly failed to describe the persons or things to be seized, despite the fact that the requisite particularized description was contained in the search warrant application. The residential search that was conducted pursuant to this facially invalid warrant was therefore unreasonable, despite the fact that the officers conducting the search exercised restraint in limiting the scope of the search to materials listed in the application.

Government officials are able to obtain such a warrant only when they can show probable cause to believe that the search will turn up the specified evidence of criminal activity. Supreme Court decisions, however, have narrowed the protection of the Fourth Amendment by providing for circumstances in which no search warrant is needed. For example, warrantless searches of automobiles, under certain circumstances, are allowed. Moreover, the Supreme Court even held in one case that an out-of-car arrest and subsequent warrantless search of the individual's car did not violate the individual's Fourth Amendment rights. The Supreme Court decided in another case that police highway checkpoints, where police officers questioned drivers on a particular highway for information about a recent incident, did not violate drivers' Fourth Amendment rights, even though the police arrested one of the passing drivers for drunk driving.

Improvements in technology have also caused problems in application of the Fourth Amendment, because it is now simpler to eavesdrop on people and to engage in other covert activities. One such case was decided by the U.S. Supreme Court in mid-2001. In that case, the police had information from informants that led them to believe that Danny Kyllo was growing marijuana in his home. Kyllo also had unusually high electricity bills (common when one is using heat lamps to grow the plants indoors). The police used a thermal imager, an instrument that can detect unusually high levels of heat emissions and translate them into an image, to provide them with the evidence necessary to get a warrant to physically search his house. The question the Court had to address was whether the use of the thermal imaging instrument on the property constituted a “search.” Or, if we think of the case the way judges do, by comparing it to past precedents, it is a question of whether thermal imaging is more like going through someone’s garbage or more like using a high-powered telescope to look through someone’s window. If the former situation is more analogous, then the behavior does not constitute a search; however, if the case is more analogous to the latter scenario, then using thermal imaging on a home is a search.

35 Id.
that requires a warrant. The Ninth Circuit, in a case of first impression (the first time an issue is ruled on by the court), found that using thermal imaging was not a search that was prohibited by the Fourth Amendment in the absence of a warrant.

The U.S. Supreme Court, however, in a 5–4 decision, ruled that police use of a thermal imaging device to detect patterns of heat coming from a private home is a search that requires a warrant. The Court said further that the warrant requirement would apply not only to the relatively crude device at issue, but also to any “more sophisticated systems” in use or in development that let the police gain knowledge that in the past would have been impossible without a physical entry into the home. In explaining the decision, Justice Scalia wrote that in the home, “all details are intimate details, because the entire area is held safe from prying government eyes.” He went on to add that the Court’s precedents “draw a firm line at the entrance to one’s house.”

Although many were happy with the Supreme Court’s decision in this case, some were quick to point out that this case is not necessarily the final word when it comes to the use of technology. They noted that Scalia seemed to rely heavily on the fact that the thermal imaging was used to see inside a home. It is, therefore, not clear whether thermal imaging of some other locale would be upheld.

The Fourth Amendment protects corporations as well as individuals. This protection is generally applicable, as noted earlier, in criminal cases. Fourth Amendment issues also arise, however, when government regulations authorize, or even require, warrantless searches by administrative agencies.

Although administrative searches are presumed to require a search warrant, an exception has been carved out. If an industry has been subject to pervasive regulation, a warrantless search is considered reasonable under the Fourth Amendment. In such industries, warrantless searches are required to ensure that regulations are being upheld, and a warrantless search would not be unreasonable because the owner has a reduced expectation of privacy. When a warrantless search is challenged, and the state argues that the “pervasively regulated” exception should apply, before the court will find that the search was reasonable, the agency will have to demonstrate that:

1. there is “a substantial government interest that informs the regulatory scheme pursuant to which the inspection is made”;
2. the warrantless inspections must be “necessary to further the regulatory scheme”;
3. “the statute’s inspection program, in terms of the certainty and regularity of its application, must provide a constitutionally adequate substitute for a warrant,” that is, it advises the business owner that “the search is being made pursuant to the law and has a properly defined scope,” and limits the discretion of the inspecting officers.

As the Fourth Amendment is currently interpreted, a warrantless search authorized by the Gun Control Act or the Federal Mine Safety and Health Act would be legal. A warrantless search under the Occupational Safety and Health Act, however, would violate the Fourth Amendment because there is no history of pervasive legislation on working conditions before passage of that act.

---

39 Id.
41 Id.
42 Id.
43 Id.
THE FIFTH AMENDMENT

The **Fifth Amendment** provides many significant protections to individuals. For instance, it protects against self-incrimination and double jeopardy (that is, being tried twice for the same crime). Of more importance to businesspersons, however, is the **Due Process Clause** of the Fifth Amendment. This provision provides that one cannot be deprived of life, liberty, or property without due process of law.

There are two types of due process: procedural and substantive. Originally, due process was interpreted only procedurally. **Procedural due process** requires that a criminal whose life, liberty, or property would be taken by a conviction be given a fair trial; that is, he or she is entitled to notice of the alleged criminal action and the opportunity to confront his or her accusers before an impartial tribunal. The application of procedural due process soon spread beyond criminal matters, especially after passage of the Fourteenth Amendment, discussed in the next section, which made the requirement of due process applicable to state governments.

Today, the Due Process Clause has been applied to such diverse situations as the termination of welfare benefits, the discharge of a public employee from his or her job, and the suspension of a student from school. It should be noted, however, that the types of takings to which the Due Process Clause applies are not being continually increased. In fact, after a broad expansion of the takings to which this clause applied, the courts began restricting the application of this clause during the 1970s and have continued to do so since then. The courts restrict application of the clause by narrowing the interpretation of property and liberty. This narrowing is especially common in interpreting the Due Process Clause as it applies to state governments under the Fourteenth Amendment.

What procedural safeguards does procedural due process require? The question is not easily answered. The procedures that the government must follow when there may be a taking of an individual’s life, liberty, or property vary according to the nature of the taking. In general, as the magnitude of the potential deprivation increases, the extent of the procedures required also increases.

The second type of due process is **substantive due process**. The concept of substantive due process refers to the basic fairness of laws that may deprive an individual of his or her liberty or property. In other words, when a law is passed that will restrict individuals’ liberty or their use of their property, the government must have a proper purpose for the restriction, or it violates substantive due process.

During the late nineteenth and early twentieth centuries, this concept was referred to as economic substantive due process and was used to strike down a number of pieces of social legislation, including laws that established minimum wages and hours. Business managers successfully argued that such laws interfered with the liberty of employer and employee to enter into whatever type of employment contract they might choose. Analogous arguments were used to defeat many laws that would allegedly have helped the less fortunate at the expense of business interests. Economic substantive due process flourished only until the late 1930s. Today, many pieces of social legislation are in force that would have been held unconstitutional under the old concept of economic substantive due process.

---

**Fifth Amendment** Protects individuals against self-incrimination and double jeopardy and guarantees them the right to trial by jury; protects both individuals and businesses through the Due Process Clause and the Takings Clause.

**Due Process Clause** Provides that no one can be deprived of life, liberty, or property without “due process of law”; found in the Fifth Amendment.

**Procedural due process** Procedural steps to which individuals are entitled before losing their life, liberty, or property.

**Substantive due process** Requirement that laws depriving individuals of liberty or property be fair.

---

**Goldberg v. Kelly,** 90 U.S. 101 (1970). In this case, the Supreme Court stated that the termination of a welfare recipient’s welfare benefits by a state agency without affording him or her opportunity for an evidentiary hearing before termination violates the recipient’s procedural due process rights.
The concept of substantive due process is not dead. Its use today, however, protects not economic interests, but personal rights, such as the still-evolving right to privacy. The right to privacy is a liberty now deemed to be protected under the Constitution. In order for a law restricting one's right to privacy to conform to substantive due process, the restriction in question must bear a substantial relationship to a compelling governmental purpose.

The Fifth Amendment further provides that if the government takes private property for public use, it must pay the owner just compensation. This provision is referred to as the **Takings Clause**. Unlike the protection against self-incrimination, which does not apply to corporations, both the Due Process Clause and the provision for just compensation are applicable to corporations. This provision for just compensation has been the basis of considerable litigation. One significant issue that has arisen is the question of what constitutes a “public use” for which the government can take property. This issue is discussed in greater detail in Chapter 14.

A second issue under this takings provision is the question of when a government regulation can become so onerous as to constitute a taking for which just compensation is required. These takings, which do not involve a physical taking of the property, are called **regulatory takings**. Environmental regulations, because they often have an impact on the way landowners may use their property, have been increasingly challenged as unconstitutional regulatory takings.

Perhaps one of the most important takings cases was **Lucas v. South Carolina Coastal Commission**,\(^{45}\) which was decided in 1992. The case arose out of a dispute between a beachfront property owner and the state of South Carolina, after the state passed a regulation prohibiting permanent construction on any eroding beach. Lucas had bought two beachfront lots for $975,000 a few years before the law was passed, and planned to build a couple of condominiums on the land. He challenged the law as constituting an unlawful taking because it prohibited him from building the condominiums or really doing anything with the property. The state court agreed with Lucas that the regulation denied him the economic value of his land and thus constituted an unconstitutional taking without compensation. It ordered the state to pay him $1.2 million in compensation. The South Carolina Supreme Court, however, citing U.S. Supreme Court precedents, overturned the lower court's decision.

Lucas appealed the decision to the U.S. Supreme Court, which reversed the state supreme court ruling in a 6–3 decision. The Court held that a state regulation that deprives a private property owner of all economically beneficial uses of property, except those that would not have been permitted under background principles of state property and nuisance law, constitutes a taking of private property for which the Fifth Amendment requires compensation. The highest court in the land said that the state court had erred in applying the principle that the Takings Clause does not require compensation when the regulation at issue is designed to prevent “harmful or noxious uses” of property.

One of the factors that many commentators believed was critical to the Court’s ruling in Lucas was the fact that the law that led to his inability to develop his land had been enacted after Lucas had acquired his property. In the 2001 case of **Palazzolo v. Rhode Island**,\(^{46}\) however, the Supreme Court held by a 5–4 vote that someone who bought property after restrictions on development were in place could still challenge the restrictions as an unconstitutional “taking” of private property.

---


Many advocates of private property rights now believe that the Takings Clause has taken on new importance because of cases such as *Lucas* and *Whitney Benefits, Inc. v. United States*,\(^{47}\) wherein a federal court found that the federal Surface Mining and Reclamation Act constituted a taking with respect to one mining company whose land became completely useless as a result of the act. Whether the “Property Firsters,” as they call themselves, will be successful in the future remains to be seen, but they have clearly brought back attention to an argument against regulation that had been fairly dormant for the past 50 years. Moreover, they are using their arguments primarily to challenge a broad range of environmental laws involving matters from forcing cleanups of hazardous waste sites to restricting grazing and rationing water, as well as land use planning statutes.

For example, in *Dolan v. Tigard*,\(^{48}\) the owner of a store in the city’s business district sued when her receipt of a permit to double the size of her store and pave its gravel parking lot was made contingent on the condition that she dedicate a sixth of her land to the city. She was to make part of the land, which was in a floodplain, a public recreational greenway and part of a bike trail that could help reduce the increased congestion in the area that might result from the expansion of her store. The U.S. Supreme Court found that there was no evidence of a reasonable relationship between the floodplain easement required of Dolan and the impact of the new building. They held that the city had the right to take the easement for the greenway, but it had to provide just compensation for the regulatory taking.

Using the Fifth Amendment to bring individual challenges to land use regulations and zoning laws is a very time-consuming process, so many property rights organizations have instead focused on trying to pass state laws that would make it easier for property owners to get compensation when their property values fall because of new regulations. In 2004, such groups achieved their greatest success with the passage of Ballot Measure 37\(^{49}\) in the state of Oregon. The measure, which was initially struck down by the state court, but was subsequently upheld by the Oregon State Supreme Court, provides that any property owners who can prove that environmental or zoning laws have hurt their investments can force the government to compensate them for their losses or get an exemption from the rules. Other states that have laws providing compensation for aggrieved property owners are Florida, Texas, Louisiana, and Mississippi, but these laws provide compensation only after a particular loss threshold has been reached, usually a 25 percent reduction in the property’s value. Those laws also allow compensation only for losses caused by new land use laws. Whether the passage of the legislation in Oregon indicates the beginning of a new wave of legislation remains to be seen.

Another factor that many who studied the *Lucas* case saw as important was the fact that the regulation really deprived its owner of any possible economically viable use for the land. Challenges based on the idea of a regulatory taking have not been quite as successful when there is just arguably a diminishment of the value of the property, as property rights advocates have found when attempting to use the law to challenge smoking bans as constituting a regulatory taking in violation of the Fifth Amendment. In the following case, the Sixth Circuit Court of Appeals examined a citywide smoking ban challenged as violating the Fifth Amendment, as applied to the state by the Fourteenth Amendment.

\(^{47}\)926 F.2d 1169 (Fed. Cir. 1991).


\(^{49}\)Subsequently codified as Oregon Revised Statutes (ORS) 195.305.
The City Council for the City of Toledo, Ohio, passed the Clean Indoor Air Ordinance, No. 509-03, which regulated smoking in public places, including restaurants and bars. A number of bar, restaurant, and bowling alley owners came together as D.A.B.E., Inc., to sue the City of Toledo. D.A.B.E. argued the Clean Indoor Air Ordinance constituted a regulatory taking of their property in violation of the Fifth and Fourteenth Amendments. The district court denied D.A.B.E.'s motions for relief, and D.A.B.E. appealed.

**Judge Martin**

I

Ordinance No. 509-03 regulates the ability to smoke in public places, such as retail stores, theaters, courtrooms, libraries, museums, health facilities, and—most relevant to the instant case—restaurants and bars. In enclosed public places, smoking is generally prohibited except in a “separate smoking lounge” that is designated for the exclusive purpose of smoking and that satisfies the following criteria:

1. it cannot constitute more than 30 percent of the total square footage of space to which the public is invited;
2. it must be completely enclosed on all sides by floor-to-ceiling walls;
3. it must have a separate ventilation system not used by the nonsmoking portion of the establishment;
4. it must not incorporate the sole path to or from the restrooms, to or from the nonsmoking portion of the establishment, or into or out of the building or waiting areas.
5. it cannot be located in an area where employees are required to work.

The ordinance provides for a 120-day exemption within which an establishment may construct a smoking lounge meeting these requirements.

II

We review for abuse of discretion the district court’s denial of appellants’ request for injunctive relief; within this standard, the district court’s legal conclusions are reviewed de novo and its factual findings are upheld unless clearly erroneous. With regard to appellants’ request for a declaration that the Clean Indoor Air Ordinance is “void and unenforceable,” the district court’s legal conclusions are subject to de novo review.

A. Regulatory Taking Claim

The Takings Clause of the Fifth Amendment, made applicable to the States through the Fourteenth Amendment, provides that private property shall not “be taken for public use, without just compensation.” “The Supreme Court has recognized two categories of takings: regulatory and physical.” Appellants allege the former. Furthermore, their attack on the ordinance is limited to a facial challenge, which requires them to prove that the “mere enactment” of the ordinance constitutes a taking of their property. According to the Supreme Court, the test to be applied in considering facial challenges such as this one is “fairly straightforward.” Under that test, “[a] statute regulating the uses that can be made of property effects a taking if it denies an owner economically viable use of his land.” Sustaining such a facial challenge is a “heavy burden.”

The evidence presented in this case fails to establish that, on its face, the Clean Indoor Air Ordinance denies appellants “economically viable use” of their respective properties. Appellants have submitted affidavits alleging that they have lost—or fear they will lose—customers as a result of the ordinance, because smoking is an activity in which many customers wish to engage while patronizing their establishments. Even if true, however, those allegations are simply not enough to satisfy appellants’ burden of proof.

In *Hodel v. Virginia Surface Mining & Reclamation Ass’n*, 452 U.S. 264 (1981), the Supreme Court held that the Surface Mining Control and Reclamation Act did not, on its face, effect a regulatory taking because of three features of the Act: first, it did not, “on its face, prevent beneficial use of coal-bearing lands”; second, it did not “categorically prohibit surface coal mining” but “merely regulate[d] the conditions under which such operations may be conducted”; and third, it did not “purport to regulate alternative uses to which coal-bearing lands may be put.” The same factors that compelled the Court’s conclusion in *Hodel* apply in this case. First, there is nothing on the face of the Clean Indoor Air Ordinance that prevents the “beneficial use” of appellants’ property. To the contrary, the ordinance has absolutely no effect on any aspect of appellants’ businesses other than to restrict the areas in which appellants’ patrons may smoke. Second, the ordinance does not “categorically prohibit” smoking inside appellants’ establishments; it “merely regulates the conditions under which” smoking is permitted. We recognize that the construction of separate smoking lounges in most cases will require some financial investment, but an ordinance does not effect a taking merely because compliance with it “requires the expenditure of money.” Finally, for obvious reasons, the ordinance does not “purport to regulate alternative uses” of appellants’ respective properties. Therefore, pursuant to *Hodel*, it is clear that appellants have failed to establish that the Clean Indoor Air Ordinance, on its face, effects a regulatory taking of their property.

**Affirmed** in favor of the Defendant, City of Toledo.
Although the appellate court in D.A.B.E. ruled that the smoking ban was not a regulatory taking, the case was not appealed to the U.S. Supreme Court, so we do not know how the highest court in the land would rule on this issue.

A final problem that often causes confusion among businesspersons is the question of the extent of Fifth Amendment protections for corporations. The Fifth Amendment protection against self-incrimination has not been held to apply to corporations. Some decisions, however, have raised questions about this long-standing interpretation. In United States v. Doe, the U.S. Supreme Court determined that even though the contents of documents may not be protected under the Fifth Amendment, a sole proprietor should have the right to show that the act of producing the documents would entail testimonial self-incrimination as to admissions that the records existed. Therefore, the sole proprietor could not be compelled to produce the sole proprietorship’s records.

In the subsequent case of Braswell v. United States, however, the Court clearly distinguished between the role of a custodian of corporate records and a sole proprietor. In Braswell, the defendant operated his business as a corporation, with himself as the sole shareholder. When a grand jury issued a subpoena requiring him to produce corporate books and records, Braswell argued that to do so would violate his Fifth Amendment privilege against self-incrimination. The U.S. Supreme Court denied Braswell’s claim and said that, clearly, subpoenaed business records are not privileged, and, because Braswell was a custodian for the records, his act of producing the records would be in a representative capacity, not a personal one, so the records must be produced. The Court stated that, had the business been a sole proprietorship, Braswell would have had the opportunity to show that the act of production would have been self-incriminating. Because his business was a corporation, he was acting as a representative of a corporation, and regardless of how small the corporation, he could not claim a privilege. In 2003, the Court of Appeals for the Eighth Circuit applied the Supreme Court’s decision in the Braswell case, as the appellate court ordered a woman to produce corporate documents even though the corporation’s charter had been revoked. The appellate court reasoned that the subpoena of documents from an inactive corporation does not constitute a violation of the corporate custodian’s Fifth Amendment rights.

PART ONE • Introduction to the Law and the Legal Environment of Business

THE FOURTEENTH AMENDMENT

The Fourteenth Amendment is important because it applies the Due Process Clause to the state governments. It has been interpreted to apply almost the entire Bill of Rights to the states, with the exceptions of the Fifth Amendment right to indictment by a grand jury for certain types of crimes and the right to trial by jury.

The Fourteenth Amendment is also important because it contains the Equal Protection Clause, which prevents the states from denying “the equal protection of the laws” to any citizen. This clause, discussed in more detail in Chapter 22, has been a useful tool for people attempting to reduce discrimination in this country.

Standard of Review. The Equal Protection Clause prohibits “invidious” discrimination, that is, discrimination not based on a sufficient justification. To determine whether a specific classification system being used by the government has sufficient justification, the Supreme Court has established standards of review based upon the nature of the classification. The standards are: strict scrutiny, intermediate scrutiny, and the rational basis test.

Strict scrutiny is used when a government activity classifies people based on their belonging to a suspect class (race, color, national origin). For the court to uphold such a classification, the government must have a compelling reason for the classification and the regulation must be narrowly drawn so that it goes no further than necessary to meet the compelling government interest.

Intermediate scrutiny is applied when the classification is based on a protected class other than race, color, or national origin, such as sex, age, or religion. In such a case the government must have an important reason for treating those in the classification differently, and the regulation must be “reasonably related” to furthering that reason.

If the classification does not involve a suspect classification, then the court will simply apply a rational basis test, meaning that there has to be some legitimate reason why the government would treat members of that class differently. The regulation at issue must simply be reasonably related to furthering that reasonable government interest. For example, in 2008, the Iowa Supreme Court ruled that a law that taxed apartment buildings at a higher commercial rate rather than at the lower residential rate charged to owners of owner-occupied condominiums did not violate the Equal Protection Clause.53

SUMMARY

The framework of our nation is embodied in the U.S. Constitution, which established a system of government based on the concept of federalism. Under this system, the power to regulate local matters is given to the states; the federal government is granted limited powers to regulate activities that substantially affect interstate commerce. All powers not specifically given to the federal government are reserved to the states.

The Commerce Clause is the primary source of the federal government’s authority to regulate business. The same clause restricts states from passing regulations that would interfere with interstate commerce. The state and federal governments are limited in their regulations by the amendments to the Constitution, especially the Bill of Rights. The First Amendment, for example, protects our individual right to free expression; commercial speech is also entitled to a significant amount of protection in this area.

Other important amendments for the businessperson are the Fourth Amendment, which protects one’s right to be free from unwarranted searches and

seizures, and the Fifth Amendment, which establishes one’s right to due process. A final amendment that has a significant impact on the legal environment is the Fourteenth Amendment, which applies most of the Bill of Rights to the states and also contains the Equal Protection Clause.

REVIEW QUESTIONS

5-1 Explain the relationship between the Supremacy Clause and the doctrine of federal preemption.
5-2 How does the Commerce Clause affect federal regulation of business activities?
5-3 What is police power?
5-4 How does the Commerce Clause affect state regulation of business?
5-5 Explain why you believe that the courts have found each of the following to either constitute or not constitute a regulatory taking:
   (a) a city ordinance reducing the size limit for freestanding signs within the city limits, forcing plaintiff to replace his sign;
   (b) a city ordinance prohibiting billboards along roads in residential areas of the city;
   (c) the refusal of the Army Corps of Engineers to grant Florida Rock Company a permit to allow it to mine limestone that lay beneath a tract of wetlands.
5-6 How does the First Amendment’s protection of private speech differ from its protection of commercial speech?

REVIEW PROBLEMS

5-7 Voters in the State of California decide that the tobacco industry is having too great an impact on the outcome of local referenda limiting smoking in public places. To curb the influence of that powerful lobby, so that the fate of the legislation will more clearly reflect the will of “the people,” they pass a law prohibiting firms in the tobacco industry and tobacco industry associations from (a) purchasing advertising related to smoking-related referenda and (b) making cash contributions to organizations involved in campaigns related to antismoking legislation. Several tobacco firms challenge the law. What is the constitutional basis for their challenge? Why will they be likely to succeed or fail?
5-8 Ms. Crabtree is given a one-year, nontenured contract to teach English at Haddock State University, a public institution. After her contract year ends, she is not offered a contract for the next year and is not given any explanation as to why she is not being rehired. She sues the school, arguing that her right to procedural due process has been violated. Is she correct?
5-9 The State of Ohio decides that Ohio’s landfills are becoming too full at too rapid a pace, so it passes a law banning the import of waste generated out of state. Several landfill operators have contracts with out-of-state generators, so they sue the state to have the statute declared void. What arguments will each side make in this case? What is the most likely decision? Why?
5-10 Chen opens a small business. As business thrives, he decides to incorporate. He becomes the corporation’s president and also its sole shareholder. Chen comes under investigation for tax fraud and is subpoenaed to produce the corporate tax records for the previous three years. He challenges the subpoena on the ground that it violates his Fifth Amendment right not to incriminate himself. Must he comply with the subpoena?
5-11 Congress passed the Americans with Disabilities Act requiring, among other provisions, that places of public accommodation remove architectural barriers to access where such removal is “readily achievable.” If such removal is not “readily achievable,” the firm must make its goods or services available through alternative methods if such methods are readily achievable. To comply with the law, Ricardo’s Restaurant will have to construct a ramp at the entrance to the restaurant and two ramps within the dining area, rearrange some of the tables and chairs, and remodel the restrooms so that they will accommodate wheelchairs. Because of the expenditures Ricardo will have to make to comply with the law, he challenges the law as being a taking of private property without just compensation in violation of the Fifth Amendment. Does the law violate the Fifth Amendment?
5-12 Plaintiffs owned a piece of lakeside property. The land was subsequently rezoned to prohibit high-density apartment complexes and restrict the use of the property to single-family dwellings. On what basis would the plaintiffs claim that their constitutional rights had been violated by the zoning change? Would they be correct?
5-13 The Alabama legislature was considering an amendment to the state’s constitution that would require that certain construction projects be performed only by Alabama companies or companies that only hired Alabama residents. Some senators were concerned that the amendment would violate the Commerce Clause, so they requested an opinion from the State Supreme Court as to the constitutionality of the proposed amendment.

How do you think the court held as the constitutionality of this proposed amendment? Opinions of the Justices, ___ So.3 ___, 2010 WL 876820, Sup. Ct., Ala., 2010.

5-14 Derrick Lowery, Jacob Giles, Joseph Dooley, and Dillon Spurlock were all varsity football players at Jefferson County High School. Discontented with their coach and his methods, the students began to circulate a petition among the football team members to try to have the coach removed from his position. When the coach found out about the petition, he began questioning the players individually. Giles, Dooley, and Lowery refused the individual interviews and said they would talk to the coach together. The coach said that if they would not talk to him alone, they could “take their stuff and leave.” On the way out, Dooley announced to the team, “I know how much you hate him, and you guys need to leave with us right now.” Spurlock, who was not there for the original interview, was subsequently interviewed, at which time he told the coach he did not want to play for him and was then told to leave. The four players sued in district court, challenging their removal from the team as being a violation of their First Amendment right to free speech. How should the court have ruled? What legal precedents discussed in this case are likely to be relevant to this opinion? Why? Lowery et al. v. Marty Euverard, Dale Schneitman, Craig Kisabeth, Jefferson County Board of Education, 497 F.3d 584 (6th Cir. 2007).

5-15 Alderman, who was on parole for felony robbery, was arrested for buying cocaine. At the time of his arrest, he was wearing a bulletproof vest, so he was charged with violating a federal law that makes it illegal for a person convicted of a felony involving a crime of violence to possess body armor. Alderman challenged the constitutionality of the Body Armor Act of 2002, contending that it exceeded Congress’s authority under the Commerce Clause. The district court rejected that argument and convicted him of violating the statute. Alderman appealed. Do you think the court upheld the authority of Congress to pass the statute? Why or why not? What case discussed in this chapter is relevant to the decision? United States v. Alderman, 565 F.3d 641 (9th Cir. 2009).

5-16 Scrap metal is a big business in Tennessee, and most of the scrap metal is shipped out of state. Tennessee was concerned that much of the metal being sold to dealers in the state was stolen, so the legislature passed a law designed to give law enforcement a better opportunity to determine whether metal on dealers’ lots was stolen. The new law included, among other provisions, requirements for screening of metal sellers, recordkeeping requirements, and a 10-day waiting period between when purchased metal could be resold by a dealer. The Scrap Recyclers Association sued the state, arguing that the law violated the Commerce Clause and also the Fifth Amendment. The district court upheld the law and the Recyclers appealed. What do you think the outcome of this case was and why? Tennessee Scrap Recyclers Association v. Bredesen, 556 F.3d 442 (6th Cir. 2009).

5-17 Aurora, Colorado, passed an ordinance banning pit bulls and other selected breeds of dogs from being inside the city limits. The American Canine Foundation, an organization aimed at improving the canine industry, sued to have the ordinance struck down as unconstitutional. The Foundation argued that the ordinance infringed on their constitutional rights, in violation of the Fifth and Fourteenth Amendments. Specifically, they argued the law resulted in an uncompensated taking and violated the Due Process and Equal Protection Clauses. Explain why the ordinance is or is not constitutional. American Canine Foundation v. City of Aurora, Colorado, 618 ESupp.2d 1271; 2009 WL 1370893 (D. Colo. 2009).

5-18 The State of Washington established a program to provide legal services for the needy. The program, called Interest on Lawyers’ Trust Accounts (IOLTA), required that clients deposit their legal payments into trust accounts, and that the interest earned on such accounts would be channeled to a nonprofit organization. This organization would then use the interest earned to fund charitable legal services and for educational purposes. The program was later extended to include nonlawyer limited practice officers (LPOs).

Several parties, including two individuals who frequently bought and sold real estate, brought suit against the nonprofit organization, alleging that the payments they made to LPOs via IOLTA accounts resulted in an unlawful taking of interest earned on those accounts. Because they did not receive just compensation for this taking, the two individuals contended that the organization violated their Fifth Amendment rights.

The district and appellate courts both argued that there had been no taking and that even if there had been a taking, the amount of just compensation would
be zero. The two individuals appealed. Explain why you believe the U.S. Supreme Court either upheld or overturned the decision of the appellate court. *Brown v. Legal Foundation of Washington*, 538 U.S. 216 (2003).

**5-19** Fred Phelps, founder and pastor of a Baptist church in Kansas, believes that God hates homosexuality and is punishing America for tolerating it. To publicize this belief, Phelps and some members of his church picket funerals of homosexuals and maintain a Web site, www.godhatesfags.com, to publicize their views.

Phelps and some of his family members picketed the funeral of a Marine killed in Iraq, Matthew Snyder, carrying signs saying “God Hates the USA,” “Fag Troops,” “America is doomed,” “Pope in hell,” and “Thank God for dead soldiers.” They alerted the media, in advance, of their plans to picket the funeral. When they returned to Kansas after the picketing, they posted pictures of the picketing on their Web site and stated on the site that Snyder’s father, Albert, had taught had Matthew “to defy his creator,” “raised him for the devil,” and “taught him that God was a liar.” Albert Snyder sued for intrusion into privacy and mental distress. The jury awarded him $2.9 million in compensatory damages and $8 million in punitive damages. The judge reduced the total damage award to $5 million. Phelps appealed, arguing that his activities were protected by the First Amendment. What do you believe happened on appeal? Why? *Snyder v. Phelps*, 580 F.3d 206 (4th Cir. 2009).

**5-20** Jaksha applied to be a firefighter. He passed the written and physical exams given by the Montana Firefighter’s Testing Consortium, but was not considered for a job when a position came open because state law required that applicants be younger than 34 years of age. The state justified the classification on the ground that it protected public safety. Jaksha sued, arguing that the law violated the Montana Equal Protection Clause (EPC). He lost at the trial-court level, and appealed. Assuming that the appellate court applied the same method of analysis to the state EPC as it would have to the federal EPC, how do you think the appellate court ruled? Why?


---

**THINKING CRITICALLY ABOUT RELEVANT LEGAL ISSUES**

**Protection of Corporate Political Speech**

Over the past decade, a number of groups and individuals have argued against many of the legal protections that corporations receive. These critics argue that problems such as those associated with Enron, Tyco, and WorldCom would not have been as severe if corporations did not have legal protection for their political speech, which limits their accountability to the people. What these critics miss, however, is that going back as far as 1889, in *Minneapolis & St. Louis Railroad Co. v. Beckwith*, 129 U.S. 26, the Supreme Court has found corporations to be persons. This finding of personhood means that corporations are properly granted the same protections for their political speech as are enjoyed by other individuals.

The First Amendment grants individuals the right to free speech. When the right to free speech is combined with the Fourteenth Amendment’s Equal Protection Clause, corporations are also provided protection for their political speech. The framers of our Constitution intended for all parties to have the right to free speech, and the critics who want to strip corporations of this right are acting in an unconstitutional and unpatriotic manner. After all, one of the principles underlying the American Revolution was the belief in “no taxation without representation,” and corporations are taxpayers.

Another reason corporations deserve protections for their political speech is that, although corporations are treated as artificial persons, they are not capable of voting. Instead, the only means corporations have available to influence laws and the political culture is through their political speech. To limit corporations’ political speech would be similar to barring corporations from having any fair say in the political process. Individuals are allowed to engage in political speech and vote; if corporations are not given a similar right, they are at a disadvantage in putting forward their point of view. The fair thing to do in this situation is to continue to grant corporations protections for their political speech. Corporations may not be able to directly have equal say and equal representation in government, but continuing to grant them their political speech protections is an important step toward equality in the political realm.

Finally, allowing corporations to engage in political speech is not the same as saying that the general population will agree with the corporations’ political speech. Rather, corporate political speech allows
corporations to express their opinions openly and then allows the people to agree or disagree with these opinions. Accordingly, there is no threat to the political speech of others to have corporations have greater access to corporate political speech. Also, in *First National Bank of Boston v. Bellotti*, 435 U.S. 765 (1978), the Supreme Court held that corporate political speech cannot be limited to try to grant others more speech. Hence, any such attempts should be prohibited.

1. How would you frame the issue and conclusion of this essay?

2. What are the relevant rules of law used to justify the argument in this essay?

3. Does the argument contain significant ambiguity in the reasoning?
   **Clue:** What word(s) or phrase(s) could have multiple meanings that would change the meaning of the reason entirely?

4. Write an essay that someone who holds an opinion opposite to that of the essay author might write.
   **Clue:** What other ethical norms could influence an opinion about this issue?

---

**ASSIGNMENT ON THE INTERNET**

This chapter introduces you to the many constitutional principles that govern business activities. One such principle is that of free speech and the extent to which it applies to commercial speech. For example, should advertisements for pharmaceuticals be subject to Federal Drug Administration regulations and limitations? Read the summary from a Supreme Court decision about the advertising of pharmaceuticals from the pharmaceutical industry, found at [www.oyez.org/oyez/resource.case/1462](http://www.oyez.org/oyez/resource.case/1462). Can you determine from the summary if the *Central Hudson* test was applied to the case? If so, how?

---

**ON THE INTERNET**

- [www.gpoaccess.gov/constitution/pdf2002/019.pdf](http://www.gpoaccess.gov/constitution/pdf2002/019.pdf) GPO is a Web site run by the Government Printing Office, and is intended to make available a large amount of government information to the general public. The link is to a document that has information summarizing important constitutional court cases. Pages 1176-1185 (also at [www.gpoaccess.gov/constitution/pdf2002/2004supplement.pdf](http://www.gpoaccess.gov/constitution/pdf2002/2004supplement.pdf) on page 27 of the PDF file) contain information specifically pertaining to commercial speech cases.
- [classes.ills.edu/archive/manheimk/114d3/echarts/taking4x.htm](http://classes.ills.edu/archive/manheimk/114d3/echarts/taking4x.htm) This Web site includes information regarding the questions relevant to determining when a valid taking has occurred pursuant to the Fifth Amendment’s Takings Clause.
- [www.landmarkcases.org/gibbons/power.html](http://www.landmarkcases.org/gibbons/power.html) Landmark Supreme Court cases interpreting the Commerce Clause can be found at this site. Pay close attention to how Congress has used the Commerce Clause to police and regulate businesses.
- [www.law.umkc.edu/faculty/projects/ftrials/conlaw/statecommerce.htm](http://www.law.umkc.edu/faculty/projects/ftrials/conlaw/statecommerce.htm) This Web site links to information regarding the impact of the Commerce Clause on states’ abilities to regulate commerce. In addition, the site contains useful links to information regarding important Commerce Clause cases.
FOR FUTURE READING


laws that govern cyberspace are changing daily. Companies such as Napster start, thrive, and then change as a consequence of legal challenges that test the boundaries of cyberspace. They are replaced by new companies, such as Grokster, Ltd., Ruckus, and LimeWire, which offer new business models and raise new legal questions for courts to resolve. Companies such as Apple release a new product such as an iPhone, and face immediate threats from hackers, which call for new technological solutions. At one point in business history, companies felt threatened by Microsoft’s power; more recently, Microsoft has felt threatened by Google Inc.’s power.1 Yahoo and Facebook are currently siding with Google in a dispute with Viacom over allegations of widespread copyright violations by Google.2 News stories have chronicled the dark side of the Internet, for example, the proliferation of child pornography, computer viruses, and identity theft. Criminals have tampered with communications systems, shutting off access to 911 emergency service for customers in major cities. Telecommunication providers and Internet service providers have responded quickly, averting problems.3 This area of law is dynamic and shows how traditional legal rules can adapt to meet challenges in cyberspace.

This chapter presents issues that fall under a wide range of legal topics, including a general discussion of how legal issues in cyberspace provide an opportunity for managers to see how law changes as society changes; an overview of the new slant on intellectual property issues and e-commerce; an outline of issues related to privacy and online marketing; a summary of employment issues in cyberspace, including employment-at-will in cyberspace and online harassment; and an explanation of how government regulators and law enforcement officials are working with the business community to battle cybercrime.

1 “Daily Briefing,” Atlanta Journal-Constitution (Sept. 28, 2007). Microsoft does not want Google Inc. to be able to purchase DoubleClick, Inc., because the deal would make Google the “overwhelmingly dominant pipeline for all forms of online advertising.”
2 Greg Sandoval, “Yahoo, Facebook Side with Google Against Viacom,” May 27, 2010, available at
3 Rhonda Cook, “Norcross Man Faces 10 Years for Shutting Down 911 Access,” Atlanta Journal-Constitution (Sept. 27, 2007). The problem was solved within two hours.
CHAPTER 6 • Cyberlaw and Business

Cyberlaw and Business:
How Law Changes as Society Changes

THE FLEXIBILITY OF LAW

Chapter 1 noted the flexible nature of law. In particular, the chapter explained that as the business environment changes, the legal system adjusts to those changes. Businesspeople expect the law to provide a path that allows them to achieve their business goals. Currently, the legal system is adapting to the most important changes in the business environment that are being brought about by the Internet and e-commerce (i.e., the increasing commercial uses of the World Wide Web). Business conducted on the Internet is not constricted by territorial boundaries; consumers who make purchases with a click of a mouse expect businesses to respond quickly and efficiently. The same is true of business-to-business commerce. As Exhibit 6-1 indicates, those who interact with the Internet and e-commerce have learned new concepts to describe transactions.

In this new world without boundaries, American citizens are getting to see just how flexible our legal system is and experiencing firsthand the tensions between clashing values and ethical norms. Recent cases, such as the lawsuits between the motion picture and recording industries and those who use their products without paying for them, have raised the following important questions:

• Is the “wide open, no standards” format of cyberspace a strength or a weakness when it comes to e-commerce?4
• Will cyberspace meet society’s expectation that speech should remain free?
• Will freedom of speech clash with the concept of security and intellectual property rights?
• Will cyberspace facilitate free trade, or will citizens see darker sides to freedom?

When the United States Supreme Court first decided a case involving cyberspace in 1997 in Reno v. ACLU, 521 U.S. 844 (see the section titled “Cyberlaw and Business: How Law Changes as Society Changes”), the Court defined cyberlaw terms. Here are some definitions created from that case:

The Internet: “an international network of interconnected computers . . . ‘a unique and wholly new medium of worldwide human communication’” (pp. 849–50).

Online services: “offer access to their own extensive proprietary networks as well as a link to the much larger resources of the Internet . . . [examples are America Online, Compuserv . . . ]” (p. 850).

Cyberspace: “Tools . . . [examples are e-mail, chat rooms, the World Wide Web], . . . constitute a unique medium—known to its users as ‘cyberspace’—[which is] located in no particular geographical location but available to anyone, anywhere in the world, with access to the Internet” (p. 851).

World Wide Web: “The best known category of communication over the Internet. . . . It allows users to search for and retrieve information stored in remote computers, as well as, in some cases, to communicate back to designated sites. . . . the Web consists of a vast number of documents stored in different computers all over the world. Some of these documents are simply files containing information. However, more elaborate documents, known as Web ‘pages,’ are also prevalent” (p. 852).

EXHIBIT 6-1
THE LANGUAGE OF CYBERSPACE

Who benefits in a world in which geographical, physical, and political limits do not apply? Who might suffer?

What kind of legal system does an increasingly technologically based society need?

Changes in the Ways Courts Function

On a more practical level, those who administer the law are starting to see how changes brought about by the Internet and a variety of forms of technology are changing the way they function. Some groups are starting to resolve small claims disputes online through services such as SquareTrade.com. Actors in the traditional legal system may appreciate this trend, as many courts are unable to handle the caseload increase brought about by e-commerce transaction questions. Courts are also facing administrative challenges brought about by social media. For example, courts have been required to develop rules to prohibit jurors from interacting about cases on Facebook. Additionally, judges have had to reprimand lawyers for text-messaging clients during depositions.

In the meantime, however, traditional courts are grappling with important issues that arise from a borderless world. For example, before a court can reach a decision in a case, it must be sure it has the power to hear the case. Recall that jurisdiction is the power of a court to hear a case and render a binding decision. Courts must have jurisdiction over both the subject matter and a person or property.

As e-commerce has evolved, courts have had to decide (1) whether a court can establish jurisdiction over a nonresident person or business based on the presence of a Web site in a particular forum, and (2) whether defendants who use the Internet to transact business are “purposefully availing”5 themselves of doing business in every state in the United States and throughout the world.

Generally, courts have held that the mere presence of a Web site in a particular forum is not enough to give a court personal jurisdiction over a nonresident defendant. Specific cases have considered the extent of interactivity of a Web site to determine whether the site subjects the defendant to personal jurisdiction. Although the Pennsylvania case of Zippo Manufacturing Co. v. Zippo Dot Com Inc.6 is not binding on other jurisdictions, many courts have used the sliding scale the court developed in that case as the basis for their decisions about personal jurisdiction (Exhibit 6-2).

The toughest cases are the ones that fall in the middle of the scale. Businesses that want to engage in e-commerce do not want to defend themselves in expensive litigation if a dispute arises. Issues arising from order forms, toll-free numbers for ordering from anywhere in the world, consumer interaction with a salesperson, and e-mail to the Web site can all lead to disputes that end up in court. Courts are just now making decisions related to these topics.

You have already learned about four values that underlie ethical decision making. You learned about four values that influence business ethics: freedom, security, justice, and efficiency. Step into the shoes of a judge who is trying to decide where to draw the line in one of the “middle” cases related to personal jurisdiction. Would a judge who values freedom over other values draw the line at a different place than one who values security above other values? What about a judge who cherishes the value of efficiency? Why is the ethical norm of justice less relevant than the other values when deciding on questions related to jurisdiction?

Interactivity The extent to which a Web site involves two-way communication between the site and user.

5Recall that we learned in World-Wide Volkswagen Corp. v. Woodson, 444 U.S. 286 (1980), that corporations that “purposefully avail” themselves of the privilege of conducting activities within the forum state have clear notice that they are subject to suit in that forum.

The defendant clearly transacts business over the Internet: Does the defendant enter into contracts that require knowingly and repeatedly transmitting computer files over the Internet? Does the defendant sell goods over the Internet? The more accessible the Web site is in a particular forum and the more commerce is transacted, the more likely it is that the defendant is subject to personal jurisdiction in that forum.

The user exchanges information with the Web site: How much does the site interact with the user? The more interactive the site, the more likely the court will find that in personam jurisdiction exists.

The Web site is passive: Does the defendant merely advertise its services on a Web site? This low level of interactivity is not enough to establish in personam jurisdiction.

Source: See United States v. Microsoft, 65 F. Supp. 2d 1 (D.D.C. 1999). In 1999, in a preliminary ruling, Judge Thomas Penfield Jackson did find that Microsoft holds monopoly power with its Windows operating system and that it used its power to harm both consumers and competitors. In June 2000, Judge Jackson issued a final ruling, which called for Microsoft to be split into two companies, one for the Windows operating system and one for its Internet and other businesses. In June 2001, in United States v. Microsoft, 253 F.2d 34 (D.C. Cir. 2001), the Court of Appeals affirmed the decision in part, reversed it in part, and remanded it in part. In September 2001, the Department of Justice decided to stop seeking the breakup of Microsoft.

CHALLENGES TO THE LIMITS AND POWERS OF GOVERNMENT

Actions Taken by the Federal Government. As the legal system adjusts to the explosive growth of the Internet and World Wide Web, state and federal governments are redefining their roles. At the federal level, individuals who follow business news have watched the Justice Department use antitrust laws to protect free markets by putting a stop to Microsoft’s alleged abuse of its monopoly power. The government is also providing protection in the area of e-commerce. Later in this chapter, you will read about how a variety of public and private actors are working together to stop cybercrime related to e-commerce.

Citizens also count on the U.S. Supreme Court to provide a check on Congress. In Case 6-1, the U.S. Supreme Court considers a First Amendment case concerning a state law creating liability for transmitting certain material over the Internet.

CASE 6-1

Supreme Court of the United States 521 U.S. 844 (1997)

This was the first case involving the limits and powers of government to regulate the Internet to be heard by the U.S. Supreme Court. The American Civil Liberties Union (ACLU) and the federal government asked the Court to decide whether Congress violated the free speech protections of the First Amendment of the U.S. Constitution when it passed the Communications Decency Act (CDA).

A Pennsylvania district court had found this legislation unconstitutional under the First Amendment.

The CDA created criminal liability for the online transmission of “indecent” and “patently offensive” material to minors. In addition, it created a defense for defendants who, in good faith, took effective actions to restrict access by minors to indecent material or for those defendants

who conditioned access on the provision of a credit card, debit account, adult access code, or adult personal identification number. Because technology, however, does not currently exist that would allow senders to block minors but not adults from accessing Internet communications, the CDA would limit adult-to-adult communications in addition to communications with minors.

In this case, the Court considered these issues: (1) Does the Internet enjoy the fullest degree of First Amendment protection? (2) Is the CDA unconstitutionally overbroad? (3) Can the CDA be considered a “cyberzone” and analyzed as a time, place, and manner regulation because it applies to all of cyberspace? (4) Did Congress demonstrate that it could not find less restrictive means of advancing its interest in protecting children from indecent speech?

After deciding that the contested provisions of the CDA were content-based blanket restrictions on speech and, thus, could not be analyzed as time, place, and manner regulations, the Court applied strict scrutiny to the statute.

Justice Stevens

Neither before nor after the enactment of the CDA have the vast democratic fora of the Internet been subject to the type of government supervision and regulation that have attended the broadcast industry. Moreover, the Internet is not as “invasive” as radio or television. The District Court specifically found that “[c]ommunications over the Internet do not ‘invade’ an individual’s home or appear on one’s computer screen unbidden. Users seldom encounter content ‘by accident.’” It also found that “[a]lmost all sexually explicit images are preceded by warnings as to the content,” and cited testimony that “odds are slim that a user could come across a sexually explicit site by accident.”

In Sable [Communications of California, Inc.], a company engaged in the business of offering sexually oriented prerecorded telephone messages (popularly known as “dial-a-porn”) challenged the constitutionality of an amendment to the Communications Act that imposed a blanket prohibition on indecent as well as obscene interstate commercial telephone messages. We held that the statute was constitutional insofar as it applied to obscene messages but invalid as applied to indecent messages. In attempting to justify the complete ban and criminalization of indecent commercial telephone messages, the Government . . . [argued] that the ban was necessary to prevent children from gaining access to such messages. We agreed that “there is a compelling interest in protecting the physical and psychological well-being of minors” which extended to shielding them from indecent messages that are not obscene by adult standards. . . . [H]owever, we could not allow the blanket prohibition on indecent messages because “[t]he dial-it medium requires the listener to take affirmative steps to receive the communication.”

[T]he Internet . . . provides relatively unlimited, low-cost capacity for communication of all kinds. The Government estimates that “[a]s many as 40 million people use the Internet today; and that figure is expected to grow to 200 million by 1999.” This dynamic, multifaceted category of communication includes not only traditional print and news services, but also audio, video, and still images, as well as interactive, real-time dialogue. Through the use of chat rooms, any person with a phone line can become a town crier with a voice that resonates farther than it could from any soapbox. Through the use of Web pages, mail exploders, and newsgroups, the same individual can become a pamphleteer. As the District Court found, “the content on the Internet is as diverse as human thought.” We agree with its conclusion that our cases provide no basis for qualifying the level of First Amendment scrutiny that should be applied to this medium.

The District Court was correct to conclude that the CDA effectively resembles the ban on “dial-a-porn” invalidated in Sable. In Sable, this Court rejected the argument that we should defer to Congressional judgment that nothing less than a total ban would be effective in preventing enterprising youngsters from gaining access to indecent communications. Sable thus made clear that the mere fact that a statutory regulation of speech was enacted for the purpose of protecting children from exposure to sexually explicit material does not foreclose inquiry into its validity. . . . [T]hat inquiry embodies an “over-arching commitment” to make sure that Congress has designed its statute to accomplish its purpose “without imposing an unnecessarily great restriction on speech.”

The breadth of the CDA’s coverage is wholly unprecedented. . . . [T]he scope of the CDA is not limited to commercial speech or commercial entities. Its open-ended prohibitions embrace all nonprofit entities and individuals posting indecent messages or displaying them on their own computers in the presence of minors.

The breadth of this content-based regulation of speech imposes an especially heavy burden on the Government to explain why a less restrictive provision would not be as effective as the CDA. It has not done so. The arguments in this Court have referred to possible alternatives such as requiring that indecent material be “tagged” in a way that facilitates parental control of material coming into their homes, making exceptions for messages with artistic or educational value, providing some tolerance for parental choice, and regulating some portions of the Internet—such as commercial Web sites—differently than others, such as chat rooms. . . . [W]e are persuaded that the CDA is not narrowly tailored.

We agree with the District Court’s conclusion that the CDA places an unacceptably heavy burden on protected speech, and that the defenses do not constitute the sort of “narrow tailoring” that will save an otherwise patently invalid constitutional provision. In Sable, we remarked that the speech restriction at issue there amounted to “burn[ing] the house to roast the pig.” The CDA, casting a far darker shadow over free speech, threatens to torch a large segment of the Internet community.

The growth of the Internet has been and continues to be phenomenal. As a matter of constitutional tradition, in the absence of evidence to the contrary, we presume that governmental regulation of the content of speech is more likely to interfere with the free exchange of ideas than to encourage it. The interest in encouraging freedom of expression in a democratic society outweighs any theoretical but unproven benefit of censorship.

Affirmed in favor of the Appellee, American Civil Liberties Union.
CRITICAL THINKING ABOUT THE LAW

As you know, courts often use analogies when making decisions. Often, once the Court decides which analogy it will use, it has decided who will win and lose the case. This is true in Case 6-1 in which the Court scrutinized the CDA.

Please refer to Case 6-1 and consider the following questions:

1. The U.S. Supreme Court decided that the Sable case was a good analogy to the case before the Court. Once the government realized that the Court saw Sable as a good analogy, the government knew it was likely to lose and that the CDA would be struck down. How so?
   
   **Clue:** Reread the discussion of Sable, paying particular attention to the level of scrutiny the Court applied to the law challenged in that case.

2. If you were a member of Congress who had a hand in drafting the CDA, how would you modify this legislation in light of the Court's opinion?
   
   **Clue:** Reread the Court's discussion of the ways in which the CDA is too broad and think of ways to make the law narrower in scope.

In 2000, the U.S. Supreme Court decided another First Amendment case in a way that affirms its commitment to First Amendment protection of speech. In *United States v. Playboy Entertainment, Inc.* Playboy Entertainment Group challenged a federal law that required cable systems to limit sexually explicit channels to late-night hours. The Court ruled that Congress overstepped its bounds when it passed the Telecommunications Act of 1996. This act required operators to scramble sexually explicit channels in full or limit programming on such channels to certain hours.

At issue in *Playboy* was Section 505 of this act, which responded to the problem of “signal bleed” in cable television; signal bleed refers to the momentary bits of video and/or audio from some channels (i.e., Playboy channels) that viewers may sometimes see or hear while watching other programs. Section 505 required blocking technology to be installed in every household in every cable system that offers adult programming, including two-thirds of homes without children. Alternatively, cable operators could restrict transmission of adult networks from 6:00 A.M. to 10:00 P.M.

In striking down Section 505, the Court emphasized that when technology allows users of communication tools to choose what they see or hear, those users rather than the government should do the choosing. In effect, the Court ruled in favor of individual choice over government regulation. Legal experts expect this decision to restrict Congress’s efforts to regulate speech in cyberspace.

**State Actions.** State governments are also adjusting to changes brought about by the use of the Internet and World Wide Web. State legislatures have passed statutes that attempt to balance freedom with other ethical norms, such as security for children. In 2002, for example, Pennsylvania passed the Internet Child Pornography Act. This act forced Internet service providers to block customers’ access to Web sites thought to be distributing child pornography. The Pennsylvania law was the first state attempt to impose criminal liability on Internet service providers when they had no direct relationship with the content source. In September 2004, a

---

11 *Id.*
12 *Id.*
federal district court declared the statute an unconstitutional restriction on free speech, because it blocked an extensive amount of innocent speech.  

Another example of how states are responding to the evolving nature of cyberspace relates to Internet wine sales. Today, approximately two dozen states ban direct shipment of wine from out-of-state to in-state residents, even though they allow in-state wineries to pursue direct shipment to in-state residents. In 2005, the U.S. Supreme Court struck down state laws that forbid interstate wine sales. The Court ruled that the Commerce Clause (which prohibits discrimination against interstate commerce) trumps the Twenty-First Amendment (which gives states the authority to regulate access to alcohol). This decision made it possible for wine sellers to move forward with plans to sell wine over the Internet. States that have placed restrictions on shipment of wines from out of state want to make sure they protect minors and collect taxes on the products. Consumers and winery owners want a more fluid wine market. They like the idea of goods flowing freely across state lines.

A final example focuses on challenges to states’ traditional regulatory role. Traditionally, states have regulated the way consumers gain access to prescription drugs. E-commerce has changed the way consumers gain access to these drugs because the Internet does not respect state or international boundaries. Consequently, some health law lawyers believe that states can no longer regulate effectively and that citizens will see ongoing debates about whether federal regulators should expand their power to regulate in this area. Federal regulators promise to protect consumers from harm without dampening the pharmaceutical industry’s interest in innovation.

---

**Censorship in Burma**

The OpenNet Initiative, a research organization that studies censorship, indicates that at least 25 countries block Web sites for political, social, or other reasons. OpenNet, a collaboration between researchers at Cambridge, the University of Oxford, Harvard University, and the University of Toronto, was surprised at the extent of censorship in particular parts of the world.

China, Iran, Burma (the Union of Myanmar), Syria, Tunisia, and Vietnam filter political sites extensively. Iran, Oman, Saudi Arabia, Sudan, Tunisia, the United Arab Emirates, and Yemen filter social sites extensively, especially sites that include pornography, gambling, and content related to being gay and lesbian.

Burma engages in extensive censorship. General Than Shwe, Burma’s dictator, was embarrassed in 2006, when a 10-minute video clip of his daughter’s wedding showed the bride, Thandar Shwe, wearing sumptuous jewels, enjoying champagne and five-star comforts. Viewers were shocked, as Burma is one of the poorest countries in Asia. More recently, Burma’s military government cut off its citizens’ Internet access and cell phone lines. This censorship is designed to suppress information about the largest prodemocracy protests in the country in decades.


---

15 Id.
19 Id. at B21.
Intellectual Property Issues in Cyberspace

PATENTS

A patent protects a product, a process, an invention, a machine, or a plant that has been produced by asexual reproduction. The government grants an exclusive property right when an invention is novel and useful. Also, the invention must be genuine and not obvious. This exclusive property right lasts for 20 years.

Historically, inventors have patented physical inventions. Now, however, inventors want to apply for patents to protect Internet business methods and technologies, such as methods for streaming digital audio and video. Patent infringement occurs when someone uses, sells, or manufactures the patented invention without the patent holder’s permission. In a line of related cases, a company called Acadia Research filed lawsuits against distributors of adult videos, asserting that these distributors infringed on patents that cover methods for streaming digital audio and video. Legal experts expect to see more lawsuits such as these, requesting protection for specific technologies rather than more tangible inventions.

TRADEMARKS

A trademark is a distinctive mark, word, design, picture, or arrangement used by the producer of a product that tends to cause consumers to identify the product with the producer. The goal of trademark law is to protect the right of commercial businesses to create marks that consumers will identify with a particular producer. An issue that has arisen in cyberspace is whether “keywording” violates the spirit of fair competition that trademark law is supposed to protect.

Keywording occurs when advertisers pay to have their advertisements displayed when a computer user types in certain keywords. For example, travel site Expedia might buy the search terms “Orbitz” and “Travelocity” so that when a user enters a search using “Orbitz” or “Travelocity,” an advertisement for Expedia will pop up nearby. Travel-site competitors Orbitz and Travelocity will want to use trademark law to protect their keywords.

Similar issues arise regarding the use of domain names. Domain names are text names matched to particular Internet protocols or addresses. They have become trademarks that allow us to identify products with producers. For instance, you probably identify the domain name “Amazon.com” with a particular product (books). It is clear that domain names are more to businesses than mere addresses.

Trademark and Piracy. As these domain names have become more valuable, they have provided an opportunity for cybersquatters (also known as cyberpirates) to engage in questionable acts to make a profit. Typically, cybersquatting occurs when an individual or business intentionally obtains a domain name registration for a company’s trademark so it can sell the domain name back to the trademark owner; in short, the individual “pirates” the domain name.

Another form of cybersquatting occurs when an individual or business registers a domain name that is the same as or similar to a preexisting trademark that belongs to someone else. The intent is to confuse the consumer. For instance, a cybersquatter might register the domain name “eBuy,” hoping the consumer will be confused and believe that “eBuy” is “eBay,” a well-known online auction site.

Still another problem occurs when two businesses have good-faith desires to use the same domain name. For instance, more than one e-commerce

---

21 Id.
22 Id.
consulting firm might want to use the domain name “e-solutions.com.” Domain names are like telephone numbers; to work as intended, they must be unique to a single owner. It would not be possible for two companies to use the domain name “e-solutions.com” unless they agreed to share a Web site.

Additionally, the law does not respond to a problem known as warehousing, which occurs when an individual or business registers names in the hope of later selling them to a business that wants a particular name. This idea of warehousing is similar to cybersquatting but without the bad-faith component.

The Anticybersquatting Consumer Protection Act. In November 1999, the United States became the first country to pass legislation aimed directly at these types of activities. The Anticybersquatting Consumer Protection Act (ACPA) responds to the first two problems just described: traditional piracy and intentional confusion. The act gives courts the power to forfeit, cancel, or transfer domain names. This was not possible under traditional intellectual property laws, which provide remedies for trademark dilution, unfair competition, false advertising, and counterfeiting. Under the new law, cybersquatters may be required to pay both actual and statutory damages that range from $1,000 to $100,000 per domain name. This new legislation does not respond to the problem of two businesses registering the same domain or the problem of warehousing. Undoubtedly, future legislation will deal with these matters. Warehousing continues today. Some technology lawyers have indicated that the presence of warehousing today demonstrates a deficiency in the ACPA.

COPYRIGHTS

Copyrights protect the expression of creative ideas. Copyrights protect fixed forms of expression, not ideas themselves. Copyrights protect a diverse range of creative works, such as books, periodicals, musical compositions, plays, motion pictures, sound recordings, lectures, works of art, and computer programs. For a work to be copyrightable, it must be fixed (i.e., set out in a tangible medium of expression), original, and creative. Copyrights are protected under common law. A person who wants to make sure that he or she can collect damages from a copyright infringer protects his or her work by registering it with the Register of Copyrights and providing two copies of the work to the Library of Congress.

Copyrights and Piracy. If a person believes that someone is infringing on his or her copyright, that person may ask a court to enjoin the infringer from reproducing the copyrighted work. In response, alleged infringers often assert the fair use doctrine, which provides that a copyrighted work may be reproduced for a range of purposes, including criticism, news reporting, and teaching. In Case 6-2, the court considers what it means for a company to engage in direct copyright infringement and what the company must assert to establish a defense based on the fair use doctrine.

LINKING LAW AND BUSINESS

Human Resource Management

In the field of human resource management, you have learned about nondisclosure agreements and noncompetition (noncompete) agreements. These agreements are useful in protecting intellectual property, including patents. Employers can use contracts with employees to reward employees who make discoveries that add value to the firm, even though the firm itself owns the intellectual property the employee created.

warehousing A practice in which an individual or business registers domain names in the hope that the names can be sold to a business.

copyright The exclusive legal right to reproduce, publish, and sell the fixed form of expression of an original creative idea.

fair use doctrine A legal doctrine providing that a copyrighted work may be reproduced for purposes of criticism, comment, news reporting, teaching (including multiple copies for classroom use), scholarship, and research.

Record companies and music publishers sued Napster. Napster is a free online music trading service. The company provides software that facilitates the transmission and retention of digital audio files (called MP3 files) by users. Users download Napster’s MusicShare software, which allows them to access the directory and index on a Napster server to locate MP3 files on other users’ hard drives. Users download MP3 files from other users’ hard drives. Although the MP3 files do not transfer through Napster’s servers, users must access Napster’s system to get access to file names and routing data.24

The plaintiffs sought an injunction against Napster, asking a trial court to prohibit Napster from facilitating the copying, downloading, or distributing of thousands of plaintiffs’ copyrighted musical compositions and sound recordings without the plaintiffs’ permission. In May and July 2000, Judge Marilyn Hall Patel issued two opinions, both of which supported the injunction the plaintiffs requested. She rejected several of Napster’s claims, including claims that its service constituted fair use, that its service constituted valid sampling or space-shifting, and that the First Amendment protected the company’s service. In the excerpt that follows, an appellate court decides whether the trial court applied the law correctly when deciding to issue the injunction. The excerpt focuses on direct copyright infringement and selected parts of the court’s discussion of fair use.

**Circuit Judge Beezer**

**A. Infringement**

Plaintiffs must satisfy two requirements to present a prima facie case of direct infringement: (1) they must show ownership of the allegedly infringed material and (2) they must demonstrate that the alleged infringers violate at least one exclusive right granted to copyright holders under 17 U.S.C. § 106. . . . Plaintiffs have sufficiently demonstrated ownership. The record supports the district court’s determination that “as much as eighty-seven percent of the files available on Napster may be copyrighted and more than seventy percent may be owned or administered by plaintiffs.”

The district court further determined that plaintiffs’ exclusive rights under § 106 were violated: “here the evidence establishes that a majority of Napster users use the service to download and upload copyrighted music. . . . And by doing that, it constitutes—the uses constitute direct infringement of plaintiffs’ musical compositions, recordings.” . . . The district court also noted that “it is pretty much acknowledged . . . by Napster that this is infringement.” We agree that plaintiffs have shown that Napster users infringe at least two of the copyright holders’ exclusive rights: the rights of reproduction, § 106(1); and distribution, § 106(3). Napster users who upload file names to search the index for others to copy violate plaintiffs’ distribution rights. Napster users who download files containing copyrighted music violate plaintiffs’ reproduction rights. Napster asserts an affirmative defense to the charge that its users directly infringe plaintiffs’ copyrighted musical compositions and sound recordings.

**B. Fair Use**

Napster contends that its users do not directly infringe plaintiffs’ copyrights because the users are engaged in fair use of the material. . . . Napster identifies three specific alleged fair uses: sampling, where users make temporary copies of a work before purchasing; space-shifting, where users access a sound recording through the Napster system that they already own in audio CD format; and permissive distribution of recordings by both new and established artists.

The district court considered factors listed in 17 U.S.C. § 107, which guide a court’s fair use determination. These factors are: (1) the purpose and character of the use; (2) the nature of the copyrighted work; (3) the “amount and substantiality of the portion used” in relation to the work as a whole; and (4) the effect of the use upon the potential market for the work or the value of the work. . . . The district court concluded that Napster users are not fair users. We agree.

[The court then agreed with the district court that the first three factors weigh against a finding of fair use.]

**C. Effect of Use on Market**

Addressing this factor, the district court concluded that Napster harms the market in “at least” two ways: it reduces audio CD sales among college students and it “raises barriers to plaintiffs’ entry into the market for the digital downloading of music.” The district court relied on evidence plaintiffs submitted to show that Napster use harms the market for their copyrighted musical compositions and sound recordings. . . . Notably, plaintiffs’ expert, Dr. E. Deborah Jay, conducted a survey (the “Jay Report”) using a random sample of college and university students to track their reasons for using Napster and the impact Napster had on their music purchases. The court recognized that the Jay Report focused on just one segment of the Napster user population and found “evidence of lost sales attributable to
college use to be probative of irreparable harm for purposes of the preliminary injunction motion.” . . . [The court then discusses additional studies offered by the plaintiffs.]

As for defendant’s experts, plaintiffs objected to the report of Dr. Peter S. Fader, in which the expert concluded that Napster is beneficial to the music industry because MP3 music file-sharing stimulates more audio CD sales than it displaces. The district court found problems in Dr. Fader’s minimal role in overseeing the administration of the survey and the lack of objective data in his report. . . . [The court then concluded that the district court demonstrated a proper exercise of discretion in using the studies to reject a fair use defense. Then, the court considered Napster’s sampling and space-shifting arguments and concluded that the district court did not abuse its discretion in finding that these uses do not constitute a fair use.]

Affirmed in favor of A & M Records, Inc.

---

**Critical Thinking About the Law**

Courts often use ambiguous language when crafting definitions. Case 6-2 gives us an opportunity to take a look at ambiguous language. It also presents a good reminder of the importance of a particular set of facts in determining the outcome of a case.

1. Identify one ambiguous word or phrase in the court’s decision in Case 6-2, and show how that ambiguity affects your willingness to accept the court’s conclusion.
   **Clue:** Consider Napster’s main defense.

2. If you could change one fact in Case 6-2 to make it less likely that the judge would rule against Napster, which fact would you change?
   **Clue:** Look at how the district court responds to reports from experts.

---

**Contributory Copyright Infringement.** In *A & M Records, Inc. v. Napster*, the court also ruled that it was likely that Napster had engaged in contributory copyright infringement. Contributory copyright infringement occurs when one, with knowledge of an infringing activity, induces, causes, or materially contributes to the infringing conduct of another. The court stated that liability exists if Napster engaged in conduct that encouraged or assisted infringers. The court ruled that Napster had facilitated transmission and retention of digital files by its users and had actual knowledge that specific infringing material was available on its system. Napster had also failed to remove infringing material.

In 2004, a California federal appeals court issued a ruling regarding peer-to-peer technologies that was more favorable to online music trading services. In *Metro-Goldwyn-Mayer Studios, Inc. v. Grokster Ltd.*, the U.S. Court of Appeals for the Ninth Circuit (California) considered online music trading services that differ from Napster’s original format in that they do not store directories on a central server. In particular, the court considered whether software distributors Grokster Ltd. and StreamCast Networks, Inc., were liable to songwriters, music publishers, and motion picture studios for copyright infringement based on the theory of contributory copyright infringement.

Distributors of peer-to-peer file-sharing computer networking software can be liable for contributory infringement only if they had knowledge of copyright infringement by users of their software. In *Grokster*, Grokster’s and StreamCast’s decentralized services meant they would not have knowledge of infringement by users. The peer-to-peer file-sharing networking software did nothing to encourage or assist infringers. Additionally, the court noted that the technology at issue in the case has many noninfringing uses. This fact makes peer-to-peer file-sharing software more like copiers, tape recorders, and video recorders.

---

25 380 F.3d 1154 (9th Cir. 2004).
recorders. All of these products can be and are used in ways that do not violate copyright laws.26

The recording industry, through the Recording Industry of America (RIAA), and the motion picture industry, through the Motion Picture Association of America (MPAA), are unlikely to be discouraged by the court’s decision in Grokster. Both organizations are pursuing several strategies to protect the rights of copyright holders. The RIAA and MPAA have filed copyright infringement lawsuits against individuals and companies throughout the world.27 Both the RIAA and MPAA would like government regulators to impose criminal penalties on copyright infringers. Today, however, civil remedies are the primary tools for combatting copyright infringement.28

E-Commerce Issues

This chapter has already presented several topics that fall under the general topic of e-commerce. The increasing importance of e-commerce, however, raises key legal issues, many of which remain unresolved, such as whether and how states can collect taxes on sales transacted on the Internet. In this section, you will learn about three significant topics that directly affect e-commerce transactions: privacy, online marketing, and cybersignatures.

PRIVACY

When people express concerns about privacy in the context of cyberspace, they usually mean they either want to be free from external surveillance or to be able to control their private information. For example, people might be concerned that a marketing company can monitor which Web sites they visit and compile a profile that would be used for targeted marketing campaigns; people who are considering banking online might worry that others can look into their accounts and learn facts about their finances. Currently, Facebook users are asking serious questions about who owns, controls, and has access to the information they post on the site.29

The concept of privacy is especially important to e-commerce. Many people are afraid to have their personal information floating in cyberspace where hackers can get it. It does not matter that these fears may not be realistic. The more confident consumers are about how companies protect their privacy, the likelier they will be to engage in e-commerce.

Public-Sector Protection. The law of privacy is under increased scrutiny as cyberspace becomes more important to society. At the federal level, the U.S. Supreme Court has interpreted the U.S. Constitution to provide a privacy right in only limited circumstances. One federal statute, the Privacy Act of 1974, places limits on which information the federal government can collect and how the government can use that information. This act generally prohibits the government from disclosing data without an individual’s consent.

At the federal level, government regulators have passed privacy guidelines for those who process information about individuals, from patient medical

26 Id., p. 1167.
28 Id.
information to purchasing patterns. For instance, Congress passed the Electronic Communications Privacy Act of 1986 (ECPA) to respond to concerns about the impact of computer data banks on individual privacy.\(^{30}\) The ECPA prohibits any person from knowingly revealing to any other person the contents of an electronic communication, although that communication is in transmission or in electronic storage. This law provides a basis for individuals to sue Internet service providers and others who fail to protect e-mail and voice mail privacy.

Law in this area is especially dynamic. *In re DoubleClick Inc. Privacy Litigation*, for example, a federal district court decided in 2001 that a business, DoubleClick Inc., an Internet advertiser, had not violated the EPCA when it created consumer profiles by placing cookies (small text files) on users’ hard drives.\(^{31}\) In 2002, however, although appeals were pending, DoubleClick settled that lawsuit. The plaintiffs, represented by state attorneys general, had been concerned that the advertiser was creating consumer profiles in violation of privacy laws. DoubleClick agreed to pay damages to the plaintiffs, and also agreed to operate more transparently. It agreed, for instance, to allow individual consumers to access the profiles the company had created about them.

More recent statutes include the Children’s Online Privacy Protection Act of 1998 (COPPA) and the Financial Services Modernization Act of 1999 (FSMA). COPPA requires Web sites that collect personal information from children to provide notice on the site of what information will be collected and how it will be used. Additionally, the site must obtain parental consent to collect information from children under age 13. The FSMA aims to give Internet consumers more control over who has access to their banking information.

**Private-Sector Protection.** In the private sector, privacy laws vary by state and industry. Common law also protects privacy. Common law varies from state to state, although states typically recognize some kind of privacy tort. The torts most helpful to individuals who operate in cyberspace are those that remedy damage caused by public disclosure of private facts and damage caused when a person uses another person’s information or identity inappropriately.

In addition to tort law, contract law provides some remedies. Most businesses and Web sites post privacy policies, which are contracts.\(^{32}\) These privacy policies range from brief notices that let consumers know the site is secure to policies with pages of details. The goal of privacy policies is to let Internet users know how a company will collect personal data about the consumer and what the company will do with the information it collects. The policies also reassure consumers that sites are secure.

Privacy policies have been the subject of lawsuits based on a variety of theories, including the theories of unfair or deceptive trade practices and fraud. For example, a subscriber to Yahoo! sued this Internet service provider for violating his privacy.\(^{33}\) Yahoo! let AnswerThink Consulting Group Inc. know the name of an Ohio man who used the screen name Aquacool_2000 (Aquacool) after AnswerThink subpoenaed the information. AnswerThink wanted to know which of its employees had posted negative comments about his boss on a

---

\(^{30}\) The Privacy Act often conflicts with the Freedom of Information Act.


\(^{32}\) It is important to note that privacy policies posted on Web sites become contracts only if the user accepts them.

In the field of marketing, you learned about the concept of direct-to-consumer advertising. This form of marketing uses television and/or Web sites to allow marketers to reach out to consumers directly, rather than marketing to an intermediary, such as a doctor. The first DTC advertising was for a hair-loss treatment called Rogaine. A television advertisement encouraged consumers to ask their doctors for Rogaine.

### ONLINE MARKETING

Increasingly, marketers are advertising products on the Internet. Marketers view the Internet as a significant opportunity to reach out to customers throughout the world. This new advertising format brings with it both great opportunities and the threat of misleading or deceptive advertising strategies and fraud.

Consumer rights advocates are especially concerned about the possibility that marketers will violate consumers’ privacy rights by collecting information about them without their knowledge and/or consent. (See the discussion of privacy issues in the preceding section.) As you will learn in the section on cybercrime, criminals are finding creative ways to use e-commerce to their advantage. Consumers are worried that the kinds of scams consumers experience via telephone and mail will invade the Internet.

In Case 6-3, the court considers an online marketing issue. In particular, the court considers whether companies that advertise prescription drugs directly to consumers on television and Web sites have a duty to warn them about the dangers of the drugs. Increasingly, drug manufacturers engage in direct-to-consumer (DTC) advertising via the Internet, especially on social media sites. With DTC advertising of prescription drugs on the rise, more courts will be considering these types of issues.

### CASE 6-3

**Centocor, Inc. (Plaintiff-Appellant) v. Patricia Hamilton (Respondent)**  
Texas Court of Appeals, Thirteenth District  
310 S.W.3d 476; 2010 WL 744212 (2010)

Patricia Hamilton, 47, began taking Remicade for her Crohn’s disease in December 2001. Remicade is manufactured and marketing by Centocor, Inc. Crohn’s disease is an inflammatory disease of the intestines. The following year, Hamilton developed drug-induced lupus. Lupus is a chronic autoimmune connective disease that can affect any part of the body.

Hamilton sued Centocor, claiming that the company failed to warn doctors of the drug’s risks. Hamilton had watched a company-provided videotape about Remicade treatment that did not list lupus-like syndrome as a potential side effect. Instead, the videotape indicated that Remicade changed patients’ lives. Hamilton thought she would feel great after the Remicade treatments, like the patients who shared their stories in the videotape.

A Corpus Christi jury found that Centocor was liable for fraud. The jury awarded Hamilton $4,687,461.70 in actual and punitive damages. The jury awarded Thomas Hamilton, Patricia’s spouse, $120,833.71 in actual and punitive damages.
On appeal, Centocor argued that the learned intermediary doctrine precludes the Hamiltons’ recovery because, as a matter of law, Centocor’s warnings to Patricia’s physicians were adequate. Centocor argued that it had no duty to warn Patricia directly. In the decision excerpted here, the appellate court rejects Centocor’s argument and recognizes an exception to the learned intermediary doctrine when a drug manufacturer engages in direct-to-consumer advertising that fraudulently touts the drug’s efficacy while failing to warn of its risks.

Justice Yáñez

The changes in the delivery of healthcare brought about by direct marketing and managed care demonstrate that the theoretical underpinnings of the “learned intermediary” doctrine do not apply when a drug manufacturer directly markets to its consumers, the patients.

First, although a doctor must still write a prescription for prescribed drugs, it is clear that many doctors are not spending the amount of time necessary to pass along warnings by pharmaceutical companies. The problem this creates is compounded by the fact that patients [now] make the ultimate decisions regarding the drugs they will take and will often ask for drugs by name.

Second, drug manufacturers who directly market their products to consumers are hard-pressed to argue that only a physician would understand the propensities and dangers involved and that they lack effective means to communicate directly with consumers. In fact, by directly marketing to consumers and providing warnings in those advertisements, drug manufacturers have completely undermined their own arguments.

Third, and similarly, it is illogical that requiring manufacturers to provide direct warnings to a consumer will undermine the patient-physician relationship when, by its very nature, consumer-directed advertising encroaches on that relationship by encouraging consumers to ask for advertised products by name.

In sum, the premises underlying the doctrine are unpersuasive when considered in light of direct marketing to patients. The situation presented is more similar to the recognized exceptions to the doctrine, where courts considering the issue have found it was unreasonable for a manufacturer to rely on an intermediary to convey a warning, given that direct advertising and changes in the provision of healthcare impact the doctor’s role and promote more active involvement by the patient. Under these circumstances, we hold that when a pharmaceutical company directly markets to a patient, it must do so without fraudulently misrepresenting the risks associated with the product. Affirmed in favor of the Plaintiff-Respondent, Hamilton.

**CRITICAL THINKING ABOUT THE LAW**

Please refer to Case 6-3 and consider the following questions:

1. If you were charged with defending a pharmaceutical company, what would you advise the company to do to encourage a court in a future case to reject the learned intermediary doctrine?

   **Clue:** Think about what you would ask both patients and doctors during the discovery process about the facts that led the doctor to prescribe a particular drug to a patient.

2. In rejecting the learned intermediary doctrine, which ethical norm is the court showing it prefers?

   **Clue:** Figure out who benefits from the court’s decision and how this group benefits.

**CYBERSIGNATURES**

In 2000, Congress passed the Electronic Signatures in Global and National Commerce Act, which is commonly referred to as ESIGN. The purpose of this legislation is to make it easier for businesses to create valid contracts over the Internet. In particular, ESIGN outlines how businesses can create valid contracts electronically with methods that imitate the effect of written signatures on paper. ESIGN allows a wide range of authentication possibilities. Some of these possibilities are surprisingly low-tech. For instance, the law allows the use of information unique to a customer, such as a mother’s maiden name. On the high-tech end, ESIGN allows individuals and businesses to create digital signatures using encryption software. This authentication procedure involves a third party who holds the identity of the two parties and can use software to make sure only the two parties involved in a contract can obtain and sign the document.

---

CHAPTER 6 • Cyberlaw and Business

Employment Law Issues in Cyberspace

PRIVACY VERSUS EMPLOYMENT-AT-WILL

Not only does privacy matter in the context of business-to-consumer and business-to-business transactions, but it also is important in the context of employment. Employee monitoring is a growing issue:

- Are employers allowed to record employee keystrokes as they occur?\(^{35}\)
- Can employers fire employees who frequently type words such as “union” and “strike”?\(^{36}\)
- Can employers keep track of which Web sites employees visit?
- Can employers ban employee access to certain sites?

The increasing use of social media has raised additional questions about privacy:

- Can employers retract employment offers after using social media to screen job candidates?
- Can employers monitor social media to investigate suspicious claims for worker’s compensation or unemployment benefits?
- Can employers monitor employee conduct, especially conduct that might reflect poorly on the company?

Courts throughout the country are considering these questions. These issues highlight the employees’ right to privacy and employers’ right to control what happens in their workplaces.

In Case 6-4, a Pennsylvania court makes a decision about how much privacy employees can expect from their employers. As you read the case, consider your own workplace e-mail communications. Could you end up in the same situation as Smyth?

CASE 6-4

Michael A. Smyth v. The Pillsbury Co.

This case arose when Pillsbury Company fired Michael A. Smyth for transmitting inappropriate and unprofessional comments over Pillsbury’s e-mail system. In particular, Smyth made threats related to sales management (he threatened to “kill the backstabbing bastards”) and referred to a holiday party the company had planned as the “Jim Jones Koolaid affair.”\(^{37}\) Pillsbury had repeatedly assured its employees that it would keep all e-mail communications confidential. After his employer read Smyth’s comments, the company fired him.

At issue in the case is whether Smyth can maintain a wrongful discharge action under the public policy exception to the employment-at-will doctrine. A Pennsylvania court had previously stated that it was possible that a discharge related to an employer’s tortious invasion of an employee’s privacy might violate public policy. The court made this statement in the context of privacy related to an employer’s drug and alcohol policy that requires urinalysis and/or personal property searches. Smyth asked the court to extend this idea of privacy as a public policy exception to privacy in e-mail communications. Pillsbury filed a motion to dismiss.

---


\(^{36}\) Id.

\(^{37}\) Jim Jones is the cult leader whose followers committed mass suicide by drinking a poisoned drink in Jonestown, Guyana, in 1978.
District Judge Weiner

As a general rule, Pennsylvania does not provide a common law cause of action for the wrongful discharge of an at-will employee such as plaintiff. Pennsylvania is an employment at-will jurisdiction and an employer “may discharge an at-will employee with or without cause, at pleasure, unless restrained by some contract.”

However, in the most limited of circumstances, exceptions have been recognized where discharge of an at-will employee threatens or violates a clear mandate of public policy. A “clear mandate” of public policy must be of a type that “strikes at the heart of a citizen’s social right, duties and responsibilities.” This recognized public policy exception is an especially narrow one.

Plaintiff claims that his termination was in violation of “public policy which precludes an employer from terminating an employee in violation of the employee’s right to privacy as embodied in Pennsylvania common law.”

[W]e find that the plaintiff has failed to state a claim upon which relief can be granted. In the first instance . . . we do not find a reasonable expectation of privacy in e-mail communications voluntarily made by an employee to his supervisor over the company e-mail notwithstanding any assurances that management would not intercept such communications. Once plaintiff communicated the alleged unprofessional comments to a second person (his supervisor) over an e-mail system, which was apparently utilized by the entire company, any reasonable expectation was lost. Significantly, the defendant did not require plaintiff, as in the case of a urinalysis or personal property search, to disclose any personal information about himself. Rather, plaintiff voluntarily communicated the alleged unprofessional comments over the company e-mail system. We find no privacy rights in such communications.

In the second instance, even if we found that an employee had a reasonable expectation of privacy in the contents of his e-mail communications over the company e-mail system, we do not find that a reasonable person would consider the defendant’s interception of these communications to be a substantial and highly offensive invasion of his privacy. Again, we note that by intercepting such communications, the company is not . . . requiring the employee to disclose any personal information about himself or invading the employee’s person or effects. Moreover, the company’s interest in preventing inappropriate and unprofessional comments or even illegal activity over its e-mail system outweighs any privacy interest the employee may have in those communications.

In sum, we find that the defendant’s actions did not tortiously invade the plaintiff’s privacy and, therefore, did not violate public policy.

 Granted motion to dismiss filed by the Defendant, Pillsbury Company.

CRITICAL THINKING ABOUT THE LAW

As a critical thinker, you know there are many ways to phrase an issue. How a judge decides to describe the issue often tells the reader who is likely to win the case. Case 6-4 helps readers think about ways to word an issue. It also presents a good reminder of the importance of analogies in legal reasoning.

1. In Case 6-4, the judge carefully chose how to word the issue. Step into Smyth’s shoes and write the issue as he saw it. In other words, if Smyth, through his lawyers, were allowed to state the issue, how would the issue be read?
   Clue: Reread the part of the case containing Smyth’s main arguments.

2. Smyth wants the court to look at what happened to him regarding privacy and view any violations as comparable to violations of privacy related to urinalysis and/or personal property searches. Why does the court reject Smyth’s comparison?
   Clue: Reread the part of the decision in which the court discusses privacy rights.

ONLINE HARASSMENT

In the Smyth case, the employer wanted to control the employee’s behavior at the expense of the employee's privacy. Employers might not react the same way to online harassment. Online harassment usually involves peer-to-peer harassment. Some employers are less likely to assert control to protect one employee from another. For example, some companies might look the other way when employees view pornographic Web sites during the working day and possibly thereby harass other employees. Other companies might assert control and put a stop to this unproductive activity (though possibly not from motives related to protection of other employees).
Later in this book, you will learn that hostile-environment sexual harassment occurs when an employee’s behavior creates an intimidating, hostile, or offensive workplace for other employees. Generally, courts have held employers responsible for employee behavior when they knew or should have known of an employee’s inappropriate behavior. To escape liability, employers also need to conduct sexual harassment training and have clear workplace policies prohibiting harassing behavior.

Recent online harassment cases have raised several interesting questions, including:

- Can employers be vicariously liable for defamation?
- How do courts decide when an employer-sponsored Internet bulletin board is part of the workplace?
- Can an Internet service provider be held responsible for defamatory comments posted to online bulletin boards?

A New Jersey court ruled that employers have a duty to remedy online harassment when they notice that “employees are engaged in a pattern of retaliatory harassment using a work-related online forum.” In this case, Tammy Blakey, a Continental Airlines pilot, had already won a federal sexual harassment suit in 1997. In the 1997 federal lawsuit, Blakey succeeded in proving that Continental Airlines had failed to protect her from sexual harassment, including the airline’s failure to remove pornography from planes Blakey was flying. (Other pilots had placed the pornography in planes specifically to make her uncomfortable.) After a five-week trial, a jury awarded Blakey $875,000, which included $500,000 for emotional distress.

In 1995, while the federal litigation was under way, the case took a new twist. Blakey’s fellow pilots started using an electronic bulletin board to discuss her case. From February to July 1995, several male pilots posted comments about Blakey on the pilots’ online computer bulletin board, called the “Crew Members Forum.” This electronic bulletin board was maintained by CompuServ and provided information to pilots and crew members about their schedules and flight assignments. Pilots posted comments on the Crew Members Forum that questioned Blakey’s ability to pilot a plane. Coworkers also called her a “feminazi” and accused her of filing the federal lawsuit “to get a quick buck.”

The focus of the state case was on the comments employees posted on the Crew Members Forum. In this New Jersey case, Blakey sought damages for defamation, hostile-environment sexual harassment under the state’s antidiscrimination statute, business libel, and intentional infliction of emotional distress. The court ruled that although the electronic bulletin board was located outside the workplace, it was an extension of the workplace. In remanding the case to the trial court, the appellate court instructed the trial court to consider whether Continental derives a “substantial benefit” from the electronic bulletin board and whether this bulletin board is “sufficiently integrated in the workplace” to require the employer to put a stop to harassment. The court explained that if the online bulletin board is actually work related, Continental will be liable for messages that created a hostile work environment for Tammy Blakey.

39 A judge reduced the jury’s award to $625,000. A significant portion of this award was for attorney fees.
40 Gallaher, supra note 37.
41 Id.
42 Id.
As a consequence of the appellate court’s ruling, it would be wise for employers throughout the country to take a serious look not only at how employees are using technology to make unprofessional comments about their employers (as in the Smyth case), but also at how employees are using technology to inflict damage on their coworkers. If employers find peer sexual harassment online, they should take action to stop the harassment.

The War Against Cybercrime

As technology evolves and expands opportunities, criminals are finding new ways to cause harm to the public. They are creating brand-new crimes such as denial-of-service attacks and identity theft. Additionally, criminals are adding new twists to some old crimes, such as illegal gambling and insider trading. This section discusses these four crimes to illustrate some of the challenges law enforcement officials are facing in the area of cybercrime.

DENIAL-OF-SERVICE ATTACKS

In spite of developments in computer security such as firewalls and encryption, computer criminals are finding ways to threaten e-commerce. One of the most common of these tactics is a denial-of-service attack. A denial-of-service attack occurs when hackers clog a Web site’s equipment by sending too much unsolicited commercial or “junk” e-mail at one time. This form of e-mail is also called spam.

A quick flood of spam can slow the site’s performance and/or crash the site. Law enforcement officers are able to stop the attacks by getting companies, Internet service providers, and telecommunications suppliers to work together to write programs to reject requests that are clogging equipment.

Federal and state law enforcement officers try to stay one step ahead of cybercriminals. Sometimes they face many challenges, including the lack of private-sector cooperation from companies such as Yahoo! and eBay. These companies do not want to call attention to weaknesses in their computer security systems. They also fear that officers will confiscate their computers to search for evidence that may be stored in the hard drives. In addition, law enforcement officers face (1) obstacles presented by technology, such as vanishing evidence; (2) difficulty in locating and identifying criminals who operate through the Internet; and (3) the lack of sufficient financial resources.

More recently, however, actors in the private sector have wanted to work with law enforcement officials to put a stop to spamming. Both the National Cyber-Forensics and Training Alliance, a nonprofit organization, and the Direct Marketing Association, a trade association, have worked with the Department of Justice (DOJ) and Federal Bureau of Investigation (FBI) to protect legitimate e-mail marketing and stop spamming.

IDENTITY THEFT

Law enforcement officials have also linked spam to the relatively new crime of identity theft. Identity theft is a form of fraud in which an individual assumes someone else’s identity as his or her own.

---

denial-of-service attack
A crime that occurs when hackers clog a Web site’s equipment by sending it too many requests for information.

spam
Unsolicited commercial or “junk” e-mail.

identity theft
A form of fraud in which an individual assumes someone else’s identity information as his or her own.

---

44 Id. at 39.
information to do so. Spammers with criminal intent sometimes use junk e-mailing to engage in online profiling. Spammers have been able to gather personal information about computer users, including account and/or Social Security numbers. If criminals are able to steal this kind of information, they can use it to engage in a pattern of criminal behavior. For example, criminals can use personal information to obtain false driver’s licenses, which they can then use to open additional credit card and checking accounts to perpetuate additional acts of fraud.

Identity thieves can sometimes accumulate a significant collection of assets. For instance, husband-and-wife confidence artists Nalin and Meena Rawal engaged in acts of identity theft that allowed them to obtain cash and telephone service, a $20,000 Honda for their son to take to college, a $23,000 Mercedes vehicle, a $600,000 house, and even laser eye surgery for Meena.47 Most of their swindling was made possible by use of Meena Rawal’s real estate license and Nalin Rawal’s notary public license. Law enforcement officials caught the Rawals, and both are serving jail sentences and are expected to pay restitution to their victims.

The Federal Trade Commission (FTC), a federal agency responsible for helping consumers who have become victims of identity theft, gives several recommendations for how individuals can prevent identity theft. For example, the FTC recommends that individuals refrain from giving out personal information over the telephone or mail unless they have initiated the contact or are sure they know the individual or business they are dealing with.48 Another tip is to keep your Social Security card in a secure place. The agency also recommends that you guard your mail and trash. Finally, the FTC recommends that your passwords that provide access to accounts not be obvious.49 Exhibit 6-3 presents the FTC’s tips for Internet users who want to prevent identity theft.50

**INSIDER TRADING**

Cybercriminals have also found creative ways to manipulate the stock market to their advantage. For instance, some criminals have discovered how easy it is to manipulate stock prices by posting false information on Internet bulletin boards.51 Other criminals have used the Internet to engage in traditional insider trading.

---

**EXHIBIT 6-3**

**IDENTITY THEFT PREVENTION FOR INTERNET USERS**

- Keep your virus protection software up-to-date.
- Do not open files or click on hyperlinks sent by strangers.
- If you use a high-speed Internet connection, use a firewall program to prevent hackers from taking over your computer.
- Use a secure browser.
- Try to refrain from storing financial information on your laptop.
- Use complicated passwords, such as those that use a combination of letters, numbers, and symbols.
- Delete personal information when you dispose of a computer.
- Prefer Web sites with privacy policies.

---

48 [www.consumer.gov/idtheft/protect_againstidt.html#5.](http://www.consumer.gov/idtheft/protect_againstidt.html#5)
49 Id. This site gives a more exhaustive list of tips than the text has presented.
50 Id.
Management Information Systems

In the field of management information systems, you have learned about the concept of encryption. Encryption software protects transactions and communications over the Internet. This software also adds challenges to law enforcement because encryption software enhances the security and privacy of criminals as well.

Insider trading is the use of material, nonpublic information to purchase or sell securities in violation of a duty the person owes to the company whose stock the person is trading.

For example, in one case, a part-time clerk at Goldman Sachs & Company was charged with insider trading after he allegedly made $8.4 million on illegal tips. By using an America Online chat room, he was able to draw others into his scam. He exchanged inside information for kickbacks with friends in both the real and virtual worlds. In this case, the clerk used inside information (i.e., non-public information he got through his job) and then engaged in manipulation (i.e., added false information to the inside information), showing he could pursue both new and traditional forms of illegal trading at the same time.

INTERNET GAMBLING

Another challenge for law enforcement officers is how to regulate gambling on the Internet. Some states make gambling a crime and are quick to shut down gambling sites that operate through servers located in their states. However, even if a state bans companies in that state from providing access to gambling, they cannot control companies whose servers are located outside their jurisdiction.

Some people argue that attempts to limit Internet gambling are inappropriate. They ask why a person is allowed to physically travel to Las Vegas to gamble but not allowed to travel to Las Vegas via the Internet to gamble. Should states be allowed to make decisions about how to protect the moral welfare of their residents? Ultimately, Congress will pass legislation that answers questions about how to regulate Internet gambling. Congress has already considered some statutes and is likely to pass legislation in the near future.

53The American Bar Association’s Committee on Cyberspace Law, Cyberspace Law Developments—Annual Survey (paper presented at the spring 1998 meeting, St. Louis, MO), 32.
bounds when passing legislation that places limits on speech on the Internet. Additionally, courts are changing the way they function. For example, new rules govern in personam jurisdiction.

Intellectual property law is also changing. For example, domain names have become valuable trademarks. These domain names have become so valuable that cyberpirates may want to take advantage of trademark owners by intentionally obtaining a domain name registration for a company’s trademark and then trying to sell that domain name back to the trademark owner. Copyright law is also facing challenges. In response to challenges, courts are coming up with creative new concepts, such as contributory copyright infringement, which occurs when creators of a Web site present material on the site that encourages visitors to their site to violate copyright laws. At the same time, courts are recognizing the impact of technological change on property rights. This recognition is allowing courts to reconsider and redefine the rights of individuals who create songs, movies, and other forms of intellectual property.

Many e-commerce issues are arising in cyberspace. Individuals are increasingly concerned about their privacy rights. Online marketing is triggering some lawsuits and investigations by administrative agencies. How to establish and use cybersignatures is an important topic.

Employment issues in cyberspace include new reasons for employers to fire employees (e.g., when they use e-mail inappropriately) and new opportunities for employees to harass one another in the context of cyberspace.

Government regulators are waging a war against cybercrime. Government actors are responding to denial-of-service attacks, identity theft, insider trading, and illegal gambling. Increasingly, government actors are working through alliances in the private sector. Many individuals and groups in the private sector are starting to realize that they have important interests in battling cybercrime.

**REVIEW QUESTIONS**

6-1 Explain two specific challenges states are facing as they try to regulate the Internet.

6-2 Explain how the concepts of domain names, trademarks, and cybersquatting are related.

6-3 Explain the concept of contributory copyright infringement and how legal interpretations of that concept have evolved from Napster to Grokster.

6-4 Explain how a person can use a cybersignature and why the subject of cybersignatures is significant.

6-5 Explain how the Internet is giving employers the opportunity to show that they understand the employment-at-will doctrine.

6-6 Explain two specific kinds of crime that are on the rise with increasing use of the Internet.

**REVIEW PROBLEMS**

6-7 Congress decides it wants to issue a total ban on online advertising of prescription medicines. If a pharmaceutical company challenges this total ban, is the company likely to be successful?

6-8 You are an employee who has just discovered that an e-mail message you thought you sent to your close friend at work was sent to an entire department. In this message, you disclose the fact that you believe your boss is having an extramarital affair with someone else at the company. If your boss finds out, can she fire you for sending the message? Does it matter whether your news is true?

6-9 Suppose you are the attorney general of your state. You want to file an action against a gaming corporation.
You want to seek an injunction against the company, asking it to stop making Internet gambling opportunities available to residents of your state via the Internet. Are you likely to be successful in getting the injunction?

6-10 Paul led a crime ring that used computers to engage in a variety of fraudulent activities, including obtaining credit card numbers and selling them to others to use illegally. If Paul is prosecuted and found guilty of this crime, what is his likely jail sentence? What factors will help determine the sentence?

6-11 Suppose HighTech Inc., the owner of the trademark “high-tech,” sued seeking an injunction against the owner of the trademark “high-tech.” Suppose HighTech wants to stop the owner of the trademark “high-tech” from using that mark. How will a court decide whether to issue the injunction?

6-12 LookinGood sued Babes, Inc. for copyright violation after Babes, Inc. copied photographs from LookinGood’s Web site and put them on its own Web site, babes.com. LookinGood can provide proof of its copyright. In particular, Babes, Inc. copied 10 copyrighted photographs of 5 models. How much is Babes, Inc., likely to have to pay LookinGood? Does it matter that Babes, Inc.’s behavior was willful?

CASE PROBLEMS

6-13 Robert A. Delsman, Jr., maintains a blog. In that blog, he criticized the business practices of Sedgwick Claims Management Services, Inc. Sedgwick provides insurance claims services to various companies and their employees, including Delsman. In addition to criticizing Sedgwick via the blog, Delsman mailed postcards styled as “WANTED” posters bearing the photographs of two Sedgwick executives, and included critical commentary. Sedgwick alleges that Delsman engaged in copyright infringement by using the two photos. Additionally, Sedgwick alleges that Delsman’s blogs defamed the company. Delsman wants all claims dismissed. Was Delsman successful? Sedgwick Claims Management Services, Inc., No. C 09-1468 SBA; WL 2157473 (N.D. Cal. 2009).

6-14 Fortune Hi-Tech Marketing, Inc. is a direct sales company. Fortune asserts that the company’s trademarks and service marks—FORTUNE HI-TECH MARKETING and FHTM—have become well known in the industry; it has established goodwill and a solid reputation using these marks. Joseph Issacs became an independent representative (IR) who markets Fortune’s products and services. Issacs decided to organize and operate a website called www.fortunesocial.com to facilitate networking among Fortune IRs who register as members of the website. Fortune asserts that the Web site misappropriated Fortune’s trademarks and service marks and sought to profit from Fortune’s good name and reputation. When Issacs refused to remove the trademarks and service marks from the Web site, Fortune terminated Issacs. Fortune then filed a civil action in a Kentucky federal court against Issacs, asserting a number of intellectual property issues. Issacs filed a motion to dismiss, alleging that an exercise of jurisdiction over him, a Florida resident, was unreasonable. Was Fortune able to get personal jurisdiction over Issacs?

6-15 The NYC Triathlon is an Olympic-distance triathlon, consisting of a 1,500-meter swim in the Hudson River, a 40-kilometer bike ride up the West Side Highway, and a 10-kilometer run into Central Park. The triathlon has been run every summer in New York City since 2001. NYC Triathlon has used the name and mark THE NEW YORK CITY TRIATHLON, and variations, in connection with the event. The race has developed a loyal and enthusiastic following. Moreover, it has been covered by numerous national news and media outlets. SBR Multisports, Inc. is a retail outlet that sells triathlon equipment and has served as one of many sponsors to the NYC Triathlon. On January 25, 2010, SBR issued a press release stating that the company was changing its name from “SBR Triathlon Club” to “NYC Triathlon Club.” The New York City Triathlon brought action against SBR alleging violations of federal and state law, and sought a preliminary injunction against SBR, seeking to restrain SBR from using any trade name or trade mark likely to cause confusion with the triathlon. SBR opposed the preliminary injunction. What was the result? New York City Triathlon, LLC v. NYC Triathlon Club, Inc., No. 10 Civ. 1464 (CM); WL 808885 (S.D.N.Y. 2010).

6-16 Four “Julie Does”—girls aged 13 to 15—were sexually assaulted by men they met through the social networking site, MySpace. The Julie Does, through their parents or guardians, have sued MySpace for negligence, gross negligence, and strict product liability. MySpace sought to dismiss the complaint, asserting that the Communications Decency Act immunizes the company from liability. What was the result? Doe v. MySpace, Inc., 175 Cal. App. 4th 561, 96 Cal. Rptr. 3d 148 (2009).
6-17 The City of Ontario in California decided to review text messages Jeff Quon sent and received. Quon, a police sergeant and member of the city’s SWAT team, had complied with the city’s policy requiring payment for overages (e.g., transmissions that went beyond the city’s allotted 25,000 characters per pager per month and charging officers for characters beyond the allotted number). Quon went over the monthly character limit three or four times, and Quon paid the city for the overages. The city grew weary of collecting for the overages and asked Arch Wireless, the company that provided text-messaging services to the city, to provide transcripts so the city could determine whether the character allotment should be changed. (If the text messages were all work related, the city would increase the allotment, but if the text messages included personal messages, the city would continue to charge officers for overages.) Upon review of the transcripts, the city realized that several of Quon’s messages were sexually explicit messages sent to his wife. Quon, his wife, and other employees sued the city and Arch Wireless, asserting that their privacy had been violated. Did Arch Wireless violate privacy laws by providing transcripts to the city? Did employees have an expectation of privacy in their messages? Quon v. Arch Wireless Operating Co., Inc., 529 F.3d 892 (9th Cir. 2008).

6-18 Kenneth Zeran brought a negligence action against America Online, Inc. (AOL), alleging that AOL unreasonably delayed the removal of defamatory messages posted by an unidentified third party. Zeran was a hoax victim whose business telephone number appeared on an Internet electronic bulletin board, advertising items that featured slogans glorifying the Oklahoma City bombing. After Zeran sued AOL, he also sued a radio station, owned by Diamond Broadcasting, Inc., for defamation, false-light invasion of privacy, and intentional infliction of emotional distress. He argued that the station violated Oklahoma law when it read Zeran’s telephone number over the air and encouraged listeners to call him. Was Zeran able to hold Diamond Broadcasting, Inc., liable for its role in the hoax? Zeran v. Diamond Broadcasting, Inc., 203 F.3d 714 (10th Cir. 2000).

6-19 Plaintiff, SFX Motor Sports, Inc. (SFX), owns a copyright to live motorcycle racing events. It promotes and produces these events under the name Supercross. These racing events take place at venues across the country and are broadcast live via radio, television, and Internet. SFX asked a Texas federal court to issue a preliminary injunction against Davis, owner of SupercrossLIVE.com (SupercrossLIVE), after this site posted a link on its Web site, linking to SFX’s motorcycle racing event. SupercrossLIVE’s only act was to host a link to SFX’s Webcast on the Super crossLIVE.com site. What was the result in the federal district court? Will the result survive on appeal? Live Nation Motor Sports, Inc. v. Davis, [slip op.] 2007 WL 79311 (N.D. Tex. 2007).


6-21 Perfect 10, Inc. (Perfect 10), an adult magazine publisher, sued Visa International Service Association (Visa), for copyright and trademark infringement arising out of Visa’s act in processing credit card payments to Internet Web sites that infringed Perfect 10’s intellectual property rights. Perfect 10 had notified Visa about the infringing Web sites. What was the result? Perfect 10, Inc. v. Visa International Service Association, 494 F.3d 788 (9th Cir. 2007).

THINKING CRITICALLY ABOUT RELEVANT LEGAL ISSUES

Illegal Downloads at Universities

Universities should take stronger action to prevent students from illegally downloading music on the Internet. The issue is a matter of both business sense and ethics.

Currently, universities are immune from liability for illegal file sharing on college networks. This immunity clause is part of the 1998 Digital Millennium Copyright Act (DMCA), which generally aims to create an updated version of copyright laws to respond to the unique
challenge of regulating digital material. The law is designed to protect both copyright owners and consumers. The RIAA indicates that two-thirds of illegal downloads are by college students. If universities refrain from preventing illegal downloading, it is likely Congress will reconsider the immunity clause in the DMCA. Thus, it is in universities’ long-term interests to be more proactive in preventing illegal downloading.

Given the prevalence of illegal downloading at universities, it is not surprising that the RIAA is currently targeting universities. Typically, the RIAA sends prelitigation notices to college students, and asks them to settle for about $3,000. If universities are more active in preventing illegal downloading, their students are less vulnerable to action by the RIAA.

Moreover, illegal downloading is expensive to universities themselves, not just students who get caught breaking the law. Illegal downloads take up a considerable amount of bandwidth, which costs universities thousands of dollars. Moreover, the downloads often contain viruses and spyware, which can damage the university’s system.

In addition to the cost issues, universities must consider their role as educators. Illegal downloading is similar to plagiarism. Universities do not tolerate stealing when it takes the form of stealing scholars’ ideas. Similarly, they should not tolerate stealing music, which affects a range of stakeholders, from musicians, to technicians, to retail workers who sell CDs and DVDs.

Some students claim that no reasonable alternatives to illegal downloading exist, but they are wrong. Students can subscribe to services such as the new Napster, iTunes, and Rhapsody Music. Also, they can rely on Ruckus, whose basic service is free—advertisers pay for space, which makes basic subscription costs unnecessary.

1. How would you frame the issue and conclusion of this essay?

2. What ethical norms would cause the author of this essay to take this position?
   
   Clue: Look at the ethical norms discussed in Chapter 1.

3. What, in your judgment, is the author’s strongest reason? Weakest? Explain your answer.

4. Write an essay that someone who holds an opinion opposite to that of the essay author might write.
   
   Clue: What other ethical norms could influence an opinion on this issue?


ASSIGNMENT ON THE INTERNET

Industry trade associations play an important role in advocating for particular changes in the law. For example, the Recording Industry Association of America plays an important role in advocating for changes in the law to protect its property interests. You can find the RIAA at www.riaa.org.

This assignment asks you to search the Internet to find two additional trade associations that advocate for changes in cyberlaw. In particular, you should (1) identify trade associations that represent the interests of a group this chapter has highlighted (e.g., Internet service providers), (2) look on each trade association’s Web site to discover the particular legal reforms each trade association advocates, and (3) write a short paper that describes the advocacy work of the two trade associations you discovered.

Finally, engage in an Internet search to find trade associations and/or nonprofit organizations that are in an adversarial relationship with the two associations you found. For example, the interests of the Center for Democracy and Technology are different from those of Internet service providers (see www.cdt.org).
ON THE INTERNET

www.ftc.gov/bcp/edu/pubs/consumer/tech/tec08.shtm Look at this site to see how the Federal Trade Commission educates a range of stakeholders (e.g., teachers, parents) about the Children’s Online Privacy Protection Act.

www.cybercrime.gov Look at this site to see how the criminal division of the U.S. Department of Justice is battling cybercrime.

www.ncfta.net Check out the National Cyber-Forensics and Training Alliance, a partnership between the public and private sectors (e.g., industry, academia, and law enforcement) that shares information and resources related by cyber incidents.

www.the-dma.org If you look at the Web site for the Direct Marketing Association, it will give you some ideas to help you complete the preceding assignment on the Internet.

FOR FUTURE READING


White-Collar Crime and the Business Community

CRIME AND CRIMINAL PROCEDURE
DISTINGUISHING FEATURES OF WHITE-COLLAR CRIME
COMMON WHITE-COLLAR CRIMES
PREVENTION OF WHITE-COLLAR CRIME
FEDERAL LAWS USED IN THE FIGHT AGAINST WHITE-COLLAR CRIME
STATE LAWS USED IN THE FIGHT AGAINST WHITE-COLLAR CRIME
GLOBAL DIMENSIONS OF WHITE-COLLAR CRIME

Amidst the turmoil and fallout of the Enron scandal that led to the company’s declaration of bankruptcy, a number of former Enron officials faced charges for various offenses. One such official was former CEO Jeffrey Skilling, who was ultimately found guilty of 19 fraud related charges, including conspiracy, insider trading, securities fraud, and making false statements to auditors. As punishment for his misdeeds, the 52-year-old Skilling was sentenced in 2006 to 24 years and 4 months in a federal prison. In addition, he was fined $45 million, which was to be put into a fund to benefit those who had been harmed by Enron’s collapse. Skilling is currently serving his jail sentence, but his case is still under appeal, and final resolution of his appeals isn’t expected until 2012. In 2010, he won a minor victory when the U.S. Supreme Court found that instructions to the jury with respect to one of the charges were inaccurate, and threw out the conviction on that charge. The case was then sent back to the trial court judge to determine whether the inaccurate instructions regarding the one charge tainted the convictions on the other charges. Unfortunately, this story is just one of many recent large and complex white-collar crime scandals. During 2009, Internet crime resulted in losses in the United States of $559.7 million, more than two times as much as in 2008. At the end of 2008, the FBI was investigating 545 corporate fraud cases each of which involved investor losses that exceeded $1 billion. The Coalition Against Insurance Fraud reports that insurance fraud costs Americans more than $80 billion per year.

White-collar crimes—crimes committed in a commercial context—occur every day. Collectively, these crimes often result in millions of dollars of damages. In recent years, as corporate crimes such as the ones detailed in Exhibit 7-1 become more publicized, people’s attitudes toward corporations and white-collar crime are being affected.

Bernard Madoff, Businessman. Sentence: 150 years
Madoff, 72, directed one of the largest Ponzi schemes in U.S. history. Madoff, in his role as CEO of Bernard L. Madoff Investment Securities LLC, stole from his clients in a $65 billion Ponzi scheme. Despite a continuing decline in the economy, Madoff continued to assure his clients that his numbers (investment returns) would continue rising. As the economy continued to decline, Madoff’s increases became suspicious and clients began to contact him to get their money back. When the requests for returned funds reached $7 billion, Madoff met with his sons and told them that his business was fraudulent. The sons turned Madoff in to the authorities.

In 2009, Madoff pleaded guilty to, among other things, securities fraud, wire fraud, money laundering, making false filings with the SEC, and making false statements. He was sentenced to the maximum 150 years in prison for his offenses. His projected release date is November 14, 2159. Since Madoff’s plea, David Friehling from his accounting department has pled guilty to securities fraud, investment advisor fraud, and making false filings with the SEC. Additionally, Frank DiPascali has pled guilty to securities fraud, investment advisor fraud, mail fraud, wire fraud, income tax evasion, international money laundering, falsifying books and records, and more.

Joseph Naccio. Sentence: 6 years
Joseph Naccio, 60, was the chief financial officer and chairman of the board for Qwest Communications International. Qwest is a telecommunications provider in the western United States. When the economy began to decline, Naccio continued to assure Wall Street that the company would continue making large returns even though he knew that such returns would not occur. Based on inside information, Nacchio sold $52 million of Qwest stock just before the prices fell.

In 2007, Naccio was convicted on 19 counts of insider trading and sentenced to 6 years in federal prison. Additionally, Naccio was ordered to pay a $19 million fine and restitution of the $52 million he had made as a result of illegal stock transactions. Although his conviction was overturned in 2008 because of improperly excluded expert testimony, the conviction was reinstated in 2009 when he finally began serving his six-year term.

Jamie Olis, Vice President of Finance. Sentence: 24 years
Jamie Olis, 38, was vice president of finance and senior director of tax planning at Dynergy, a natural gas energy company. Olis attempted to conceal more than $300 million in company debt from public investors. When the attempted concealment was discovered, millions of investor dollars were lost, including a $105 million loss suffered by 13,000 participants in the California Retirement Plan.

In 2004, Olis was sentenced to 292 months in prison after being convicted of securities fraud, mail fraud, and three counts of wire fraud. The 24-year sentence is one of the longest terms for fraud in U.S. history, in part because of the large financial losses to thousands of investors. In addition to the jail time, Olis was fined $25,000. Olis, however, did not act alone in the concealment. Gene Foster and Helen Sharkey, both former Dynergy executives, pled guilty to conspiracy and aided in the investigation. They then entered into a plea bargain under which Foster and Sharkey were to receive sentences of up to 5 years in prison and $250,000 in fines.

Reed Slatkin, Investment Manager. Sentence: 14 years
For approximately 15 years, Slatkin ran a nearly $600 million Ponzi scheme that bilked hundreds of investors. His clients included people of modest means, as well as more famous people such as actor Joe Pantoliano, model Cheryl Tiegs, and attorney Greta Van Susteren. He did not treat all clients equally, paying well-known clients returns in excess of their investments from funds received from other investors.

In April 2002, Slatkin pleaded guilty to five counts of mail fraud, three counts of wire fraud, six counts of money laundering, and one count of conspiracy to obstruct justice. He was sentenced to 14 years in federal prison and ordered to pay victims $240 million in restitution.

Frank Quattrone, Wall Street Banker. Sentence: 18 months and 2 years probation
Frank Quattrone, a former star technology banker, was charged with three counts of obstruction of justice related to an e-mail he forwarded to colleagues in 2000 encouraging them to “clean up” their files during a federal probe into how shares of hot initial public offerings of stock were allocated during the tech boom.

(Continued)
In 2004, Quattrone was found guilty of obstruction of justice. He was sentenced in September 2004 to 18 months’ prison and 2 years’ probation. He was also fined $90,000. Near the end of that year, the National Association of Securities Dealers permanently banned Quattrone from the securities industry, although he had planned to appeal the ban to the Securities and Exchange Commission.

Richard Scrushy, CEO of HealthSouth
Richard Scrushy, the founder of HealthSouth, is no stranger to white-collar criminal allegations. After being acquitted of charges under the Sarbanes-Oxley Act for lack of evidence in 2005, Scrushy was indicted on new charges a mere four months later. The new charges were for bribery and mail fraud linked to former Alabama governor Don Siegelman. The charges involved fraud through exchanging campaign funds for political favors.

Scrushy was ultimately found guilty by a federal jury in 2006 for bribery, mail fraud, and obstruction of justice. He was sentenced in 2007 to almost 10 years’ imprisonment, in addition to having to pay a fine of $150,000 and an additional $267,000 in restitution to the United Way. Scrushy is currently in jail.

Walter Forbes, CEO of Cendant Corporation
In 2004, Walter Forbes went on trial for fraudulently inflating the company’s revenue by $500 million to increase its stock price. Forbes was charged with wire fraud, mail fraud, conspiracy, and securities fraud. In addition, Forbes was also accused of insider trading of $11 million in Cendant stock only weeks before the accounting scandal was discovered. The former vice president was also charged with similar crimes. The Cendant CFO testified against both the vice president and Forbes, saying that he was asked to be “creative” in reorganizing revenue.

Despite his persistent use of the “dumb CEO defense” (I did not know about the wrongdoing), Forbes was found guilty in his third trial, which lasted all of 17 days. In January 2007, Forbes was sentenced to 12 years and 7 months in federal prison. He was also required to pay $3.275 billion in restitution.

Kenneth Lay, CEO of Enron
In 2004, Kenneth Lay went on trial, pleading not guilty to 11 felony counts, including wire fraud, bank fraud, securities fraud, and conspiracy, for his part in falsifying Enron’s financial reports, and denying that he profited enormously from his fraudulent acts. The extent of the fraud was discovered when the energy company went bankrupt in late 2001. As a result of the accounting fraud, Enron’s stock plummeted, leaving thousands of people with near-worthless stock, hitting retirement funds especially hard.

The Securities and Exchange Commission also filed a civil complaint against Lay, which could have led to more than $90 million in penalties and fines. Lay was accused of selling large amounts of stock at artificially high prices, resulting in an illegal profit of $90 million.

On May 25, 2006, Lay was found guilty of 10 of the 11 counts against him. Each count carried a maximum 5- to 10-year sentence, which would have amounted to 50 to 100 years maximum, with most commentators predicting a 20- to 30-year sentence. On July 5, 2006, however, Lay died of a heart attack before the scheduled date of his sentencing. Due to his death, the federal judge for the Fifth Circuit, pursuant to Fifth Circuit precedent, abated Lay’s sentence. The abatement made it as if Lay had never been indicted.

Bernie Ebbers, CEO of WorldCom
In 2004, Bernie Ebbers, former CEO of the bankrupt phone company WorldCom, pleaded not guilty to three counts of fraud and conspiracy. The accounting fraud, which involved hiding expenses and inflating revenue reports, left $11 billion in debt at the time of the bankruptcy. The former CFO of WorldCom, Scott Sullivan, pleaded guilty to fraud and agreed to assist in the prosecution of Ebbers. Sullivan faced up to 25 years in prison for his role in the accounting scandal. In addition, MCI sued Ebbers to recover more than $400 million in loans that he took from WorldCom, now called MCI.

Bernie Ebbers, in one of the longest prison sentences given to a former CEO for white-collar crimes, was sentenced in 2005 to a 25-year prison term in a federal prison. Ebbers, 63 years old at the time of his sentencing, began serving his term in federal prison in 2006.

Dennis Kozlowski, CEO of Tyco International
In a second trial in early 2005 after a mistrial, Dennis Kozlowski faced charges of corruption and larceny for stealing more than $600 million from Tyco International and failing to pay more than $1 million in federal taxes. Kozlowski had Tyco pay for such over-the-top expenses as a $15,000 umbrella holder and a $2,200 garbage can. Kozlowski’s sentence could have been up to 30 years in prison.

Kozlowski, as well as former Tyco CFO Mark Swartz, was sentenced to 8 years and 4 months to 25 years. Unlike other CEOs convicted for white-collar crimes, such as Bernie Ebbers, Kozlowski was convicted in state court. In addition to his prison sentence, to be served in a New York state prison, Kozlowski, with Swartz, was also ordered to pay $134 million to Tyco. In addition, Kozlowski was also fined an additional $70 million. Kozlowski is currently serving his term in prison.
CRITICAL THINKING ABOUT THE LAW

Why should we be concerned about white-collar crime? You can use the following critical thinking questions to help guide your thinking about white-collar crime as you study this chapter.

1. As a future business manager, you may be forced to make tough decisions regarding white-collar crime. Imagine that you discover that one of your employees planned to offer a bribe to an agent from the Environmental Protection Agency to prevent your company from being fined. Although the result of the potential bribe could greatly benefit your company, you know that the bribe is illegal. What conflicting ethical norms are involved in your decision?
   **Clue:** Review the list of ethical norms offered in Chapter 1.

2. White-collar crime is typically not violent crime. Therefore, many people assume that street crime is more serious and should receive harsher punishment. Can you generate some reasons why that assumption is false? Why might white-collar crimes deserve more severe sentences?
   **Clue:** Reread the introductory paragraphs that provide information about white-collar crime. Why might a business manager deserve a more severe sentence than a young woman who commits a robbery? What are the consequences of both actions? Think about white-collar crime against this background as you study this chapter.

3. If a judge strongly valued justice, do you think he or she would give a lighter sentence to a business manager who embezzled $50,000 than to a person who robbed a bank of $50,000? Why?
   **Clue:** Think about the definitions of justice offered in Chapter 1.

The future manager must be prepared to respond to a growing lack of public confidence and avoid becoming a corporate criminal. He or she must find ways to develop a corporate climate that discourages, not encourages, the commission of white-collar crime. This chapter will help readers prepare to face the challenges posed by corporate crime. The first section defines crime and briefly explains criminal procedure. Next, the factors that distinguish corporate crime from street crime are discussed. Section three explains in detail some of the more common white-collar crimes. Section four introduces some ideas on how we can reduce the incidence of white-collar crime. The fifth and sixth sections discuss the federal and state responses to white-collar crime. The chapter closes with an overview of the international dimensions of white-collar crime.

Crime and Criminal Procedure

**CRIME**

Criminal law is designed to punish an offender for causing harm to the public health, safety, or morals. Criminal laws prohibit certain actions and specify the range of punishments for such conduct. The proscribed conduct generally includes a description of both a wrongful behavior (an act or failure to act where one has a duty to do so) and a wrongful intent or state of mind. The legal term for wrongful intent is *mens rea* (guilty mind). An extremely limited number of crimes do not require *mens rea*. These crimes are the “strict liability,” or regulatory, crimes. They typically occur in heavily regulated industries and arise when a regulation has been violated. Regulatory crimes are created when the legislature decides that the need to protect the public outweighs the traditional requirement of *mens rea*. Because of the absence of the *mens rea* requirement for regulatory crimes, punishment for their violation is generally less severe than it is for wrongful behavior. In some states, punishment is limited to fines.

Crimes are generally classified as treason, felony, misdemeanor, or petty crime on the basis of the seriousness of the offense. *Treason* is engaging in war against the United States or giving aid or comfort to its enemies. *Felony* is a serious crime that is punishable by death or imprisonment in a penitentiary.
misdemeanor A crime that is less serious than a felony and is punishable by fine or imprisonment in a local jail.

petty crime A minor crime punishable, under federal statutes, by fine or incarceration of no more than six months.

arrest To seize and hold under the authority of the law.

probable cause The reasonable inference from the available facts and circumstances that the suspect committed the crime.

Miranda rights Certain legal rights—such as the right to remain silent to avoid self-incrimination and the right to an attorney—that a suspect must be immediately informed of upon arrest.

EXHIBIT 7-2
THE MIRANDA WARNINGS

Before any questioning by authorities, the following statements must be made to the defendant:

1. “You have the right to remain silent and refuse to answer any questions.”
2. “Anything you say may be used against you in a court of law.”
3. “You have the right to consult an attorney before speaking to the police and have an attorney present during any questioning now or in the future.”
4. “If you cannot afford an attorney, one will be appointed for you before the questioning begins.”
5. “If you do not have an attorney available, you have the right to remain silent until you have had an opportunity to consult with one.”
6. “Now that I have advised you of your rights, are you willing to answer any questions without an attorney present?”

CRIMINAL PROCEDURE

Criminal proceedings are initiated somewhat differently from civil proceedings. The procedures may vary slightly from state to state, but usually the case begins with an arrest of the defendant. The police must, in almost all cases, obtain an arrest warrant before arresting the defendant and taking him or her into custody. A magistrate (the lowest-ranking judicial official) will issue the arrest warrant when there is probable cause to believe that the suspect committed the crime. A magistrate is a public official who has the power to issue warrants; he or she is the lowest-ranking judicial official. Probable cause exists if it appears likely, from the available facts and circumstances, that the defendant committed the crime. An arrest may be made by a police officer without a warrant, but only if probable cause exists and there is no time to secure a warrant. An arrest without a warrant is most commonly made when police are called to the scene of a crime and catch the suspect committing the crime or fleeing from the scene.

The Miranda Warnings. At the time of the arrest, the suspect must be informed of her or his legal rights. These rights are referred to as the Miranda rights, because they were developed in response to the Supreme Court’s decision in Miranda v. Arizona. If the defendant is not informed of these rights, any statements the defendant makes at the time of the arrest will be inadmissible at the defendant's trial. These rights are listed in Exhibit 7-2.

Despite the courts’ effort to create an “objective rule to give clear guidance to the police,” many arrests and interrogations create significant questions about...
the application of the Miranda warnings. In 2004 alone, the Supreme Court issued three separate decisions clarifying the application and use of the Miranda warnings. In *United States v. Patane*, the Court held that physical evidence found through statements made without receipt of the Miranda warnings were admissible in court so long as those statements were not forced by the police; the incriminating statements, however, would not be admissible.

In *Missouri v. Seibert*, the Supreme Court found that a confession made after the Miranda warnings were given could not be admissible if the police first ask for the confession, then give the Miranda warnings and ask for the same confession. Delivering the opinion of the Court, Justice Souter wrote, "*Miranda* addressed interrogation practices . . . likely . . . to disable [an individual] from making a free and rational choice" about speaking, and held that a suspect must be "adequately and effectively" advised of the choice the Constitution guarantees. "The object of question-first is to render Miranda warnings ineffective by waiting for a particularly opportune time to give them, after the suspect has already confessed."

Finally, in *Yarborough v. Alvarado*, the Court examined the ambiguity of when a person is "in custody" and, therefore, is entitled to the Miranda warnings. The "in custody" standard is whether a reasonable person would feel free to leave or end questioning. Such a standard, however, can be influenced by a person’s age and education. Nevertheless, the Court held that maintaining a clear and objective standard for police is of utmost importance, and noted that considerations of age and education "could be viewed as creating a subjective inquiry." The Court found that the confession of guilt to police by Alvarado, age 17, during an interview was admissible even though he had not been read his Miranda warnings, because he was never "in custody."

Hundreds of cases have sought to clarify the Miranda warnings since they were first created in 1966 in *Miranda v. Arizona*. The cases just discussed suggest the importance the judicial system places on informing suspects of their constitutional rights and privileges.

**Booking and First Appearance.** After the defendant has been arrested, he or she is taken to the police station for booking, the filing of criminal charges against the defendant. The arresting officer then files a criminal complaint against the defendant. Shortly after the complaint is filed, the defendant makes his or her first appearance before a magistrate. At this time, the magistrate determines whether there was probable cause for the arrest. If there was not, the suspect is set free and the case is dismissed.

If the offense is a minor one, and the defendant pleads guilty, the magistrate may accept the guilty plea and sentence the defendant. Most defendants, however, maintain their innocence. The magistrate will make sure that the defendant has a lawyer; if the defendant is indigent, the court will appoint a lawyer for him or her. The magistrate also sets bail at this time. Bail is an amount of money that is paid to the court to ensure that the defendant will return for trial. In some cases, especially in white-collar crimes, if the magistrate believes that the defendant has such "ties to the community" that he or she will not try to flee the area to avoid prosecution, the defendant may be released without posting bail. In such cases, the defendant is said to be released "on his [or her] own recognizance."

---

5 124 S. Ct. 2620 (2004).
Information or Indictment. If the crime is a misdemeanor, the next step is the prosecutor’s issuance of an information, a formal written accusation or charge. The information is usually issued only after the prosecutor has presented the facts to a magistrate who believes that the prosecution has sufficient grounds to bring the case.

In felony cases, the process begins with the prosecutor (the prosecuting officer representing the United States or the state) presenting the facts surrounding the crime to a grand jury, a group of individuals under oath who determine whether to charge the defendant with a crime. The grand jury has the power to subpoena witnesses and require them to produce documents and tangible evidence. If the grand jury is convinced, by a preponderance of the evidence, that there is reason to believe the defendant may have committed the crime, an indictment (a formal, written accusation) is issued against the defendant. A grand jury does not make a finding of guilt; it simply decides whether there is enough evidence that the defendant committed the crime to justify bringing the defendant to trial. Government resources are limited, and the prosecution may not always believe it has sufficient evidence to prove a case beyond a reasonable doubt, so not every crime is prosecuted. Usually, the decision to seek an indictment depends on whether the prosecution believes it can get a conviction and whether the interests of justice would be served by prosecuting the crime.

At the federal level, almost all criminal prosecutions are initiated by the indictment process, and the decision on whether to prosecute is generally guided by the Principles of Federal Prosecution, published by the Justice Department in 1980. These principles state that the primary consideration is whether the existing admissible evidence is sufficient to obtain a conviction for a federal crime. Even if sufficient evidence does exist, the prosecutor’s office might choose not to prosecute a crime if no substantial federal interest would be served by doing so, if the defendant could be efficiently prosecuted in another jurisdiction, or if an adequate noncriminal alternative to criminal prosecution exists. The factors influencing the substantiality of the federal interest are listed in Exhibit 7-3. The principles clearly recognize that other prosecutorial actions may offer fairer or more efficient ways to respond to the criminal conduct. Some alternatives might be to institute civil proceedings against the defendant or to refer the complaint to a licensing board or the professional organization to which the defendant belongs.

Another alternative to indictment is pretrial diversion (PTD). Pretrial diversion attempts to keep certain criminal offenders out of the traditional criminal justice system by channeling them into a program of supervision and services. A PTD participant signs an agreement with the government acknowledging responsibility for the act at issue but not admitting guilt. The participant agrees to be supervised by the U.S. Probation Office and comply with the terms established for the agreed-upon period of the agreement, up to 18 months. Terms,
which vary according to the circumstances and the criminal activity, might include participating in community programs or paying restitution. If the participant complies with the agreement, the matter is closed. If not, he or she is then prosecuted.

After the indictment comes the **arraignment**, a time when the defendant appears in court and enters a plea of guilty or not guilty. A not-guilty plea entitles the defendant to a trial before a petit jury. If the defendant declines a jury trial, the case is heard by a judge alone, in a procedure called a **bench trial**.

A defendant may also enter a plea of **nolo contendere**. By making this plea, the defendant does not admit guilt but agrees not to contest the charges. The advantage of a nolo contendere plea over a plea of guilty is that the former cannot be used against the defendant in a civil suit.

**Plea Bargaining.** At any time during the proceedings, the parties may engage in **plea bargaining**, which is a process of negotiation between the defense attorney and the public prosecutor or district attorney. The result of this process is that the defendant pleads guilty to a lesser offense, in exchange for which the prosecutor drops or reduces some of the initial charges. Plea bargaining benefits the criminal by eliminating the risk of a greater penalty. It benefits the prosecutor by giving her or him a sure conviction and reducing a typically overwhelming caseload. It saves both parties the time and expense of a trial.

Plea bargaining is used extensively for white-collar crimes, generally at a much earlier stage than for street crimes. In white-collar cases, plea bargaining often occurs even before the indictment. This process, as well as other modifications of criminal procedures in white-collar crime cases, helps to make the white-collar criminal seem less of a criminal, and thus reduces the likelihood of severe punishment.

**Burden of Proof.** If the case goes to trial, the burden of proof is usually on the prosecutor. The burden of proof has two aspects: the burden of production of evidence and the burden of persuasion. The prosecution bears the burden of production of evidence of all the elements of the crime. Thus, the prosecution must present physical evidence and testimony that prove all elements of the crime. The burden of producing evidence of any affirmative defenses (defenses in which the defendant admits to doing the act but claims some reason for not being held responsible, such as insanity, self-defense, intoxication, or coercion) lies with the defendant.

The prosecution also bears the burden of persuasion, meaning that the prosecutor must convince the jury beyond a reasonable doubt that the defendant committed the crime. In some states, a defendant who presents an affirmative defense must persuade the jury of the existence and appropriateness of the defense by a preponderance of the evidence, meaning that the defendant’s lawyer must prove that it is more likely than not that the defense exists and is valid. In other states, the burden of persuasion lies with the prosecutor to show beyond a reasonable doubt that the defense does not exist or is invalid.

The actual trial itself is similar to a civil trial, and the role of the prosecutor or district attorney is similar to that of the plaintiff’s attorney. One major difference, however, is that the defendant in a criminal case cannot be compelled to testify, and the finder of fact is not to hold the exercise of this right against the defendant. This right to not testify is guaranteed by the constitutional provision in the Fifth Amendment that no person “shall be compelled in any criminal case to be a witness against himself.”

**Defenses.** Obviously, one of the most common defenses is that the defendant did not do the act in question. But even if the defendant did commit the act, a number of affirmative defenses might be raised to preclude the defendant from...
being convicted of the crime. Affirmative defenses may be thought of as excuses for otherwise unlawful conduct. Four of the most common are entrapment, insanity, duress, and mistake.

**Entrapment** occurs when the idea for the crime was not the defendant’s but was, instead, put into the defendant’s mind by a police officer or other government official. An extreme example is a case in which a government official first suggests to an employee that the employee could make good money by altering certain corporate records. The official then shows up at the employee’s home at night with a key to the office where the records are kept and reminds the employee that the record keeper is on vacation that week. The official also reminds the employee that most of the other workers rarely stay late on Friday nights, so Friday after work might be an ideal time to get the books. If prosecuted for fraud, the employee could raise the defense of entrapment.

Entrapment is not always easy to prove. Police are allowed to set up legitimate “sting” operations to catch persons engaged in criminal activity. The key to a legitimate sting is that the defendant was “predisposed” to commit the crime; the officer did not put the idea in the defendant’s head. If an officer dresses up like a prostitute and parades around in an area where prostitution is rampant, a potential customer who solicits sex could not raise the charge of entrapment against a charge of soliciting a prostitute. Most cases, however, fall between our two examples, so it is often difficult to predict whether the entrapment defense will be successful.

**Insanity** is one of the best-known criminal defenses, although it is not used nearly as frequently as its notoriety might imply. The **insanity defense** is used when a person’s mental condition prevents him or her from understanding the wrongful nature of the act he or she committed or from distinguishing wrong from right.

**Duress** occurs when a person is forced to commit a wrongful act by a threat of immediate bodily harm or loss of life, and the affirmative **duress defense** can be used by a person who believes that he or she was forced to commit a crime. For example, if Sam holds a gun to Jim’s head and tells him to forge his employer’s signature on a company check or he will be shot, Jim can raise the defense of duress to a charge of forgery. This defense is generally not available to a charge of murder.

A **mistake-of-fact defense** may sometimes be raised when that mistake vitiates the criminal intent. For example, if Mary takes Karen’s umbrella from a public umbrella rack, thinking it is her own, she can raise mistake as a defense to a charge of theft.

A mistake of law, however, is generally not a defense. A person could not, for example, fail to include payment received for a small job on his or her income tax return because of a mistaken belief that income for part-time work of less than $100 did not have to be reported.

Any defendant who does not prevail at the trial court can appeal the decision, just as in a civil case. The steps of a criminal action are set out in Exhibit 7-4.

**Distinguishing Features of White-Collar Crime**

An initial problem with any discussion of white-collar crime is its definition. The term **white-collar crime** does not have a precise meaning. The term was first made popular in 1939 by sociologist Edwin Sutherland, who defined **white-collar crime** as “crime committed by a person of respectability and high social status in the course of his occupation.” Traditionally, it has been the classification for those crimes committed in a commercial context by members of the professional and managerial classes. It includes such diverse acts as bribery of corporate or government officials and violations of federal regulations such as the Occupational Safety and Health Act and the Internal Revenue Service...
Code. In this book, we will use the traditional definition. For illustrations of some white-collar criminals and the crimes of which they were convicted, see Exhibit 7-1.

THE CORPORATION AS A CRIMINAL

One of the distinguishing features of white-collar crime is that sometimes the “criminal” may be difficult to identify. In a street crime, the identity of the criminal is fairly clear: It is the person who committed the act. If a person hires another to commit a crime, the person doing the hiring is likewise guilty of a crime. In the case of white-collar crime, the crime is often committed on behalf of a corporation, which is as an artificial legal entity or an artificial person. An important question, then, is whether liability can be imposed on the corporation for the criminal acts committed by employees of the corporation on behalf of the corporation.

Initially, the courts said no. A corporation had no mind, so it could not have the mental state necessary to commit a crime. This rule was first eroded by the imposition of liability on corporations for so-called strict liability offenses, those for which no state of mind is required. These generally are cases in which corporate employees failed to take some action required by a regulation. For example, under most blue-sky laws (state securities regulations), it is a violation to file a false statement of a company’s financial condition with a state’s secretary of state. Filing a false statement is a crime, even if the corporate officer filing the statement believed it was true, as no state of mind is required to commit the crime.

The courts then began to impose liability on corporations for criminal acts of the employees by imputing the state of mind of the employee to the corporation. Today, as a general rule, the only crimes for which a corporation is not held liable are those that are punishable only by incarceration. Obviously, the rationale for this rule is that the punishment could not be carried out. Some states have eliminated this problem by passing a statute providing specific fines for corporations that commit offenses otherwise punishable by incarceration only.
Many corporate executives may not realize the extent to which a corporation today can be held liable for the acts of its employees. That liability can extend down to acts of even the lowest-level employees and even to acts in violation of corporate directives, as long as two conditions are met. First, the conduct must be within the scope of the employee agent’s authority. Second, the action must have been undertaken, at least in part, to benefit the corporation. Some examples of employee actions for which corporations have been held liable include employees physically harming a customer for not paying his bill, an employee sexually harassing another employee, and a car salesman’s obtaining automobile loans for the dealership’s customers by misrepresenting financial data to the lending bank.

In a move indicating that the Department of Justice (DOJ) is serious about pursuing white-collar corporate criminals, in 2006, Deputy U.S. Attorney General Paul McNulty issued a memorandum stating that prosecuting corporate crimes was a priority of the DOJ. In addition, McNulty advised federal prosecutors not to stop with finding corporate liability, but also to look for individuals within the firm who should be punished for the firm’s wrongdoings.

Many states have passed statutes imposing criminal liability on partnerships under the same circumstances as those under which liability is imposed on a corporation. In the absence of such a statute, liability is not imposed on the partnership because a partnership is not a legal person.

ARGUMENTS IN SUPPORT OF CORPORATE LIABILITY

Needless to say, there is no consensus about whether, as a matter of policy, corporations should be held criminally liable. Some of the arguments in favor of such liability include:

1. Imposing financial sanctions against the corporation will result in lower dividends for the shareholders, which, in turn, will prompt the shareholders to take a more active role in trying to make sure that the corporation behaves legally. They will carefully select directors who will scrupulously monitor corporate behavior and will express concern when anything appears to be unethical or illegal.

2. In situations in which the crime is an omission and the responsibility for performing the omitted duty is not clearly delegated to any specific party, the duty rests with no particular individual. Therefore, there is no one to blame, and the corporation cannot be held responsible. If no one, not even the corporation, is held liable, there is no incentive to obey the laws.

3. Closely related to reason 2 is the fact that there are a tremendous number of suspects in a corporation. Most enforcement agencies do not have the resources to investigate the large number of employees involved and to build cases against each. It is much easier and less expensive for the government to investigate and bring a case against the corporation as an entity.

4. The fact that many decisions are committee decisions—or else decisions made by an initial person or group and then approved by several tiers of management—again makes it hard to point the finger at one individual. Sometimes one individual is responsible for making an initial decision, and then someone else is responsible for implementing that decision.

5. A further reason is that corporate personnel are expendable. To lose a manager because of a conviction does not really harm the enterprise that profited from the wrongdoing. In fact, it allows the firm to externalize the costs...

---

of the criminal behavior; that is, to absolve itself of guilt in the eyes of the public. The manager takes the blame, and the corporation, which profited from the manager’s illegal act, continues to thrive.

6. Even if one could impose liability on one or two individuals, it is unfair to single them out for punishment when the behavior in question probably resulted from a pattern of behavior common to the entire corporation.

7. Some people assume that the beneficiaries of crime committed on behalf of the corporation are the shareholders, because they may get higher dividends if corporate crime keeps costs lower. To fail to impose sanctions on the corporation would be to allow the shareholders to benefit from the illegal activity.

8. If an action is taken against the corporation, the criminal act will be linked to the corporation in the public’s mind. In a market-oriented society such as ours, disclosure of full information about businesses is essential for consumers to make informed decisions about the types of firms with which they want to transact business.

ARGUMENTS IN OPPOSITION TO CORPORATE LIABILITY

The following are arguments against imposing liability on corporations:

1. Imposing fines on corporations is a waste of time and effort because the fines are never going to be severe enough to act as a deterrent. Even if more substantial fines were imposed, the firms would simply pass on the losses to consumers in the form of increased product prices. Thus, it would really be the consumers of the corporation’s products who would be punished.

2. Some people believe that the shareholders’ dividends may be reduced if fines are imposed on the corporation because the cost of the fines will reduce the profits available for dividend payments. Reducing dividends, it is argued, is unfair because in most corporations, the shareholders really do not have any power to control corporate behavior.

3. Because criminal prosecutions of corporations are not well publicized, they do not harm the corporation’s public image. The corporations have enough money and public relations personnel to easily overcome any negative publicity with a well-run advertising campaign designed to polish their public image. For example, the prosecution of Revco of Ohio for defrauding Medicaid of hundreds of thousands of dollars resulted in only a temporary decline in the value of Revco’s stock. 12

IMPOSITION OF LIABILITY ON CORPORATE EXECUTIVES

Another potential candidate for liability in the case of white-collar crime is the corporate executive. Top-level corporate executives, as a group, have tremendous power through their control over national corporations. When these corporations earn record-setting profits, top-level executives rush forward to take credit for their corporations’ successes. These same executives, however, do not rush forward to take responsibility for their corporations’ criminal violations. In fact, very few corporate officials are held liable by law enforcement for the actions of their companies. 13 This lack of liability is believed to occur because of the delegation of responsibility to lower tiers of management and reliance on

---


Defendant Park, the president of a national food-chain corporation, was charged, along with the corporation, with violating the Federal Food, Drug, and Cosmetic Act by allowing food in the warehouse to be exposed to rodent contamination. Park had conceded that he was responsible for the sanitary conditions as part of his responsibility for the “entire operation,” but claimed that he had turned the responsibility for sanitation over to dependable subordinates. He admitted at the trial that he had received a warning letter from the Food and Drug Administration regarding the unsanitary conditions at one of the company’s warehouses.

The trial court found the defendant guilty. The court of appeals reversed. The case was appealed to the U.S. Supreme Court.

Chief Justice Burger

The question presented was whether “the manager of a corporation, as well as the corporation itself, may be prosecuted under the Federal Food, Drug, and Cosmetic Act by allowing food in the warehouse to be exposed to rodent contamination.” Park had conceded that he was responsible for the sanitary conditions as part of his responsibility for the “entire operation,” but claimed that he had turned the responsibility for sanitation over to dependable subordinates. He admitted at the trial that he had received a warning letter from the Food and Drug Administration regarding the unsanitary conditions at one of the company’s warehouses.

The trial court found the defendant guilty. The court of appeals reversed. The case was appealed to the U.S. Supreme Court.

In reversing the judgment of the Court of Appeals and reinstating Dotterweich’s conviction, this Court looked to the purposes of the Act and noted that they “touch phases of the lives and health of people which, in the circumstances of modern industrialism, are largely beyond self-protection.” It observed that the Act is of “a now familiar type” which “dispenses with the conventional requirement for criminal conduct—awareness of some wrongdoing. In the interest of the larger good it puts the burden of acting at hazard upon a person otherwise innocent but standing in responsible relation to a public danger.”

Central to the Court’s conclusion that individuals other than proprietors are subject to the criminal provisions of the Act was the reality that “the only way in which a corporation can act is through the individuals who act on its behalf.” The Court also noted that corporate officers had been subject to criminal liability under the Federal Food and Drugs Act of 1906, and it observed that a contrary result under the 1938 legislation would be incompatible with the expressed intent of Congress to “enlarge and stiffen the penal net” and to discourage a view of the Act’s criminal penalties as a “license fee for the conduct of an illegitimate business.”

At the same time, however, the Court was aware of the concern which was the motivating factor in the Court of Appeals’ decision, that literal enforcement “might operate too harshly by sweeping within its condemnation any person however remotely entangled in the proscribed shipment.” A limiting principle, in the form of “settled
doctrines of criminal law” defining those who “are responsible for the commission of a misdemeanor,” was available. In this context, the Court concluded, those doctrines dictated that the offense was committed “by all who . . . have . . . a responsible share in the furtherance of the transaction which the statute outlaws.”

The rule that corporate employees who have “a responsible share in the furtherance of the transaction which the statute outlaws” are subject to the criminal provisions of the Act was not formulated in a vacuum. Cases under the Federal Food and Drugs Act of 1906 reflected the view both that knowledge or intent were not required to be proved in prosecutions under its criminal provisions, and that responsible corporate agents could be subjected to the liability thereby imposed. Moreover, the principle had been recognized that a corporate agent, through whose act, default, or omission the corporation committed a crime, was himself guilty individually of that crime.

The rationale of the interpretation given the Act in Dotterweich, as holding criminally accountable the persons whose failure to exercise the authority and supervisory responsibility reposed in them by the business organization, resulted in the violation complained of, has been confirmed in our subsequent cases. Thus, the Court has reaffirmed the proposition that “the public interest in the purity of its food is so great as to warrant the imposition of the highest standard of care on distributors.” In order to make “distributors of food the strictest censors of their merchandise,” the Act punishes “neglect where the law requires care, and inaction where it imposes a duty.” “The accused, if he does not will the violation, usually is in a position to prevent it with no more care than society might reasonably expect and no more exertion than it might reasonably extract from one who assumed his responsibilities.”

Thus, Dotterweich and the cases which have followed reveal that in providing sanctions which reach and touch the individuals who execute the corporate mission—and this is by no means necessarily confined to a single corporate agent or employee—the Act imposes not only a positive duty to seek out and remedy violations when they occur but also, and primarily, a duty to implement measures that will insure that violations will not occur. The requirements of foresight and vigilance imposed on responsible corporate agents are beyond question demanding, and perhaps onerous, but they are not more stringent than the public has a right to expect of those who voluntarily assume positions of authority in business enterprises whose services and products affect the health and well-being of the public that supports them.

The Act does not, as we observed in Dotterweich, make criminal liability turn on “awareness of some wrongdoing” or “conscious fraud.” The duty imposed by Congress on responsible corporate agents is, we emphasize, one that requires the highest standard of foresight and vigilance, but the Act, in its criminal aspect, does not require that which is objectively impossible.

[It is equally clear that the Government established a prima facie case when it introduced evidence sufficient to warrant a finding by the trier of the facts that the defendant had, by reason of his position in the corporation, responsibility and authority either to prevent in the first instance, or promptly to correct, the violation complained of, and that he failed to do so. The failure thus to fulfill the duty imposed by the interaction of the corporate agent’s authority and that statute furnishes a sufficient causal link. The considerations which prompted the imposition of this duty, and the scope of the duty, provide the measure of culpability.

Reversed in favor of the Government.

CRITICAL THINKING ABOUT THE LAW

The court in Case 7-1 was guided by a fundamental principle that it did not explicitly state: To the extent that one has authority, he or she also has responsibility and can be liable for criminal action. This guiding principle played a significant role in the Court’s justification (i.e., reasoning) for its decision.

Context was very important in the formulation of this principle, as well as in its application to Case 7-1. Key facts, primary ethical norms, and judicial precedent were important elements of this context. Consequently, the questions that follow focus on those aspects of Case 7-1.

1. What key fact was very important to the Court in its determination of Park’s guilt?

   Clue: Think again about the Court’s guiding principle in this case. You want to identify the key fact that allowed the Court to apply the principle to this particular case.

2. Precedent plays a crucial role in the Court’s reasoning and, thus, in its decision. What key precedent in criminal law did the Dotterweich decision dispense with, thereby clearing the way for the guiding principle discussed previously to take on greater significance and make conviction in the present case possible?

   Clue: Reread the section in which Justice Burger discusses the Dotterweich decision.
Although the *Park* case demonstrates that corporate executives may be found guilty of committing a corporate crime, few are charged and even fewer are actually convicted. Even when they are convicted, harsh penalties are not likely to be imposed. Furthermore, even when executives do go to prison, because they are not seen as security risks they are often sent to prisons that some would argue are nicer than the motels many people can afford to stay in on vacations! See Exhibit 7-5 for a glimpse of some of these prisons where white-collar criminals are likely to end up.

A primary reason for the limited number of convictions is the diffusion of responsibility. It is often difficult to establish who was responsible for the criminal act. Another problem related to corporate structure is that everyone usually has a specific job, and putting all of the pieces of the crime together is difficult. The reader should remember that the burden of proof is on the prosecution. Corporate executives also tend to have high-caliber counsel who specialize in defending white-collar criminals. These skilled attorneys, often paid for by the corporation or (when permitted by law) by an insurance carrier, usually get involved during the initial investigation of the case and perceive one of their key functions as keeping evidence out of the hands of the prosecutor. They often regard themselves as having lost the case if they do not prevent their client from being indicted or if they do not at least get the charge reduced to the lowest possible misdemeanor.14 Another alleged reason for the limited number of convictions of corporate executives is that they are generally persons with a great deal of knowledge, including knowledge of inefficiencies and improprieties on the part of the government officials who are regulating them. It is argued that

---

**EXHIBIT 7-5**

**WHITE-COLLAR PRISON CAMPS**

*Elgin* is the original “club fed.” This prison’s open dorms hold 50 men who sleep in two-person cubicles. The prison has an actual music department that sponsors inmate bands and has instruments prisoners can check out. Sports options include softball, basketball, soccer, flag football, weight machines, and free weights.

*Allenwood* has dorms that house up to 80 men in two-person cubicles and offers inmates soccer, basketball, flag football, universal weight machines, free weights, pool, and Ping-Pong tables. The prison provides 150- and 500-hour certificate programs in horticulture, as well as a music program with inmates providing instruction.

*Morgantown* is a compound in the beautiful Blue Ridge Mountains, where deer can sometimes be sighted. It holds 300 people in dorms where men sleep in two-person cubicles. Inmates can lift weights, play pool and Ping-Pong, and take courses in leather working, art, and wood carving. They can participate in apprenticeship programs in baking, commercial photography, computer technology, air-conditioning systems, landscaping, printing presses, painting, and plumbing.

*At Nellis,* located in North Las Vegas, inmates sleep four to a cubicle in air-conditioned dorms where they can play softball, soccer, and flag football. They can work out in a gym that offers universal weight machines, stationary bikes, stair steppers, pool tables, and Ping-Pong tables.

---

regulators are unlikely to press for prosecution when their own ineptness may be revealed in the process.

**IMPOSITION OF LIABILITY ON LOWER-LEVEL CORPORATE CRIMINALS**

Although much debate has been generated over the extent to which the corporation and its top executives should be held liable for crimes committed on behalf of the corporation, it is important to remember that lower-level and mid-level corporate employees can also be held liable for their individual criminal actions, and imposition of liability on the corporation does not in any way preclude imposition of liability on the individual actor as well. It is likewise no excuse on the part of employees that they were committing the wrongful act only because their employer instructed them to do so.

**FACTORS ENCOURAGING THE COMMISSION OF WHITE-COLLAR CRIME**

White-collar crime can be distinguished from street crime by some of the factors that facilitate its commission (Exhibit 7-6). Recognition of these factors is not meant to excuse this behavior; instead, it may be used to help devise ways to control corporate crime. As an informed corporate manager, your knowledge of these factors may help you to avoid the temptation to engage in criminal activities and to discourage others from doing so.

Initially, we must recognize that many people in our society value material success above all else. When the focus of our energies is on material success, we are much more willing to engage in illegal means to achieve our goal than we would be if our focus were on, for instance, ethical conduct. With the stress on success, the line between illegality and a shrewd business deal becomes blurred. The culture of some corporations creates an atmosphere in which corporate crime may thrive. For instance, if rewards such as salary and promotion are tied to meeting short-term goals, employees may use whatever means are available to help them achieve those goals.

Once illegal behavior is initiated, it tends to become institutionalized because of a phenomenon referred to by social psychologist Irving Janis as *groupthink*. In groupthink, there is an implicit agreement not to bring up upsetting facts. In the corporation, where junior managers’ success depends to some degree on the

---

**EXHIBIT 7-6**

**FACTORS FACILITATING THE COMMISSION OF WHITE-COLLAR CRIMES**

1. Societal stress on material success, without equal emphasis on means of achieving success.
2. Linkage of corporate rewards of salary and promotion to accomplishing short-term goals.
4. Ease of rationalizing illegal behavior.
5. Dispersion of decision making.
6. Retention of status by persons convicted of white-collar crime.
7. The lack of an adversarial relationship between the corporation and government regulators.
8. Poor personnel policies that leave employees feeling insecure, unappreciated, and underpaid.

---

approval of senior managers, a junior manager would be extremely reluctant to criticize a senior manager’s actions. One dramatic instance of this dynamic is the E. F. Hutton case, in which the practice of writing illegal checks spread throughout the company. Nobody wanted to bring up the upsetting fact that perhaps the practice was illegal. Instead, managers just went along.\textsuperscript{16}

Another factor making white-collar crime easy to commit is the fact that decision making is often distributed among various individuals. Because responsibility is diffuse, individuals may feel only very limited personal responsibility for the results of their actions. This spreading of responsibility also results in an awareness that the likelihood of getting caught is small. Another factor related to the complex organizational structure of a corporation is that once a decision has been made, many people implement it. Thus, even if a manager has second thoughts about a decision, it is often too late to stop the process. Also, once a decision has been made, and when it is implemented by others, the decision maker feels limited responsibility.

The businesspersons who are unlucky enough to get caught do not automatically lose their status among their peers. Some, in fact, may be admired. Violations of the law are not necessarily violations of businesspersons’ ethical codes. It is important to note that, unlike street criminals, who usually recognize that they are committing crimes, white-collar criminals are frequently regarded by themselves and their peers as respectable, law-abiding citizens.

In some instances, corporate crime is facilitated because the supposed adversarial relationship between the corporation and the government agency “watchdog” does not exist. Top corporate executives and high-level government officials may share similar values and lifestyles. Business managers often make career moves directly to a government agency regulating that business and then back to business. These factors may make some government officials reluctant to crack down on businesspersons, and businesspersons’ awareness of this reluctance contributes to an environment in which white-collar crime is tolerated.

Finally, a corporation’s personnel and operating procedures often encourage its employees to commit white-collar crimes. Although many of the previously discussed factors are not easily amenable to change, personnel and operating policies are under the direct control of management and, therefore, business managers concerned about white-collar crime can have an impact on the likelihood of its occurrence by carefully examining their corporate policies. For example, employees are much more likely to commit white-collar crimes when corporate policies lead to a lack of job security, inadequate pay, a lack of recognition for outstanding work, perceived inequities in employee salaries, poor promotion opportunities, inadequate expense accounts or unreasonable budget expectations, poor training, or poor communication practices.

**SENTENCING OF WHITE-COLLAR CRIMINALS**

Another feature that some would say distinguishes white-collar crime is the attitudes of the judges who hand down the sentences for these crimes. A public perception that judges were not giving long enough sentences to white-collar criminals and were not imposing large enough fines led to the adoption of the 1991 Sentencing Guidelines for use by federal judges. These guidelines are said to provide “just punishment, adequate deterrence, and incentives for organizations to maintain internal mechanisms for preventing, detecting, and reporting criminal conduct in all aspects of their activity.”\textsuperscript{17} Until early 2005, these guidelines were in fact mandatory restrictions on the judge’s

\textsuperscript{16} Id.

sentencing authority. Today, these guidelines are just what their name implies: guidelines.

Under these sentencing guidelines, a fine is a product of a “base fine” and a “culpability score.” The base fine is the greatest of the company's gain, the victim's loss, or a dollar amount corresponding to an offense level. The culpability score provides a multiplier that is applied to the base fine. The culpability score is determined by looking at a chart of potential mitigating and aggravating factors. An example of an aggravating factor might be that high levels of management were aware of the criminal activity but did nothing to stop it. Mitigating factors would be having a meaningful compliance program in effect at the time of the offense and upper management's taking steps to remedy the harm, discipline the offender, and prevent a recurrence. Because of the difference that these aggravating and mitigating factors can have on the amount of the fine—a crime with a base fine of $5 million, for example, could be as low as $2 million or as high as $20 million, depending on the culpability score—supporters hope that the guidelines will not only result in fairer penalties but actually have a major impact on the way firms operate.

When the sentencing guidelines were established, there was a concern about the lack of prison time served by most white-collar criminals and the general judicial leniency toward white-collar crimes. Consequently, some confinement was mandated for almost all white-collar offenses. Sentences are determined in a way similar to fines, with a base sentence and culpability factor. Judges, however, were given discretion, under extraordinary circumstances, to modify the sentence and depart from the guidelines, and may impose alternative penalties (as described later in this section). Some of the factors that allow departure include “substantial cooperation” of the defendant; extraordinary effects of a prison sentence on third parties, including the defendant's family; an overstatement of loss from the crime; and diminished capacity.

Some critics of the guidelines argue that although prison sentences are required for a broad range of white-collar crimes, the sentences for these crimes are still much less than for street crimes. For example, the base sentence for an antitrust violation is as low as two to eight months.18 During 2001, the average sentence in the 8,328 cases of fraud was 22.9 months.

The power of the sentencing guidelines began to crumble as a result of the 2004 U.S. Supreme Court decision in Blakely v. Washington,19 in which the high court ruled that under the Sixth Amendment, juries, not judges, should determine the facts that increase sentences beyond guideline maximums. In that case, the facts admitted into evidence supported a maximum sentence of 53 months. The judge, however, imposed a sentence of 90 months after finding that the defendant had acted with deliberate cruelty, a statutorily enumerated ground for departing from the standard range. The Washington State Supreme Court had rejected the defendant's argument that the judge's acting on facts not admitted into evidence denied him his constitutional right to have a jury determine, beyond a reasonable doubt, all facts legally essential to his sentence. On appeal, the U.S. Supreme Court agreed with the defendant and overturned the state court's decision.

Although this case involved a state sentencing law, the decision immediately called into question the validity of the Federal Sentencing Guidelines. Within a month of the decision in Blakely, two circuit courts of appeal had ruled that the guidelines were unconstitutional, with the judge in one case stating that, “In order to comply with Blakely and the Sixth Amendment, the mandatory system of fixed

---

rules calibrating sentences automatically to facts found by judges must be displaced by an indeterminate system in which the Federal Sentencing Guidelines in fact become ‘guidelines’ in the dictionary-definition sense.”

He further said that instead of judges viewing the guidelines as mandatory, they should “view the guidelines in general as recommendations to be considered and then applied only if the judge believes they are appropriate and in the interests of justice in the particular case.”

A similar holding applied to the federal courts in the 2005 consolidated case of United States v. Booker and United States v. Fanfan. The key question in these cases was whether judges can increase criminal sentences based on arguments from prosecutors that juries never considered. The high court found that the mandatory guidelines are unconstitutional. The mandatory sentencing scheme of the guidelines when coupled with its reliance on judicial factfinding is incompatible with the Sixth Amendment. Although district courts still calculate sentencing ranges under the guidelines, these ranges are now considered merely advisory. Subsequent congressional action on the matter is anticipated.

Even before these rulings, judges had departed from the guidelines under extraordinary circumstances and, sometimes, also used alternative sentencing instead of imposing prison sentences or fines. One alternative to prison that judges favor for white-collar offenders is community service. Offenders have been assigned to perform such services as giving speeches about their wrongful acts to business and civic groups and working among the poor in drug rehabilitation clinics. A corporate criminal who dumped industrial waste into San Diego’s sewers, claiming it was domestic sewage, received a $250 fine and 3 years’ probation, with an unusual twist: For violating waste disposal laws, he was required to complete a hazardous materials course; perform 120 hours of volunteer work for the Veterans of Foreign Wars; and spend 40 hours at the city’s pump station where waste is discharged by trucks into the city’s sewage treatment system. The man was also ordered to inform the waste haulers who came into the pump station that he had falsified a report describing the type of waste he was discharging.

Another popular alternative to prison is occupational disqualification. The white-collar criminal is prohibited for a specific period from engaging in an occupation in which she or he would be able to commit the same crime again. Policing such a prohibition is difficult, so if a corporation really wants the convicted employee’s services, it can easily adjust the employee’s job title to make it appear that the job is one the employee can legally hold.

An alternative touted as saving money for the taxpayers is house arrest or home confinement. The criminal is not allowed to leave home for the period of incarceration and is compelled to wear an unremovable sensor that allows government officials to detect his or her location at all times. In some cases, the defendant is allowed to serve his or her prison term on weekends.

**Common White-Collar Crimes**

Thus far, we have focused on the white-collar criminal, but any study of white-collar crime must include consideration of who the victims are and what some of the precise crimes are. The victims of white-collar crime are widespread, and they vary according to the precise crime committed. White-collar crimes may be committed against the public in general, as when environmental regulations are violated; against consumers, as when they are forced to pay higher prices because of violations of the antitrust laws or when they die because the products

---

21 Id.
22 No. 03-104 (2004).
23 No. 03-105 (2004).
they purchased were made without undergoing the tests required by the Pure Food, Drug, and Cosmetic Act; against the taxpayers, as when income taxes are not paid; and against the corporation itself, as when employees steal from their employer. When the victims are the corporation the criminal works for, we sometimes refer to the crime as an intrabusiness crime. Estimates of the annual costs of intrabusiness crime range from $4 billion to $44 billion. In this section, we examine some of the more common white-collar crimes, noting their elements and their victims.

**Bribery**

Bribery is the offering, giving, soliciting, or receiving of money or any object of value for the purpose of influencing a person’s action, especially a government official. The law against bribery is necessary to protect the integrity of the government and to ensure that the government functions fairly and efficiently. Bribery would include paying a judge to rule in favor of a party and giving a senator free use of your condominium if he or she votes for a particular piece of legislation. For example, Antonio Bras pled guilty to bribing Department of Public Work (DPW) officials in Washington, D.C., to falsify records showing that Bras’s company was providing more asphalt than it actually was, allowing Bras to overcharge the DPW. To enable his overcharging, Bras paid DPW officials to accept falsified records. Bras was sentenced to three years and one month imprisonment, which was less than the maximum of five years he could have received.25

Some states broaden their definition of bribery to include certain payoffs in a commercial context. It is often considered bribery to offer to confer a benefit upon an employee or agent of another in an attempt to influence that agent’s behavior on behalf of his or her employer or principal without that employer or principal’s knowledge. Thus, an employee’s offer to pay a contracting officer $5,000 in exchange for that officer’s promise to purchase all the widgets the employer makes the next year would be considered a bribe in many states.

**Violations of Federal Regulations**

During the past few decades, regulatory agencies have been created and federal regulations enacted to control business. Analogous state regulations have also been enacted. Some primarily regulate economic matters; others are designed to protect the health, safety, and welfare of employees, consumers, and the public in general. You will study many of the regulations in the public law part of this book, Chapters 19 through 26.

Violation of any of these regulations constitutes a white-collar crime. The victims of these crimes vary according to the regulation that has been violated. For example, Occupational Safety and Health Act standards are established to protect the health and safety of workers. When these standards are violated, the violation is a criminal act that victimizes the employee, who is working under less safe or less healthful conditions than those required by law. When we examine these different regulations in later chapters of this book, the reader should consider who would be victimized by violations of each of the regulations. The reader who has a clear understanding of who might be hurt by such violations may be careful not to violate those regulations when he or she is a manager.

Violations of these regulations are often not perceived as criminal because they are frequently remedied outside the traditional courtroom setting. These regulations are often enforced by the appropriate regulatory agency through the

---

25 482 F.3d 560 (D.C. Cir. 2007).
issuance of a warning, a recall of defective products, or a consent agreement (a contract in which the violator agrees to cease engaging in the illegal activity). A cease-and-desist order may also be issued, ordering the corporation to cease violating the law and imposing a fine on the corporation for each day it violates the order. Warning letters are often the first approach of the regulatory agency, and the prudent businessperson should heed them. In cases of substantial violations, regulatory agencies may, of course, seek to impose fines on the corporation or manager responsible for the violation or may ask the court to impose a prison sentence on an offender.

The maximum monetary penalty that can be issued for violating federal regulations enacted to control business varies according to the regulation in question. For example, the maximum corporate penalty for violating the antitrust law is $100 million, a sum rarely awarded, which is larger than the previous maximum of $1 million but still not very large compared with the billions of dollars of assets and sales of some violators. For other acts, maximums are much lower. For example, $1,000 is the maximum for a first offense under the Pure Food, Drug, and Cosmetics Act, and $500,000 is the maximum for Occupational Health and Safety Act violations.

The maximum fines for individuals vary; a fine of $10,000 under acts such as the Pure Food, Drug, and Cosmetics Act and the Securities Exchange Act is typical. Maximum prison sentences usually range from six months to one year, with a few acts allowing up to five-year sentences. Maximum sentences are rarely imposed.

**CRIMINAL FRAUD**

Criminal fraud is a generic term that embraces a wide variety of means by which an individual intentionally uses some sort of misrepresentation to gain an advantage over another person. State fraud statutes vary, but most require proof of three elements: (1) an intent to defraud, (2) the commission of a fraudulent act, and (3) the accomplished fraud. It is very difficult to prove fraud, especially the first element: the intent to defraud. Some fraudulent acts that commonly occur in the corporate setting are:

1. Defalcation, the misappropriation of trust funds or money held in a fiduciary capacity.
2. False entry (entries), the making of an entry into the books of a bank or corporation that is designed to represent the existence of funds that do not exist.
3. False token, a false document or sign of existence used to perpetrate a fraud, such as making counterfeit money.
4. False pretenses, a designed misrepresentation of existing facts or conditions by which a person obtains another's money or goods, such as the writing of a worthless check.
5. Forgery, the material altering of anything in writing that, if genuine, might be the foundation of a legal liability.
6. Fraudulent concealment, the suppression of a material fact that the person is legally bound to disclose.

This list is by no means all-inclusive, but it demonstrates the broad variety of actions captured by the term fraud.

A person or corporation that uses the mail to execute a scheme or artifice to defraud the public out of money or property may be prosecuted under the federal law that prohibits mail fraud. Likewise, a person or corporation that uses the telephone, telegraph, television, radio, or other device to transmit a fraudulent message may be prosecuted for the federal crime of wire fraud. Mail fraud
claims can be brought in a wide range of situations. Seeking greater deterrence of mail and wire fraud, Congress passed the White-Collar Crime Penalty Act of 2002 as part of the Sarbanes-Oxley Act. The act increased maximum prison sentences for mail and wire fraud from 5 years to a new maximum of 20 years.

As the following case indicates, the likelihood that a fraudulent scheme will succeed is inconsequential to the decision of guilt or innocence.

**CASE 7-2**

*United States v. Gray*

Eleventh Circuit Court of Appeals

367 F.3d 1263 (2004)

The appellant, Kevin Gray, was found guilty of mail fraud. He had attempted to convince a businessman, Frank Patti, who was on trial for tax evasion and faced substantial jail time, that for $85,000 he would bribe the jury, thus avoiding the threat of jail for the businessman. The methods used by the appellant were, however, at times hardly believable. As a result, the appellant seeks a judgment of acquittal on the ground that his fraudulent scheme was “so absurd” that a person of ordinary prudence would not have believed it; the scheme, therefore, fell outside the realm of conduct proscribed by the mail fraud statute.

Circuit Judge Tjoflat

On May 8, 2002, a federal grand jury in the Northern District of Florida returned an indictment charging the appellant on one count of mail fraud. He pled not guilty, and the case proceeded to trial before a jury. The jury, having received evidence establishing the facts set forth above, found the appellant guilty, and the district court sentenced him to prison for 28 months. This appeal followed.

The appellant’s initial attack on his conviction is that the evidence was insufficient to make out a case of mail fraud. He argues that to prove the crime of mail fraud, the Government must establish that the defendant “intended to create a scheme ‘reasonably calculated to deceive persons of ordinary prudence and comprehension.’” Additionally, it must show that the defendant took some action in furtherance of his scheme—to bring it to fruition—in the form of a material misrepresentation made to the would-be victim that “a reasonable person would have acted on.” It is on this peg that the appellant hangs his hat, contending that a reasonable person would not have acted on his representations when considered as a whole. In bolstering his argument, he draws attention to his statement to Patti that $85,000 would be needed to bribe three of the jurors who would be trying his case: $35,000 for J-1, and $25,000 each for J-2 and J-3.

The appellant contends that a reasonable person would know that since the pool from which these jurors would be selected would not be known until April 15—when the pool assembled at the courthouse for the trial—the representation had to be phony.

While it is true that statements like the one he cites would seem absurd or fanciful to a reasonable person, the mail fraud statute does not require that every representation a defendant utters while executing his scheme must be credible. Instead, the statute requires proof that the defendant’s scheme to defraud involved the use of material, false representations or promises. The initial representations the appellant made to Patti satisfy this requirement.

In the letter to Patti, the appellant made a false promise: “we can assure you . . . no imprisonment but you must pay the agreed tax settlement issued by the court.” In addition, he falsely represented that an undisclosed number of sympathizers—including “our mutual friend” and “our associates in Pensacola”—would work to extricate Patti from his legal predicament if the businessman would agree to follow certain instructions. True, the letter did not identify precisely how the writer and these sympathizers would help Patti, but this omission did not render the letter devoid of any material misrepresentations that were capable of prompting a reasonable person to act as Patti did. What the appellant overlooks is that the mail fraud statute “punishes unexecuted, as well as executed, schemes. This means that the Government can convict a person for mail fraud even if his targeted victim never encountered the deception—or, if he encountered it, was not deceived.” All that the Government needs to show to establish the mens rea element of the offense is that the defendant anticipated the intended victim’s reliance, and the appellant’s anticipation of Patti’s reliance can be inferred from, among other things, the fact that he was prepared to call Patti at the pay phone at the time and location specified in the letter.

Because the letter received by Patti contained false material representations from the appellant as part of an effort to receive cash payments from the desperate businessman, the crime of mail fraud was complete when the appellant delivered the letter via FedEx to Patti.

*Affirmed* in favor of the Prosecution.
CRITICAL THINKING ABOUT THE LAW

The defendant in this case seems to misunderstand the law. His contention is that his offer to bribe is an absurdity and that Patti should have recognized it as such. His logic is that there can be no fraud unless the person who is allegedly being helped by the fraud reasonably believes the promised act will occur. In other words, the more outrageous the promise, the more the person charged with fraud can escape liability. The court in this case makes it clear that it is the act of the person initiating the fraud that is the key to the offense, not the response of the person being defrauded.

1. Does the rule of law in mail fraud cases require any particular action or belief on the part of the person being defrauded?
   
   **Clue:** Study the quote in the next-to-last paragraph of the decision.

2. What ethical norm is being emphasized by the rule of law with respect to mail fraud?
   
   **Clue:** Look back at the list of alternative ethical norms and make a determination about which of them is being advanced by the rule of law as it applies to mail fraud.

Fraud can range from a single act that victimizes one individual to a long-term scheme that victimizes thousands. In the corporate setting, fraud is sometimes committed by managers to make themselves look better so that they can secure promotions at the expense of others who perhaps deserve the promotions. Fraudulent entries in corporate records may result in artificially inflating the purchase price of stock at the expense of its purchasers. Fraud may also be committed against the corporation and, thus, against the shareholders, as when an employee on a bonus system fraudulently reports sales before they have been completed to collect an early bonus or “pads” his or her expense account. The more autonomy employees have, and the fewer people overseeing their actions, the greater the likelihood of their committing fraud.

Consumers may also be victims of corporate fraud, as when businesspersons make false representations in advertising and labeling. Consumers may also be victimized by the fraudulent substitution of inferior goods for higher-quality ones. Even have the potential to give rise to fraud claims.

Even student loans can provide the opportunity for fraud. In 2010, Rachel Yould, a former beauty queen, Stanford graduate, and Rhodes Scholar pled guilty to fraud charges after having defrauded lenders out of over $680,000 in fraudulent student loans. She borrowed the maximum amount of student loan money allowed, and then was able to obtain a new social security number through a domestic violence protection program, and used that new number to fraudulently obtain more student loan money, which she used to purchase a condominium, start a journal, and invest in the stock market.26

One of the fastest-growing forms of fraud is identity theft, whereby one’s credit card, Social Security number, driver’s license number, and other personal information are used for fraudulent purposes. According to Javelin Strategy & Research, a financial research company that has been tracking identity theft for the past decade, more than 11 million Americans were victims of identity theft in 2009, costing consumers more than $54 billion.27 To combat this growing and

---


costly form of fraud, Congress passed the Identity Theft and Assumption Deterrence Act of 1998, making identity theft a federal felony punishable by up to 25 years in prison. The act also requires the FTC to help victims restore their credit. In addition, the FTC and other federal agencies suggest methods for reducing the likelihood of identity theft, including restricting the use of your Social Security number to occasions when it is legally required, reviewing your credit report at least twice a year, and proceeding with caution before giving out personal information over the Internet.

**Larceny**

Another frequently occurring type of white-collar crime is larceny. **Larceny** is a matter of state criminal law, so the definition may vary slightly by state, but it can generally be defined as the secretive and wrongful taking and carrying away of the personal property of another with the intent to permanently deprive the rightful owner of its use or possession. The means of carrying out this crime is stealth: Larceny is not carried out by means of fear or force, which is the means of committing a robbery, and it is not carried out by means of false representation, which is one means of committing fraud. Larceny is commonly called theft by persons without legal training.

Most states distinguish petty larceny from grand larceny, with the distinction based on the value of the item. Grand larceny involves items of higher value than those involved in petty larceny. It is usually considered a felony and, thus, punishable by either a more severe fine or a longer term of imprisonment, or both.

In the corporate context, larceny generally involves employees' taking the employer's property. Common instances of larceny include an employee's taking home stationery or supplies from the office.

**Embezzlement**

Another white-collar offense is **embezzlement**. This crime is commonly defined as the wrongful conversion of the property of another by one who is lawfully in possession of that property. In some states, by statute, the crime may be committed only by certain classes of people, such as fiduciaries, attorneys, and public officials. As the reader might guess, larceny and embezzlement sometimes overlap. Like larceny, embezzlement is usually divided into degrees based on the value of the property embezzled. Some states also treat different kinds of embezzlers differently; that is, those embezzling from different types of institutions or those holding different types of positions may be distinguished.

**Computer Crimes**

As technology evolves, so do ways of committing corporate crime. With the arrival of the computer and the increasing automation of many facets of business, an area of crime has developed that society has not yet found an effective means of handling. No one knows the exact cost of computer crime each year, but estimates range from $300 million to $67 billion.

For the most part, computer crime, rather than being a new type of crime, is a means of making traditional crimes easier to commit. See Exhibit 7-7 for examples of some typical computer-crime techniques. Think about how many employees have access to a computer at work. When the number of individuals with home computers is added, there are myriad opportunities available for computer crime. Computer systems must now be protected from management, lower-level employees, and outsiders, sometimes known as hackers. With all these individuals having access to computers, a continuing increase in the amount of computer crime seems highly likely. Not only do computers make crime easier, but it appears
that computers also make crime more profitable. According to federal officials, the average loss in a bank robbery is $10,000, and the average loss in a nonelectronic embezzlement is $23,500. But in a computer fraud, the average loss is $24,000.

Computer crimes are also not frequently prosecuted; some analysts estimate that less than 1 percent of those who engage in computer fraud are actually prosecuted. One reason these criminals are so successful is that many computer crimes are extremely difficult to detect. Even if the crime is detected, if the victim is a business, it will often not prosecute because it does not want its competitors to know that its system was vulnerable. A final problem with convicting people of computer crimes is that the crimes sometimes do not fit precisely within the statutory definitions of traditional crimes.

Partially in response to this lack of adequate statutes under which to prosecute computer crime, Congress passed the Counterfeit Access Device and Computer Fraud and Abuse Act of 1984. The act not only imposes criminal sanctions, but also allows parties injured by a violation to bring a civil action to recover compensatory damages for the losses they incurred because of the violation. This act was subsequently amended by passage of the Computer Fraud and Abuse Act of 1986 (CFAA), which expanded the coverage of the original act. Congress continued to expand the scope of the law in 1989, 1990, 1994, 1996, and 2001. The most recent amendment to CFAA was passed as part of the USA PATRIOT Act to provide broader scope for prosecution of computer crimes. Under the latest version of the act, seven categories of activities are regulated:

1. The unauthorized use of or access to a computer to obtain classified military or foreign policy information with the intent to harm the United States or to benefit a foreign country.
2. Accessing a protected computer (government computers, computers in financial institutions, or those used in interstate commerce) without authority or in excess of authority.
3. The intentional, unauthorized access to a federal computer and the use, modification, destruction, or disclosure of data it contains or the prevention of authorized persons' use of such data.
4. Accessing a protected computer without or in excess of authority with the intent to obtain something of value.
5. Knowingly causing the transmission of a program, code, or command, and as a result causing damage to a protected computer.
6. The fraudulent transfer of computer passwords or other similar data that could aid unauthorized access that either (a) affects interstate commerce or (b) permits access to a government computer.
7. Transmitting in interstate or foreign commerce any threat that could cause damage to a protected computer with the intent to extort something of value.
One important issue that had to be clarified under this act was whether the act would be violated if persons knowingly accessed a computer without permission but did so not knowing what damage they would cause by their action. This issue was settled by U.S. v. Tappen, in which the court held that the intent goes to the intent to access the computers because Congress added the intent element to ensure that people who inadvertently got into someone else’s computer systems were not punished under the act.

Although it may seem as if the federal statute is fairly comprehensive, there are still a number of computer crimes that do not really violate that act. Those crimes must be prosecuted, if at all, under one of the state computer-crime statutes, which now exist in every state in some form, or under one of the traditional crime statutes.

As society attempts to find ways to respond to computer crimes, we have initially attempted to categorize the crimes. Following is just one way to categorize and think about these crimes.

**Destruction of Data.** Destruction of data is one of the biggest problems facing business today. A person with expertise in programming can create what is commonly referred to as a *virus*, a program designed to rearrange, replace, or destroy data. Once a virus is planted in a computer’s instructions, it can spread to other systems or programs by rapidly copying itself. Hence, if a computer virus is not caught early, it can be extremely destructive.

A number of software programs have been developed to detect and destroy viruses. These programs, however, are reactive, not proactive. Every time a new type of virus is discovered, a new antiviral program must be developed. By 2006, there were more than 100,000 known viruses; hence, keeping antivirus software current is no easy task, though it is essential. In 2005, it was estimated that computer viruses and *worms* cost businesses more than $67 billion in damages.

Destruction of data may also be more limited. For example, a disgruntled employee who is fired might program his computer to destroy a section of data every time a file is saved. Before anyone realizes what has occurred, valuable data may be lost.

**Unlawful Appropriation of Data or Services.** Employees at work are often provided with expensive computer systems and software. They have access to vast amounts of data. When employees use their work computers or data accessed through these computers in a manner not authorized by their employer, they have engaged in theft of computer services or data.

**Entering of Fraudulent Records or Data into a Computer System.** Entering fraudulent records includes altering a person’s credit rating electronically and breaking into a university’s computer system and changing someone’s course grades. For example, in 2007, 34 people, including former student employees, were charged with computer fraud and conspiracy charges regarding a six-year long cash-for-grades scheme at Diablo Valley College in California. Allegedly, some of the students charged with the crimes illegally gained access to records of student grades and would take cash payments to alter grades for other students. By 2008, two of the ringleaders agreed to cooperate with prosecutors in exchange for sentences of one year in jail and four years’ probation. Three others who were involved in changing grades were found guilty and charges against one were dropped because of a lack of evidence. The cases have not yet all been resolved. In May of 2010 another student implicated in the fraud was arrested, leaving four of those named in the scheme still at large.

**Financial Crimes.** Fraud, embezzlement, and larceny are now easier to accomplish by computer. An employee could electronically transfer ownership of

---

28 Second Circuit Court of Appeals, 928 F. 2d 504 (1991).
funds from a corporate account to a personal account. Any object subject to lawful transfer electronically can also be stolen electronically.

Keeping these differences in mind, it is easy to see why, when fraud is suspected, the wise manager may wish to hire a fraud examiner, rather than simply rely on either an internal or external audit, to settle the question of whether fraud has occurred.

**Prevention of White-Collar Crime**

We should all be interested in the prevention of white-collar crime because we are all its victims in more than one aspect of our lives. We are victims as consumers, shareholders, responsible employees, taxpayers, and citizens in general. The suggested ways for reducing white-collar crime are numerous and varied.

First, we will examine some of the ways in which corporate crime committed on behalf of the corporation may be prevented. One suggestion is to replace state chartering of corporations with federal chartering. Proponents argue that such chartering would prevent competition among states, which may lead to bribery and state officials’ routinely overlooking corporate violations of the laws. As a part of federal chartering (or until then, by state law), corporations could be required to have outside directors (directors who are not also officers or managers). A counterargument to that suggestion is that outside directors do not have a significant impact on the behavior of management. They have neither the knowledge nor the interest to provide effective supervision.

An even more innovative suggestion, put forward by Christopher Stone, is that each corporation doing more than a certain amount of business be required to have a general public director (GPD). The GPD would have an office at the corporation with a small staff, would be given access to corporate books and records, and would represent the public interest in the ongoing functions of the corporation. General public directors would sit on corporate committees

---

**Accounting**

When people initially think about how to detect fraud, they may think that fraud detection is the auditor’s responsibility. If you remember what you learned about the role of an auditor from your accounting class, however, you would quickly recognize that although an auditor may discover something that tips him or her off that fraud has occurred, fraud detection is *not* the auditor’s responsibility. It is useful, when thinking about fraud detection, to keep in mind the differences between the role of independent auditors and the role of fraud examiners, which are detailed in the following list:

- Auditors follow a program; fraud examiners look for the unusual.
- Auditors look for errors and omissions; fraud examiners look for oddities and exceptions.
- Auditors assess internal control risk; fraud examiners “think like a criminal” and look for holes in the controls.
- Auditors use the concept of materiality with amounts higher than a fraud examiner would use.
- Auditors usually start fresh with materiality each year; fraud examiners look at cumulative materiality.
- Auditors work with financial accounting and auditing logic; fraud examiners think about motive, opportunity, and integrity.

---

and advise corporate officials about the legality of their activities. These public-interest watchdogs would be full-time workers paid from tax money. Stone further suggested that special public directors (SPDs), who would function like GPDs except that they would work in a special area such as workplace safety or antitrust, be assigned to corporations that have committed a series of violations in any specific area. SPDs would attempt to prevent further violations of a similar nature.

Two other proposals are to link the amounts of fines to the benefits obtained by the violations and to increase the amount of both corporate and individual fines. More than 90 percent of the fines paid by corporations between 1975 and 1976 were less than $5,000. When imposed on a relatively small corporation, one with annual sales of $300 million, such fines are analogous to giving a person who earns $15,000 a year a two-and-a-half-cent fine. Hence, fines as they currently exist do not really serve any deterrent function. Likewise, requiring greater and mandatory prison sentences for corporate

---

**TECHNOLOGY AND THE LEGAL ENVIRONMENT**

### Are We Prepared to Fight Cybercrime?

After the worldwide attack by the Philippine “love bug” virus, and the difficult time that nation had in prosecuting the perpetrator of the cybercrime, McConnell International LLC, a global technology policy and management consulting firm, undertook a study to determine the readiness of most countries to successfully prosecute those who committed cybercrimes. Their conclusion was that in most countries around the world, existing laws are likely to be unenforceable against such crimes, meaning that businesses and governments must rely solely on technical measures to protect themselves from those who would steal, deny access to, or destroy valuable information. This unfortunate state of the law is very important because the number of cybercrimes seems to be continually escalating. For example, according to the Computer Emergency Response Team Coordination Center (CERT/CC), the number of reported incidences of security breaches in the first three quarters of 2000 rose by 54 percent over the total number of reported incidences in 1999 (see [www.cert.org](http://www.cert.org)). What makes these figures all the more frightening, however, is that some corporations and governments do not want to admit being victims of cybercrimes, so the figures must be an understatement of the scope of the problem.

McConnell International’s report analyzes the state of the law in 52 countries. It finds that only 10 of these nations have amended their laws to cover more than half of the kinds of crimes that must be addressed. Although many of the others have initiatives under way, most countries do not have laws that cover cybercrimes. For example, in many countries, laws that prohibit physical acts of trespass or breaking and entering do not cover their “virtual” counterparts.

To prepare the report, McConnell International asked global technology policy officials in the 52 countries to provide copies of their laws that would be used to prosecute criminal acts involving both private- and public-sector computers. Countries that provided legislation were evaluated to determine whether their criminal statutes had been extended into cyberspace to cover 10 different types of cybercrime in 4 categories: data-related crimes, including interception, modification, and theft; network-related crimes, including interference and sabotage; crimes of access, including hacking and virus distribution; and associated computer-related crimes, including aiding and abetting cybercriminals, computer fraud, and computer forgery.

Thirty-three of the countries surveyed had not yet updated their laws to address any type of cybercrime. Of the remaining countries, 9 have enacted legislation to address 5 or fewer types of cybercrime, and 10 have updated their laws to prosecute 6 or more of the 10 types of cybercrime. Among those nations that had substantially or fully updated their laws were the United States, Canada, Japan, and the Philippines.

---

executives who are found to have violated federal and state regulations might cause them to take these laws more seriously. Some also suggest elimination of the nolo contendere plea.

Because it is believed that the courts are unlikely to impose stiff fines on either corporations or convicted executives, the imposition of equity fines has been proposed. If a company is convicted of a white-collar crime, it would be forced to turn over a substantial block of its stock to a victims' compensation fund. This relinquishing of the company's stock would make its executives' holdings worth less. It would also provoke the ire of shareholders, whose holdings would be diluted, and might prompt them to call for the ouster of the responsible executives. Finally, it might put pressure on managers, who realize that the existence of a block of stock in one place would make a takeover attempt easier.

It is also believed that regulations are often broken because of ineffective monitoring by agencies. One remedy, it is argued, is to increase the operating budgets of the regulatory agencies to allow them to hire more people to monitor corporations and to improve the training of regulatory agency employees. A related argument is that the regulations themselves are often vague and complex. Simplification of these laws would make them more understandable and easier to follow. It would also make violations of these laws easier to recognize and prosecute.

These ideas and suggestions are all beyond the direct control of most corporate managers. There are, however, some very practical things that managers can do to reduce the likelihood that their employees or companies will commit white-collar crimes. First, have a well-defined company code of ethics that the employees read and sign. Make sure that the employees understand that dishonest and unethical behavior is not acceptable. Second, provide a hotline for anonymous tips. Employees should be encouraged to use the hotline to report any instances of fraud on the part of other employees. Third, provide an employee assistance program. Often employees commit fraud and other white-collar crimes because they are having problems with substance abuse, gambling, or money management. If they can get assistance with these problems, it may prevent their trying to solve them by committing crimes against the company. Finally, conduct proactive fraud auditing.

**LINKING LAW AND BUSINESS**

**Management**

*Responsibility* is defined as the obligation to complete specific activities. Typically, managers will assign individuals to particular positions in which they are entrusted with the responsibility of carrying out a task. Job activities are often divided by the functional similarity method, which is a basic method for separating duties in an organization. There are four interconnected steps in this method: (1) Examine organizational objectives; (2) delegate appropriate activities to meet established objectives; (3) design specific jobs for each activity; and (4) place individuals with responsibility for each specific job.

Another guide to the functional similarity method suggests that overlapping responsibility should be avoided. *Overlapping responsibility* refers to situations in which more than one person has responsibility for a specific task. When more than one employee is assigned to a certain task, there is a greater likelihood for employee conflicts and poorer working relationships.

There is, however, a disadvantage to avoiding overlapping responsibility. When individuals are given greater responsibility and autonomy, there is also a greater possibility for fraudulent activities. When there are fewer people working along with an individual, there may be a greater temptation to engage in fraud. Thus, managers should weigh the costs and risks associated with the level of responsibility given to employees before dividing responsibility for various activities.
Federal Laws Used in the Fight Against White-Collar Crime

THE RACKETEER INFLUENCED AND CORRUPT ORGANIZATIONS ACT (RICO)

In the eyes of many plaintiffs’ attorneys and prosecutors, a major weapon in the fight against white-collar crime can be found in Title IX of the Organized Crime Control Act of 1970, the Racketeer Influenced and Corrupt Organizations Act, or RICO, as it is commonly called. This statute was originally enacted to help fight organized crime, but its application in the commercial context soon became apparent. In fact, a study by the Task Force on Civil RICO of the American Bar Association revealed that only about 9 percent of the RICO cases involved what is commonly considered organized crime; 37 percent of the cases involved common-law fraud in a commercial setting, and 40 percent involved securities fraud allegations.

RICO is such a powerful statute because it allows any person whose business or property is injured by a violation of the statute to recover treble damages plus attorney’s fees in a civil action. Hence, this is an instance in which a civil lawsuit may help prevent criminal action.

How does one violate RICO? RICO prohibits persons employed by or associated with an enterprise from engaging in a pattern of racketeering activity. Judicial interpretations have interpreted “pattern” to mean more than one act. Thus, RICO cannot be used against the one-time violator. What constitutes “racketeering activity,” however, has been very broadly defined to include almost all criminal actions, including acts of violence, the provision of illegal goods and services, bribery, antitrust violations, securities violations, and fraud.

RICO has been used so successfully in many of these areas that many corporate and brokerage firm attorneys are making appeals to the legislature through the press to limit the application of RICO. They argue that the statute is unfair because it does not require that a defendant be convicted of the alleged criminal activity before a civil RICO suit can be brought. They argue that this lack of a requirement of a previous conviction leads to spurious lawsuits and encourages out-of-court settlements by intimidated legitimate businesses. Opponents also argue that the courts are, or will be, “flooded” with such lawsuits and that valuable resources will thus be wasted. They also argue that the law was designed to attack “organized crime,” not employees of “legitimate businesses,” against whom it is now being successfully used.

Proponents of RICO argue that the law should continue in force as it is. They point out that fraud is a national problem, costing the nation more than $200 billion each year. Proponents further believe that given our lack of success in prosecuting criminal fraud cases in the past, we should retain this tool, which may allow us to punish persons who have been able to escape criminal prosecution. Criminal activity in “legitimate” businesses is a major problem facing the country today, and curing it can only enhance the reputations of those in the business world. If a corporation and its officers are not engaging in illegal or quasi-legal activities, they have nothing to fear from RICO.

FALSE CLAIMS ACT

A largely ignored 141-year-old federal law has come back to life since 1986 and is now being used vigorously in the fight against white-collar crime.

52 Stricharchuk and Pasztor, supra note 26.
53 Mann, supra note 13, at 86.
Under the False Claims Act, private citizens may sue employers on behalf of the government for fraud against the government. A successful party may receive 25 percent of the amount recovered if the government chooses to intervene in the action, or 30 percent if the government does not participate in the suit. Between the law's amendment in 1986 to encourage private whistleblowers and the end of 2009, the government has recovered $2,399,854,364 under this act.\footnote{The False Claims Act Legal Center, \url{www.taf.org/statistics.htm}, accessed May 1, 2010.} As of September 30, 2009, the U.S. government had a total of 996 “qui tam” cases under investigation.\footnote{Id.}

The act also offers protection to persons using the law to sue their employer. An employer may be held liable to the employee for twice the amount of back pay plus special damages if found guilty of retaliation. Between the law’s amendment in 1986 to encourage private whistleblowers and September 2006, the government paid whistleblowers a total of more than $1.6 billion.\footnote{Nolan Law Firm, “Qui Tam Frequently Asked Questions,” \url{www.whistleblowerfirm.com/faq.html}, accessed February 22, 2008.}

The Sarbanes-Oxley Act contains a provision that provides safeguards to protect whistleblowers, as does the Homeland Security Act of 2002. The new provisions were encouraged after whistleblowers received much attention with the rise in corporate fraud scandals. Perhaps no whistleblower is more notable in the business world than Sherron Watkins. As the vice president for corporate development at Enron, Watkins wrote several letters to chairman Kenneth Lay exposing corporate officials Andrew Fastow and Jeffery Skilling for committing the fraud. Although it was left for the courts to decide the facts of the Enron case and assign blame, Watkins played a significant role in exposing the company’s failures. Because of the important role whistleblowers can play in revealing fraud or other illegal behavior, Congress considered the Congressional Whistleblower Protection Act of 2007, which would have expand safeguards for federal employee whistleblowers who are fearful of future employment discrimination, and would have amended the Whistleblower Protection Act of 1989, which also protects federal employees who act as whistleblowers against the government. However, while the bill passed in the House, it failed in the Senate, and is not likely to be revived again in the near future.

The False Claims Act has also been used in a wide variety of circumstances. For example, in 2010, it was used to force Schwarz Pharma Inc. to pay $22 million to settle a claim that charged the company with marketing two unapproved drugs, Deponit and Hyoscyamine Sulfate Extended Release (Hyoscyamine Sulfate ER). The federal government received $12.24 million and the state received $9.76 million. Whistleblowers Constance and James Conrad received $1,836,575 from federal settlement, plus a share of the state settlement.\footnote{http://www.taf.org/}

Because of Justice Department estimates that fraud costs the taxpayers as much as $100 billion a year,\footnote{H. Berleman, “A Few Big Penalties Make for a Record Year,” \textit{Nat’l L.J.} (Oct. 24, 1994).} there are many proponents of the use of this act. Its use is encouraged because it motivates persons in the best positions to be aware
of fraud to report its occurrence. Employers who know that their employees may bring an action if asked to engage in fraud may be deterred from engaging in such acts. Nonetheless, as the following case demonstrates, proving that a party may legally bring a claim under the False Claims Act is not always an easy task.

CASE 7-3

Rockwell International Corp. v. United States
Supreme Court of the United States
127 S. Ct. 1397 (2007)

While employed as an engineer at a nuclear weapons plant run by Rockwell under a government contract, James Stone predicted that Rockwell’s system for creating solid “pondcrete” blocks from toxic pond sludge and cement would not work because of problems in piping the sludge. Rockwell, however, successfully made such blocks and discovered “insolid” ones only after Stone was laid off in 1986. In 1989, Stone filed a qui tam suit under the False Claims Act. Stone’s 1989 complaint included discussion of the piping system for the sludge.

In 1996, the government intervened, and, with Stone, filed an amended complaint, which did not allege that Stone’s predicted piping-system defect caused the insolid blocks. Nor was such defect mentioned in a statement of claims included in the final pretrial order, which instead alleged that the pondcrete failed because a new foreman used an insufficient cement-to-sludge ratio. The jury found for the United States and Stone with respect to claims covering the pondcrete allegations but found for Rockwell with respect to all other claims. The district court denied Rockwell’s postverdict motion to dismiss Stone’s claims due to Stone’s lack of jurisdiction under the False Claims Act. The Tenth Circuit affirmed in part but remanded for the district court to determine whether Stone qualified. The district court found that Stone did not qualify, but the Tenth Circuit disagreed. Rockwell again appealed.

Justice Scalia

Section 3730(e)(4)(A) [of the False Claims Act] provides that

no court shall have jurisdiction over an action under this section based upon the public disclosure of allegations or transactions in a criminal, civil, or administrative hearing, audit, or investigation, or from the news media, unless the action is brought by the Attorney General or the person bringing the action is an original source of the information.

Section 3730(e)(4)(B) defines “original source” as “an individual who [1] has direct and independent knowledge of the information on which the allegations are based and [2] has voluntarily provided the information to the Government before filing an action under this section which is based on the information.” As this case comes to the Court, it is conceded that the claims on which Stone prevailed were based upon publicly disclosed allegations within the meaning of § 3730(e)(4)(A). The question is whether Stone qualified under the original-source exception to the public-disclosure bar.

The only false claims ultimately found by the jury (and hence the only ones to which our jurisdictional inquiry is pertinent to the outcome) involved false statements with respect to environmental, safety, and health compliance over a one-and-a-half-year period between April 1, 1987, and September 30, 1988. As described by Stone and the Government in the final pretrial order, the only pertinent problem with respect to this period of time for which Stone claimed to have direct and independent knowledge was insolid pondcrete. Because Stone was no longer employed by Rockwell at the time, he did not know that the pondcrete was insolid; he did not know that pondcrete storage was even subject to [the Resource Conservation and Recovery Act of 1976] (RCRA); he did not know that Rockwell would fail to remedy the defect; he did not know that the insoloid pondcrete leaked while being stored onsite; and, of course, he did not know that Rockwell made false statements to the Government regarding pondcrete storage.

Stone’s prediction that the pondcrete would be insolid because of a flaw in the piping system does not qualify as “direct and independent knowledge” of the pondcrete defect. Of course a qui tam relator’s misunderstanding of why a concealed defect occurred would normally be immaterial as long as he knew the defect actually existed. But here Stone did not know that the pondcrete failed; he predicted it. Even if a prediction can qualify as direct and independent knowledge in some cases (a point we need not address), it assuredly does not do so when its premise of cause and effect is wrong. Stone’s prediction was a failed prediction, disproved by Stone’s own allegations. As Stone acknowledged, Rockwell was able to produce “concrete hard” pondcrete using the machinery Stone said was defective. According to respondents’ allegations in the final pretrial order, the insolidity problem was caused by a new foreman’s reduction of the cement-to-sludge ratio in the winter of 1986, long after Stone had left Rocky Flats.

Because Stone did not have direct and independent knowledge of the information upon which his allegations were based, we need not decide whether Stone met the
second requirement of original-source status, that he have voluntarily provided the information to the Government before filing his action.

Respondents contend that even if Stone failed the original-source test as to his non-specific allegations, the Government’s intervention in his case provided an independent basis of jurisdiction. Section 3730(c)(4)(A) permits jurisdiction over an action based on publicly disclosed allegations or transactions if the action is “brought by the Attorney General.” Respondents say that any inquiry into Stone’s original-source status with respect to amendments to the complaint was unnecessary because the Government had intervened, making this an “action brought by the Attorney General.” Even assuming that Stone was an original source of allegations in his initial complaint, we reject respondents’ “intervention” argument.

The False Claims Act contemplates two types of actions. First, under § 3730(a), “if the Attorney General finds that a person has violated or is violating section 3729, the Attorney General may bring a civil action under this section against the person.” Second, under § 3730(b), “[a] person may bring an action for a violation of section 3729 for the person and for the United States Government.” When a private person brings an action under § 3730(b), the Government may elect to “proceed with the action,” § 3730(b)(4)(A), or it may “decline to take over the action, in which case the person bringing the action shall have the right to conduct the action,” § 3730(b)(4)(B). The statute thus draws a sharp distinction between actions brought by the Attorney General under § 3730(a) and actions brought by a private person under § 3730(b). An action brought by a private person does not become one brought by the Government just because the Government intervenes and elects to “proceed with the action.”

Arguing against what was ultimately the position of the Court, the U.S. Government claimed that establishing a precedent where a person who filed qui tam on behalf of the government, but later lost the ability to sue because of a change to the legal claims made, was a dangerous precedent and threatened to create a disincentive for whistleblowers to file suit for the government under the False Claims Act. The government asserted that it needed the flexibility to work with private citizens to put forth the best case possible, even if it was under different claims than those originally filed, as was true of Stone in the preceding case. The Court dismissed the government’s concerns as invalid and argued that the concerns did not change the legal issue of whether Stone was a legal party who could sue based upon the claim that was filed.

Opponents of the use of the False Claims Act cite a variety of reasons. Some fear that frivolous or politically motivated lawsuits may be brought. Others say that the 60-day time period during which the Justice Department has to decide whether to join in the action is too brief and places an undue burden on the DOJ. During that limited time period, the government must decide whether to join in a complex suit that may take years to resolve.

In addition, the government can use, or choose not to use, the False Claims Act for political reasons. Despite the fact that more than a dozen False Claims Act lawsuits were filed by whistleblowers because of fraud in the Iraq reconstruction, the government has yet to join in on a single one of these suits. Fraud in Iraq reconstruction is estimated to be in the tens of millions of dollars, but the government has not helped out a single citizen who has filed suit. Some commentators have remarked that the government’s refusal to sign on to a False
Claims Act case frequently leads judges to doubt the validity of the claim, in that the government chose not to join the suit. For now, at least, use of the False Claims Act is increasing; but as the rising number of large judgments to whistleblowers keeps making headlines—at least a dozen whistleblowers thus far have collected more than $15 million each—more people are starting to question whether the whistleblower “rewards” are a wise use of taxpayers’ money. Some have proposed capping the amount a whistleblower can collect at $10 or $15 million. Those who have collected some of the awards above those amounts, however, have said that such a cap probably would have kept them from reporting the fraud. Because the majority of the awards are below $10 million, with the median award from 1986 to mid-2001 being around $150,000, it seems unlikely that amending the law to institute a cap will be a major item on the congressional agenda in the near future.

**SARBANES-OXLEY ACT**

The large number of high-profile companies engaged in fraudulent acts during the end of the 1990s and beginning of the 2000s led to the passage of the Sarbanes-Oxley Act of 2002. This act, fully discussed in Chapter 24, establishes new rules regarding corporate accounting, government oversight, and financial regulations. Although the act applies only to publicly held companies, many of the act’s rules influence the behavior of private and nonprofit organizations. Specifically, the act seeks to eliminate the conflicts of interests that can lead to fraudulent activity. For example, the act establishes the Public Company Accounting Oversight Board, which seeks to ensure proper accounting practices; mandates the separation of audit and nonaudit services; and requires corporate officials to certify their financial statements, which makes those officials responsible and liable for fraudulent statements. In addition, the Sarbanes-Oxley Act contains provisions that prevent publicly traded companies from firing, demoting, suspending, and otherwise discriminating against or harassing any employee who reports (blows the whistle on) corporate wrongdoing to the government.

**WHISTLEBLOWER PROTECTION ACT**

The Whistleblower Protection Act (WPA), similar to portions of the Sarbanes-Oxley Act, is intended to offer protections to those who act as whistleblowers. Whereas Sarbanes-Oxley protects private citizens, however, the WPA offers protections to federal employees who report illegal governmental activities. The WPA, originally enacted in 1989, offers protections to the vast majority of federal executive-branch employees. Congress explained the intent of the WPA as encouraging honest and responsible government by offering protections for those employees who know of governmental wrongdoing. Generally, the WPA applies to present and past federal executive-branch employees, as well as applicants for such jobs. The WPA does not cover all of these federal executive employees, however. Positions that are related to policy making and policy determination, as well as positions related to foreign intelligence or counterintelligence, are not protected by the WPA. In addition, federal employees in the following areas are also not protected by the WPA: the postal service, the Government Accountability Office, the Federal Bureau of Investigation, the Central Intelligence Agency, the Defense Intelligence Agency, the National Security Agency, as well as several other agencies’ employees.

---

Despite its good intentions, the WPA is not always effective at protecting and encouraging open government and citizen reporting of governmental wrongdoing. For example, as this book went to press, stories of governmental wrongdoing and fraud in Iraq and Iraqi reconstruction contracts were starting to come to light. Before the stories started to make it into mainstream media, a number of governmental employees and officials, such as “Bunny” Greenhouse, were subjected to retaliatory actions for acting as whistleblowers. Bunny worked for the Army Corps of Engineers as a high-ranking civilian officer. In 2005, Bunny testified before Congress regarding widespread fraud in Iraq rebuilding contracts involving Halliburton. For her trouble, Bunny was demoted and moved to a different department where she now has no decision-making authority and is given little work to do.40

State Laws Used in the Fight Against White-Collar Crime

Some states have whistleblower statutes that protect employees who testify against their employers. Some state acts also allow government whistleblowers to bring actions against the state government, and a few—Texas, California, and Alaska—even allow government-employee whistleblowers to seek punitive damages. Although a whistleblower statute with unlimited potential for recovery may sound like a good idea, not everyone supports such laws.

40 Id.

Whistleblowers in the United Kingdom

The United Kingdom, like the United States, is concerned about white-collar crime. One way to prevent or reduce white-collar crime is through whistleblowing. Although the United States has several federal laws that offer protections for whistleblowers, the primary protections for whistleblowers are through state laws. Conversely, the United Kingdom uses a national law to protect whistleblowers. The UK’s whistleblower law is the Public Interest Disclosure Act of 1998 (PIDA). The United Kingdom’s law differs in many ways from whistleblower laws in the United States.

First, the emphasis of the PIDA is fixing the problem within the company. The preferred (and most protected) disclosure is disclosure to a manager within the company. The basic form of the law is that a good-faith disclosure based on genuine concerns about crime, civil offenses, miscarriage of justice, danger to health and safety, or the environment and the cover-up of any of these protects the whistleblower from firing or retaliation. The first step is often to disclose the possible violation to a manager in the company. Disclosure to someone at the company is not always advisable or possible, so whistleblowers have other protections as well.

Disclosures to the appropriate ministry are acceptable, when applicable, as well as disclosures to the appropriate regulatory agency, such as the Health and Safety Executive. Rather than just having a suspicion of wrongdoing, whistleblowers must believe that their allegations are substantially true before disclosing to a regulator. Wider disclosure is protected under certain circumstances. If the whistleblower reasonably believed that he or she would be victimized for disclosure to the company or regulator, reasonably believed that a cover-up was likely and there was no prescribed regulator, or had already raised the issue internally or with a regulator and no action had been taken, he or she would be protected for a wider disclosure.

At no point may whistleblowing be protected for the purposes of personal gain. Unlike in the United States, UK whistleblowers do not get monetary rewards. They may be protected and compensated if action is taken against them, but they do not receive anything for the act of whistleblowing.

Although there are differences in the approach to whistleblowing, the PIDA in the UK and various whistleblower protections in the United States share the same goal: to encourage people to come forward if they know about wrongdoing.

Despite its good intentions, the WPA is not always effective at protecting and encouraging open government and citizen reporting of governmental wrongdoing. For example, as this book went to press, stories of governmental wrongdoing and fraud in Iraq and Iraqi reconstruction contracts were starting to come to light. Before the stories started to make it into mainstream media, a number of governmental employees and officials, such as “Bunny” Greenhouse, were subjected to retaliatory actions for acting as whistleblowers. Bunny worked for the Army Corps of Engineers as a high-ranking civilian officer. In 2005, Bunny testified before Congress regarding widespread fraud in Iraq rebuilding contracts involving Halliburton. For her trouble, Bunny was demoted and moved to a different department where she now has no decision-making authority and is given little work to do.40
Global Dimensions of White-Collar Crime

White-collar crime is not just a U.S. problem; it is a worldwide problem. Ironically, improvements in technology have increased the amount of white-collar crime on a worldwide scale by creating more opportunities for skilled employees to commit such crimes. For example, the availability of credit cards that can be used worldwide has increased the opportunities for credit card fraud.

When companies operate multinational, they may be able to avoid regulation and escape the jurisdiction of any nation by not really basing their operations in any country. One example of a company that was able to successfully engage in criminal behavior for years without detection was Investor’s Overseas Services (IOS). This company was much admired until its collapse in 1970. Using sales representatives recruited worldwide, IOS was able to persuade clients to invest $2.5 billion in a variety of mutual fund companies. Sales kept growing until the company finally went broke and the investors lost their money.

To some extent, IOS had been able to operate in a fraudulent manner because the company was not domiciled in any country or group of countries, and thus it was subject to no particular country’s regulation. Managers registered and domiciled their funds wherever they could in order to avoid taxation and regulation. Consequently, they were able to do things that no company domiciled in a single country could do. The prudent manager should make sure that any multinational firm with which he or she does business is domiciled in some country.

Another factor leading to the commission of white-collar crime on an international scale is the unfortunate lack of cooperation among the police of different countries. This situation may be changing, however. In April 2001, the United States and 12 other countries agreed to start sharing confidential data about the complaints they receive from consumers, in a bid to crack down on cross-border Internet fraud. The FTC voted unanimously to begin pooling its U.S. complaints with those from other countries to create a single database, something an FTC spokesperson said would “greatly improve international law enforcement agencies’ ability to address cross-border Internet fraud and deception.”41 The countries participating in the project, in addition to the United States, are Australia, Canada, Denmark, Finland, Hungary, Mexico, New Zealand, Norway, South Korea, Sweden, Switzerland, and the United Kingdom. Under the agreement, law enforcement agencies in each country will have access to the database through a single, password-protected Web site, the agency said. FTC officials said the information will tip them off to Internet scam artists.

Another important global initiative, the Convention on Cybercrime, is being undertaken by the United States, Canada, Japan, and the 43 members of the Council of Europe (COE). Initiated in 1997, after 27 drafts, a final version was agreed upon at the end of June 2001, paving the way for international rules governing copyright infringement, online fraud, child pornography, and hacking. The three main topics covered by the convention are harmonization of the national laws that define offenses, definition of investigation and prosecution procedures to cope with global networks, and establishment of a rapid and effective system of international cooperation. Full information about the treaty, including its text and a list of countries that have signed and ratified the treaty, can be found at http://conventions.coe.int/Treaty/Commun/QueVoulezVous.asp?NT5185&CM58&DF502/06/2010&CL5ENG.

The convention came into effect internationally on January 7, 2004, with the ratification by the fifth signing nation. As of December, 2010, 46 nations had signed the convention, with 29 of the signators having ratified the convention. The United States officially ratified the Convention on Cybercrime on September 29, 2006, and the convention went into effect in the United States on January 1, 2007.

SUMMARY

Criminal law is that body of laws designed to punish persons who engage in activities that are harmful to the public health, safety, or welfare. A crime generally requires a wrongful act and a criminal intent.

Criminal procedure is similar to civil procedure, but there are some significant differences. A criminal prosecution begins with the issuance of an information by a magistrate or an indictment by a grand jury. The next step is the arraignment, which is followed by the trial, and then, in some cases, an appeal.

White-collar crimes—crimes committed in a commercial context—may be even more costly to society than street crimes, but they are more difficult to prosecute and often carry relatively light sentences. Some of the more common white-collar crimes are larceny, the secretive and wrongful taking of another’s property; embezzlement, the wrongful conversion of property of which one has lawful possession; and violations of federal regulations. Increasingly, computers are being used to commit white-collar crime, making the detection and prosecution of these crimes even more difficult.

Attempts are being made to fight white-collar crime on the federal level through such statutes as RICO and the False Claims Act. Some states have now passed whistleblower statutes to help fight white-collar crime.

When thinking about white-collar crime, it is important to remember that one of the drawbacks of increasing globalization is that it has led to increasing amounts of cross-border white-collar crime. Criminals have taken advantage of the lack of international cooperation among law enforcement officials.

REVIEW QUESTIONS

7-1 What is the purpose of criminal law?
7-2 Explain how crimes are classified.
7-3 Explain the basic procedural stages in a criminal prosecution.
7-4 State two alternative definitions of white-collar crime and give an example of one crime that fits under both definitions and another crime that would fit only one of the definitions.
7-5 Explain the rationale for imposing criminal liability on corporations.
7-6 Explain two sentencing alternatives to prison for white-collar criminals.

REVIEW PROBLEMS

7-7 Rawlsworth is an employee of General Sam Corporation. One of Rawlsworth’s jobs is to monitor the amount of particular pollutants and to record the results on a form that is submitted to the Environmental Protection Agency. This self-monitoring is required by law to ensure that firms limit the amount of particular pollutants they discharge. One day the firm’s equipment is malfunctioning, and so Rawlsworth records that the firm’s discharge is in excess of the lawful amount. When Matheson, Rawlsworth’s supervisor, sees what he has done, Matheson tells him to change the records to state that the firm is in compliance and, in the future, never to record such violations. When Rawlsworth calls the vice president to report this violation, he is told that the vice president does not take care of such matters and does not want to know about them. Rawlsworth then falsifies the records as instructed. When the falsification is discovered, who can be held criminally liable? Why?

7-8 Several corporations were convicted of violating the Sherman Act as a result of an unlawful agreement among their agents that the suppliers who supported
an association to attract tourists would be given preferential treatment over those who did not contribute financially to the association. The corporations appealed on the grounds that the corporate agents involved were acting contrary to general corporate policy. Was the defense valid?

7-9 Defendant Laffal was the president of a corporation that operated a restaurant. It was alleged that prostitutes frequented the restaurant, picking up men there and returning them after a short time, thus making the restaurant an illegal “bawdy house” in violation of the state criminal law. Laffal argued that he could not be charged with operating a bawdy house because he was never present when any of the illegal acts took place and he did not even know they were going on. Was Laffal correct?

7-10 Evans was a loan officer for a bank and in this capacity had approved several loans to Docherty, all of which were legitimate and were repaid on time. Evans asked Docherty to apply for a loan from the bank for $2,000 and then to give the money to Evans, who would repay the loan. Evans explained that he could not obtain the loan himself because bank policy did not allow him to borrow from the bank. Docherty agreed. Was Evans’s or Docherty’s behavior illegal?

7-11 A defendant managed a corporation chartered for the purpose of “introducing people.” He obtained a loan from a Mrs. Russ by telling her that he wanted the loan to build a theater on company property and that the loan would be secured by a mortgage on the property. The loan was not repaid; the mortgage was not given to the lender because the corporation owned no property. The defendant, in fact, simply deposited the money in the corporate account and used it to pay corporate debts. What crime, if any, did the defendant commit?

7-12 Jones worked for a small community college teaching business students how to set up inventories on various computer programs. The college had purchased the software and was licensed to use several copies of it for educational purposes. Jones started his own small business on the side and used the software for his own firm’s inventory control. He saw his own use as “testing” the product to make sure he was teaching students to use a process that really worked. Is his behavior lawful or unlawful? Why?

**CASE PROBLEMS**

7-13 Teresa Chambers worked as the Chief of the United States Park Police from February 10, 2002 to July 9, 2004, when she was removed from her position. The United States Park Police is a component of the National Park Service, which is an agency within the Department of the Interior. In 2003, when the Office of Management and Budget decided against increasing the Park Police budget, Chambers spoke with a reporter from the Washington Post and a staffer for the United States House of Representatives Interior Appropriations Subcommittee. Chambers was placed on administrative leave when the staffer told her supervisor about the conversation and the Washington Post ran an article attributing several remarks to Chambers.

On December 17, 2003, the supervisor suggested removing Chambers from her position based on six charges of misconduct. The two relevant charges were: (2) making public remarks regarding security on the National Mall, in parks, and on parkways in the Washington, D.C. metropolitan area; and (3) improperly disclosing budget deliberations to a Washington Post reporter. Chambers claims that charges 2 and 3 concern statements that are protected under the Whistleblower Act.

Charge 3 concerns improper disclosure of budget deliberations and was tied to Chambers’s statement to the reporter from the Washington Post that “she said she has to cover a $12 million shortfall for this year and she asked for $8 million more for next year.” Chambers contends that the disclosure was protected under the Whistleblower Protection Act as disclosing a substantial and specific danger to public safety. The agency contends that because the budget for the coming year had not been submitted to Congress, the disclosure was premature and in violation of agency protocol.

Charge 2 concerns statements that Chambers claims are related to issues of public safety. Chambers made statements about how traffic accidents have increased in an area that has only two officers instead of the recommended four and how there are not enough officials to protect the green areas around Washington, D.C. How do you think the court should rule? *Chambers v. Department of the Interior*, 602 F.3d 1370; 2010 U.S. App. LEXIS 8209 (Fed. Cir. 2010).

7-14 Kyle Kimoto was president of Assail, Inc. Assail was a telemarketing firm responsible for marketing a financial package developed by another company that included a pay-as-you-go debit card. Assail employees would use call lists to choose individuals who had recently applied for a credit card and been rejected. The telemarketer would tell these individuals that they...
were now eligible for a Visa or Mastercard. If the individuals said they were interested, the telemarketer would place the call on hold to obtain “authorization.” After letting a few minutes pass, the telemarketer would get back on the line to tell the individual that he or she had been approved. The telemarketer would tell the individuals that they would be charged a one-time processing fee of $159.95. The call was then transferred to another department to verify payment of the processing fee.

While the call was being transferred, the individual listened to a recording that informed him that the card was a pay-as-you-go MasterCard and there would be no credit on the card until a payment was made. However, any questions from the individual were answered in such a way as to support the assumption that this card would function as a typical credit card.

Defendant was indicted on one count of conspiracy, one count of mail fraud, and twelve counts of wire fraud. On appeal, Kimoto contends that as president he was in the business of selling pay-as-you-go credit cards and that the scripts used were not deceptive. Kimoto did not endorse employee statements indicating that the cards were credit cards. How do you think the court of appeals should rule? List the reasons you would use to support your position? United States v. Kimoto, 588 F.3d 464 (7th Cir. 2009).

7-15 Sam Hartig worked at and resigned from Sam’s Wines & Liquors, Inc. Sam’s Wines alleges that Hartig stole and misappropriated confidential customer data from the company computer system. The customer data was password protected and employees with access, like Hartig, were required to sign a form indicating that they would not disclose the information. Sam’s Wines alleges that Hartig stole the information and took it to his new employer, Plinio Group LLC. At Plinio, Hartig used the information to obtain new customers.

Hartig and Plinio moved to dismiss the claim as failing to state a claim under the Computer Fraud and Abuse Act. Defendants claim that because Hartig was an authorized employee, he could not violate the sections of CFFA requiring that the use be unauthorized or exceed authorized access. Defendants also claim that the complaint does not properly plead damage under CFFA. Defendants argue that the misappropriation of data does not impair the integrity or availability of the data. Do you think the plaintiff has properly pled damage and lack of authorization under CFFA? How should the court rule on the defendant’s motion to dismiss? Sam’s Wines & Liquors, Inc. v. Hartig, 2008 U.S. Dist. LEXIS 76451 (N.D. Ill. Sept. 24, 2008).

7-16 Betty Werner, the widow of a World War II veteran, had been receiving Veterans Administration (VA) Dependency and Indemnity Compensation (DIC) since the death of her husband in 1976. In 1995, due to severe mental problems, Werner’s son, Joel Ruben, had Werner admitted to an institution that would provide her primary care. Ruben obtained a durable power of attorney, putting himself in charge of his mother’s finances in order to provide for her care. Ruben redirected the VA’s DIC payments made to his mother into his own personal accounts, and never actually used the money to pay for the care of his mother. When the VA began investigating the whereabouts of the payments made to Werner, Ruben admitted that he had used the money to pay off his own financial obligations and to care for his ill son. Of what crime is Ruben guilty? What evidence is necessary to prove these allegations? United States v. Ruben, 2006 U.S. App. LEXIS 12528 (2006).

7-17 Cedric Kushner Promotions, Ltd., a corporation that promotes boxing events, sued Don King, the president and sole shareholder of Don King Productions, a corporation that also promotes boxing events. The lawsuit against King claimed that King conducted boxing-related events in violation of the Racketeer Influenced and Corrupt Organizations Act (RICO). The district court dismissed the case, and the appeals court affirmed the reasoning that Don King was not acting as a separate “person” from the corporation, Don King Productions. If no separation exists between the corporation and the person, then RICO does not hold. The case was appealed to the Supreme Court. How should the Court resolve this dispute? Why? How does the Court determine if a separation exists between the corporation and the person? Cedric Kushner Promotions, Ltd. v. Don King, 121 S. Ct. 2087 (2001).

7-18 Kenneth Harvey was a civilian employee with U.S. Army Intelligence and Security Command (INSCOM) which entered into a contract with Program Contract Services, Inc. (PCS). PCS was wholly owned and controlled by Michael Kronstein, a long-time friend of Harvey. In setting up the contract between INSCOM and PCS, Harvey made numerous misrepresentations about PCS’s ability to handle the job. Harvey stated that PCS had the personnel to handle the job when the company did not even have the minimum number of necessary employees. Harvey also said that PCS was the only company capable of handling the job in the area; there were actually hundreds of other capable companies.

Throughout the duration of the contract, PCS received $4,795,265.79 from INSCOM. Beginning in the fall of 1999, money was transferred from PCS accounts to a convenience store owned by Kronstein. Transfers were also made from PCS to businesses owned by Harvey in amounts totaling $43,000. In 2006, Harvey left INSCOM, allegedly to work for another company. In reality, Harvey began working directly for PCS.
Harvey and Kronstein were indicted on two counts of wire fraud and one count each of bribery. The trial court convicted both men. On appeal, the men both argue that the government lacked direct evidence of an intent to defraud and/or bribery. The government argues that intent to defraud can be inferred from the circumstances. Are the circumstances in this case sufficient to establish intent to defraud? United States v. Harvey, 532 F.3d 326 (4th Cir. 2008).

7-19 In 2004, James Clayton Terry was elected to serve as a member of the Lowndes County, Mississippi, Board of Supervisors, as the supervisor for District Four. As a member of the board, Terry was given a county vehicle and a Fuelman card, to be used for business purposes only. The county later began to receive complaints that Terry was making inappropriate purchases of gasoline and using the vehicle to take personal trips to casinos. Following an investigation, Terry was indicted for embezzlement.

The trial court found Terry guilty. On appeal, Terry argued that the conviction should be overturned because the state had failed to specify the dates during which the embezzlement supposedly occurred. The state argued that because the embezzlement was continuous, specific dates were not necessary. What exactly was embezzled, and should it matter whether the state alleged specific dates on which the embezzlement occurred? Terry v. State, 26 So. 3d 378 (Miss. Appellate Court, 2009).

7-20 Frank Robbins’s Wyoming guest ranch is made up of separated land parcels that abut privately owned land, as well as parcels owned by Wyoming and the federal government. The owner before Robbins had granted the government an easement for a road in exchange for a right-of-way on the federal land parcel. Robbins took ownership of the land without the easement, and he did not regrant the easement upon subsequent governmental request. Robbins claims that after negotiations broke down, employees from the Bureau of Land Management began a campaign of harassment and intimidation to force him to regrant the lost easement. Robbins filed suit against the government and its employees for, among other things, violation of RICO. If you were Robbins’s attorney, what would you have to prove to succeed on the RICO claim? How likely are you to succeed given the facts in this case? Wilkie v. Robbins, 127 S. Ct. 2588 (2007).

THINKING CRITICALLY ABOUT RELEVANT LEGAL ISSUES

Allocating Blame for White-Collar Crime

Despite the prevalence of white-collar crime in the business world, it is wrong to try to pin the blame for a white-collar crime on just anyone. Our seeking someone to blame is exactly the motivation underlying the practice of pinning liability on managers for the wrongdoing of those employees below the managers. Just because a manager might be easier to identify and blame does not make it right to attach legal liability to the manager by virtue of his or her role as “manager.”

The vast majority of crimes require a wrongful act, as well as a guilty mind, or mens rea. The problem with finding managers liable for the actions of those below them is that neither the element of wrongful act nor that of mens rea is met with respect to the manager. That is, just because a low-level employee commits a white-collar crime does not mean the manager participated or even intended for a crime to be committed. Liability imposed on managers for the wrongful acts of others overexcites the bounds of proper criminal liability. After all, is it right to legally hold parents responsible for the actions of their kids? What about holding teachers liable for an illegal act by one of their students? To hold a manager (or parent or teacher) accountable for the wrongful acts of another is absurd.

Another problem with imposing liability upon a manager for the actions of a lower-level employee is that the imposition of liability ignores the manager’s other responsibilities. Managers are in charge of numerous people, as well as having their own work they need to complete. Accordingly, managers cannot be expected to keep an eye on every little action of all of the employees below them at all times. Even the most vigilant of managers has the potential to miss one act of wrongdoing by a lower-level employee. It seems wrong to hold this diligent manager legally liable because one employee was able to fool the manager and hide his wrongdoing from the manager.

Finally, businesses in general are harmed by the practice of holding managers liable for the actions of other employees. Businesses need qualified managers to ensure that everything runs smoothly. Holding managers liable for the actions of others, however, creates a disincentive for becoming a manager. If the practice of holding a manager liable for the white-collar crimes of lower-level employees continues, the number of competent, caring people who want to become managers will greatly decrease. This decrease could cost businesses by
preventing the best people from rising to the top to be managers, because these people could fear the wrongful attribution of liability for the acts of another.

1. How would you frame the issue and conclusion of this essay?

2. Is there relevant missing information in the argument?
   Clue: What would you like to know before deciding whether the author is correct?

3. What ethical norm does the author appear to rely upon most heavily in making the argument?

4. Write an essay that someone who holds an opinion opposite to that of the essay author might write.
   Clue: What other ethical norms could influence an opinion on this issue?

ASSIGNMENT ON THE INTERNET

You have now learned several approaches to deter white-collar crime in this chapter, including federal laws such as RICO and the False Claims Act, individual state laws, and the proposed GPD. There, however, are many other independent steps a business can take to ensure that employees do not engage in illegal behavior. Use the Internet to find out what other businesses are doing to prevent white-collar crime. You can begin by visiting www.expertlaw.com/library/criminal/corporate_criminality.html#Q2.

As a business manager, what additional deterrents to white-collar crime would you create or adopt? How does United States v. Park, discussed earlier in this chapter, affect your attitude toward the responsibility of a manager to prevent white-collar crime?

ON THE INTERNET

www.nw3c.org This site is the location of the National White Collar Crime Center, which provides investigative support services to fight against white-collar crimes.

www.whitecollarcrimefyi.com White-Collar Crime FYI provides information regarding various types of white-collar crime; it also offers links to related Web sites and a list of relevant sources regarding the topic.

www.usdoj.gov/criminal/fraud This is the Web site of the Department of Justice division that prosecutes fraud and white-collar crime.

www.ic3.gov/ The Internet Crime Complaint Center is a joint endeavor by the FBI and the National White Collar Crime Center to create an easy-to-use forum for reporting Internet-based crimes.

www.findlaw.com/industry/white If you wish to find laws particular to your state about white-collar crime, visit this site. Also provided are articles and recent cases involving white-collar crime from your state.

www.bna.com/products/lit/wcln.htm BNA tracks developments in white-collar crime for business and legal professionals. This Web site allows you to track white-collar crime litigation, and also provides other related services.


On December 2, 1984, in Bhopal, India, lethal methylisocyanate (MIC) gas leaked from a chemical plant owned by Union Carbide India Ltd., killing approximately 2,000 people and injuring thousands more, many of whom are still receiving treatment. Union Carbide’s chairman, Warren Anderson, a lawyer, flew to India with a pledge of medical support and interim assistance totaling $7 million. He was arrested and deported from the country. Lawsuits on behalf of the deceased and injured were brought by U.S. law firms as well as by the government of India. Litigation continues in Indian courts.

The price of Union Carbide stock dropped from $48 to $33. In August 1984, GAF Corporation attempted to take over Union Carbide. Union Carbide successfully fought off the takeover attempt in 1985. On May 13, 1986, a federal court judge dismissed the personal injury and wrongful death actions, stating that the complaints should be more properly heard in a court in India. The judge attached certain conditions to the dismissal, one of which was that Union Carbide would have to agree to pay any damages awarded by an Indian court. The trial began in August 1988 in a New Delhi court amidst rumors that a former disgruntled employee had sabotaged Union Carbide’s Bhopal plant, causing the gas leakage. In January 1988, Union Carbide shares traded on the New York Stock Exchange for $49, and the much leaner company was one of the 30 companies making up the composite Dow Jones Industrial Average. It might be helpful to read this case, set out in edited form in Chapter 9. For additional and updated facts through 2010, see the comments after Case 9-3.

In an unrelated, but similarly disturbing situation, the death toll for accidents involving Ford Explorers equipped with Firestone tires rose to at least 174 by June 2001, and the number of reported injuries topped 700. Ford recalled most of the Firestone tires on Explorers, and eventually it switched to other brands. Meanwhile, the tire manufacturer maintained that the problem was not the tires but the design of the Explorer. As the two companies continued to try to place responsibility primarily on each other, consumers continued to purchase Ford Explorers, although not at quite the same rate as before all the negative publicity.
The Bhopal incident in 1984, along with a stream of insider trading cases beginning in 1986 and continuing into the 1990s, as well as a number of white-collar crime cases in the 2000s (highlighted in Chapter 7) have brought a heightened awareness of the need for debate as to whether the business community has a responsibility solely to shareholders or to other stakeholders as well. Such cases force us to ask ourselves, What should be the legal rules that businesses must obey in their daily operations? Additionally, there are ethical questions that force us to consider how we should behave if we are to live in a better world. Business ethics is the study of the moral practices of the firms that play such an important role in shaping that better world.

Whenever you wonder whether a business decision requires us to think about ethics, simply ask yourself, Will this decision affect the quality of life of other people? If the answer is yes, the decision involves ethics. We think you will agree that business ethics is an extremely important aspect of our environment because almost all business decisions influence the quality of our lives.

This chapter presents material on business ethics in a neutral way. Readers are left to make their own choices about what part ethics should play in business decision making and about whether the business community, the trade groups that represent it, and individual managers should act in a “socially responsible” manner. This chapter includes (1) a broad definition of ethics and social responsibility; (2) some recognized theories of ethical thought and their application to business problems; (3) a discussion of individual, corporate, trade association, and professional ethical codes; and (4) schools of social responsibility as applied to business problems. The chapter ends with a brief discussion of some current trends in the area of ethics and social responsibility, as well as some proposals now being debated, which, if implemented, would change the structure of corporate governance.

**CRITICAL THINKING ABOUT THE LAW**

Business ethics is perhaps one of the most personal and emotional areas in business decision making. Business ethics can be confusing and complex because a right or wrong answer often does not exist. Because this area is so emotional and controversial, it is extremely important to use your critical thinking skills when thinking about business ethics. It would be very easy to make arguments based on your gut reaction to cases such as the Bhopal gas incident. You should, however, carefully use your critical thinking skills to draw an informed conclusion. The following questions can help you begin to understand the complexity surrounding business ethics.

1. As critical thinkers, you have learned that ambiguous words—words that have multiple possible meanings—can cause confusion in the legal environment. Perhaps the best example of ambiguity in the legal environment is the phrase *social responsibility*. What definitions of responsibility can you generate?
   **Clue:** Consider the Bhopal incident. Do you think Union Carbide would have the same definition of social responsibility as the families of the Indian accident victims?

2. It is common for individuals, businesses, judges, and juries each to use different meanings of the phrase *social responsibility*. Preferences for certain ethical norms might account for these different meanings. If executives of a company thought that security was extremely important, how might their definition of social responsibility be affected?
   **Clue:** Remember the definitions of security in Chapter 1. If Union Carbide valued security, how might the company treat the victims of the Bhopal incident?

3. Your friend discovers that you are taking a class on the legal environment of business. He says, “I’m extremely angry at the cigarette companies. They knew that cigarettes cause cancer. Don’t those companies have a responsibility to protect us?” Because you are trained in critical thinking, you know that his question does not have a simple answer. Keeping your critical thinking skills in mind, how would you intelligently respond to his question?
   **Clue:** Consider the critical thinking questions about ambiguity, ethical norms, and missing information.
Definition of Business Ethics and Social Responsibility

**BUSINESS ETHICS**

*Ethics* is the study of good and bad behavior. *Business ethics* is a subset of the study of ethics and is defined as the study of what makes up good and bad business conduct. This conduct occurs when the firm acts as an organization, as well as when individual managers make decisions inside the organization. For example, there may be differences between the way Warren Anderson personally looked at the Bhopal tragedy (a failure of the plant to implement company operating standards) and the way the corporation’s board of directors and the chemical industry did (the Indian government allowed people to live too close to the plant). It is important to look at “business” ethics not as a single monolithic system, but from the perspective of individual managers, corporations, and industry-wide ethical concerns. Each may view and judge a particular happening in a different way.

How these groups think depends on their ethical norms and on their philosophy or theory of ethics. To help you understand their thinking, we include a discussion of three schools of ethical thought. Individual managers, corporations, or industries may belong to any one of the schools, as each school has its advocates and refinements. In addition, each school attempts to explain why an action is right or wrong and how one knows it to be right or wrong.

**THE SOCIAL RESPONSIBILITY OF BUSINESS**

The social responsibility of business is defined as a concern by business about both its profit-seeking and its non-profit-seeking activities and their intended and unintended impacts on groups and individuals other than management or the owners of a corporation (e.g., consumers, environmentalists, and political groups). Since the late 1960s, an outcry has arisen for business to be more socially responsible. This expression of public concern has resulted in part from three factors:

1. **The complexity and interdependence of a postindustrial society.** No individual or business is an island unto itself. If a company builds a chemical plant in Bhopal, India, and its primary purpose is to make profits for its shareholders, can it be held responsible to the public that lives around the plant when there is a gas leak? The public is dependent on the firm’s good conduct, and the firm is dependent on the public and its political representatives to supply labor, an adequate water supply, tax forgiveness, roads, and so on.

2. **Political influence that has translated public outcry for socially responsible conduct into government regulation.** Whether a malfunction occurs at a nuclear plant at Three Mile Island or a human disaster is caused by a gas leak in Bhopal, India, the political arm of government at all levels sees the solution as more regulation. This attitude pleases the government’s constituents and makes its officials more electable.

3. **Philosophical differences about what the obligations of business should be.** Neoclassical economic theory would argue that the sole purpose of business is to make a profit for its investing shareholders, who, in turn, reinvest, creating expanded or new businesses that employ more people, thus creating a higher standard of living.

Others hold different theories of social responsibility. Some argue for a managerial or coping approach; that is, “throw money” at the problem when it occurs, such as the Bhopal disaster, and it will go away. Others subscribe to a more encompassing theory of social responsibility, holding that business, like...
any other institution in our society (e.g., unions, churches), has a social responsibility not only to shareholders (or members or congregations) but also to diverse groups, such as consumers and political, ethnic, racial-group, and gender-oriented organizations. These and other schools of social responsibility are discussed later in this chapter.

The following case offers several possible theories of social responsibility as applied to a controversial factual situation.

**CASE 8-1**

**In re Exxon Valdez**  
U.S. District Court, District of Alaska  

On Good Friday, March 24, 1989, the oil tanker *Exxon Valdez* was run aground on Bligh Reef in Prince William Sound, Alaska. On March 24, 1989, Joseph Hazelwood was in command of the *Exxon Valdez*. Defendant Exxon Shipping [Company] owned the *Exxon Valdez*. Exxon employed Captain Hazelwood, and kept him employed knowing that he had an alcohol problem. The captain had supposedly been rehabilitated, but Exxon knew better before March 24, 1989. Hazelwood had sought treatment for alcohol abuse in 1985 but had “fallen off the wagon” by the spring of 1986. Yet, Exxon continued to allow Hazelwood to command a supertanker carrying a hazardous cargo. Because Exxon did nothing despite its knowledge that Hazelwood was once again drinking, Captain Hazelwood was the person in charge of a vessel as long as three football fields and carrying 53 million gallons of crude oil. The best available estimate of the crude oil lost from the *Exxon Valdez* into Prince William Sound is about 11 million gallons. Commercial fisheries throughout this area were totally disrupted, with entire fisheries being closed for the 1989 season. Subsistence fishing by residents of Prince William Sound and Lower Cook Inlet villages was also disrupted. Shore-based businesses dependent upon the fishing industry were also disrupted as were the resources of cities such as Cordova. Exxon undertook a massive cleanup effort. Approximately $2.1 billion was ultimately spent in efforts to remove the spilled crude oil from the waters and beaches of Prince William Sound, Lower Cook Inlet, and Kodiak Island. Also, Exxon undertook a voluntary claims program, ultimately paying out $303 million, principally to fishermen whose livelihood was disrupted. [Law suits] (involving thousands of plaintiffs) were ultimately consolidated into this case.

The jury awarded a breathtaking $5 billion in punitive damages against Exxon. Exxon appealed the amount of punitive damages [to the U.S. Court of Appeals for the Ninth Circuit]. [T]he Ninth Circuit Court of Appeals in this case reiterated [that] the guideposts for use in determining whether punitive damages are grossly excessive [include] the reprehensibility of the defendant’s conduct. The court of appeals remanded the case [and] unequivocally told this court that “[t]he $5 billion punitive damages award is too high” and “[i]t must be reduced.”

**Justice Holland**

[T]he reprehensibility of the defendant’s conduct is the most important indicium [indication] of the reasonableness of a punitive damages award. In determining whether a defendant’s conduct is reprehensible, the court considers whether “The harm caused was physical as opposed to economic; the tortious conduct evinced an indifference to or a reckless disregard of the health or safety of others; the target of the conduct had financial vulnerability; the conduct involved repeated actions or was an isolated incident; and the harm was the result of intentional malice, trickery, or deceit, or mere accident.”

The reprehensibility of a party’s conduct, like truth and beauty, is subjective. One’s view of the quality of an actor’s conduct is the result of complex value judgments. The evaluation of a victim will vary considerably from that of a person not affected by an incident. Courts employ disinterested, unaffected lay jurors in the first instance to appraise the reprehensibility of a defendant’s conduct. Here, the jury heard about what Exxon knew, and what its officers did and what they failed to do. Knowing what Exxon knew and did through its officers, the jury concluded that Exxon’s conduct was highly reprehensible.

Punitive damages should reflect the enormity of the defendant’s offense. Exxon’s conduct did not simply cause economic harm to the plaintiffs. Exxon’s decision to leave Captain Hazelwood in command of the *Exxon Valdez* demonstrated reckless disregard for a broad range of legitimate Alaska concerns: the livelihood, health, and safety of the residents of Prince William Sound, the crew of the *Exxon Valdez*, and others. Exxon’s conduct targeted some financially vulnerable individuals, namely subsistence fishermen. Plaintiffs’ harm was not the result of an isolated incident but was the result of Exxon’s repeated decisions, over a period of approximately three years, to allow Captain Hazelwood to remain in command despite Exxon’s knowledge that he was drinking and driving again. Exxon’s bad
conduct as to Captain Hazelwood and his operating of the *Exxon Valdez* was intentionally malicious.

Exxon’s conduct was many degrees of magnitude more egregious [flagrant] [than defendant’s conduct in other cases]. For approximately three years, Exxon management, with knowledge that Captain Hazelwood had fallen off the wagon, willfully permitted him to operate a fully loaded crude oil tanker in and out of Prince William Sound—a body of water which Exxon knew to be highly valuable for its fisheries resources. Exxon’s argument that its conduct in permitting a relapsed alcoholic to operate an oil tanker should be characterized as less reprehensible than [in other cases] suggests that Exxon, even today, has not come to grips with the opprobrium [disgracefulness] which society rightly attaches to drunk driving. Based on the foregoing, the court finds Exxon’s conduct highly reprehensible.

[T]he court reduces the punitive damages award to $4.5 billion as the means of resolving the conflict between its conclusion and the directions of the court of appeals.

[T]here is no just reason to delay entry of a final judgment in this case. The Court’s judgment as to the $4.5 billion punitive damages award is deemed final.

**COMMENT:** In February 2008, the U.S. Supreme Court heard the oral argument on appeals from the U.S. Court of Appeals (D.C. Circuit), which affirmed the U.S. District Court. In May, 2010, in the midst of a cleanup of oil spilled in the Gulf of Mexico by a rig operated by British Petroleum and others, the hardships endured by Alaskans and their economy was again reviewed. It would appear, for example, that the once-rich herring fishery in Alaska is still struggling. Will this be repeated for fisheries and workers in the Gulf? See W. Yardley, “Community Recovery Still Incomplete after Valdez Spill,” *New York Times*, May 6, 2010, p. A-22.

---

**Theories of Ethical Thought**

**CONSEQUENTIAL THEORIES**

Ethicists, businesspeople, and workers who adhere to a consequential theory of ethics judge acts as ethically good or bad based on whether the acts have achieved their desired results. The actions of a business or any other societal unit are looked at as right or wrong only in terms of whether the results can be rationalized (Table 8-1).

This theory is best exemplified by the utilitarian school of thought, which is divided into two subschools: *act utilitarianism* and *rule utilitarianism*. In general, adherents of this school judge all conduct of individuals or businesses on whether that conduct brings net happiness or pleasure to a society. They judge an act ethically correct after adding up the risks (unhappiness) and the benefits (happiness) to society and obtaining a net outcome. For example, if it is necessary for a company to pay a bribe to a foreign official in order to get several billion dollars’ worth of airplane contracts, utilitarians would argue, in general, that the payment is ethically correct because it will provide net happiness to society; that is, it will bring jobs and spending to the community where the airplane company is located. If the bribe is not paid, the contracts, jobs, and spending will go to a company somewhere else.

**TABLE 8-1**

**THEORIES OF ETHICAL THOUGHT**

<table>
<thead>
<tr>
<th>Theories of Ethical Thought</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Consequential theories</strong></td>
<td>Acts are judged good or bad based on whether the acts have achieved their desired results. Acts of the business community or any other social unit (e.g., government, school, fraternity, and sorority).</td>
</tr>
<tr>
<td><strong>Deontological theories</strong></td>
<td>Actions can be judged good or bad based on rules and principles that are applied universally.</td>
</tr>
<tr>
<td><strong>Humanist theories</strong></td>
<td>Actions are evaluated as good or bad depending on whether they contribute to improving inherent human capacities such as intelligence, wisdom, and self-restraint.</td>
</tr>
</tbody>
</table>
Business Ethics

Managers often attempt to encourage ethical practices in the workplace. A significant reason for managers' concern with ethics is to portray their organizations in a favorable light to consumers, investors, and employees. As a means of creating an ethical workplace, there are several methods that managers should implement that you may recall from your management class:

1. Create a code of ethics, which is a formal statement that acts as a guide for making decisions and actions within an organization. Distribution and continual improvement of the code of ethics are also important steps.
2. Establish a workplace or office for the sole purpose of overseeing organizational practices to determine if actions are ethical.
3. Conduct training programs to encourage ethical practices in the organization.
4. Minimize situations in which unethical behavior is common and create conditions in which people are likely to behave ethically. Two practices that often result in unethical behavior are to give unusually high rewards for good performance and uncommonly harsh punishments for poor performance. By eliminating these two causal factors of unethical behavior, managers are more likely to create conditions in which employees choose to behave ethically within the organization. Therefore, a manager's hope to represent the organization in a respectable manner may be achieved through the institution and implementation of these methods.


Act utilitarians determine if an action is right or wrong on the basis of whether that individual act (the payment of a bribe) alone brings net happiness to society, as opposed to whether other alternatives (e.g., not paying the bribe or allowing others to pay the bribe) would bring more or less net happiness. Rule utilitarians argue that an act (the payment of the bribe) is ethically right if the performance of similar acts by all similar agents (other contractors) would produce the best results in society or has done so in the past. Rule utilitarians take the position that whatever applicable rule has been established by political representatives must be followed and should serve as a standard in the evaluation of similar acts. If payment of bribes has been determined by the society to bring net happiness, and a rule allowing bribes exists, then rule utilitarians would allow the bribe. In contrast, the Foreign Corrupt Practices Act of 1977, as amended in 1988, which forbids paying bribes to foreign government officials to get business that would not have been obtained without such a payment, is an example of a standard that rule utilitarians would argue must be followed but that would lead to a different result. Hence, the act utilitarians might get the airplane plant, but the rule utilitarians, if they were following the Foreign Corrupt Practices Act, would not.

We must note that both act and rule utilitarians focus on the consequences of an act and not on the question of verifying whether an act is ethically good or bad. Either one of these theories can be used by individuals or businesses to justify their actions. Act utilitarians use the principle of utility (adding up the costs and benefits of an act to arrive at net happiness) to focus on an individual action at one point in time. Rule utilitarians believe that one should not consider the consequences of a single act in determining net happiness, but instead

---

should focus on a general rule that exemplifies net happiness for the whole society. Case 8-1 illustrates a rule-utilitarian view of jurisprudence.

**DEONTOLOGICAL THEORIES**

*Deontology* is derived from a Greek word meaning “duty.” For advocates of deontology, rules and principles determine whether actions are ethically good or bad. The consequences of individual actions are not considered. The golden rule, “do unto others as you would have them do unto you,” is the hallmark of this theory.

Absolute deontology claims that actions can be judged ethically good or bad on the basis of absolute moral principles arrived at by human reason regardless of the consequences of an action, that is, regardless of whether there is net happiness.\(^3\) Immanuel Kant (1724–1804) provided an example of an absolute moral principle in his widely studied “categorical imperative.” He stated that a person ought to engage only in acts that he or she could see becoming a universal standard. For example, if a U.S. company bribes a foreign official to obtain a contract to build airplanes, then U.S. society and business should be willing to accept the principle that foreign multinationals will be morally free to bribe U.S. government officials to obtain defense contracts. Of course, the reverse will be true if nonbribery statutes are adopted worldwide. Kant, as part of his statement of the categorical imperative, assumed that everyone is a rational being having free will, and he warned that one ought to “treat others as having intrinsic values in themselves, and not merely as a means to achieve one’s end.”\(^4\) For deontologists such as Kant, ethical reasoning means adopting universal principles that are applied to everyone equally. Segregation of one ethnic or racial group is unethical because it denies the intrinsic value of each human being and thus violates a general universal principle. See Case 8-2, in which the court appears to leave the decision making to a trial jury.

**HUMANIST THEORIES**

A third school of thought, the humanist school, evaluates actions as ethically good or bad depending on what they contribute to improving inherent human capacities such as intelligence, wisdom, and self-restraint. Many natural law theorists (examined in Chapter 2) believe that humans would arrive by reason alone at standards of conduct that ultimately derive from a divine being or another ultimate source such as nature. For example, if a U.S. business participates in bribing a foreign official, it is not doing an act that improves inherent human capacities such as intelligence and wisdom; thus, the act is not ethical. In a situation that demanded choice, as well as the use of the intelligence and restraint that would prevent a violation of law (the Foreign Corrupt Practices Act of 1977), the particular business would have failed ethically as well as legally.

**Codes of Ethics**

**INDIVIDUAL CODES OF ETHICS**

When examining business ethics, one must recognize that the corporations, partnerships, and other entities that make up the business community are a composite of individuals. If the readers of this book are asked where they

\(^3\) Lacroix, *supra* note 1, at 13.

obtained their ethical values, they might respond that their values come from
parents, church, peers, teachers, brothers and sisters, or the environment. In
any event, corporations and the culture of a corporation are greatly influenced
by what ethical values individuals bring to them. Often, business managers are
faced with a conflict between their individual ethical values and those of the
corporation. For example, a father of three young children, who is divorced
and their sole support, is asked by his supervisor to “slightly change” figures
that will make the results of animal tests of a new drug look more favorable
when reported to the Food and Drug Administration. His supervisor hints that
if he fails to do so, he may be looking for another job. The individual is faced
with a conflict in ethical values: individual values of honesty and humaneness
toward potential users of the drug versus business values of profits, efficiency,
loyalty to the corporation, and the need for a job. Which values should deter-
mine his actions?

Individual Ethical Codes versus Groupthink

On January 28, 1986, just 74 seconds into its launch, the space shuttle Challenger exploded, killing the first schoolteacher in space, Christa McAuliffe, and six other astronauts on board. A presidential commission set up to investigate the disaster found that faulty O-rings in the booster rockets were to blame. Two engineers testified before the commission that they had opposed the launch but were overruled by their immediate supervisor and other officials of the Thiokol Corporation that manufactured the booster rockets. The two engineers continued to warn of problems with the O-rings until the day before the launch. After the launch, one engi-
neer was assigned to “special projects” for the firm. Another took leave and
founded a consulting firm. The second schoolteacher in space, Barbara Morgan,
was a backup to McAuliffe. She returned to teaching for 22 years after the Challenger incident until August 8, 2007, when she and six other astronauts were sent (successfully) to the International Space Station on the shuttle Endeavor.

On September 11, 2001, two planes flew into (the Twin Towers) of the World
Trade Center in New York City; one plane flew into the Pentagon in Washington,
D.C.; and another flew into a field near Pittsburgh, Pennsylvania. Approximately
3,000 people were killed by terrorists flying the planes. Again, a presidential com-
mision was set up. In 2004, the commission reported that the failure of intermediate-
level employees to be heard within intelligence agencies, as well as the inability of
agencies such as the Central Intelligence Agency (CIA), Defense Intelligence Agency
(DIA), and National Security Agency (NSA) to bring early warning information for-
ward to the decision makers (in the White House), was in part responsible for the
events that took place. The CIA director resigned and other officials at some agencies
retired. A new structure was set up for intelligence gathering in 2004, which allows
a single individual to be responsible for intelligence provided to the president of the
United States.

These factual situations are very different, but when reading the testimony pre-
sented to the presidential commissions, it appears that, in both cases, there were
conflicts between individual ethical values and groupthink. Groupthink, as used
here, is defined as a form of thinking that people engage in when they are involved
in a cohesive in-group, striving for unanimity, which overrides a realistic appraisal
of alternative courses of action. Groupthink refers “to a deterioration of mental ef-
ciciency, reality testing, and moral efficiency that results from in-group pressures.”

---

For the engineers in the *Challenger* case and the middle-level managers of the intelligence agencies, the question always will remain: Were they part of a group-think process that altered the outcome? Are there important factual differences in these cases: private-sector employment (Thiokol) as opposed to public-sector intelligence agencies?

Groupthink, however, may be necessary in our society. Without it, how would we organize our corporations, the military, and government agencies? If we allowed everyone to think independently, would anyone follow orders in the military or build rocket boosters in industry? Also, people often do not think like whistleblowers (see discussion of the Sarbanes-Oxley Act later in this chapter and in Chapter 24) for fear of losing their status and their jobs, which are often necessary to support egos and families.

Before answering any of the questions posed here, return to Chapter 1 and review the eight steps in critical thinking outlined there.

### CORPORATE CODES OF ETHICS

The total of individual employees' ethical values influences corporate conduct, especially in a corporation's early years. The activities during these years, in turn, form the basis of what constitutes a *corporate culture* or an environment for doing business. In a free-market society, values of productivity, efficiency, and profits become part of the culture of all companies. Some companies seek to generate productivity by cooperation between workers and management; others motivate through intense production goals that may bring about high labor turnover. Some companies have marketed their product through emphasis on quality and service; others emphasize beating the competition through lower prices.\(^5\) Over time, these production and marketing emphases have evolved into what is called a *corporate culture*, often memorialized in corporate codes.

Since the mid-1960s, approximately 90 percent of all major corporations have adopted codes of conduct. In general, the codes apply to upper- and middle-level managers. They are usually implemented by a chief executive officer or a designated agent. They tend to establish sanctions for deviant behavior, ranging from personal reprimands that are placed in the employee’s file to dismissal. Some formal codes allow for due process hearings within the corporation, in which an employee accused of a violation is given a chance to defend himself or herself. With many employees bringing wrongful dismissal actions in courts of law, formal internal procedures are increasingly evolving to implement due process requirements. A study of corporate codes reveals that the actions most typically forbidden are:\(^6\)

- Paying bribes to foreign government officials
- Fixing prices
- Giving gifts to customers or accepting gifts from suppliers
- Using insider information
- Revealing trade secrets

---


Corporate Ethics

Internal Housecleaning

Following several financial scandals involving companies such as Enron, Martha Stewart Living, Inc., ImClone Systems, WorldCom, Inc. (now MCI), and Tyco International (see Chapter 7 for analysis of some of these), Congress passed the Sarbanes-Oxley Act in 2002. This act required publicly traded companies to set up confidential internal systems by April 2003 so that employees and others could have a method of reporting possible illegal or unethical auditing and accounting practices, as well as other problems such as sexual harassment.

Web reporting systems such as Ethicspoint allow employees of companies to click an icon on their computers and be linked anonymously to the reporting services. Employees may report alleged unethical or illegal activity. The reporting system then alerts a management person or the audit committee of the board of directors to any possible problem. Other systems use a special hot-line phone number (800 or 900). No system is perfect, but the key factor is that Sarbanes-Oxley has given legal impetus to “cleaning house” internally.

Whistleblowing protection under Section 806 of Sarbanes-Oxley prohibits any publicly traded company from “discharging, demoting, suspending, threatening or otherwise discriminating against an employee who provides information to the government or assists in a government investigation regarding conduct that an employee believes may be a violation of the securities laws.” As noted in Chapter 24, penalties are both civil and criminal in nature.

INDUSTRY CODES OF ETHICS

In addition to corporate ethical codes, industry codes exist, such as those of the National Association of Broadcasters or the National Association of Used Car Dealers. In most cases, these codes are rather general and contain either affirmative inspirational guidelines or a list of “shall-nots.” A “hybrid model” including “dos and don’ts” generally addresses itself to subjects such as:

- Honest and fair dealings with customers
- Acceptable levels of safety, efficacy, and cleanliness
- Nondeceptive advertising
- Maintenance of experienced and trained personnel, competent performance of services, and furnishing of quality products

Most trade associations were formed for the purpose of lobbying Congress, the executive branch, and the regulatory agencies, in addition to influencing elections through their political action committees (PACs). They have not generally been effective in monitoring violations of their own ethical codes. In light of the reasons for their existence and the fact that membership dues support their work, it is not likely that they will be very effective disciplinarians.

Some effective self-regulating mechanisms, however, do exist in industries. In Chapter 24, readers will see that self-regulating organizations (SROs) such as the National Association of Securities Dealers and the New York Stock Exchange have used the authority delegated to them by the Securities and Exchange Commission (SEC) in an extremely efficient manner. In addition, the Council of Better Business

---

Bureaus, through its National Advertising Division (NAD), has provided empirical evidence that self-regulation can be effective. The NAD seeks to monitor and expose false advertising through its local bureaus and has done an effective job, receiving commendations from a leading consumer advocate, Ralph Nader.  

**PROFESSIONAL CODES OF ETHICS**

Within a corporation, managers often interact with individual employees who are subject to “professional” codes of conduct that may supersede corporate or industry-wide codes in terms of what activities they can participate in and still remain licensed professionals. For example, under the Model Code of Professional Responsibility, a lawyer must reveal the intention of his or her client to commit a crime and the information necessary to prevent the crime.  

When a lawyer, a member of the law department of Airplane Corporation X, learns that his company deliberately intends to bribe a high-level foreign official in order to obtain an airplane contract, he may be forced, under the Model Code, to disclose this intention, because the planned bribe is a violation of the Foreign Corrupt Practices Act of 1977, as amended, an act that has criminal penalties. Failure to disclose could lead to suspension or disbarment by the lawyer’s state bar. Management must be sensitive to this and to the several professional codes that exist (discussed later in this chapter).

*Professionals* is an often-overused term, referring to everything from masons to hair stylists to engineers, lawyers, and doctors. When discussing professions or professionals here, we mean a group that has the following characteristics:

- Mandatory university educational training before licensing, as well as continuing education requirements
- Licensing-examination requirements
- A set of written ethical standards that is recognized and continually enforced by the group
- A formal association or group that meets regularly
- An independent commitment to the public interest
- Formal recognition by the public as a professional group

Management must often interact with the professions outlined in the following paragraphs. Each of them has a separate code of conduct. An awareness of this fact may lead to a greater understanding of why each group acts as it does.

**Accounting.** The American Institute of Certified Public Accountants (AICPA) has promulgated a code of professional ethics and interpretive rules. The Institute of Internal Auditors has set out a code of ethics, as well as a Statement of Responsibilities of Internal Auditors. In addition, the Association of Government Accountants has promulgated a code of ethics.

Disciplinary procedures are set forth for both individuals and firms in the Code of Professional Ethics for Certified Public Accountants (CPAs). Membership in the AICPA is suspended without a hearing if a judgment of conviction is filed with the secretary of the institute as related to the following:

- A felony as defined under any state law
- The willful failure to file an income tax return, which the CPA as an individual is required to file

---


9 See Model Code of Professional Responsibility DR 4-401(C) and Formal Op. 314 (1965).

10 See AICPA Professional Standards, vol. 2, Disciplinary Suspensions and Termination of Membership Hearings, GL 730.01.
• The filing of a fraudulent return on the part of the CPA for his or her own return or that of a client
• The aiding in the preparation of a fraudulent income tax return of a client

The AICPA Division for CPA Firms is responsible for disciplining firms, as opposed to individuals. Through its SEC practice and its private company sections, this division requires member firms to (1) adhere to quality-control standards, (2) submit to peer review of their accounting and audit practices every three years, (3) ensure that all professionals participate in continuing education programs, and (4) maintain minimum amounts of liability insurance.

Accountants’ ethical responsibility is reinforced by the Sarbanes-Oxley Act of 2002, which was passed by Congress following a series of financial scandals (see Chapters 7 and 24). This Act mandated the creation of a Public Company Accounting Oversight Board; it also included provisions requiring auditor independence. Under Section 802 of the act, accountants are required to maintain on file working papers relating to an audit or review for five years. A willful violation is subject to a fine, imprisonment for up to 10 years, or both.

Other statutory provisions affecting accountants include Sections 11 and 12(2) of the 1933 Securities Act, as well as Sections 10(b) and 18 of the 1934 Securities Exchange Act. The 1933 act deals with accountant liability for false statements or omission of a material fact in auditing financial statements required for registration of securities. A defense is due diligence and a reasonable belief that the work is complete.

Under Section 10(b) of the 1934 act, accountants are liable for false and misleading statements in reports required by the act (see Chapter 24). Willful violations bring criminal penalties. Additionally, provisions of the Internal Revenue Code provide (felony) criminal penalties for tax preparers who willfully prepare or assist in preparing a false return. Tax preparers who negligently or willfully understate tax liability are also subject to criminal penalties. Furthermore, failure to provide a taxpayer with a copy of his or her return may subject a tax preparer to criminal penalties.

Insurance and Finance. The American Society of Chartered Life Underwriters (ASCLU) adopted a Code of Ethics consisting of eight guides to professional conduct and six rules of professional conduct. The guides are broad in nature, whereas the rules are specific. Enforcement of the Code of Ethics is left primarily to local chapters. Discipline includes reprimand, censure, and dismissal. A local chapter can additionally recommend suspension or revocation to a national board. Very few disciplinary actions have been forthcoming.

In addition, the Society of Chartered Property and Casualty Underwriters (CPCU) has a code of ethics consisting of seven “Specified Unethical Practices,” as well as three “Unspecified Unethical Practices” of a more general nature. Upon receipt of a written and signed complaint, the president of the society appoints a three-member conference panel to hear the case. If a panel finds a member guilty of an unspecified unethical practice, the president directs the member to cease such action. If a member is found guilty of a specified unethical practice, the society’s board of directors may reprimand or censure the violator or suspend or expel her or him from membership in the society.

---

Law. The American Bar Association’s Model Rules of Professional Responsibility were submitted to the highest state courts and the District of Columbia for adoption, after the association’s House of Delegates approved them in August 1983 (before then, the states had adopted the Model Code of Professional Responsibility). There are nine Canons of Professional Responsibility. From these are derived Ethical Considerations and Disciplinary Rules. The Model Rules set out a minimal level of conduct that is expected of an attorney. Violation of any of these rules may lead to warnings, reprimands, public censure, suspension, or disbarment by the enforcement agency of the highest state court in which the attorney is admitted to practice. Most state bar disciplinary actions are published in state bar journals and local newspapers, so lawyers and the public in general are aware of attorneys who have been subject to disciplinary action.

The case excerpted here illustrates some legal problems surrounding professional ethical codes when they result in price-fixing.

CASE 8-2

Bates v. State Bar of Arizona
United States Supreme Court
433 U.S. 350 (1977)

 Plaintiff-appellants Bates and O’Steen, licensed to practice law in the state of Arizona, opened a “legal clinic” in 1974. The clinic provided legal services to people with modest incomes for approximately two years, after which the clinic placed an advertisement in the Arizona Republic, a daily newspaper circulated in the Phoenix area, stating the prices it charged for legal services. The plaintiffs conceded that this advertisement was a violation of Disciplinary Rule 2-101(B) incorporated in Rule 29(a) of the Arizona Supreme Court rules, which stated in part:

A lawyer shall not publicize himself or his partner or associate, or any other lawyer affiliated with him or his firm, as a lawyer through newspapers, or magazine advertisements, radio, television announcements, display advertisements in the city telephone directories or other means of commercial publicity, nor shall be authorize others to do so in his behalf.

A complaint was initiated by the president of the State Bar of Arizona, and a hearing was held before a three-member special local administrative committee. The committee recommended to the Arizona Supreme Court that each of the plaintiffs be suspended from practice for not less than six months. The court agreed and ordered the plaintiffs suspended. The plaintiffs appealed to the U.S. Supreme Court.

Justice Blackmun

The heart of the dispute before us today is whether lawyers may constitutionally advertise the prices at which certain routine services will be performed. Numerous justifications are proffered for the restriction of such price advertising. We consider each in turn:

1. The Adverse Effect on Professionalism. Appellee places particular emphasis on the adverse effects that it feels price advertising will have on the legal profession. The key to professionalism, it is argued, is the sense of pride that involvement in the discipline generates. It is claimed that price advertising will bring about commercialization, which will undermine the attorney’s sense of dignity and self-worth. The hustle of the marketplace will adversely affect the profession’s service orientation, and irreparably damage the delicate balance between the lawyer’s need to earn and his obligation selflessly to serve. Advertising is also said to erode the client’s trust in his attorney. Once the client perceives that the lawyer is motivated by profit, his confidence that the attorney is acting out of a commitment to the client’s welfare is jeopardized. And advertising is said to tarnish the dignified public image of the profession.

We recognize, of course, and commend the spirit of public service with which the profession of law is practiced and to which it is dedicated. The present Members of this Court, licensed attorneys all, could not feel otherwise. And we would have reason to pause if we felt that our decision today would undercut that spirit. But we find the postulated connection between advertising and the erosion of true professionalism to be severely strained. At its core, the argument presumes that attorneys must
conceal from themselves and from their clients the real-life fact that lawyers earn their livelihood at the bar. We suspect that few attorneys engage in such self-deception. And rare is the client, moreover, even one of modest means, who enlists the aid of an attorney with the expectation that his services will be rendered free of charge.

Moreover, the assertion that advertising will diminish the attorney's reputation in the community is open to question. Bankers and engineers advertise, and yet these professionals are not regarded as undignified. In fact, it has been suggested that the failure of lawyers to advertise creates public disillusionment with the profession. The absence of advertising may be seen to reflect the profession's failure to reach out and serve the community. Studies reveal that many persons do not obtain counsel even when they perceive a need because of the feared price of services or because of an inability to locate a competent attorney. Indeed, cynicism with regard to the profession may be created by the fact that it long has publicly eschewed advertising, while condoning the actions of the attorney who structures his social or civic associations so as to provide contacts with potential clients.

2. Inherently Misleading Nature of Attorney Advertising. It is argued that advertising of legal services inevitably will be misleading. The argument that legal services are so unique that fixed rates cannot meaningfully be established is refuted by the record in this case. The appellee State Bar itself sponsors a Legal Services Program in which the participating attorneys agree to perform services like those advertised by the appellants at standardized rates.

3. The Adverse Effect on the Administration of Justice. Advertising is said to have the undesirable effect of stirring up litigation. But advertising by attorneys is not an unmitigated source of harm to the administration of justice. It may offer great benefits. Although advertising might increase the use of the judicial machinery, we cannot accept the notion that it is always better for a person to suffer a wrong silently than to redress it by legal action.

4. The Undesirable Economic Effects of Advertising. It is claimed that advertising will increase the overhead costs of the profession, and that these costs then will be passed along to consumers in the form of increased fees. Moreover, it is claimed that the additional cost of practice will create a substantial entry barrier, deter- ring or preventing young attorneys from penetrating the market and entrenching the position of the bar's established members.

These two arguments seem dubious at best. Neither distinguishes lawyers from others and neither appears relevant to the First Amendment. The ban on advertising serves to increase the difficulty of discovering the lowest cost seller of acceptable ability. As a result, to this extent attorneys are isolated from competition, and the inventive to price competitively is reduced. Although it is true that the effect of advertising on the price of services has not been demonstrated, there is revealing evidence with regard to products: where consumers have the benefit of price advertising, retail prices often are dramatically lower than they would be without advertising. It is entirely possible that advertising will serve to reduce, not advance, the cost of legal services to the consumer.

The entry-barrier argument is equally unpersuasive. In the absence of advertising, an attorney must rely on his contacts with the community to generate a flow of business. In view of the time necessary to develop such contacts, the ban in fact serves to perpetuate the market position of established attorneys. Consideration of entry-barrier problems would urge that advertising be allowed so as to aid the new competitor in penetrating the market.

5. The Adverse Effect of Advertising on the Quality of Service. It is argued that the attorney may advertise a given "package" of service at a set price, and will be inclined to provide, by indiscriminate use, the standard package regardless of whether it fits the client's needs . . . . Even if advertising leads to the creation of "legal clinics" like that of appellants—clients that emphasize standardized procedures for routine problems—it is possible that such clinics will improve service by reducing the likelihood of error.

6. The Difficulties of Enforcement. Finally, it is argued that the wholesale restriction is justified by the problems of enforcement if any other course is taken. Because the public lacks sophistication in legal matters, it may be particularly susceptible to misleading or deceptive advertising by lawyers.

It is at least somewhat incongruous for the opponents of advertising to extol the virtues and altruism of the legal profession at one point, and, at another, to assert that its members will seize the opportunity to mislead and distort. We suspect that, with advertising, most lawyers will behave as they always have: They will abide by their solemn oaths to uphold the integrity and honor of their profession and of the legal system.

In sum, we are not persuaded that any of the proffered justifications rise to the level of an acceptable reason for the suppression of all advertising by attorneys. As with other varieties of speech, it follows as well that there may be reasonable restrictions on the time, place, and manner of advertising.

The constitutional issue in this case is only whether the State may prevent the publication in a newspaper of appellants’ truthful advertisement concerning the availability and terms of routine legal services. We rule simply that the flow of such information may not be restrained, and we therefore hold the present application of the disciplinary rule against appellants to be violative of the First Amendment.

Reversed in favor of Plaintiff, Bates.
Early in this chapter, the social responsibility of business was defined as concern by business about both its profit and its nonprofit activities and their intended and unintended impact on others. As you will see, theories of ethics and schools of social responsibility are not necessarily mutually exclusive. For example, the primary purpose of a steel company is to make a profit for its individual and institutional shareholders. The unintended effects of this company’s actions might be that the surrounding community has polluted waters and homes are affected by ash that falls from the company’s smokestack. Similarly, in the Union Carbide incident described at the beginning of this chapter, the purpose of Union Carbide India Ltd. was to make a profit for its shareholders. By doing so, it was able to employ people. The unintended effect of this activity was a gas leak that killed approximately 2,000 people and injured many more. The question in both of these cases is: What responsibility, if any, do firms have for the unintended effects of their profit-seeking activity? This section discusses five views of social responsibility that seek to answer that question: profit oriented, managerial, institutional, professional obligation, and regulation (Table 8-2). Each of these schools reflects, or is an implementation of, the ethical values or culture of a corporation. The reader should analyze each, realizing, as in the case of ethical theories, that each has its strong advocates but that the “answer” may not lie in any one.

**PROFIT-ORIENTED SCHOOL**

The profit-oriented school of social responsibility begins with a market-oriented concept of the firm that most readers were exposed to in their first or second course in economics. Holders of this theory argue that business entities are distinct organizations in our society and that their sole purpose is to increase profits for shareholders. Businesses are to be judged solely on criteria of economic efficiency and
TABLE 8-2
SCHOOLS OF SOCIAL RESPONSIBILITY

<table>
<thead>
<tr>
<th>School</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit-oriented school</td>
<td>Business entities are distinct organizations in our society whose sole purpose is to increase profits for shareholders.</td>
</tr>
<tr>
<td>Managerial school</td>
<td>Advocates of this theory argue that business entities (particularly large ones) have a number of groups that they must deal with. They include not only stockholders but also employees, customers, activist groups, and government regulators, all of whom may make claims on the entities' resources.</td>
</tr>
<tr>
<td>Institutional school</td>
<td>Business entities have a responsibility to act in a manner that benefits all society.</td>
</tr>
<tr>
<td>Professional obligation school</td>
<td>Business managers and members of boards of directors must be certified as “professionals” before they assume managerial responsibilities. They must have a responsibility to the public interest beyond making profits. The Sarbanes-Oxley Act (see Chapters 7 and 24) may be leading in that direction.</td>
</tr>
<tr>
<td>Regulation school</td>
<td>All business units are accountable to elected officials. See the Sarbanes-Oxley Act in regard to dealing with independent financial audits (Chapter 24).</td>
</tr>
</tbody>
</table>

How well they contribute to growth in productivity and technology. Corporate social responsibility is shown by managers who maximize profits for their shareholders, who, in turn, are able to reinvest such profits, providing for increased productivity, new employment opportunities, and increased consumption of goods.

Classical economists, who advocate this position, recognize that there will be unintended effects of such profit-seeking activities (externalities) that affect society and cannot be incorporated into or passed on in the price of output. They would argue that this is the “social cost” of doing business. Such social costs are a collective responsibility of the government. Individual businesses should not be expected to voluntarily incorporate in their product’s price the cost of cleaning up water or air, because this incorporation will distort the market mechanism and the efficient use of resources. Profit-seeking advocates argue that, when government must act in a collective manner, it should act in a way that involves the least interference with the efficiency of the market system, preferably through direct taxation.

In summary, efforts at pollution control, upgrading minority workers, and bringing equality of payment to the workforce are all tasks of the government and not of the private sector, which is incapable of making such choices and is not elected in a democratic society to do so. Its sole responsibility is to seek profits for its shareholders. The following box represents an important set of issues.

“Old Joe Camel” was adopted by R. J. Reynolds (RJR) in 1913 as the symbol for the brand Camel. In late 1990, RJR revived Old Joe with a new look in the form of a cartoon that appealed to young smokers.

In December 1991, the Journal of the American Medical Association (JAMA) published three surveys that found the cartoon character Joe Camel reached children very effectively. Of children between ages 3 and 6 who were surveyed, 51.1 percent recognized Old Joe Camel as being associated with Camel cigarettes. The 6-year-olds were as familiar with Joe Camel as they were with the Mickey Mouse logo for the Disney Channel.

An RJR spokeswoman claimed that “just because children can identify our logo doesn’t mean they will use our product.” Since the introduction of Joe Camel, however, Camel’s share of the under-18 market climbed to 33 percent from 5 percent. Among 18- to 24-year-olds, Camel’s market share climbed to 7.9 percent from 4.4 percent.

The Centers for Disease Control reported in March 1992 that smokers between ages 12 and 18 preferred Marlboro, Newport, or Camel cigarettes, the three brands with the most extensive advertising.

---
b Id.
Teenagers throughout the country were wearing Joe Camel T-shirts. Brown & Williamson, the producer of Kool cigarettes, began testing a cartoon character for its advertisements, a penguin wearing sunglasses and Day-Glo sneakers. Company spokesman Joseph Helewicz stated that the advertisements were geared to smokers between 21 and 35 years old. Helewicz added that cartoon advertisements for adults were not new and cited the Pillsbury Doughboy and the Pink Panther as effective advertising images.

In mid-1992, then-Surgeon General Novella, along with the American Medical Association, began a campaign called “Dump the Hump” to pressure the tobacco industry to stop advertising campaigns that encourage kids to smoke. In 1993, the FTC staff recommended a ban on the Joe Camel advertisements. In 1994, then-Surgeon General Jocelyn Elders blamed the tobacco industry’s $4 billion in advertisements for increased smoking rates among teens. RJR’s tobacco division chief, James W. Johnston, responded, “I’ll be damned if I’ll pull the ads.” RJR put together a team of lawyers and others it referred to as in-house censors to control Joe’s influence. A campaign to have Joe wear a bandana was nixed, as was one for a punker Joe with pink hair.

In 1994, RJR’s CEO James Johnston testified before a congressional panel on the Joe Camel controversy and stated, “We do not market to children and will not,” and added, “We do not survey anyone under the age of 18.”

Internal documents about targeting young people were damaging, though. A 1981 RJR internal memorandum on marketing surveys cautioned research personnel to tally underage smokers as “age 18.” A 1981 Philip Morris internal document indicated that information about smoking habits in children as young as 15 was important, because “today’s teenager is tomorrow’s potential regular customer.” Other Philip Morris documents from the 1980s expressed concern that Marlboro sales would soon decline because teenage smoking rates were falling.

A 1987 marketing survey in France and Canada by RJR before it launched the Joe Camel campaign showed that the cartoon image with its fun and humor attracted attention. One 1987 internal document used the phrase young adult smokers and noted a campaign targeted at the competition’s “male Marlboro smokers ages 13–24.”

A 1997 survey of 534 teens by USA Today revealed the following:

<table>
<thead>
<tr>
<th>Advertisement</th>
<th>Have Seen Advertisement</th>
<th>Liked Advertisement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Joe Camel</td>
<td>95%</td>
<td>65%</td>
</tr>
<tr>
<td>Marlboro Man</td>
<td>94%</td>
<td>44%</td>
</tr>
<tr>
<td>Budweiser Frogs</td>
<td>99%</td>
<td>92%</td>
</tr>
</tbody>
</table>

Marlboro was the brand smoked by most teens in the survey. The survey found that 28 percent of teens between ages 13 and 18 smoked—an increase of 4 percent since 1991. In 1987, Camels were the cigarette of choice for 3 percent of teenagers when Joe Camel debuted. By 1993, the figure had climbed to 16 percent.

In early 1990, the Federal Trade Commission (FTC) began an investigation of RJR and its Joe Camel advertisements to determine whether underage smokers were illegally targeted by the 10-year Joe Camel campaign. The FTC had dismissed a complaint in 1994 but did not have the benefits of the newly discovered internal memorandums.

In late 1997, RJR began phasing out Joe Camel. New Camel advertisements featured healthy-looking men and women in their twenties, in clubs and swimming pools, with just a dromedary logo somewhere in the advertisement. RJR also vowed not to feature the Joe Camel character on nontobacco items such as T-shirts. The cost of the abandonment was estimated at $250 million.

In 1996, Philip Morris proposed its own plan to halt youth smoking, which included no vending machine advertisements, no billboard advertisements, no tobacco advertisements in magazines with 25 percent or more youth subscribers, and limits on sponsorships to events (rodeos, motor sports) where 75 percent or more of attendees were adults.

In 1998, combined pressure from Congress, the state attorneys general, and ongoing class action suits produced what came to be known as “the tobacco settlement.”
In addition to payment of $206 billion, the tobacco settlement in all of its various forms bars outdoor advertising, the use of human images (Marlboro Man) and cartoon characters (Joe Camel), and vending-machine sales. This portion of the settlement was advocated by those who were concerned about teenagers and their attraction to cigarettes via these advertisements and cigarettes' availability in machines.

**MANAGERIAL SCHOOL**

Advocates of the managerial school of social responsibility argue that businesses, particularly large institutions, have a number of interest groups or constituents both internally and externally that they must deal with regularly, not just stockholders and a board of directors. A business entity has employees, customers, suppliers, consumers, activist groups, government regulators, and others that influence decision making and the ability of the entity to make profits. In effect, modern managers must balance conflicting claims on their time and the company's resources. Employees want better wages, working conditions, and pensions; suppliers want prompt payment for their goods; and consumers want higher-quality goods at lower prices. These often-conflicting demands lead advocates of a managerial theory of social responsibility to argue that the firm must have the trust of all groups, both internal and external. Thus, it must have clear ethical standards and a sense of social responsibility for its unintended acts in order to maximize profits and to survive in both the short and long runs. A firm that seeks to maximize short-run profits and ignores the claims of groups, whether they be unions, consumer activists, or government regulators, will not be able to survive in the complex environment in which business operates.

If one reviews the Union Carbide India Ltd. incident described earlier, it is clear that the explosion in Bhopal, India, had at least three consequences: (1) It precipitated an attempt by GAF to take over the company. (2) Union Carbide made a successful but costly attempt to fight off this takeover. (3) The value of the stock decreased and, thus, the investors suffered large losses. Advocates of managerial theory would point to the investors' trust in management's ability to deal with this disaster as being important to how the market evaluated Union Carbide's stock. They also would argue that when its Tylenol product was tampered with (poisoned), the management of Johnson & Johnson took decisive action and was, thus, perceived by investors and customers as being trustworthy. As a result, Johnson & Johnson stock value recovered relatively quickly after the incident.

In the following case, note the conflicting claims of stakeholders.

**CASE 8-3**

**Cooper Industries v. Leatherman Tool Group, Inc.**

*United States Supreme Court 121 S. Ct. 1678 (2001)*

Leatherman (plaintiff) sued Cooper (defendant) in federal district court for unfair competition. Leatherman Tool Group, Inc., manufactured and sold a multifunctional tool called the PST that improved on the classic Swiss Army knife. Leatherman dominated the market for multifunctional pocket tools.

In 1995, Cooper Industries, Inc., decided to design and sell a competing multifunctional tool under the name “ToolZall.” Cooper introduced the ToolZall in August 1996 at the National Hardware Show in Chicago. At that show, Cooper used photographs in its posters, packaging, and advertising materials that purported to

---

be a ToolZall but were actually of a modified PST. When those materials were prepared, the first of the ToolZalls had not yet been manufactured. A Cooper employee created a ToolZall “mock-up” by grinding the Leatherman trademark off a PST and substituting the unique fastenings that were to be used on the ToolZall. At least one of the photographs was retouched to remove a curved indentation where the Leatherman trademark had been. The photographs were used not only at the trade show, but also in marketing materials and catalogs used by Cooper’s sales force throughout the United States.

The lower court found for Leatherman in the amount of $50,000 in compensatory damages and $4.5 million in punitive damages. Cooper appealed, but the court of appeals affirmed the lower court’s decision, seeing no “abuse of discretion” by the lower court as to punitive damages. Cooper appealed to the U.S. Supreme Court, petitioning for a de novo review of the facts as to the size of the punitive damages.

 Justice Stevens

Although compensatory damages and punitive damages are typically awarded at the same time by the same decision maker, they serve distinct purposes. The former are intended to redress the concrete loss that the plaintiff has suffered by reason of the defendant’s wrongful conduct. The latter, which have been described as “quasi-criminal,” operate as private fines intended to punish the defendant and to deter future wrongdoing. A jury’s assessment of the extent of a plaintiff’s injury is essentially a factual determination, whereas its imposition of punitive damages is an expression of its moral condemnation. The question [of] whether a fine is constitutionally excessive calls for the application of a constitutional standard to the facts of a particular case, and in this context de novo review of that question is appropriate.

Reversed and remanded based on a de novo standard in favor of Cooper, to determine whether the punitive damage award is excessive.

INSTITUTIONAL SCHOOL

Advocates of an institutional school of social responsibility for business argue that business entities have a responsibility to act in a manner that benefits all of society, just as churches, unions, courts, universities, and governments have. Whether it is a sole proprietorship, a partnership, or a corporation, a business is a legal entity in our society that must be held responsible for its activities. Proponents of this theory argue that the same civil and criminal sanctions should be applied to business activities that injure the social fabric of a society (e.g., the pollution of water and air) as are applied to acts of individuals and of other institutions. When managers fail to deal adequately with “externalities,” they should be held accountable not only to their boards of directors, but also to government enforcement authorities and individual citizens as well.

PROFESSIONAL OBLIGATION SCHOOL

Advocates of a professional obligation school of social responsibility state that business managers and members of boards of directors should be certified as “professionals” before they are allowed to assume managerial responsibility. In our discussion of professional ethical codes, we defined professionals as persons who are subject to (1) educational entrance requirements and continuing education standards, (2) licensing-examination requirements, (3) codes of conduct that are enforced, (4) a formal association that meets regularly, and (5) an independent commitment to the public interest. Advocates of a professional obligation theory argue that business directors and managers, like doctors and lawyers, have a responsibility to the public beyond merely making profits, and that the public must thus be able to be sure that these people are qualified to hold their positions. They should be licensed by meeting university requirements and passing a state or a national test. They should be subject to a disciplinary code that could involve revocation or suspension of their license to “practice the management of a business” if they are found by state or national boards to have failed to meet their codified responsibilities. Such responsibilities would include accountability for the unintended effects of their profit-making activities (externalities).
REGULATION SCHOOL

A regulation school of social responsibility sees all business units as accountable to elected public officials. Proponents of this theory argue that, because business managers are responsible only to a board of directors that represents shareholders, the corporation cannot be trusted to act in a socially responsible manner. If society is to be protected from the unintended effects of profit-making business activities (e.g., pollution, sex discrimination in the workplace, and injuries to workers), it is necessary for government to be involved.

The degree of government involvement is much debated by advocates of this theory. Some argue in the extreme for a socialist state. Others argue for government representatives on boards of directors, and still others argue that government should set up standards of socially responsible conduct for each industry. The last group advocates an annual process of reporting conduct, both socially responsible and otherwise, similar to the independent financial audits now required by the SEC of all publicly registered firms. The growth of ethics offices within corporations has played a role in dealing with ethical and legal problems. Sometimes these offices are mandated by courts when sentencing takes place in white-collar criminal cases. Often corporations set up such offices as preventive measures.

CASE 8-4

Fog Cutter Capital Group v. Securities and Exchange Commission
U.S. Court of Appeals, District of Columbia Circuit
474 F.3d 822 (2007)

The National Association of Securities Dealers (NASD) operated an electronic exchange on which Fox Cutter Capital Group was listed. Stocks and bonds are sold on exchanges like the NASD’s, but are generally supervised by the SEC. Andrew Wiederhorn had founded Fog Cutter in 1997 to manage a restaurant chain and make other investments. With family members, Wiederhorn controlled more than 50 percent of Fog Cutter’s stock. The firm agreed that if Wiederhorn was terminated “for cause,” he was entitled only to his salary through the date of termination. If terminated “without cause,” he would be owed three times his $350,000 annual salary, three times his largest annual bonus from the previous three years, and any unpaid salary and bonuses. “Cause” included the conviction of a felony.

In 2001, Wiederhorn became the target of an investigation into the collapse of Capital Consultants, LLC. Fog Cutter then redefined “cause” in his termination agreement to cover only a felony involving Fog Cutter. In June 2004, Wiederhorn agreed to plead guilty to two felonies, serve 18 months in prison, pay a $25,000 fine, and pay $2 million to Capital Consultants. The day before he entered his plea, Fog Cutter agreed that while he was in prison, he would keep his title, responsibilities, salary, bonuses, and other benefits. It also agreed to a $2 million “leave of absence payment.”

In July, the NASD delisted Fog Cutter from the NASDAQ. Fog Cutter appealed this decision to the Securities and Exchange Commission (SEC), which dismissed the appeal. Fog Cutter petitioned the U.S. Court of Appeals for the District of Columbia Circuit for review.

Justic Randolph

Fog Cutter’s main complaint is that the Commission failed to take into account the company’s sound business reasons for acting as it did. The decision to enter into the leave-of-absence agreement was, Fog Cutter argues, in the best interest of its shareholders. The company tells us that Wiederhorn’s continuing commitment to the company and his return to an active role in the company after his incarceration were essential to preserving Fog Cutter’s core business units.

Fog Cutter made a deal with Wiederhorn that cost the company $4.75 million in a year in which it reported a $4.94 million net loss. We know as well that Fog Cutter handed Wiederhorn a $2 million bonus right before he went off to prison, a bonus stemming directly from the consequences of Wiederhorn’s criminal activity.

Here there was ample evidence supporting the NASD’s grounds for taking action against Fog Cutter: Wiederhorn’s guilty plea, the leave-of-absence deal and its cost to the
Global Dimensions of Ethics
and Social Responsibility

CODE OF CONDUCT FOR TRANSNATIONAL CORPORATIONS

A United Nations effort to prevent misconduct by transnational corporations has been promulgated. Four objectives include:

1. Respect for national sovereignty in countries where such companies operate. Often transnational companies operate in developing nations where governments are less stable and more corrupt, making this goal very difficult to achieve.

2. Adherence to sociocultural values. The code seeks to prevent transnational companies from imposing value systems that are detrimental to those of the host country.

3. Respect for human rights. Companies should not discriminate on the basis of race, color, sex, religion, language, or political or other opinion. In developing nations, achievement of this goal is sometimes very difficult when the host country does discriminate on the basis of some of these factors.

4. Abstention from corrupt practices. Transnational corporations shall refrain from the offering, promising, or giving of any payment, gift, or other advantage to a public official or refrain from performing a duty in accordance with a business transaction.

SUMMARY

We have sought to define ethics and social responsibility within the context of business associations. We examined consequential theories of ethics based on the consequences of the company’s actions. Deontological schools of ethics, in contrast, are based on duties. Humanist theories of ethics evaluate actions as good or bad based on how the actions improved inherent human capacities.

This chapter also examined codes of ethics emanating from businesses and professions. It discussed five schools of social responsibility based on the unintended effects of corporate and human conduct. Finally, global dimensions of ethical and socially responsible conduct are highlighted, through an examination of the United Nations’ Code of Conduct for Transnational Corporations.

REVIEW QUESTIONS

8-1 Define the humanist theory of ethics. On the basis of this theory and a reading of the Union Carbide case synopsis, do you think that Union Carbide acted ethically after the Bhopal incident? Explain.

8-2 List the differing views on whether corporations should act in a socially responsible manner. Explain each one.

8-3 How are professional codes of ethics different from individual codes? Explain.

8-4 What actions are typically forbidden by corporate codes? Explain.

8-5 Why are industry ethical codes generally ineffective? Explain.

REVIEW PROBLEMS

8-6 A, a middle-level manager of Drug Company X, has been told by her boss, B, to change some figures on the percentage of rats that died as a result of injections of a new drug for which Company X is seeking Food and Drug Administration approval. The percentage of animals that died in the testing must be reported as lower, she is told. A is the single mother of two children and makes $65,000 a year. Choose one ethical theory outlined in the chapter and, on the basis of that theory, advise A what to do.

8-7 B knows that 200 percent cost overruns exist because of the negligence of Company Y’s management in carrying out a federal government contract to build an airplane. B works in the comptroller’s office of Company Y and has been told by his boss to “keep his mouth shut” when the auditors from the General Accounting Office (a government agency) come. He is told that there will be “severe consequences” if he does not keep quiet. B earns $65,000 annually and is the father of three children who are attending private colleges. His wife works at home but is not compensated. Select a single ethical theory and, on the basis of that theory, advise B what he should do.

8-8 C, a student at University Z, discovers a method of bypassing the telephone system that allows him to make free telephone calls. C tells his roommate, D, about this method. How would you advise D to act, based on one of the ethical theories discussed in this chapter?

8-9 You are hiring a new manager for your department. You have several good applicants. Assume that the one who is best suited for the job in terms of training and experience has also been found to have done one of the things in the following list. How would knowing what this person has done affect your decision? Would your answer be the same regardless of which theory of ethical thought you applied? Examine each factual situation in the list and explain how your answer is affected.

1. The individual listed on his résumé that he had an MBA from Rutgers. He does not have an MBA.
2. The individual listed that his prior salary was $40,000. The prior salary was actually $43,000.
8-10  You are a purchasing manager for Alpha Corporation. You are responsible for buying two $1 million generators. Your company has a written policy prohibiting any company buyer from receiving a gratuity in excess of $50 and requiring that all gratuities be reported. The company has no policy regarding whistleblowing. A salesperson for a generator manufacturer offers to arrange it so that you can buy a $20,000 car for $7,000 from a third party. You decline the offer. Do you now report it to your superior? To the salesperson’s superior? How would the various schools of social responsibility influence your decision? Pick one school and use its tenets to justify your decision. Explain.

8-11  You are a laboratory technician for the Ethical Drug Company. You run tests on animals and prepare a summary that is then doctored by your superior to make a drug appear safe when in fact it is not. Your supervisor determines your salary and has significant influence on whether you keep your job. You are the sole source of support for your two children, have no close relative to help you, and are just barely making it financially. Jobs equivalent to yours are difficult to find. You are convinced that if the company markets the drug, the risk of cancer to the drug users will increase significantly. The drug provides significant relief for hemorrhoids. What will you do? Which school of social responsibility would be the basis for your decision? Explain.

CASE PROBLEMS

8-12  Samara Brothers, Inc. (Samara), is a designer and manufacturer of children’s clothing. The core of Samara’s business is its annual new line of spring and summer children’s garments. Samara sold its clothing to retailers, which in turn sold the clothes to consumers. Wal-Mart Stores, Inc. (Wal-Mart), operates a large chain of budget warehouse stores that sell thousands of items at very low prices. In 1995, Wal-Mart contacted one of its suppliers, Judy-Philippine, Inc. (JPI), about the possibility of making a line of children’s clothes just like Samara’s successful line. Wal-Mart sent photographs of Samara’s children’s clothes to JPI (the name “Samara” was readily discernible on the labels of the garments) and directed JPI to produce children’s clothes exactly like those in the photographs. JPI produced a line of children’s clothes for Wal-Mart that copied the designs, colors, and patterns of Samara’s clothing. Wal-Mart then sold this line of children’s clothing in its stores, making a gross profit of more than $1.15 million on these clothes during the 1996 sales season. Samara discovered that Wal-Mart was selling the knock-off clothes at a price that was lower than Samara’s retailers were paying Samara for its clothes. After sending unsuccessful cease-and-desist letters to Wal-Mart, Samara sued Wal-Mart, alleging that Wal-Mart had copied Samara’s trade dress (i.e., look and feel) in violation of Section 43(a) of the Lanham Act. Although it did not find that Samara’s clothes had acquired a secondary meaning in the minds of the public, the district court held in favor of Samara and awarded damages. The court of appeals affirmed. Wal-Mart appealed to the U.S. Supreme Court. Was it ethical conduct for Wal-Mart to sell the alleged knock-off clothes at a lower price? Wal-Mart v. Samara Bros., 529 U.S. 205 (2000).

8-13  McDonald’s Corporation operates the largest fast-food restaurant chain in the United States and the world. It produces such famous foods as the “Big Mac” hamburger, chicken “McNuggets,” the egg “McMuffin,” French fries, shakes, and other foods. A McDonald’s survey showed that 22 percent of its customers are “Super Heavy Users,” meaning that they eat at McDonald’s at least 10 times a month, and usually more. Super Heavy Users make up approximately 75 percent of McDonald’s sales. The survey also found that 72 percent of McDonald’s customers were “Heavy Users,” meaning that they ate at McDonald’s at least once a week.

Jazlen Bradley consumed McDonald’s foods her entire life, during school lunch breaks and before and after school, approximately five times per week, ordering two meals per day. When Bradley was 19 years old, she sued McDonald’s Corporation for causing her obesity and health problems associated with obesity.

Plaintiff Bradley sued McDonald’s in U.S. district court for violating the New York Consumer Protection Act, which prohibits deceptive and unfair acts. She alleged that McDonald’s misled her, through its advertising campaigns and other publicity, to believe that its food products were nutritious, of a beneficial nutritional nature, and easily part of a healthy lifestyle if consumed on a daily basis. The plaintiff sued on behalf of herself and a class of minors residing in New York state who purchased and consumed McDonald’s products. McDonald’s filed a motion with the district court to dismiss the plaintiff’s complaint. To which ethical school of thought does McDonald’s belong? Bradley v. McDonald’s, 2003 U.S. Dist. LEXIS 15202, 2003 WL 22052778 (S.D.N.Y. Sept. 3, 2003).
The Johns-Manville Corporation made a variety of building and other products. It was a major producer of asbestos, which was used for insulation in buildings. It has been medically proven that excessive exposure to asbestos causes asbestosis, a fatal lung disease. Thousands of employees of the company and consumers who were exposed to asbestos and had contracted this fatal disease sued the company for damages.

In response, the company filed for reorganization bankruptcy. It argued that if it did not, an otherwise viable company that provided thousands of jobs and served a useful purpose in this country would be destroyed, and that without the declaration of bankruptcy a few of the plaintiffs who filed their lawsuits first would win awards of millions of dollars, leaving nothing for the remainder of the plaintiffs. Under the bankruptcy court’s protection, the company was restructured to survive. As part of the release from bankruptcy, the company contributed money to a fund to pay current and future claimants. The fund was not large enough to pay all injured persons the full amount of their claims.

Was it ethical for Johns-Manville to declare bankruptcy? Select a school of social responsibility that the board of directors might use to rationalize its conduct in declaring bankruptcy. Explain.


Richard Fraser was an “exclusive career insurance agent” under a contract with Nationwide Mutual Insurance Co. Fraser leased computer hardware and software from Nationwide for his business. During a dispute between Nationwide and the Nationwide Insurance Independent Contractors Association, an organization representing Fraser and other exclusive career agents, Fraser prepared a letter to Nationwide competitors asking whether they were interested in acquiring the represented agents’ policyholders. Nationwide obtained a copy of the letter and searched its electronic file server for e-mail indicating that the letter had been sent. It found a stored e-mail that Fraser had sent to a coworker indicating that the letter had been sent to at least one competitor. The e-mail was retrieved from the coworker’s file of already received and discarded messages stored on the server. When Nationwide canceled its contract with Fraser, he filed a suit in a federal district court against the firm, alleging, among other things, violations of various federal laws prohibiting the interception of electronic communications during transmission.


Charles Zandford was a securities broker for Prudential Securities, Inc., in Annapolis, Maryland. In 1987, he persuaded William Wood, an elderly man in poor health, to open a joint investment account for himself and his mentally retarded daughter. The stated investment objectives for the account were “safety of principal and income.” The Woods gave Zandford discretion to manage their account and to engage in transactions for their benefit without prior approval. Relying on Zandford’s promise to “conservatively invest” their money, the Woods entrusted him with $419,255. Zandford immediately began writing checks to himself on the account. Paying the checks required selling securities in the account. Before William’s death in 1991, all of the money was gone. Zandford was convicted of wire fraud and sentenced to more than four years in prison. The SEC filed a suit in a federal district court against Zandford, alleging in part misappropriation of $343,000 of the Woods’ securities and seeking disgorgement of that amount.


Disbarment of Lawyers

Egil Krogh, Jr., was admitted [to practice] law in the state of Washington on September 20, 1968. On February 4, 1974, he was suspended as a result of his having been convicted of a felony. [Krogh now appeals the disciplinary board’s decision to disbar him.]

The information referred to in the complaint charged that while the respondent was an officer and employee of the United States Government . . . and acting in his official capacity, in conjunction with others who were officials and employees of the United States Government, the defendant unlawfully, willfully and knowingly did combine, conspire, confederate and agree with his co-conspirators to injure, oppress, threaten and intimidate Dr. Lewis J. Fielding . . . in the free exercise and enjoyment of a right and privilege secured to him by the Constitution and laws of the
The court's decision hinges on the ethical norm of upholding the Constitution and the rights of citizens. The respondent, in his position of power, was expected to adhere to the principles he had sworn to uphold. The fact that he authorized such an action, knowing it would reflect discredit on his profession, is especially powerful in shaping the court's reasoning. The court found that the respondent was not aware of the potential consequences of his actions.

Th[e] rule [that attorneys are disbarred automatically when they are found guilty of a felony] still governs the disposition of such disciplinary proceedings in a number of jurisdictions. However, under our disciplinary rules, some flexibility is permitted, and the court retains its discretionary power to determine whether, on the facts of the particular case, the attorney should be disbarred.

We cannot accept the assumption that attorneys . . . can ordinarily be expected to abandon the principles which they have sworn to uphold, when asked to do so by a person who holds a constitutional office. Rather than being overseen by the authority of one who holds such an office . . . the attorney who is employed by such an officer should be the most keenly aware of the Constitution and all of its provisions, the most alert to discourage the abuse of power. In such a position those powers of discernment and reason, which he holds himself out as possessing, perform their most important function. If, when given a position of power himself, he forgets his oath to uphold the Constitution and laws of the land and instead [flouts] the constitutional rights of other citizens and holds himself above the law, can we say to the public that a person so weak in his dedication to constitutional principles is qualified to practice law?

The reputation and honor of the bar have suffered severe damage as a result. We find it difficult to believe that the respondent was not aware, when he authorized the burglary of Dr. Fielding's office, that if his conduct became known, it would reflect discredit upon his profession.

For the reasons set forth herein, we must conclude that the respondent, in spite of his many commendable qualities and achievements, has shown himself to be unfit to practice law.

The recommendation of the disciplinary board is approved, and the respondent's name shall be stricken from the roll of attorneys in this state.

1. What ethical norm is central to the court's decision in this case?
2. What fact seems especially powerful in shaping the court's reasoning?
3. What reasons does the court provide for upholding the respondent's disbarment?
4. Outline the reasons why Egil Krogh, Jr., believed he should not be disbarred by the disciplinary board of the State of California.

ASSIGNMENT ON THE INTERNET

This chapter introduces you to three theories of ethical thought and five schools of social responsibility. Explore how the three theories of ethical thought are put into practice. Using the Internet, find the code of ethics for a business or corporation that does business in your city or town. This site provides links to codes of ethics for hundreds of corporations:


Applying your critical thinking skills, determine if the chosen code of ethics relies more heavily on one theory of ethical thought than the others. Are there aspects of that business's code of ethics that you would like to see changed? Why?
www.business-ethics.com This site provides codes of ethics from hundreds of corporations and articles detailing current trends or methods of bringing ethics into the business environment.

ethics.acusd.edu/index.html Ethics Updates is designed to be used primarily by ethics instructors and their students, to provide updates on current literature.

www.legalethics.com This comprehensive ethics page provides numerous links to other valuable Web sites.

www.ethicsweb.ca/resources/business/institutions.html This site contains links to numerous business ethics centers and institutions, as well as business ethics consultants.

www.mapnp.org/library/ethics/ethics.htm#anchor1419177 This site provides information on managing ethics in the workplace. A number of links also address the social responsibility of a business.

www.globalethics.org The Web site for the Global Ethics Institute provides information about business ethics from countries around the world.

FOR FUTURE READING


The International Legal Environment of Business

- DIMENSIONS OF THE INTERNATIONAL ENVIRONMENT OF BUSINESS
- METHODS OF ENGAGING IN INTERNATIONAL BUSINESS
- RISKS OF ENGAGING IN INTERNATIONAL BUSINESS
- LEGAL AND ECONOMIC INTEGRATION AS A MEANS OF ENCOURAGING INTERNATIONAL BUSINESS ACTIVITY
- GLOBAL DISPUTE RESOLUTION

At the outset of Chapter 2, we noted that U.S. managers can no longer afford to view their firms as doing business on a huge island between the Pacific and the Atlantic Oceans. Existing and pending multilateral trade agreements open vast opportunities to do business in Europe and Asia, throughout the Americas, and indeed throughout the world. If present and future U.S. managers do not become aware of these opportunities, as well as the attendant risks, they and their firms will be at a competitive disadvantage vis-à-vis foreign competitors from all over the world.

CRITICAL THINKING ABOUT THE LAW

This chapter (1) introduces the international environment of business; (2) sets forth the methods by which companies may engage in international business; (3) indicates the risks involved in such engagement; (4) describes organizations that work to bring down tariff barriers and, thus, encourage companies of all nations to engage in international business; and (5) identifies the means by which disputes between companies doing business in the international arena are settled. Please note carefully that when we use the word companies in an international context, we are referring not only to private-sector firms, but also to nation-state subsidized entities and government agencies that act like private-sector companies.

Because of today’s widespread international opportunities and advances in communication, business managers must be aware of the global legal environment of business. As you will soon learn, the political, economic, cultural, and legal dimensions are all important international business considerations. The following questions will help sharpen your critical thinking about the international legal environment of business.

1. Consider the number of countries that might participate in an international business agreement. Why might ambiguity be a particularly important concern in international business?
   
   **Clue:** Consider the variety of cultures as well as the differences in languages. How might these factors affect business agreements?
2. Why might the critical thinking questions about ethical norms and missing information be important for international businesses?
   
   Clue: Again, consider the variety of cultures involved in international business. Why might identifying the primary ethical norms of a culture be helpful?

3. What ethical norm might influence an entity’s willingness to enter into agreements with foreign companies?
   
   Clue: How might international agreements differ from agreements between two U.S. companies?

---

**Dimensions of the International Environment of Business**

Doing international business has political, economic, cultural, and legal dimensions. Although this chapter emphasizes the legal dimensions of international business transactions, business managers need to be aware of those other important dimensions as well. (Ethical dimensions were examined in Chapter 8.)

**POLITICAL DIMENSIONS**

Managers of firms doing international business must deal with different types of governments, ranging from democracies to totalitarian states. They are concerned with the stability of these governments and with whether economic decisions are centralized or decentralized. In the Marxist form of government, such as that which existed in the former Soviet Union and in Eastern Europe until the 1990s, economic decisions were centralized, and there was political stability. This would seem to be an ideal environment in which to do business from a multinational business manager’s perspective. But it was not ideal, because a centralized economy limits the supply of goods coming from outside a country, the price that can be charged for goods inside the country, and the amount of currency that can be taken out of the country by multinational businesses.

In 1998, 88 of the world’s 191 countries were categorized as “free” in the sense that they were perceived as having high political and civil liberties (e.g., Australia, Belgium, Luxembourg, Finland, and the United States, to name a few). Fifty-three countries were classified as “partly free” because they enjoyed limited political rights and civil liberties (e.g., Egypt, China, Ethiopia, and North Korea). A trend toward democratization seems to be under way. The percentages of the total population living in free, partly free, and not free conditions in more recent years are as follows:

<table>
<thead>
<tr>
<th></th>
<th>1990</th>
<th>1998</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Free</td>
<td>38.9</td>
<td>21.7</td>
<td>41.4</td>
</tr>
<tr>
<td>Partly free</td>
<td>21.8</td>
<td>39.1</td>
<td>23.2</td>
</tr>
<tr>
<td>Not free</td>
<td>19.0</td>
<td>39.2</td>
<td>35.4</td>
</tr>
</tbody>
</table>

Despite the collapse of communism and the development of new political systems professing support of free enterprise in Eastern Europe and throughout the former Soviet Union, companies in the industrialized nations have delayed investing in some of these areas because they are uncertain of these areas’ political stability and willingness to adhere to economic agreements. In the People’s Republic of China (PRC or China), an early rush to invest was slowed by foreign companies’ experiences with a seemingly capricious government.

---

2 Adrian Karatnycky, *Freedom in the World* 6 (Freedom House, 2002).
For example, McDonald’s leased a prime location in Beijing from the centralized government but found itself ousted a few years later when the government revoked the lease to allow a department store to be built on that site. Moreover, doubts about the Chinese government’s intention to honor its agreement with the British government—that Hong Kong would retain its separate political and economic status for 50 years after the 99-year British lease expired in 1997—led one long-time Hong Kong trading company, Jardine, to move its headquarters to the Bahamas. In 2010, China’s monitoring of Google users’ Internet communications prompted Google initially to move most of its activities to Hong Kong, a district now belonging to China. Three months later, China rejected the scheme. Google, instead of continuing to reroute queries to its Hong Kong engine, started sending visitors to a new “landing page” that linked to the Hong Kong Web site where users could perform searches beyond the reach of Chinese censors. Later in 2010, a compromise was reached. China allowed Google to operate in China if it tweaked its mainland search box to ask users if they still wanted to have communications sent to the Hong Kong site. Chinese users of Google thus had a choice, and both the Chinese government and Google saved face. Despite these political problems, China’s growth rate in 2007–2009 proceeded at an annual gross domestic product (GDP) of 10–12 percent. Further, China has brought investment capital to Latin American, Asian, and African nations. It is searching for minerals and energy to develop its infrastructure. As this search continues, China’s political influence spreads worldwide.

**ECONOMIC DIMENSIONS**

Every business manager should do a country analysis before deciding to do business in another nation-state. Such an analysis not only examines political variables, but also dissect a nation’s economic performance as demonstrated by its rate of economic growth, inflation, budget, and trade balance. Four economic factors in particular affect business investment:

1. **Differences in size and economic growth rate** of various nation-states. For example, when McDonald’s decided to engage in international business, the company initially located its restaurants only in countries that already had high growth rates. As more and more developing nations moved toward a market economy, McDonald’s expanded into Russia, China, Brazil, Mexico, and other countries deemed to have potentially high growth rates.

2. **The impact of central planning versus a market economy** on the availability of supplies. When McDonald’s went into Russia, it had to build its own food-processing center to be certain it would get the quality of beef it needed. Furthermore, because of distribution problems, it used its own trucks to move supplies.

3. **The availability of disposable income.** This is a tricky issue. Despite the fact that the price of a Big Mac, french fries, and a soft drink equals the average Russian worker’s pay for four hours of work, McDonald’s is serving thousands of customers a day at its Moscow restaurant.

4. **The existence of an appropriate transportation infrastructure.** Decent roads, railroads, and ports are needed to bring in supplies and then transport them within the host country. McDonald’s experience in Russia is commonplace. Multinational businesses face transportation problems in many developing countries.

The World Bank classifies economies into one of the following categories according to per capita gross national product (GNP):³

CULTURAL DIMENSIONS

Culture may be defined as learned norms of a society that are based on values, beliefs, and attitudes. For example, if people of the same area speak the same language (e.g., Spanish in most of Latin America, with the exception of Brazil and a few small nations), the area is often said to be culturally homogeneous. Religion is a strong builder of common values. In 1995, the Iranian government outlawed the selling and use of satellite communications in Iran on the grounds that they presented “decadent” Western values that were undermining Muslim religious values. Now, in 2010, it monitors Internet communications, which has led to some U.S. congresspersons to seek a ban on all trade with Iran.

A failure to understand that some cultures are based on ascribed group membership (gender, family, age, or ethnic affiliation) rather than on acquired group membership (religious, political, professional, or other associations), as in the West, can lead to business mistakes. For example, gender- and family-based affiliations are very important in Saudi Arabia, where a strict interpretation of Islam prevents women from playing a major role in business. Most Saudi women who work hold jobs that demand little or no contact with men, such as teaching or acting as doctors only for women.

Another important cultural factor is the attitude toward work. Mediterranean and Latin American cultures base their group affiliation on family and place more emphasis on leisure than on work. We often say that the Protestant ethic, stressing the virtues of hard work and thrift, is prevalent in Western and other industrialized nations. Yet the Germans refuse to work more than 35 hours a week and take 28 days of paid vacation every year. The average hourly wage is higher in Germany than in the United States, and German workers’ benefits far outpace those of U.S. workers.

Business managers must carefully consider language, religion, attitudes toward work and leisure, family versus individual reliance, and numerous other cultural values when planning to do business in another nation-state. They also need to find a method of reconciling cultural differences between people and companies from their own nation-state and those from the country in which they intend to do business.

CORRUPTION AND TRADE

The nature of trade between nations, between multinationals, and between multinationals and nation-states has led to global competition, and sometimes bribery, and thus corruption (see the “Corruption Perception Index” from Transparency International in the “Comparative Law Corner” feature later in this chapter). Attempts to lessen such bribery and corruption through bilateral and multilateral agreements have been led by the United States Foreign Corrupt Practices Act of 1977 (FCPA) and the Convention on Combating Bribery of Foreign Officials in International Business Transactions (CCBFOIBT) drafted by the Organization for Economic Cooperation and Development (OECD) and signed by 34 countries. The Convention adopts the standards of the FCPA. Chapter 26 provides additional details governing both acts.
David Kay (defendant) was an American citizen and a vice president for marketing of American Rice, Inc. (ARI), who was responsible for supervising sales and marketing in the Republic of Haiti. Douglas Murphy (defendant) was an American citizen and president of ARI.

Beginning in 1995 and continuing to about August 1999, Kay, Murphy, and other employees and officers of ARI paid bribes and authorized the payment of bribes to induce customs officials in Haiti to accept bills of lading and other documents that intentionally understated the true amount of rice that ARI shipped to Haiti for import, thus reducing the customs duties owed by ARI and RCH to the Haitian government.

In addition, beginning in 1998 and continuing to about August 1999, Kay and other employees and officers of ARI paid and authorized additional bribes to officials of other Haitian agencies to accept the false import documents and other documents that intentionally understated the true amount of rice being imported into and sold in Haiti, thereby reducing the amount of sales taxes paid to the Haitian government.

Kay directed employees of ARI to prepare two sets of shipping documents for each shipment of rice to Haiti, one that was accurate and another that falsely represented the weight and value of the rice being exported to Haiti.

Kay and Murphy agreed to pay and authorized the payment of bribes, calculated as a percentage of the value of the rice not reported on the false documents or in the form of a monthly retainer, to customs and tax officials of the Haitian government to induce these officials to accept the false documentation and to assess significantly lower customs duties and sales taxes than ARI would otherwise have been required to pay.

ARI, using official Haitian customs documents reflecting the amounts reported on the false shipping documents, reported only approximately 66 percent of the rice it sold in Haiti and thereby significantly reduced the amount of sales taxes it was required to pay to the Haitian government.

In 2001, a grand jury charged Kay with violating the FCPA and subsequently returned the indictment, which charged both Kay and Murphy with 12 counts of FCPA violations. Both Kay and Murphy moved to dismiss the indictment for failure to state an offense, arguing that obtaining favorable tax treatment did not fall within the FCPA definition of payments made to government officials in order to obtain business. The district court dismissed the indictment, and the United States of America appealed.

Justice Wiener

The principal dispute in this case is whether, if proved beyond a reasonable doubt, the conduct that the indictment ascribed to defendants in connection with the alleged bribery of Haitian officials to understate customs duties and sales taxes on rice shipped to Haiti to assist American Rice, Inc. in obtaining or retaining business was sufficient to constitute an offense under the FCPA. Underlying this question of sufficiency of the contents of the indictment is the preliminary task of ascertaining the scope of the FCPA, which in turn requires us to construe the statute.

Because an offense under the FCPA requires that the alleged bribe be committed for the purpose of inducing foreign officials to commit unlawful acts, the results of which will assist in obtaining or retaining business in their country, the questions before us in this appeal are (1) whether bribes to obtain illegal but favorable tax and customs treatment can ever come within the scope of the statute, and (2) if so, whether, in combination, there are minimally sufficient facts alleged in the indictment to inform the defendants regarding the nexus between, on the one hand, Haitian taxes avoided through bribery, and, on the other hand, assistance in getting or keeping some business or business opportunity in Haiti.

No one contends that the FCPA criminalizes every payment to a foreign official: It criminalizes only those payments that are intended to (1) influence a foreign official to act or make a decision in his official capacity, or (2) induce such an official to perform or refrain from performing some act in violation of his duty, or (3) secure

In this text, Chapter 24, you will find a brief discussion of the FCPA provisions that forbid payments to foreign officials when those amounts are more than “grease payments.” “Facilitating payments” made to obtain permits, licenses, or other official documents associated with contract performance, or movement of goods across a country, are considered lawful. The Justice Department, as well as other agencies and individuals, may enforce the FCPA. Activities that constitute a bribe are often the basis for legal action. The case excerpted here deals with this problem.
some wrongful advantage to the payor. And even then, the FCPA criminalizes these kinds of payments only if the result they are intended to produce—their quid pro quo—will assist (or is intended to assist) the payor in efforts to get or keep some business for or with “any person.”

Stated differently, how attenuated can the linkage be between the effects of that which is sought from the foreign official in consideration of a bribe (here, tax minimization) and the briber’s goal of finding assistance or obtaining or retaining foreign business with or for some person, and still satisfy the business nexus element of the FCPA?

Invoking basic economic principles, the SEC reasoned in its amicus brief that securing reduced taxes and duties on imports through bribery enables ARI to reduce its cost of doing business, thereby giving it an “improper advantage” over actual or potential competitors, and enabling it to do more business, or remain in a market it might otherwise leave.

Section 78dd-1(b) excepts from the statutory scope “any facilitating or expediting payment to a foreign official . . . the purpose of which is to expedite or to service the performance of a routine governmental action by a foreign official. . . .” 15 U.S.C. §78dd-1(b).

For purposes of deciding the instant appeal, the question nevertheless remains whether the Senate, and concomitantly Congress, intended this broader statutory scope to encompass the administration of tax, customs, and other laws and regulations affecting the revenue of foreign states. To reach this conclusion, we must ask whether Congress’s remaining expressed desire to prohibit bribery aimed at getting assistance in retaining business or maintaining business opportunities was sufficiently broad to include bribes meant to affect the administration of revenue laws. When we do so, we conclude that the legislative intent was so broad.

Obviously, a commercial concern that bribes a foreign government official to award a contract, to award a construction, supply, or services contract violates the statute. Yet, there is little difference between this example and that of a corporation’s lawfully obtaining a contract from an honest official or agency by submitting the lowest bid, and—either before or after doing so—bribing a different government official to reduce taxes and thereby ensure that the under-bid venture is nevertheless profitable. Avoiding or lowering taxes reduces operating costs and thus increases profit margins, thereby freeing up funds that the business is otherwise legally obligated to expend. And this, in turn, enables it to take any number of actions to the disadvantage of competitors. Bribing foreign officials to lower taxes and customs duties certainly can provide an unfair advantage over competitors and thereby be of assistance to the payor in obtaining or retaining business.

This demonstrates that the question [of] whether the defendants’ alleged payments constitute a violation of the FCPA truly turns on whether these bribes were intended to lower ARI’s cost of doing business in Haiti enough to have a sufficient nexus to garnering business there or to maintaining or increasing business operations that ARI already had there, so as to come within the scope of the business nexus element as Congress used it in the FCPA. Answering this fact question, then, implicates a matter of proof and thus evidence.

Given the foregoing analysis of the statute’s legislative history, we cannot hold as a matter of law that Congress meant to limit the FCPA’s applicability to cover only bribes that lead directly to the award or renewal of contracts. Instead, we hold that Congress intended for the FCPA to apply broadly to payments intended to assist the payor, either directly or indirectly, in obtaining or retaining business for some person, and that bribes paid to foreign tax officials to secure illegally reduced customs and tax liability constitute a type of payment that can fall within this broad coverage. In 1977, Congress was motivated to prohibit rampant foreign bribery by domestic business entities, but nevertheless understood the pragmatic need to exclude innocuous grease payments from the scope of its proposals. The FCPA’s legislative history instructs that Congress was concerned about both the kind of bribery that leads to discrete contractual arrangements and the kind that more generally helps a domestic payor obtain or retain business for some person in a foreign country; and that Congress was aware that this type includes illicit payments made to officials to obtain favorable but unlawful tax treatment.

Reversed and remanded in favor of the United States.

CRITICAL THINKING ABOUT THE LAW

Congressional intent is a guiding principle of judicial interpretation. Here the court is asked to make a judgment about the scope of legislation. It answers that question by examining the purpose of the law and the applicability of that purpose to the facts of this case.

1. What is the difference between bribery and “innocuous grease payments”?
   Clue: For a payment to be innocuous, what effects would it have had to avoid?

2. What ethical norm is advanced by enforcing the statute in this case?
   Clue: How is fairness affected by permitting a firm to escape some of its tax liability?
Corruption generally discourages foreign investment, according to data published by Transparency International in its annual Corruption Perception Index (CPI). The CPI is determined by an annual survey of businesspeople, academicians, and analysts in each of 91 countries. The CPI, in its latest published data, lists Nigeria, Uganda, Indonesia, Bolivia, Kenya, Cameroon, and Russia as countries most prone to corruption. Finland, Denmark, New Zealand, Iceland, Singapore, Sweden, and Canada are perceived as having the least corruption. The United States ranks 17th.a

When doing business with countries where corruption is rampant (e.g., U.S. company trading oil equipment with Nigeria), it would behoove the business managers to learn what “facilitating payments” are lawful under U.S. law (FCPA), and what payments are legal under host-country laws (e.g., Nigerian statutes), if there exist such statutes. Even in countries that have statutes similar to those of the United States, it is also important to check with legal counsel to determine exceptions to host-countries’ laws (e.g., when a U.S. company is trading oil equipment with Canada). In both cases, one should not presume that either Nigerian or Canadian laws are similar with regard to “facilitating payments” (grease payments) as set out in the FCPA.

---

*aCorruption Perception Index, 2009, transparency.org. © 2009 Transparency International e.V.*

### Legal Dimensions

When they venture into foreign territory, business managers have to be guided by the national legal system of their own country and that of the host country, and also by international law.

**National Legal Systems.** When deciding whether to do business in a certain country, business managers are advised to learn about the legal system of that country and its potential impact in such areas as contracts, investment, and corporate law. The five major families of law are (1) common law, (2) Romano-Germanic civil law, (3) Islamic law, (4) socialist law, and (5) Hindu law (Table 9-1).

The common-law family is most familiar to companies doing business in the United States, England, and 26 former British colonies. The source of law
is primarily case law, and decisions rely heavily on case precedents. As statutory law has become more prominent in common-law countries, the courts' interpretation of laws made by legislative bodies and of regulations set forth by administrative agencies has substantially increased the body of common law.

Countries that follow the Romano-Germanic civil law (e.g., France, Germany, and Sweden) organize their legal systems around legal codes rather than around cases, regulations, and precedents, as do common-law countries. Thus, judges in civil-law countries of Europe, Latin America, and Asia resolve disputes primarily by reference to general provisions of codes and secondarily by reference to statutes passed by legislative bodies. As the body of written opinions in civil-law countries grows, and as they adopt computer-based case and statutory systems such as Westlaw and Lexis, however, the highest courts in these countries are taking greater note of case law in their decisions. Civil-law systems tend to put great emphasis on private law, that is, law that governs relationships between individuals and corporations or between individuals. Examples are the law of obligations, which includes common-law contracts, torts, and creditor–debtor relationships. In contrast to common-law systems, civil-law systems have an inferior public law: This is a law that governs the relationships between individuals and the state. In fact, their jurists are not extensively trained in such areas as criminal, administrative, and labor law.4

More than 600 million Muslims in approximately 30 countries that are predominantly Muslim, as well as many more Muslims living in countries where Islam is a minority religion, are governed by Islamic law.5 In many countries, Islamic law, as encoded in the Shari’a, exists alongside the secular law. In nations that have adopted Islamic law as their dominant legal system (e.g., Saudi Arabia), citizens must obey the Shari’a, and anyone who transgresses its rules is punished by a court. International business transactions are affected in many ways by Islamic law. For example, earning interest on money is forbidden (however, Islamic banks have found a way to work around this stricture: in lieu of paying interest on accounts, they pay each depositor a share of the profits made by the bank).

---

5 Id. at 437–38.
Socialist-law systems are based on the teachings of Karl Marx and Vladimir Lenin (who was, incidentally, a lawyer). Right after the Bolshevik Revolution of 1917 in Russia, the Czarist legal system, which was based on the Romano-Germanic civil law, was replaced by a legal system consisting of People’s Courts staffed by members of the Communist Party and peasant workers. By the early 1930s, this system had been replaced by a formal legal system with civil and criminal codes that has lasted to this day. The major goals of the Soviet legal system were to (1) encourage collectivization of the economy; (2) educate the masses as to the wisdom of socialist law; and (3) maintain national security. Most property belonged to the state, particularly industrial and agricultural property. Personal (not private) property existed, but it could be used only for the satisfaction and needs of the individual, not for profit—which was referred to as “speculation” and was in violation of socialist law. Personal ownership ended either with the death of the individual or with revocation of the legal use and enjoyment of the property. Socialist law is designed to preserve the authority of the state over agricultural land and all means of production. It is still enforced in North Korea, Cuba, and to some degree, Libya, but the countries that made up the old Soviet Union and the East European bloc have been moving toward Romano-Germanic civil-law systems and private-market economies in the past decade or so.

Hindu law, called Dharmasastra, is linked to the revelations of the Vedas, a collection of Indian religious songs and prayers believed to have been written between 100 BC and AD 300 or 400. It is both personal and religious. Hindus are divided into social categories called castes, and the rules governing their behavior are set out in texts known as Sastras. The primary concerns of Hindu law are family matters and property succession. Four-fifths of all Hindus live in India; most of the remaining Hindus are spread throughout Southeast Asia and Africa, with smaller numbers living in Europe and the Americas. After gaining independence from England in 1950, India codified Hindu law. Today it plays a prominent role in Indian law alongside secular statutory law, which, especially in the areas of business and trade, uses legal terminology and concepts derived from common law. Both the Indian criminal and civil codes strongly reflect the British common-law tradition. The civil code is particularly important today when issues involving outsourcing to and from India are discussed by the multinationals and governments involved.

Selected National Legal Systems

<table>
<thead>
<tr>
<th>Common Law</th>
<th>Romano-Germanic Civil Law</th>
<th>Islamic Law</th>
<th>Socialist Law</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>Italy</td>
<td>Saudi Arabia</td>
<td>Russia</td>
</tr>
<tr>
<td>Canada</td>
<td>Japan</td>
<td>Kuwait</td>
<td>North Korea</td>
</tr>
<tr>
<td>Great Britain</td>
<td>Mexico</td>
<td>Abu Dhabi</td>
<td>Cuba</td>
</tr>
<tr>
<td>New Zealand</td>
<td>Poland</td>
<td>Iraq</td>
<td>China</td>
</tr>
<tr>
<td>Singapore</td>
<td>France</td>
<td>Indonesia</td>
<td></td>
</tr>
<tr>
<td>Australia</td>
<td>Sweden</td>
<td>Bahrain</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Finland</td>
<td>Libya</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Germany</td>
<td>Algeria</td>
<td></td>
</tr>
</tbody>
</table>

Comment: With the growth of the Internet the classification of each nation’s law has become blurred. Further, former colonies, now independent, inherited legal principles and systems which are mixed with present day principles, customs, and religious rites in many nations.

---

6 Id. at 437–38.
7 Id. at 176–79.
8 Id. at 468–71.
International Law. The law that governs the relationships between nation-states is known as **public international law**. **Private international law** governs the relationships between private parties involved in transactions across national borders. In most cases, the parties negotiate between themselves and set out their agreements in a written document. In some cases, however, nation-states subsidize the private parties or are signatories to the agreements negotiated by those parties. In such instances, the distinction between private and public international law is blurred.

The sources of international law can be found in (1) custom; (2) treaties between nations, particularly treaties of friendship and commerce; (3) judicial decisions of international courts, such as the International Court of Justice; (4) decisions of national and regional courts, such as the U.S. Supreme Court, the London Commercial Court, and the European Court of Justice; (5) scholarly writings; and (6) international organizations. These sources are discussed throughout this text.

**International business law** includes laws governing (1) exit visas and work permits; (2) tax and antitrust matters and contracts; (3) patents, trademarks, and copyrights; (4) bilateral treaties of commerce and friendship between nations and multilateral treaties of commerce such as the North American Free Trade Agreement (NAFTA), the European Union (EU), and the World Trade Organization (WTO). All are explored later in this chapter.

The U.S. Constitution grants the U.S. president the power to enter into treaties, with the advice and consent of the U.S. Senate (two-thirds must concur). The Constitution prohibits a state from entering into “any Treaty, Alliance or Confederation.”[^9] The U.S. Supreme Court, however, has allowed the states to enter into treaties that “do not encroach upon or impair the supremacy of the United States.”[^10] The states’ power to enter into treaties is very limited, as indicated by the following case. This issue has gained some significance in today’s world because states are presently seeking to enter into trade and other agreements independent of the federal government.

---

### CASE 9-2

**Crosby v. National Foreign Trade Council**  
Supreme Court of the United States  
530 U.S. 363 (2000)

In 1996, the Commonwealth of Massachusetts passed a law barring governmental entities in Massachusetts from buying goods or services from companies doing business with Burma (Myanmar). Subsequently, the U.S. Congress enacted federal legislation imposing mandatory and conditional sanctions on Burma. The Massachusetts law was inconsistent with the new federal legislation. The National Foreign Trade Council sued on behalf of its several members, claiming that the Massachusetts law unconstitutionally infringed on the federal foreign-affairs power, violated the Foreign Commerce Clause of the U.S. Constitution, and was preempted by the subsequent federal legislation. The district and appeals courts ruled in favor of the council, and the Commonwealth appealed.

**Justice Souter**  
The Massachusetts law is preempted, and its application is unconstitutional under the Supremacy Clause of the U.S. Constitution. State law must yield to a congressional act if Congress intends to occupy the field, or to the extent of any conflict with a federal statute. This is the case even where the relevant congressional act lacks an express preemption provision. This Court will find preemption where it is impossible for a private party to comply with both state and federal law and where the state law is an obstacle to the accomplishment and execution of Congress’s full purposes and objectives. In this case, the state act is an obstacle to the federal act’s delegation.

[^9]: U.S. Const. art 1, § 10.  
of discretion to the president of the United States to control economic sanctions against Burma. Within the sphere defined by Congress, the statute has given the President as much discretion to exercise economic leverage against Burma, with an eye toward national security, as law permits. It is implausible to think that Congress would have gone to such lengths to empower the President had it been willing to compromise his effectiveness by allowing state or local ordinances to blunt the consequences of his actions—exactly the effect of the state act.

In addition, the Massachusetts law interferes with Congress’s intention to limit economic pressure against the Burmese Government to a specific range. . . . Finally, the Massachusetts law conflicts with the President’s authority to speak for the United States among the world’s nations to develop a comprehensive, multilateral Burma strategy. In this respect, the state act undermines the President’s capacity for effective diplomacy.

The Court affirmed the lower courts in favor of the defendant, National Foreign Trade Council.

Methods of Engaging in International Business

For purposes of this chapter, methods of engaging in international business are classified as (1) trade, (2) international licensing and franchising, and (3) foreign direct investment.

**TRADE**

We define international trade generally as exporting goods and services from a country and importing the same into a country. There are two traditional theories of trade relationships. The theory of absolute advantage, which is the older theory, states that an individual nation should concentrate on exporting the goods that it can produce most efficiently. For example, Sri Lanka (formerly Ceylon) produces tea more efficiently than most countries can and, thus, any surplus in Sri Lanka’s tea production should be exported to countries that produce tea less efficiently. The theory of comparative advantage arose out of the realization that a country did not have to have an absolute advantage in producing a good in order to export it efficiently; rather, it would contribute to global efficiency if it produced specialized products simply more efficiently than others did.

To illustrate this concept, let’s assume that the best attorney in a small town is also the best legal secretary. Because this person can make more money as an attorney, it would be more efficient for her to devote her energy to working as a lawyer and to hire a legal secretary. Similarly, let’s assume that the United States can produce both wheat and tea more efficiently than Sri Lanka can. Thus, the United States has an absolute advantage in its trade with Sri Lanka. Let us further assume that U.S. wheat production is comparatively greater than U.S. tea production vis-à-vis Sri Lanka. That is, by using the same amount of resources, the United States can produce two and a half times as much wheat but only twice as much tea as Sri Lanka. The United States then has a comparative advantage in wheat over tea.11

In this simplified example, we made several assumptions: that only two countries and two commodities were involved; that transport costs in the two countries were about the same; that efficiency was the sole objective; and that political factors were not significant. In international trade, things are far more complex. Many nations and innumerable products are involved, and political factors are often more potent than economic considerations.

Trade is generally considered to be the least risky means of doing international business, because it demands little involvement with a foreign buyer or seller.

---

For small and middle-sized firms, the first step toward involvement in international business is generally to hire an export management company, which is a company licensed to operate as the representative of many manufacturers with exportable products. These management companies are privately owned by citizens of various nation-states and have long-standing links to importers in many countries. They provide exporting firms with market research, identify potential buyers, and assist the firms in negotiating contracts.

Export trading companies, which are governed by the Export Trading Act in the United States, comprise those manufacturers and banks that either buy the products of a small business and resell them in another country or sell products of several companies on a commission basis. Small and medium-sized exporting companies may also choose to retain foreign distributors, which purchase imported goods at a discount and resell them in the foreign or host country. Once a company has had some experience selling in other countries, it may decide to retain a foreign sales representative. Sales representatives differ from foreign distributors in that they do not take title to the goods being exported. Rather, they usually maintain a principal–agent relationship with the exporter.

INTERNATIONAL LICENSING AND FRANCHISING

International licensing is a contractual agreement by which a company (licensor) makes its trade secrets, trademarks, patents, or copyrights (intellectual property) available to a foreign individual or company (licensee) in return either for royalties or for other compensation based on the volume of goods sold or a lump sum. All licensing agreements are subject to restrictions of the host country, which may include demands that its nationals be trained for management positions in the licensee company, that the host government receive a percentage of the gross profits, and that licensor technology be made available to all host-country nationals. Licensing agreements may differ vastly from country to country.

International licensing
Contractual agreements by which a company (licensor) makes its intellectual property available to a foreign individual or company (licensee) for payment.
International franchising

Contractual agreement whereby a company (licensor) permits another company (licensee) to market its trademarked goods or services in a particular nation.

International franchising permits a licensee of a trademark to market the licensor’s goods or services in a particular nation (e.g., Kentucky Fried Chicken franchises in China). Often companies franchise their trademark to avoid a nation-state’s restrictions on foreign direct investment. Also, political instability is less likely to be a threat to investment when a local franchisee is running the business. Companies considering entering into an international franchise agreement should investigate bilateral treaties of friendship and commerce between the franchisor’s nation and the franchisee’s nation, as well as the business laws of the franchisee country.

In some instances, licensing and franchising negotiations are tense and drawn out because businesses in many industrialized nations are intent on protecting their intellectual property against “piracy” or are adamant about getting assurances that franchising agreements will be honored. These are major and legitimate concerns. For example, between 1994 and 1999, the United States threatened to impose sanctions against China because of that nation’s sale of pirated U.S. goods and its failure to comply with international franchising requirements. A series of last-minute agreements encouraged by Chinese and U.S. businesses averted the sanctions, which would have proved expensive for private and public parties in both countries. By the year 2000, Congress and the president of the United States granted normal trade relations with China and left open the opportunity for the latter to join the WTO. In June 2001, with a China–U.S. agreement on agriculture, a major barrier to entrance was overcome.

In November 2001, China and Taiwan entered the WTO after considerable negotiations between the Western nations over many issues. For example, at China’s insistence, all membership documents refer to China as the People’s Republic of China, whereas Taiwan is referred to as the Separate Customs Territory of Taiwan, Penghu, Kinmen, and Matsu. (The latter three islands are under the control of Taiwan.) Taiwan is not recognized as an independent nation but as a territory belonging to the mainland. (See Chapter 26 for a discussion of franchising.)

FOREIGN DIRECT INVESTMENT

Direct investment in foreign nations is usually undertaken only by established multinational corporations. Foreign direct investment may take one of two forms: The multinational either creates a wholly or partially owned and controlled foreign subsidiary in the host country, or enters into a joint venture with an individual, corporation, or government agency of the host country. In both cases, the risk for the investing company is greater than the risk in international trade and international franchising and licensing, because serious amounts of capital are flowing to the host country that are subject to its government’s restrictions and its domestic law.

Large multinationals choose to create foreign subsidiaries for several reasons: (1) to expand their foreign markets; (2) to acquire foreign resources, including raw materials; (3) to improve their production efficiency; (4) to acquire knowledge; and (5) to be closer to their customers and competitors. Rarely do all these reasons pertain in a single instance. For example, U.S. companies have set up foreign subsidiaries in Mexico, Western Europe, Brazil, and India for quite different reasons. Mexico provided cheap labor and a location close to customers and suppliers for U.S. automobile manufacturers. In the case of Western Europe, the impetus was both a threat and an opportunity. The member nations of the EU have been moving to eliminate all trade barriers among themselves, but at the same time imposing stiffer tariffs on goods and services imported from non-EU countries. U.S. companies have been rushing to

---

12 See “Backers Hope China Pact Will Promote Reform,” USA Today 10 (Sept. 20, 2000).
establish foreign subsidiaries in EU countries, not only to avoid being shut out of this huge and lucrative market, but also to expand sales among the EU’s approximately 380 million people. Brazil is not only the largest potential market in Latin America, but it also offers low labor and transportation costs, making it ideal for U.S. automakers desiring to export to neighboring Latin American countries.

Union Carbide, Inc., a producer of chemicals and plastics, decided to establish a subsidiary in India, where cheap labor (including highly skilled chemists and engineers) and low-cost transportation enabled the parent company to produce various materials cheaply and thus boost its bottom line. The Indian subsidiary turned out to be a very expensive investment for Union Carbide after the Bhopal disaster. The civil suit that resulted illustrates an issue that is often overlooked by managers of multinationals when setting up subsidiaries in foreign nation-states: Should a parent corporation be held liable for the activities of its foreign subsidiary? Although the case presented here is framed in a jurisdictional context (whether a U.S. court or an Indian court should hear the suit), bear in mind the issue of corporate parent liability as you read it.

CASE 9-3

In re Union Carbide Corp. Gas Plant Disaster v. Union Carbide Corp.
United States Court of Appeals
809 F.2d 195 (2d Cir. 1987)

The Government of India (GOI) and several private class action plaintiffs (Indian citizens) sued Union Carbide India Limited (UCIL) and the parent corporation, Union Carbide Corporation (UCC), for more than $1 billion after a disaster at a chemical plant operated by UCIL in 1984. There was a leak of the lethal gas methylisocyanate from the plant on the night of December 2, 1984. The deadly chemicals were blown by wind over the adjacent city of Bhopal, resulting in the deaths of more than 2,000 persons and the injury of more than another 200,000 persons. UCIL is incorporated under the laws of India; 50.9 percent of the stock is owned by UCC, 22 percent is owned or controlled by the government of India, and the balance is owned by 23,500 Indian citizens. The federal district court (Judge Keenan) granted UCC’s motion to dismiss the plaintiffs’ action on the ground that Indian courts, not U.S. courts, were the appropriate forum for the suit. The plaintiffs appealed this decision.

Judge Mansfield

As the district court found, the record shows that the private interests of the respective parties weigh heavily in favor of dismissal on grounds of forum non conveniens. The many witnesses and sources of proof are almost entirely located in India, where the accident occurred, and could not be compelled to appear for trial in the United States. The Bhopal plant at the time of the accident was operated by some 193 Indian nationals, including the managers of seven operating units employed by the Agricultural Products Division of UCIL, who reported to Indian Works Managers in Bhopal. The plant was maintained by seven functional departments employing over 200 more Indian nationals. UCIL kept daily, weekly, and monthly records of plant operations and records of maintenance, as well as records of the plant’s Quality Control, Purchasing, and Stores branches, all operated by Indian employees. The great majority of documents bearing on the design, safety, start-up, and operation of the plant, as well as the safety training of the plant’s employees, is located in India. Proof to be offered at trial would be derived from interviews of these witnesses in India and study of the records located there to determine whether the accident was caused by negligence on the part of the management or employees in the operation of the plant, by fault in its design, or by sabotage. In short, India has greater ease of access to the proof than does the United States.

The plaintiffs seek to prove that the accident was caused by negligence on the part of UCC in originally contributing to the design of the plant and its provision for storage of excessive amounts of the gas at the plant. As Judge Keenan found, however, UCC’s participation was limited and its involvement in plant operations terminated long before the accident. Under 1973 agreements negotiated at arm’s length with UCIL, UCC did provide a summary “process design package” for construction of the plant and the services of some of its technicians to monitor
the progress of UCIL in detailing the design and erecting the plant. However, the UOI controlled the terms of the agreements and precluded UCC from exercising any authority to “detail design, erect and commission the plant,” which was done independently over the period from 1972 to 1980 by UCIL process design engineers who supervised, among many others, some 55 to 60 Indian engineers employed by the Bombay engineering firm of Humphreys and Glasgow. The preliminary process design information furnished by UCC could not have been used to construct the plant. Construction required the detailed process design and engineering data prepared by hundreds of Indian engineers, process designers, and subcontractors. During the ten years spent constructing the plant, the design and configuration underwent many changes.

In short, the plant has been constructed and managed by Indians in India. No Americans were employed at the plant at the time of the accident. In the five years from 1980 to 1984, although more than 1,000 Indians were employed at the plant, only one American was employed there and he left in 1982. No Americans visited the plant for more than one year prior to the accident, and during the five-year period before the accident the communications between the plant and the United States were almost nonexistent.

The vast majority of material witnesses and documentary proof bearing on causation of and liability for the accident is located in India, not the United States, and would be more accessible to an Indian court than to a United States court. The records are almost entirely in Hindi or other Indian languages, understandable to an Indian court without translation. The witnesses for the most part do not speak English but Indian languages understood by an Indian court but not by an American court. These witnesses could be required to appear in an Indian court but not in a court of the United States. India’s interest is increased by the fact that it has for years treated UCIL as an Indian national, subjecting it to intensive regulations and governmental supervision of the construction, development, and operation of the Bhopal plant, its emissions, water and air pollution, and safety precautions. Numerous Indian government officials have regularly conducted on-site inspections of the plant and approved its machinery and equipment, including its facilities for storage of the lethal methylisocyanate gas that escaped and caused the disaster giving rise to the claims. Thus India has considered the plant to be an Indian one and the disaster to be an Indian problem. It therefore has a deep interest in ensuring compliance with its safety standards.

Affirmed in favor of Defendant, Union Carbide.

COMMENT: The Bhopal victims filed their claims in U.S. courts against UCC because the parent company had more money than the subsidiary (UCIL). Also, suing the parent made it more likely that the case would be heard in U.S. courts, which are considered to be far better forums for winning damages in personal injury actions than Indian courts are. After the lawsuits were removed to an Indian court, UCC agreed to pay $470 million to the Bhopal disaster victims. Union Carbide’s stock substantially decreased in value, and UCC was threatened by a takeover (though the attempt was thwarted in 1985). More than half of UCC was subsequently sold or spun off, including the Indian subsidiary (UCIL). In 1989, the Indian Supreme Court ordered UCC to pay $470 million to compensate Bhopal victims; criminal charges against the company and its officials were dropped. About 12,000 people worked for UCC in 1995, in contrast to the 110,000 employed by the company a decade earlier. In 2001, Dow Chemical acquired Union Carbide. (See Wall Street Journal, August 12, 2009, p. B-10.)

On June 7, 2010, a district court in Bhopal found seven former Union Carbide India, Ltd. officials guilty of “causing death by negligence” for a gas leak at the plant that killed approximately 3,000 people some 25 years before. This was the first criminal conviction. All convicted were Indian citizens. They were sentenced to 2 years in prison and fined 100,000 rupees ($2,130). The former Union Carbide subsidiary was convicted of the same charges and fined 5,000 rupees. All seven defendants were freed on bail. As of June, 2010, no cleanup has taken place in the affected area (see Lydia Polgreen and Hari Kumar, “8 Former Executive Guilty in ‘84 Bhopal Chemical Leak,” New York Times, June 8, 2010, p. A-8; T. Lahiri, “Court Convicts Seven in Bhopal Gas Leak,” Wall Street Journal, June 8, 2010, p. A-11).
CRITICAL THINKING ABOUT THE LAW

Please refer to Case 9-3 and consider the following questions:

1. Highlight the importance of facts in shaping a judicial opinion by writing an imaginary letter that, had it been introduced as evidence, would have greatly distressed Union Carbide Corporation (UCC).
   
   **Clue:** Review the first part of the decision, in which Judge Mansfield discussed the extent of UCC’s involvement in the plant where the accident occurred. What facts would counter his statement that the parent company had only “limited” involvement?

2. Suppose a U.S. plant exploded, resulting in extensive deaths in the United States. Further, suppose that all the engineers who built the plant wrote and spoke German only. Could Judge Mansfield’s decision be used as an analogy to seek dismissal of a negligence suit against the owners of the plant?
   
   **Clue:** Review the discussion of the use of legal analogies in Chapter 1 and apply what you read to this question.

3. What additional information, were it to surface, would strengthen Union Carbide’s request for a dismissal of the case described?
   
   **Clue:** Notice the wide assortment of facts that Judge Mansfield organized to support his decision.

Joint ventures, which involve a relationship between two or more corporations or between a foreign multinational and an agency of a host-country government or a host-country national, are usually set up for a specific undertaking over a limited period of time. Many developing countries (such as China) allow foreign investment only in the form of a joint venture between host-country nationals and the multinationals. Recently, three-way joint ventures have been established among United States–based multinationals (e.g., automobile companies such as Chrysler and General Motors), Japanese multinationals (e.g., Mitsubishi and Honda), and Chinese government agencies and Chinese nationals. Joint ventures are also used in host countries with fewer restrictions on foreign investment, often to spread the risk or to amass required investment sums that are too large for one corporation to raise by itself. Some of these joint ventures are private associations, with no host-government involvement.

Risks of Engaging in International Business

Unlike doing business in one’s own country, the “rules of the game” are not always clear when engaging in business in a foreign country, particularly in what we have classified as middle- and low-income economies. Here we set out three primary risks that managers engaged in international business may face: (1) expropriation of private property by the host foreign nation, (2) the application of the sovereign immunity doctrine and the act-of-state doctrine to disputes between foreign states and U.S. firms, and (3) export and import controls.

EXPROPRIATION OF PRIVATE PROPERTY

Expropriation—the taking of private property by a host-country government for either political or economic reasons—is one of the greatest risks companies take when they engage in international business. Thus, it is essential for business managers to investigate the recent behavior of host-country government officials, particularly in countries that are moving from a centrally planned economy toward one that is market oriented (e.g., Russia and Eastern European nations).
One method of limiting risk in politically unstable countries is to concentrate on exports and imports (trade) and licensing and franchising. Another method is to take advantage of the low-cost insurance against expropriation offered by the Overseas Private Investment Corporation (OPIC). If a U.S. plant or other project is insured by OPIC and is expropriated, the U.S. firm receives compensation in return for assigning to OPIC the firm’s claim against the host-country government.

**Bilateral investment treaties (BITs)**, which are negotiated between two governments, oblige the host government to extend fair and nondiscriminatory treatment to investors from the other country. A BIT normally also includes a promise of prompt, adequate, and effective compensation in the event of expropriation or nationalization.

### SOVEREIGN IMMUNITY DOCTRINE

Another risk for companies engaged in international business is the **sovereign immunity doctrine**, which allows a government expropriating foreign-owned private property to claim that it is immune from the jurisdiction of courts in the owner’s country because it is a government rather than a private-sector entity. In these cases, the company whose property was expropriated often receives nothing because it cannot press its claims in its own country’s courts, and courts in the host country are seldom amenable to such claims.

The sovereign immunity doctrine has been a highly controversial issue between the United States and certain foreign governments of developing nations. To give some protection to foreign businesses without impinging on the legitimate rights of other governments, the U.S. Congress in 1976 enacted the Foreign Sovereign Immunities Act (FSIA), which shields foreign governments from U.S. judicial review of their public, but not their private, acts. The FSIA grants foreign nations immunity from judicial review by U.S. courts unless they meet one of the FSIA’s private exceptions. One such exception is the foreign government’s involvement in commercial activity. Case 9-4 clarifies the U.S. Supreme Court’s definition of commercial activity under the FSIA. Note how the Court emphasizes the nature of the Nigerian government’s action by asking whether it is the type of action a private party would engage in.

### CASE 9-4

**Keller v. Central Bank of Nigeria**

United States Court of Appeals
277 F.3d 811 (6th Cir. 2002)

Prince Arthur Ossai, a government official in Nigeria, entered into a contract with Henry Keller (plaintiff), a sales representative for H.K. Enterprises, Inc., a Michigan-based manufacturer of medical equipment. They agreed that, among other things, Ossai would have an exclusive distribution right to sell H.K. products in Nigeria, which would buy $4.1 million of H.K. equipment for $6.63 million, plus a $7.65 million “licensing fee.” Before the deal closed, though, Ossai demanded that $25.5 million on deposit in the Central Bank of Nigeria (CBN) be transferred into an account set up by Keller. CBN employees charged Keller $28,950 in fees for the transaction, but the funds were never transferred. Keller and H.K. filed a suit in a federal district court against the CBN and others, asserting in part a claim under the Racketeer Influenced and Corrupt Organizations Act (RICO). The defendants filed a motion to dismiss under the Foreign Sovereign Immunities Act. The court denied the motion, concluding that the claim fell within the FSIA’s “commercial activity” exception. The defendants appealed to the U.S. Court of Appeals for the Sixth Circuit.

**Justice Norris**

[The defendants] claim that the illegality of the deal alleged precludes a finding that it is a commercial activity. The
FSIA defines “commercial activity” as “either a regular course of commercial conduct or a particular commercial transaction or act.” The commercial character of an activity shall be determined by reference to the nature of the course of conduct or particular transaction or act, rather than by reference to its purpose. When a foreign government acts, not as regulator of a market, but in the manner of a private player within it, the foreign sovereign’s actions are commercial within the meaning of the FSIA.

In the instant case, the conduct was a deal to license and sell medical equipment, a type of activity done by private parties and not a “market regulator” function. The district court correctly concluded that this was a commercial activity, and that any fraud and bribery involved did not render the plan non-commercial.

Defendants claim that plaintiffs cannot establish another element of the commercial activity exception, namely, that there was a direct effect in the United States. An effect is “direct” if it follows as an immediate consequence of the defendant’s activity.

In this case, defendants agreed to pay but failed to transmit the promised funds to an account in a Cleveland bank. Other courts have found a direct effect when a defendant agrees to pay funds to an account in the United States and then fails to do so. The district court in the instant case correctly concluded, in accord with the other courts, that defendant’s failure to pay promised funds to a Cleveland account constituted a direct effect in the United States.

Affirmed for Plaintiff.

CRITICAL THINKING ABOUT THE LAW

Context plays a vital role in any legal decision. The existence or nonexistence of certain events directly affects the court’s verdict. In Case 9-4, the court applies the strictures of the FSIA to the specific facts of the case. If certain facts exist, the federal statute protects the plaintiff, and the court should appropriately reject the defendant’s motion to dismiss. Otherwise, the CBN is immune, and the statute does not protect the plaintiff.

Understanding the facts is the starting point for legal analysis. The following questions encourage you to consider the significance of the facts in Case 9-4.

1. What facts are critical in the court’s ruling in favor of the plaintiff?
   Clue: Reread the introductory paragraph.

2. Look at the facts you found. To illustrate the importance of context, which fact, if it had not been included in the case, might have resulted in the court’s granting the defendant’s motion to dismiss?
   Clue: Find the elements of the federal statute that the judge discusses and use these elements as a guide to highlight the most significant facts.

ACT-OF-STATE DOCTRINE

The act-of-state doctrine holds that each sovereign nation is bound to respect the independence of every other sovereign state and that the courts of one nation will not sit in judgment on the acts of the courts of another nation done within that nation’s own sovereign territory. This doctrine, together with the sovereign immunity doctrine, substantially increases the risk of doing business in a foreign country. Like the sovereign immunity doctrine, the act-of-state doctrine includes some court-ordered exceptions, such as when the foreign government is acting in a commercial capacity or when it seeks to repudiate a commercial obligation.

Congress made it clear in 1964 that the act-of-state doctrine shall not be applied in cases in which property is confiscated in violation of international law, unless the president of the United States decides that the federal courts should apply it. As Case 9-5 demonstrates, the plaintiff has the burden of proving that the doctrine should not apply—that is, the courts should sit in judgment of public acts of a foreign government, in this case, a former government.
Case 9-5

Republic of the Philippines v. Ferdinand E. Marcos
United States Circuit Court of Appeals
862 F.2d 1355 (9th Cir. 1988)

The Republic of the Philippines (plaintiff) brought a civil suit against its former president, Ferdinand Marcos, and his wife, Imelda (defendants), asserting claims under the Racketeer Influenced and Corrupt Organizations Act and other applicable U.S. law. The Republic alleged that the Marcoses (and other defendants) arranged for investments in real estate in Beverly Hills, California, of $4 million fraudulently obtained by the Marcoses; that the Marcoses arranged for the creation of two bank accounts in the name of Imelda Marcos at Lloyds Bank of California totaling more than $800,000, also fraudulently obtained by the Marcoses; and that the Marcoses transported into Hawaii fraudulently obtained money, jewels, and other property worth more than $7 million. The key to the Republic’s entire case is the allegation that the Marcoses stole public money. The federal district court entered a preliminary injunction enjoining the Marcoses from disposing of any of their assets except to pay attorneys and their living expenses. The Marcoses appealed.

Justice Noonan

Before determining whether issuance of an injunction was appropriate we must consider two defenses which, if accepted, would block trial of the case the Marcoses maintain. First, that their acts are insulated because they were acts of state not reviewable by our courts, and second, that any adjudication of these acts would involve the investigation of political questions beyond our court’s competence.

The classification of certain acts as “acts of state,” with the consequence that their validity will be treated as beyond judicial review, is a pragmatic device, not required by the nature of sovereign authority and inconsistently applied in international law. The purpose of the device is to keep the judiciary from embroiling the courts and the country in the affairs of the foreign nation whose acts are challenged. Minimally viewed, the classification keeps a court from making pronouncements on matters over which it has no power; maximally interpreted, the classification prevents the embarrassment of a court defending a foreign government that is “extant at the time of suit.” The “continuing vitality” of the doctrine depends on its capacity to reflect the proper distribution of functions between the judicial and political branches of the government on matters bearing upon foreign relations.

As a practical tool for keeping the judicial branch out of the conduct of foreign affairs, the classification of “act of state” is not a promise to the ruler of any foreign country that his conduct, if challenged by his own country after his fall, may not become the subject of scrutiny in our courts. No estoppel exists insulating a deposed dictator from accounting. No guarantee has been granted that immunity may be acquired by an ex-chief magistrate invoking the magic words “act of state” to cover his or her past performance.

In the instant case the Marcoses offered no evidence whatsoever to support the classification of their acts as acts of state. The burden of proving acts of state rested upon them. They did not undertake the proof.

Bribetaking, theft, embezzlement, extortion, fraud, and conspiracy to do these things are all acts susceptible of concrete proof that need not involve political questions. The court, it is true, may have to determine questions of Philippine law in determining whether a given act was legal or illegal. But questions of foreign law are not beyond the capacity of our courts. The court will be examining the acts of the president of a country whose immediate political heritage is from our own. Although sometimes criticized as a ruler and at times invested with extraordinary power, Ferdinand Marcos does not appear to have had the authority of an absolute autocrat. He was not the state, but the head of the state, bound by the laws that applied to him. Our courts have had no difficulty in distinguishing the legal acts of a deposed ruler from his acts for personal profit that lack a basis in law.

Affirmed for Plaintiff, Republic of the Philippines.

Export and Import Controls

Export Controls. Export controls are usually applied by governments to militarily sensitive goods (e.g., computer hardware and software) to prevent unfriendly nations from obtaining these goods. In the United States, the Department of State, the Department of Commerce, and the Defense Department bear responsibility, under the Export Administration Act and the Arms Export Control Act, for authorizing the export of sensitive technology. Both criminal and administrative sanctions may be imposed on corporations and individuals who violate these laws.
CRITICAL THINKING ABOUT THE LAW

1. At the outset of Case 9-5, Justice Noonan acknowledges a key ambiguity in this case that will require clarification before announcing his decision. How does that ambiguity affect the reasoning?

   Clue: Notice the key concept in the first of the two defenses used by the Marcoses.

2. What behavior of the Marcoses made it highly unlikely that the first defense would be effective?

   Clue: Review Justice Noonan’s rationale for not honoring the defense.

3. What ethical norm is implicit in the Marcoses’ struggle against the preliminary injunction?

   Clue: Look back at the discussion of the ethical norms and eliminate those that seem inconsistent with the Marcoses’ behavior and interests.

Export controls often prevent U.S. companies from living up to negotiated contracts. Thus, they can damage the ability of U.S. firms to do business abroad.

**Import Controls.** Nations often set up import barriers to prevent foreign companies from destroying home industries. Two such controls are tariffs and quotas. For example, the United States has sought historically to protect its domestic automobile and textile industries, agriculture, and intellectual property (copyrights, patents, trademarks, and trade secrets). Intellectual property has become an extremely important U.S. export in recent years, and Washington has grown more determined than ever to prevent its being pirated. After several years of frustrating negotiations with the People’s Republic of China, the U.S. government decided to threaten imposition of 100 percent tariffs on approximately $1 billion of Chinese imports in 1995, and again in 1996 and 1997. In retaliation, the Chinese government has threatened several times to impose import controls on many U.S. goods. Washington took action only after documenting that hundreds of millions of dollars’ worth of “pirated” computer software and products (including videodiscs, law books, and movies) was being produced for sale within China and for export to Southeast Asian nations in violation of the intellectual property laws of both China and the United States, as well as international law. The documentation showed that 29 factories owned by the state of Communist Party officials were producing pirated goods. A last-minute settlement in which the Chinese government pledged to honor intellectual property rights prevented a trade war that would have had negative implications for workers in import–export industries in both countries. American consumers would also have suffered because Chinese imports would have become twice as expensive had the 100 percent tariff taken effect—though the effect on consumers would have been offset by an increase in imports of the affected goods from other foreign countries (e.g., English and Japanese bikes would have replaced Chinese bikes in demand).

Another form of import control is the imposition of antidumping duties by two U.S. agencies, the International Trade Commission (ITC) and the International Trade Administration (ITA). The duties are levied against foreign entities that sell the same goods at lower prices in U.S. markets than in their own in order to obtain a larger share of the U.S. market (i.e., entities that practice “dumping”).

**Legal and Economic Integration as a Means of Encouraging International Business Activity**

Table 9-2 summarizes a number of groups that have been formed to assist businesspeople in carrying out international transactions. These groups range from the WTO (formerly the General Agreement on Tariffs and Trade), which is attempting
<table>
<thead>
<tr>
<th>Name</th>
<th>Members and Purpose</th>
</tr>
</thead>
<tbody>
<tr>
<td>World Trade Organization (WTO)</td>
<td>Replaced General Agreement on Tariffs and Trade (GATT) in 1995 and the most-favored-nation clause with the normal trade relations principle. Composed of 144 member nations. Goal is to get the nations of the world to commit to the trade principles of nondiscrimination and reciprocity so that, when a trade treaty is negotiated between two members, the provisions of that bilateral treaty will be extended to all WTO members. All members are obligated to harmonize their trade laws or face sanctions. The WTO, through its arbitration tribunals, is to mediate disputes and recommend sanctions.</td>
</tr>
<tr>
<td>European Union (EU)</td>
<td>Composed of 26 European member states. Established as the European Economic Community (later called the European Community) by the Treaty of Rome in 1957. Goal is to establish an economic “common market” by eliminating customs duties and other quantitative restrictions on the import and export of goods and services among member states. In 1986, the treaty was amended by the SEA, providing for the abolition of all customs and technical barriers between nations by December 31, 1992. In 1991, the Maastricht Summit Treaty proposed monetary union, political union, and a “social dimension” (harmonizing labor and social security regulations) among EU members. Not all aspects have been approved by all members.</td>
</tr>
<tr>
<td>North American Free Trade Agreement (NAFTA)</td>
<td>The United States, Canada, and Mexico are members at present; Chile has been invited to join. NAFTA seeks to eliminate barriers to the flow of goods, services, and investments among member nations over a 15-year period, starting in 1994, the year of its ratification. Unlike the EU, NAFTA is not intended to create a common market. Whereas EU states have a common tariff barrier against non-EU states, members of NAFTA maintain their own individual tariff rates for goods and services coming from non-NAFTA countries.</td>
</tr>
<tr>
<td>Organization for Economic Cooperation and Development (OECD)</td>
<td>Established in 1951. Western European nations with Australia, New Zealand, United States, Canada, Japan, Russia, and some Eastern European nations as associate members. The OECD’s original purpose was to promote economic growth after World War II. Today it recommends and evaluates options on environmental issues for its members and establishes guidelines for multinational corporations when operating in developed and developing countries.</td>
</tr>
<tr>
<td>European Free Trade Association (EFTA)</td>
<td>Founded in 1960 and originally composed of Finland, Sweden, Norway, Iceland, Liechtenstein, Switzerland, and Austria. EFTA has an intergovernmental council that negotiates treaties with the EU. Finland, Sweden, and Austria left the EFTA in 1995 and joined the EU. In the future EFTA will have only minor significance.</td>
</tr>
<tr>
<td>Andean Common Market (ANCOM)</td>
<td>Composed of Bolivia, Venezuela, Colombia, Ecuador, and Peru. ANCOM seeks to integrate these nations politically and economically through a commission, the Juanta Andean Development Bank, and a Reserve Fund and a Court of Justice. Founded in 1969, achievement of its goals has been hampered by national interests.</td>
</tr>
<tr>
<td>Mercado Commun del Sur Mercosul (Mercosul)</td>
<td>Composed of Argentina, Brazil, Paraguay, and Uruguay. Mercosul’s purposes are to reduce tariffs, eliminate nontariff barriers among members, and establish a common external tariff. The organization was founded in 1991, and these goals were to be met by December 31, 1994. For political reasons, they have not yet been fully met.</td>
</tr>
<tr>
<td>South American Common Market</td>
<td>A duty-free common market comprised of countries in the ANCOM and Mercosul groups, created on January 1, 1995. On that date, tariffs were ended on 95 percent of goods traded among Brazil, Argentina, Paraguay, and Uruguay. All three nations adopted common external tariffs.</td>
</tr>
<tr>
<td>Asia-Pacific Economic Corporations (APEC)</td>
<td>Formed in 1989. A loosely organized group of 15 developed and developing Pacific Group nations, including Japan, China, United States, Canada, and New Zealand. APEC is not a trading bloc and has no structure except for a secretariat.</td>
</tr>
<tr>
<td>Association of Southeast Asian Nations (ASEAN)</td>
<td>Formed in 1967. Composed of Indonesia, Malaysia, Vietnam, Philippines, Singapore, Thailand, and Brunei. ASEAN’s purpose is to encourage economic growth of member nations by promoting trade and industry. There have been tariff reductions among members, and ASEAN’s secretariat has represented nations vis-à-vis other regional groups such as the EU.</td>
</tr>
<tr>
<td>Gulf Cooperation Council (GCC)</td>
<td>Founded in 1982. Composed of Saudi Arabia, Kuwait, Bahrain, Qatar, United Arab Emirates, and Oman. The GCC’s purposes are to standardize industrial subsidies, eliminate trade barriers among members, and negotiate with other regional groups to obtain favorable treatment for GCC goods, services, and investments.</td>
</tr>
</tbody>
</table>
to reduce tariff barriers worldwide, to the proposed South American Common Market, which would form a duty-free zone for all the nations of South America. The most ambitious organization is the EU, which is in the process of forming a Western European political and economic community with a single currency and a common external tariff barrier toward nonmembers.

Multinational corporations are learning that doing international business is much easier when they are aware of the worldwide and regional groups listed in Table 9-2. We will describe three of these groups: the WTO, the EU, and NAFTA. We chose to examine these three because they represent three different philosophies and structures of legal and economic integration, not because we do not appreciate the major effects of other integrative groups outlined in the table.

THE WORLD TRADE ORGANIZATION

Purpose and Terms. On January 1, 1995, the 47-year-old General Agreement on Tariffs and Trade (GATT) organization was replaced by a new umbrella group, the World Trade Organization. The WTO has the power to enforce the new trade accord that evolved out of seven rounds of GATT negotiations, with more than 140 nations participating. All 144 signatories to this accord agreed to reduce their tariffs and subsidies by an average of one-third on most goods over the next decade, agricultural tariffs and subsidies included. Economists estimated that this trade pact would result in tariff reductions totaling $744 billion over the next 10 years.

Moreover, the accord, which the WTO will supervise, prohibits member countries from placing limits on the quantity of imports (quotas). For example, Japan had to end its ban on rice imports, and the United States had to end its import quotas on peanuts, dairy products, and textiles. Furthermore, the agreement bans the practice of requiring high local content of materials for manufactured products such as cars. It also requires all signatory countries to protect patents, trademarks, copyrights, and trade secrets. (See Chapter 15 for discussion of these topics, which fall under the umbrella of intellectual property.)

General Impact. The accord created the WTO, which consists of all nations whose governments approved and met the GATT–Uruguay Round Accord. Each member state has one vote in the Ministerial Conference, with no single nation having a veto. The conference meets at least biannually, and a general council meets as needed. The conference may amend the charter created by the pact—in some cases, by a two-thirds vote; in others, by a three-fourths vote. Changes apply to all members, even those that voted no.

The WTO has been given the power to set up a powerful dispute-resolution system with three-person arbitration panels that follow a strict schedule for dispute-resolution decisions. WTO members may veto the findings of an arbitration panel. This is a matter of great concern to the United States, and it figured prominently in the House and Senate debates preceding approval of the WTO. U.S. farmers (and other groups), who had previously won decisions before GATT panels, saw these decisions vetoed by the EU countries that subsidize the production of soybeans and other agricultural products; they enthusiastically supported the new WTO process. Environmentalists and consumer groups, in contrast, feared that the WTO would overrule U.S. environmental laws and in other ways infringe on the sovereignty of the nation. To assuage these fears, the

---

framers of the accord added a provision that allows any nation to withdraw upon six months’ notice. Congress also attached a condition to its approval that calls for the establishment of a panel of U.S. federal judges to review the WTO panels’ decisions.

**Impact on Corporate Investment Decision Making.** The WTO pact makes it less risky for multinationals to source parts—that is, to have them built in cheap-labor countries and then brought back to the multinational’s home country for use in making a product (e.g., brakes for automobiles). Industries that were expected to shift quickly to buying parts from all over the world for their products include computers, telecommunications, and other high-tech manufacturing. It is anticipated that with a freer flow of goods across borders, businesses will gain increased economies of scale by building parts-manufacturing plants at a location that serves a wide market area.

Because the tariff cuts were to be introduced gradually over a 6-year period and were to be finalized only after 10 years, the impact on trade was not immediate. Once the major nations ratified the WTO pact, however, companies began to make investment and employment decisions predicated on dramatic reductions in tariffs, subsidies, and other government-established deterrents to free trade.

**THE EUROPEAN UNION**

**Purpose.** The 27-member EU grew out of the European Economic Community (later called the European Community), established by six Western European nations through the Rome Treaty of 1957. Its goals were to create a “customs union” that would do away with internal tariffs among the member states and to create a uniform external tariff to be applied to all nonmembers. The EU is thoroughly committed to achieving the free movement of goods, services, capital, and people across borders (Exhibit 9-1).

---

**EXHIBIT 9-1**

**EUROPEAN UNION AND AN ATTEMPT TO CENTRALIZE POWER**

After eight years of negotiations, the Lisbon Treaty became effective in December of 2009. The treaty seeks to give the European Union an international role beyond Europe. It creates a full-time presidency of a council of national leaders of the 27 member countries. The president is elected for a period of two and a half years. He (Herman Van Rompuy) has a full-time staff located in Brussels. The treaty also creates a new high representative for foreign and security policy. She (Catherine Ashton) will negotiate with the European Parliament and nations worldwide over major foreign policy issues, and will coordinate a diplomatic corps of approximately 5,000 diplomats, called the External Action Service, which is intended to supplement but not replace diplomats of the 27 individual member countries.

The treaty seeks to delineate the relationships between national legislatures of individual member countries and the EU Parliament. It will seek to implement a new voting system reflecting the population size of EU member countries. The treaty will use this new voting system to prevent a single member country from blocking a proposal such as an amendment to the constitution of the EU. Moreover, the treaty will give more power to the directly elected European Parliament.

The importance of the Treaty of Lisbon is that it replaces a failed attempt at a proposed constitution which was rejected by France and the Netherlands in referendums in 2005. To treaty supporters, it was important that a new voting system be established, as 12 new nations have been added since 2004. Critics argue that it was not needed because the new bureaucracy (located in Brussels, capital of the EU) encroaches upon the national sovereignty of member states.
The EU’s ambitious plan to create an immense “common market” of 400 million people and $4 trillion worth of goods was greatly strengthened by the 1986 signing of the Single European Act (SEA), which set a deadline for economic integration of December 31, 1992, and instituted new voting requirements to make passage of EU legislation easier. A treaty that was proposed at the Maastricht Summit in 1991 was ratified in 1993. It provided for (1) monetary union through the creation of a single currency for the entire EU, (2) political union, and (3) a “social dimension” through the establishment of uniform labor and Social Security regulations. The leaders of the 12 nations that were members at the time agreed to the creation of a European Monetary Institute by 1994, a European Central Bank by 1998, and a uniform European currency unit (ECU) by 1999.

Three new members (Finland, Austria, and Sweden) joined the EU in 1994, bringing the total to 15 nations. In May 2004, 10 more nations joined the EU: Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia (see Exhibit 9-2). Bulgaria and Romania were accepted into the EU in 2007.

**Structure.** The EU consists of (1) a Council of Ministers, (2) a Commission, (3) a Parliament (Assembly), (4) the European Court of Justice (with the addition of the Court of First Instance), and (5) the European Central Bank (ECB) and the European Monetary Union (EMU).

1. **Council of Ministers.** The Council of Ministers is composed of one representative from each of the member nations. Its purposes are to coordinate the economic policies of member states and, more recently, to negotiate with nonmember states. In the past, the council generally rubber-stamped legislation proposed by the Commission, but this docility is less assured as the council begins to flex some of the authority granted it by the SEA and the Maastricht Treaty.

2. **Commission.** The Commission consists of 20 members who represent the EU, not national concerns. It is responsible for the EU’s relations with international organizations such as the United Nations and the WTO. Member states are apportioned voting power in the Commission on the basis of their population and economic power. The Commission elects a president from
Key Elements of the Treaty of Maastricht

<table>
<thead>
<tr>
<th>Agreement</th>
<th>Goals and Stumbling Blocks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monetary Union</td>
<td>The European Monetary Institute was created on January 1, 1994, and started operating on January 1, 1999. A single currency issued any day after January 1, 1999, is the goal of 25 nations that meet three standards: (1) Annual budget deficit cannot exceed the ceiling of 3 percent of gross domestic product; (2) the public debt limit for each country must not exceed 60 percent of gross domestic product; and (3) a country’s inflation rate must be lower than 2.9 percent, based on a complex formula set out in 1997. Great Britain was allowed to opt out of the EC currency union until an unspecified date. It opposes monetary union for ideological reasons. Denmark was also allowed to opt out pending a referendum on the issue, a constitutional requirement. The Danish government backs monetary union.</td>
</tr>
<tr>
<td>Political Union</td>
<td>EC jurisdiction in areas including industrial affairs, health, education, trade, environment, energy, culture, tourism, and consumer and civil protection. Member states vote to implement decisions. Increased political cooperation under a new name—European Union. Permanent diplomatic network of senior political officials created in the EC capitals. Great Britain rejected EC-imposed labor legislation, forcing the removal of the so-called social chapter from the treaty. It will be implemented separately by the other 14 members, officials said.</td>
</tr>
<tr>
<td>Federalism</td>
<td>EC leaders dropped reference to an EC “with a federal goal.” Instead, the political Union accord describes the community as “an ever-closer union in which political decisions have to be taken as near to the people as possible.” Great Britain rejected the “federalism” concept as the embodiment of what it feels would be an encroaching EC superstate.</td>
</tr>
<tr>
<td>Foreign Affairs</td>
<td>EC states move toward a joint foreign policy, with most decisions requiring unanimity. Great Britain wanted the ability to opt out of any joint decision. How this provision will be interpreted by the various sides is yet to be determined.</td>
</tr>
<tr>
<td>Defense</td>
<td>The Western EU, a long-dormant group of nine EC states, will be revived to act as the EC’s defense body but linked to the NATO alliance. Although France and Germany supported a greater military role for the Union, Great Britain, Italy, and others did not want to see NATO’s influence diluted.</td>
</tr>
<tr>
<td>European Parliament</td>
<td>The 518-member EC assembly gets a modest say in shaping some EC legislation. Its new powers fall short of what the assembly had sought (i.e., an equitable sharing of the right to make EC laws with the EC governments). Great Britain and Denmark refused to grant the assembly broader powers.</td>
</tr>
</tbody>
</table>

3. **Parliament.** The Parliament (Assembly) is made up of representatives elected from each nation-state for a term set by the nation-state. The representatives come from most of the major European political factions (Socialists, Christian Democrats, Communists, Liberals, etc.), and each of the parties in the Parliament also exists in the member states. The Parliament elects a president to preside over its deliberations. The Parliament’s general powers are to (1) serve as a consultative body to the Council, (2) refer matters affecting EU interests to the Commission or Council, (3) censure the Commission when necessary, (4) assent to trade agreements with countries outside the EU, (5) amend the EU budget, and (6) participate with the Commission in the legislative procedure.
4. **European Court of Justice.** The European Court of Justice performs the functions of arbiter and final decision maker in conflicts between EU law and individual member states. The national courts of member states are obligated to follow EU law and Court of Justice decisions. The Court of First Instance was established in 1989 to reduce the workload of the Court of Justice. It has jurisdiction over appeals of the Commission’s decisions on mergers and acquisitions. It also sets the penalties for price-fixing when non-EU companies are involved.

5. **The European Central Bank and the European Monetary Union.** The Maastricht Treaty required all member states of the EU to converge their economic and monetary policies with the goal of creating a single currency, the euro. The criteria set forth required the harmonization of budget deficits, inflation levels, and long-term interest rates, and specific levels of currency inflations to achieve exchange-rate stability. The European Monetary Union was created in January 1999. By giving up their national currencies, members of the EMU have relinquished control of their exchange rates and monetary policy to an independent European Central Bank based in Frankfurt. The primary duty of the ECB is to maintain price stability, by lowering or raising interest rates. With the exception of Denmark and Great Britain, most members of the EMU have adopted the euro.

**Impact.** **Unity of Law.** Agricultural, environmental, and labor legislation is being made uniform throughout the member nations, with allowances and subsidies for the poorer members. The national courts of member states are now following decisions of the European Court of Justice.

**Economic Integration.** The SEA and Maastricht Treaty have pushed the EU members to eliminate tariff and nontariff barriers among themselves. British and French differences over the creation of a single currency have forced the suspension of this goal.

**Political Union.** The political union envisioned by the Maastricht Treaty has been an elusive goal for the EU, because member states (and their citizens) have proved more reluctant to make the necessary compromises on national sovereignty than the treaty’s architects anticipated. Nonetheless, the EU is the only regional organization that has in place the sophisticated structure required to make political union a realistic possibility.

---

**The “Big Fat Greek” Bailout**

On May 10, 2010, Euro-zone leaders (17 nations belonging to the European Union), the International Monetary Fund (IMF), and the European Central Bank decided to “bail out” the nearly bankrupt nation of Greece. They agreed to a nearly $1 trillion package of loans, guarantees, swaps, and bond purchases for use by Greece and other EU nations. The IMF contributed $318 billion (it should be noted that the United States (taxpayer) had a role in this bailout because of its contributions to the IMF and its voting strength in that body. President Obama encouraged European leaders to act quickly. The Federal Reserve also provided credits for European banks that were lenders to Greece). Given the existing precedents, the degree of international cooperation was surprising. As of May, 2010, it seemed doubtful that the full $1 trillion would be needed, but the markets of Portugal, Spain, and Ireland, in the eyes of some, were similar to the situation in Greece.

Markets worldwide fell sharply following the bailout on May 9, 2010. Investors showed a lack of confidence in European markets and the euro. Similar to the U.S. bailout of banks and some other large business entities (insurance and automobile
companies), in 2009, the European Union sought to pledge support for debt markets in the Euro-zone combined with attempts to correct fiscal problems in certain countries. It may be easier to help individual banks and corporations in the United States than to bail out a sovereign country (or group of countries), having a single currency.

Why does a small country like Greece deserve a bailout, and why should it be able to shake the global financial system? Some thoughts follow:

- The problem may be larger than Greece. Many European nations, like Greece, have poor tax collection systems, and thus have problems servicing their sovereign debt. Spain, Portugal, Ireland, and Italy have similar problems. Spain may be too big to be bailed out.

- Prior to the establishment of the EU, problems with the euro would not have been as visible. If Greece had had its own currency (drachmas), it would have gone bankrupt, boosting both its exports and the cost of borrowing money, leaving it with less debt and perhaps more revenues and tax revenue to service the debt. Within the EU structure (with fixed exchange-rate systems like the euro), free-market signals are masked. Interest rates are held artificially low for reckless borrowers such as Greece, whose debt was largely held by private and state banks of Germany, France, and Spain. These nations played a role in bailing out Greece in 2010.

- The global economy may suffer deflationary effects. If enforceable austerity measures take place in countries that receive bailout money, millions of people (like residents in Greece) will end up living on less, resulting in less demand for worldwide natural resources, consumer goods, and housing components. The price of gold may initially jump as Europeans seek to protect a weakening euro.

- U.S. investors may be concerned about reduced earnings of multinationals that do business in EU countries. However, U.S. banks could gain from money that fleece Europe, and U.S. consumer spending could benefit from weaker commodity prices.


NORTH AMERICAN FREE TRADE AGREEMENT

**Purpose.** The NAFTA, ratified in 1994, sought to eliminate barriers to the flow of goods, services, and investments among Canada, the United States, and Mexico over a 15-year period. NAFTA envisioned a gradual phasing-out of these barriers, with the length of the phaseout varying from industry to industry. The ultimate goal was a totally free trade zone among the three member states, with eventual inclusion of other Central and Latin American countries. So far, the only country invited to join the founding members is Chile.

**Structure.** NAFTA is administered by a three-member Trade Commission, which oversees a Secretariat and arbitral panels.

*Trade Commission.* Staffed by trade ministers from each of the three nations, the Trade Commission meets once a year and makes its decisions by consensus. It supervises the implementation of the treaty and resolves disputes over interpretation. The daily operations of NAFTA are conducted by ad hoc working groups appointed by the three governments.

*Secretariat.* The permanent Secretariat is composed of national sections (departments) representing each member country. Its purposes are to provide technical support for the Trade Commission and to put together arbitral panels to resolve disputes between members.

*Arbitral Panels.* The treaty has detailed arbitration provisions for settling disputes, particularly those involving dumping of goods (selling a good in a member country at a lower price than at home) and interpretations of the treaty.
Although the arbitration proceedings are designed especially to resolve disputes between member nations, the treaty encourages private parties to use them as well. If they do, they must agree to abide by the arbitral panel’s decision.

Each arbitral panel has five members, chosen from a roster of 30 legal experts from NAFTA and non-NAFTA countries. Within 90 days, the panel will give the disputant countries a confidential report. Over the next 14 days, the disputants may present their comments on the report to the panel. Within 30 days of the issuance of the initial report, the arbitral panel must present its final report to the parties and to the Trade Commission, which publishes the report. The countries then have 30 days to resolve their dispute, or, if the panel has found one party wrong, the other may legally retaliate.

**Impact.** NAFTA has not only brought together three North American neighbors of different historical and cultural background, but it has also provided a model of economic integration for other countries in Central and Latin America.

It has had a significant impact on each country’s exports and imports. It has served as an institution for arbitration of disputes. For example, one of the first arbitral panels was set up when the U.S. government filed a complaint on behalf of United Parcel Service (UPS) and UPS believed that it was being hampered by NAFTA government regulations in Mexico, which limit the size of delivery trucks to be used in delivering packages. The arbitral panel ruled in favor of UPS.

### TECHNOLOGY AND THE LEGAL ENVIRONMENT

**WTO Says U.S. Ban on Online Gambling Violates International Law**

The island nation of Antigua and Barbuda (plaintiff) brought a case against the United States to a WTO panel. The nation licenses 19 companies that offer sports betting and casino games (e.g., blackjack) over the Internet. It argued that the United States is in violation of international law by prohibiting cross-border gambling operations via the Internet. The plaintiff argues that the U.S. trade policy does not prohibit cross-border gambling operations.

The WTO panel ruled in favor of Antigua and Barbuda. In its decision in 2004, the panel stated that U.S. policy prohibiting online gambling operations emanating from the plaintiff nation violates international law. WTO panels do not have to give reasons for their decisions.

Some important legal, political, and cultural considerations:

1. **WTO panel decisions apply only to the set of facts and case before the panel. Internet gambling using credit cards takes place in the Caribbean, Costa Rica, Great Britain, and Canada. Although this case is not a precedent, the United States should expect more legal action, as several million customers are at stake, and revenues from offshore players are important to nation-states that operate Internet casinos.**

2. **Present federal law in the United States makes it illegal to bet over the Internet if not allowed by individual states. Although untested as legal theory, the Justice Department is seeking to crack down on broadcasters and print media that accept advertising from offshore Internet casinos, on the ground that they are aiding and abetting an illegal enterprise. The airwaves are controlled by the Federal Communications Commission. Some questions are being raised:**

   a. Is the lobbying of American gambling companies against Internet betting (emanating from abroad) the real reason for the U.S. government’s stand? American companies have a lock on U.S. gambling and do not want to lose it to worldwide Internet casino interests.

   b. On the basis of international trade law, countries allowing online casino gambling may seek to raise tariffs on services or goods of U.S. companies doing business within their jurisdiction (e.g., AT&T) as a way of retaliating against U.S. policy. Will this prompt U.S. companies to express their concerns to members of Congress? Does AT&T contribute to the reelection of members of Congress? Do gambling interests provide funds for reelection bids? Will there be a clash of interests?
Global Dispute Resolution

Many times, when private or public parties enter into an international business agreement, they incorporate means for resolving future disputes (e.g., arbitration clauses) into the agreement. Another form of protection for firms doing business internationally is the insurance some nation-states offer domestic companies to encourage them to export (e.g., United States Overseas Private Investment Corporation). Still, the two methods used most frequently to resolve irreconcilable differences between parties involved in international transactions are arbitration and litigation.

ARBITRATION

Arbitration is a dispute resolution process whereby parties submit their disagreements to a private individual decision maker they have agree on or to a panel of decision makers whose selection has been provided for in the contract the parties signed. Arbitration clauses in contracts involving international business transactions should meticulously stipulate what law will govern the arbitration, where and when the arbitration will take place, what language will be used, and how the expenses of arbitration will be shared. They should also stipulate a waiver of judicial (court) review by both parties to the dispute. All these matters should be carefully negotiated when the contract is being drafted.

Arbitration of disputes may also come about through treaties. For instance, the United Nations Convention on the Recognition of Foreign Arbitral Awards encourages use of arbitration agreements and awards. The World Bank’s International Center for the Settlement of Investment Disputes (ICSID), created in 1965 by treaty (the Washington Convention), provides arbitration rules as well as experienced arbitrators to disputants, and the International Chamber of Commerce offers a permanent arbitration tribunal. Finally, individual countries have arbitration associations that can provide experienced arbitrators to parties desiring assistance in settling their disputes.

LITIGATION

When contracts do not contain arbitration clauses and no other alternative (such as mediation or conciliation) is available, litigation may be the only way to resolve a dispute between parties. Some private international business contracts include a choice-of-forum clause so that the parties know which family of law is to be applied in case of a dispute and what nation’s courts will be used. When negotiating contracts in the international arena, managers should make sure that choice-of-forum clauses are specific as to these questions. Either or both can make a major difference to the outcome. Because there is no single international court or legal system capable of resolving all commercial disputes between private parties, a choice-of-forum clause should be negotiated in all agreements involving major transactions. London’s Commercial Court, established in 1895, is the most popular neutral forum for resolving commercial litigation, owing to its more than 100 years of experience.

Most of the international and regional organizations discussed in this chapter emphatically encourage the arbitration of private contractual disputes, because the arbitration process is a quicker and less public means of resolving disputes than litigation. In certain areas of the world (particularly the Far East), companies and governments strenuously seek to avoid litigation.
GLOabalization: Hurts or Helps

In most of the chapters in this text, we have examined the globalization aspect of several areas of business ethics and law. We have attempted to present some factual bases for these discussions. In the following table, you will find a debate that is taking place all over the world. We invite you to participate in this sometimes vigorous discussion of whether globalization of business helps or hurts societies all over the world. It is skillfully summarized by Professor Murray Wiedenbaum in his text Business and Government in the Global Marketplace.

<table>
<thead>
<tr>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>Accelerates economic growth, increasing living standards</em></td>
<td><em>Generates widespread poverty in the pursuance of corporate greed</em></td>
</tr>
<tr>
<td><em>Offers consumers greater variety of products and at lower prices</em></td>
<td><em>Results in greater income inequality</em></td>
</tr>
<tr>
<td><em>Increases jobs and wages and improves working conditions</em></td>
<td><em>Moves jobs to low-wage factories that abuse workers’ rights</em></td>
</tr>
<tr>
<td><em>Encourages a greater exchange of information and use of technology</em></td>
<td><em>Provides opportunity for criminal and terrorist groups to operate on a global scale</em></td>
</tr>
<tr>
<td><em>Provides wealth for environmental cleanup</em></td>
<td><em>Pollutes local environments that lack ecological standards</em></td>
</tr>
<tr>
<td><em>Helps developing nations and lifts millions out of poverty</em></td>
<td><em>Traps developing countries in high-debt loans</em></td>
</tr>
<tr>
<td><em>Extends economic and political freedoms</em></td>
<td><em>Threatens national sovereignty</em></td>
</tr>
<tr>
<td><em>Raises life expectancy, health standards, and literacy rates</em></td>
<td><em>Worsens public health and harms social fabrics of agricultural-based societies</em></td>
</tr>
</tbody>
</table>


Summary

Although the emphasis in this book is on legal and ethical issues, managers whose companies are undertaking international business ventures need to consider the political, economic, cultural, and legal dimensions of the international environment of business. The major families of law are common law, which relies primarily on case law and precedent; civil law, which relies primarily on codes and statutory law; Islamic law, which relies on the Shari’a, a religious code of rules; socialist law, which is based on Marxism–Leninism and does not recognize private property; and Hindu law, which relies primarily on the Sastras, a religious code.

International law is divided into public international law, governing the relationships between nation-states, and private international law, governing the relationships between private parties involved in international transactions.

The major methods of engaging in international business are trade, international licensing and franchising, and foreign direct investment. The principal risk of engaging in international business are expropriation, the sovereign immunity doctrine and the act-of-state doctrine, export and import controls, and currency controls and fluctuations (particularly in developing nations).

World and regional integrative organizations, especially the WTO, the EU, and NAFTA, are making a strong impact on international business. Arbitration and litigation are the major methods of international dispute resolution.
REVIEW QUESTIONS

9-1 Contrast the common-law family with the socialist-law family.

9-2 Which of the methods of engaging in international business discussed in this chapter is least risky for a foreign multinational company? Explain.

9-3 Define the following:
   a. expropriation
   b. doctrine of sovereign immunity
   c. act-of-state doctrine
   d. arbitration clause
   e. choice-of-forum clause

9-4 Why was the GATT Pact, creating the World Trade Organization, so important to doing international business? Explain.

9-5 Why is arbitration preferred to litigation as a means of resolving international business disputes? Explain.

REVIEW PROBLEMS

9-6 Royal Bed and Spring Company, a U.S. distributor of furniture products, entered into an exclusive distributorship agreement with a Brazilian manufacturer of furniture products. Under the terms of the contract, Royal Bed was to distribute in Puerto Rico the furniture products manufactured by Famossul in Brazil. The contract contained forum-selection and choice-of-law clauses, which designated the juridical district of Curitiba, State of Parana, Brazil, as the judicial forum and the Brazilian Civil Code as the law to be applied in the event of any dispute. Famossul terminated the exclusive distributorship and suspended the shipment of goods without just cause. As a matter of public policy, Puerto Rican law refuses to enforce forum-selection clauses specifying foreign venues. In what jurisdiction should Royal Bed bring suit? Explain.

9-7 X, a U.S. company, entered into a contract with C, a Swiss subsidiary of General Motors, to sell Chevrolet automobiles in Aruba. An arbitration clause in the parties’ agreement provided that all disputes would be settled by arbitration in accordance with Aruban law. Aruba follows Dutch civil law. X argues that only U.S. law can apply, because the contract was made in the United States. Is X correct? Explain.

9-8 Zapata entered into a contract with a German corporation to use one of Zapata’s oil-drilling rigs off the coast of Italy. The contract stated, “Any dispute arising must be treated before the London Court of Justice.” A severe storm damaged the oil rig as it was being towed through the Gulf of Mexico. Zapata filed suit in federal district court. Does the U.S. court have jurisdiction to decide the dispute? What is the purpose behind a choice-of-forum clause, and should the clause be enforced?

9-9 The members of the International Association of Machinists (IAM) were disturbed by the high price of oil and petroleum-derived products in the United States. They believed that the actions of the Organization of Petroleum Exporting Countries (OPEC) were the cause of the high prices. Therefore, the IAM sued OPEC’s member countries in a federal district court, alleging that these countries’ price-setting activities violated U.S. antitrust law. OPEC raised the act-of-state doctrine as a defense. Who do you think won? Explain why.

9-10 Dr. Will Pirkey, a U.S. otolaryngologist, signed an employment contract in which he agreed to work for two years at the King Faisal Hospital in Saudi Arabia. Before his departure, Pirkey received his employment contract, which contained a clause providing that his agreement with the hospital would be construed in accordance with Saudi Arabian law. Because of the assassination of King Faisal and for other reasons, Pirkey did not go to Saudi Arabia as agreed and contested the choice-of-law provision of his employment contract as unconscionable. He argued that the laws of his home state (New York) should apply. Who won this case? Explain why.

9-11 U.S. Company (USC) owned a subsidiary in France that had a contract to deliver compressors for use in the Soviet natural gas pipeline then under construction. The U.S. government banned the export of goods to the Soviet Union by U.S. companies or U.S.-controlled foreign companies, and USC complied with the ban by ordering its French subsidiary to stop delivery of the compressors. The French government, however, ordered delivery. USC delivered the compressors. The U.S. government thereupon instituted a criminal action against USC. What is USC’s defense? Explain.
CASE PROBLEMS

9-12 Tonoga, Ltd. (Taconic), is a manufacturer incorporated in Ireland with its principal place of business in New York. In 1997, Taconic entered into a contract with a German construction company to supply special material for a tent project designed to shelter religious pilgrims visiting holy sites in Saudi Arabia. Most of the material was made in and shipped from New York. The German company did not pay Taconic and eventually filed for bankruptcy. Another German firm, Werner Voss Architects and Engineers, acting as an agent for the government of Saudi Arabia, guaranteed the payments due Taconic to induce it to complete the project. Taconic received all but the final payment. When it did not receive the full payment, the firm filed a suit in a federal district court against the government of Saudi Arabia, claiming breach of the guaranty and seeking to collect, in part, about $3 million. The defendant filed a motion to dismiss based, in part, on the doctrine of sovereign immunity. Under what circumstances does this doctrine apply? Should this suit be dismissed under the "commercial activity" exception? Explain. Tonoga, Ltd. v. Ministry of Public Works & Housing of Kingdom of Saudi Arabia, 135 F. Supp. 2d 350 (N.D.N.Y. 2001).

9-13 DaimlerChrysler Corp. makes and markets motor vehicles. DaimlerChrysler assembled the 1993 and 1994 model years of its trucks at plants in Mexico. Assembly involved sheet-metal components sent from the United States. DaimlerChrysler subjected some of the parts to a complicated treatment process, which included the application of coats of paint to prevent corrosion, to impart color, and to protect the finish. Under federal law, goods or U.S.-made parts that are assembled abroad can be imported tariff free. A federal statute provides that painting is “incidental” to assembly and does not affect the status of the goods. A federal regulation states that “painting primarily intended to enhance the appearance of an article or to impart distinctive features or characteristics” is not incidental. The U.S. Customs Service levied a tariff on the trucks. DaimlerChrysler filed a suit in the U.S. Court of International Trade, challenging the levy. Should the court rule in DaimlerChrysler’s favor? Explain. DaimlerChrysler Corp. v. United States, 361 F.3d 1378 (Fed. Cir. 2004).

9-14 In 1996, the International Trade Administration of the U.S. Department of Commerce assessed antidumping duties against Koyo Seiko Co., NTN Corp., on certain tapered roller bearings and their components imported from Japan. In assessing these duties, the ITA requested information from the makers about their home market sales. NTN responded in part that its figures should not include many sample and small-quantity sales, which were made to enable customers to decide whether to buy the products. NTN provided no evidence to support this assertion, however. In calculating the fair market value of the bearings in Japan, the ITA determined, among other things, that sample and small-quantity sales were within the makers’ ordinary course of trade. Koyo and others appealed these assessments to the U.S. Court of International Trade, objecting in part to the ITA’s inclusion of sample and small-quantity sales. Should the court order the ITA to recalculate its assessment on the basis of NTN’s objection? Explain. Koyo Seiko Co. v. United States, 186 F. Supp. 2d 1332 (Court of International Trade [CIT] 2002).

THINKING CRITICALLY ABOUT RELEVANT LEGAL ISSUES

Margaux de Chien, a naturalized U.S. citizen, was born in France. She went to work for Vin Enterprises, a wholly owned subsidiary of a Delaware corporation licensed to do business in Colorado. The parent company, Spanish Wines Are Us, has its principal place of business in Spain. Margaux worked in the United States for two years and then was transferred, at her request, to the company headquarters in Spain. Unfortunately, Margaux did not get along well in Spain. It seems that she was always being harassed because of her strong feelings about the superiority of French versus Spanish wine and culture. After three years at Vin Enterprises in Spain, Margaux was terminated. Margaux filed a charge of discrimination with the Equal Employment Opportunity Commission, seeking relief under both Colorado law and Title VII of the Civil Rights Act of 1964 on the ground that Vin Enterprises discriminated against her and ultimately fired her because of her national origin. Vin Enterprises claimed that Title VII does not apply to the employment practices of U.S. employers who are subsidiaries of foreign-owned companies doing business in their home countries. What is the result? Discuss the legal and ethical aspects of this case using the critical thinking approach set out in Chapter 1 of this text.
As this chapter demonstrates, there are many important issues to consider before engaging in international business. Pick a country that you know little about, and using the Web site www.lib.uchicago.edu/~llou/forintlaw.html, research the issues you think most important to consider before doing business in that country. What are its cultural, economic, political, and legal dimensions? What are its trade laws? Does it belong to any international treaties or organizations?

If you cannot find all the information you need, make a list of detailed questions you would want answered. Finally, for each of the questions you researched, explain why that question was significant in your thinking.

www.asil.org/resource/ergintr1.htm#Researching Use this site, maintained by the American Society of International Law, to guide you in researching international law issues on the Internet.

www.washlaw.edu/forint/forintmain.html This page provides links to primary foreign and international legal resources, research aids, and sites useful for international business.

www.loc.gov/law/guide/nations.html This link to the Law Library of Congress’s Nations of the World contains legal information for each country around the world.

www.icj-cij.org This page contains information about and rulings of the International Court of Justice.

www.un.org/law This Web site of the United Nations, on international law, provides useful information, including treaties governing business transactions and trade law.


FOR FUTURE READING


Private Law and the Legal Environment of Business

Part Two explores areas of private law that affect the legal environment of business. It opens with a discussion of contract law, then proceeds to examine the law of torts, product liability law, property law, agency law, and finally, the law of business associations.
It is a fundamental requirement of a free-enterprise economy that entities in the private sector and at all levels of government be able to enter into agreements that are enforceable by courts of law. Without the assurance that business agreements are legally enforceable, everyday commercial dealings would be difficult to carry out. Contract law has evolved to provide enterprises with the predictability and security they need to flourish and to produce quality products.

Contract law affects several other areas of law discussed in this book. When we take up the law of torts and product liability (Chapters 12 and 13), for instance, much of our discussion will concern breaches of the warranties of merchantability, fitness, or usefulness. In our review of the law of business associations (Chapters 17 and 18), we will examine contracts between principal and agents, employer and employees, and partners in partnership agreements. You will see when we analyze antitrust law (Chapter 25) that contracts that unreasonably restrain trade are prohibited. The basis for our discussion of labor law (Chapter 21) is collective bargaining agreements and what practices government regulation will tolerate being incorporated into those agreements. Finally, when we discuss the relationship between management and consumers (Chapter 26), the law of contracts will be our starting point. Contract law is thus immensely significant in the legal environment of business.

This chapter begins with a definition and classification of contract law. It analyzes the six elements of a contract and then explains which contracts must be in writing in order to be enforceable, the parol evidence rule, and the nature of third-party beneficiary contracts and assignment of rights.
CRITICAL THINKING ABOUT THE LAW

Contract law promotes predictability in exchange. In other words, as a future business manager, you might enter into a contractual agreement in which you agree to pay a certain amount of money in exchange for another business’s goods or services. Because contracts are legally enforceable, you are much more likely to receive these goods at the price on which you both agreed when there is an existing contract. Hence, there is greater predictability, and less risk, when a contract exists, because the possibility of a lawsuit deters businesses from deviating from the terms of a contract. Therefore, contracts keep businesses and individuals accountable to the agreements they make.

Predictability and accountability are only two reasons why contract law is so important, but certain primary ethical norms underlying these reasons have greater priority and influence than others. As you consider the benefits of contract law, this critical thinking exercise will urge you to think about the primary ethical norms that influence the law of contracts (see Chapter 1).

1. Which primary ethical norm would be most important to someone who viewed contract law as a crucial method of promoting predictability in exchange?
   Clue: This person might want to ensure that his business runs smoothly, even though some of his operations depend on another business or individual honoring the terms of the contract.

2. If someone were mostly concerned with contract law’s function of keeping businesses and individuals accountable to their agreements, which primary ethical norm would this person value the most?
   Clue: This person might be fearful that other businesses or individuals might not perform as they agreed, thereby harming those who depend on their performance.

Definition, Sources, and Classifications of Contract Law

DEFINITION

A **contract** is generally defined as a legally enforceable exchange of promises or an exchange of a promise for an act that assures the parties to the agreement that their promises will be enforceable. Contract law brings predictability to the exchange. For example, if a corporation manufacturing video recorders enters into an agreement with a retailer to provide a fixed number of video recorders each month, the retailer knows that it can rely on the corporation’s promise and advertise the availability of those video recorders to its customers, because if the manufacturer tries to renege on the agreement, its performance is enforceable in a court of law. Contracts are essential to the workings of a private-enterprise economy. They assist parties in the buying and selling of goods, and they make it possible to shift risks to parties more willing to bear them.

SOURCES OF CONTRACT LAW

Contract law is grounded in the case law of the state and federal courts, as well as state and federal statutory law. Case law—or what is often known as the **common law** because it originated with the law of English courts—governs contracts dealing with real property, personal property, services, and employment contracts. Statutory law, particularly the Uniform Commercial Code (UCC), generally governs contracts for the sale of goods. The UCC has been adopted in whole or in part by all 50 states and the District of Columbia. This chapter integrates case law with the UCC.

**Case Law.** The law of contracts originated in judicial decisions in England and the United States. Later, states and the federal courts modified their case law through the use of statutory law. Nonetheless, the formation of contract law and
its understanding are based on fundamental principles set out by the courts and, more recently, in the Restatement of the Law of Contracts. The Restatement summarizes contract principles as set out by legal scholars. Case law (or common law) applies to contracts that cover real property (land and anything attached permanently therein or thereto), personal property, services, and employment contracts.

**Uniform Commercial Code.** To obtain uniformity among state laws, particularly law as applicable to sales contracts, the National Conference of Commissioners on Uniform State Laws and the American Law Institute drafted a set of commercial laws applicable to all states. This effort was called the Uniform Commercial Code. Gradually, the states adopted the document in whole or in part. Thereafter, businesses had uniform requirements to expedite interstate contracts for the sale of goods.

In general, the requirements of Article 2 of the UCC regarding formation and performance of contracts are more liberal than those applied to contracts based on common-law principles. Particular differences are noted in sections of this chapter and Chapter 11. Article 2 seeks to govern the sale of goods in all states except Louisiana. A *sale* consists of the passing of title to goods from buyer to seller for a price. A contract for the sale of goods includes those for present and future sales. The code defines *goods* as tangible personal property. *Personal property* includes property other than real property (land and that attached thereto). When the UCC has not specifically modified the common law of contracts, common law applies.

Please note: Article 2 is continually being revised to provide coverage of contracts dealing with electronic data processing, licenses, and leases. Article 2A prescribes a set of uniform rules for the creation and enforcement of contracts for the sale of leases of goods (e.g., lease contracts for the sale of an automobile). As shown in this chapter and the following, technological advances are being treated carefully in areas of contract law, as much is at stake (e.g., money and prestige) when parties enter into contracts for the sale of technology.

### CLASSIFICATIONS OF CONTRACTS

A contract is generally referred to as a binding set of promises (agreement) that courts will enforce. Terms that refer to types of contracts are sprinkled throughout this text. So that you will clearly understand what we are talking about, we define several classifications of contracts in this section.

**Express and Implied Contracts.** An **express contract** is an exchange of oral or written promises between parties, which are enforceable in a court of law.

<table>
<thead>
<tr>
<th>Express</th>
<th>An exchange between parties of oral or written promises that are enforceable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Implied</td>
<td>A contract established by the conduct of the parties</td>
</tr>
<tr>
<td>Unilateral</td>
<td>An exchange of a promise for an act</td>
</tr>
<tr>
<td>Bilateral</td>
<td>An exchange of one promise for another promise</td>
</tr>
<tr>
<td>Void</td>
<td>A contract that at its formation has an illegal object or serious defects</td>
</tr>
<tr>
<td>Voidable</td>
<td>A contract that gives one of the parties the option of withdrawing from the agreement</td>
</tr>
<tr>
<td>Valid</td>
<td>A contract that meets all the legal requirements for a fully enforceable contract</td>
</tr>
<tr>
<td>Executed</td>
<td>A contract the terms of which have been performed</td>
</tr>
<tr>
<td>Unenforceable</td>
<td>A contract that exists but cannot be enforced because of a valid defense</td>
</tr>
<tr>
<td>Quasi-contract</td>
<td>A court-imposed agreement to prevent the unjust enrichment of one party when the parties have not previously agreed to an enforceable contract</td>
</tr>
</tbody>
</table>
law. Note that oral and written promises are equally enforceable. An **implied (implied-in-fact) contract** is established by the conduct of a party rather than by the party’s written or spoken words. For example, if you go to the dentist in an emergency and have a tooth extracted, you and the dentist have an implied agreement or contract. She will extract your throbbing tooth in a professional manner and you will pay her for her service. The existence and content of an implied-in-fact contract are determined by the reasonable-person test: Would a reasonable person expect the conduct of these parties to constitute an enforceable contract? See the following case for an examination of this concept.

### CASE 10-1

**Fox v. Mountain West Electric**  
Supreme Court of Idaho  
512 P.3d 848 (2002)

Lockheed Martin Idaho Technical Company (LMITCO) (plaintiff) requested bids for a comprehensive fire-alarm system in its 12 buildings located in Idaho Falls. Mountain West Electric (MWE) (defendant) was in the business of installing electrical wiring, conduit, and related hookups and attachments. Fox provided services in designing, drafting, testing, and assisting in the installation of fire-alarm systems. The parties decided that it would be better for them to work together, with MWE taking the lead on the project. The parties prepared a document defining each of their roles and jointly prepared a bid. MWE was awarded the LMITCO fixed-price contract. In May 1996, Fox began performing various services at the direction of MWE’s manager.

During the course of the project, many changes and modifications were made to the LMITCO contract. MWE and Fox disagreed on the procedure for compensation of the change orders. MWE proposed a flow-down procedure, whereby Fox would receive whatever compensation LMITCO decided to pay MWE. Fox found this unacceptable and suggested a bidding procedure to which MWE objected. Fox and MWE could not reach an agreement upon a compensation arrangement with respect to change orders. Fox left the project on December 9, 1996, after delivering the remaining equipment and materials to MWE. MWE contracted with Life Safety Systems to complete the LMITCO project.

Fox filed a complaint in July 1998, seeking money owed for materials and services provided to MWE by Fox. MWE answered and counterclaimed, seeking monetary damages resulting from Fox’s alleged breach of the parties’ agreement. This district court found in favor of MWE holding, that an implied-in-fact contract existed. Fox appealed.

**Justice Walters**

This Court has recognized three types of contractual relationships:

- **First is the express contract wherein the parties expressly agree regarding a transaction.**
- **Secondly, there is the implied in fact contract wherein there is no express agreement, but the conduct of the parties implies an agreement from which an obligation in contract exists.**
- **The third category is called an implied in law contract, or quasi contract.** However, a contract implied in law is not a contract at all, but an obligation imposed by law for the purpose of bringing about justice and equity without reference to the intent or the agreement of the parties and, in some cases, in spite of an agreement between the parties. It is a non-contractual obligation that is to be treated procedurally as if it were a contract, and is often referred to as quasi contract, unjust enrichment, implied in law contract or restitution.

> “An implied in fact contract is defined as one where the terms and existence of the contract are manifested by the conduct of the parties with the request of one party and the performance by the other often being inferred from the circumstances attending the performance.” The implied-in-fact contract is grounded in the parties’ agreement and tacit understanding. “The general rule is that where the conduct of the parties allows the dual inferences that one performed at the other’s request and that the requesting party promised payment, then the court may find a contract implied in fact.”

[UCC §] 1-205(1) defines “course of dealing” as “a sequence of previous conduct between the parties to a particular transaction which is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct.”

Although the procedure was the same for each change order, in that MWE would request a pricing from Fox for the work, which was then presented to LMITCO, each party treated the pricings submitted by Fox for the change orders in a different manner. This treatment is not sufficient to establish a meeting of the minds or to establish a course of dealing when there was no “common basis of understanding for interpreting [the parties’] expressions” under [UCC §] 1-205 (1).

After a review of the record, it appears that the district court’s findings are supported by substantial and competent,
albeit conflicting evidence. This Court will not substitute its view of the facts for the view of the district court.

Using the district court’s finding that pricings submitted by Fox were used by MWE as estimates for the change orders, the conclusion made by the district court that an implied in fact contract allowed for the reasonable compensation of Fox logically follows and is grounded in the law of Idaho.

The Supreme Court of Idaho ruled in favor of MWE, and the lower court decision is affirmed.

**CRITICAL THINKING ABOUT THE LAW**

An implied-in-fact contract is just as much a contract as any other enforceable agreement. In this case, the court could have substituted its interpretation of the facts for the view of the district court. It chose not to do so in deference to the district court.

1. What is the issue in this case?
   **Clue:** What is the question about which the parties are disagreeing?

2. What must the court have found for it to decide to overrule the district court?
   **Clue:** How would a clear meeting of the minds about how Fox was to have been compensated have changed this decision?

**Unilateral and Bilateral Contracts.** A **unilateral contract** is defined as an exchange of a promise for an act. For example, if City A promises to pay a reward of $5,000 to anyone who provides information leading to the arrest and conviction of the individual who robbed a local bank, the promise is accepted by the act of the person who provides the information. A **bilateral contract** involves the exchange of one promise for another promise. For example, Jones promises to pay Smith $5,000 for a piece of land in exchange for Smith’s promise to deliver clear title and a deed at a later date.

**CASE 10-2**

**Audito v. City of Providence**
United States District Court, District of Rhode Island

The city of Providence, Rhode Island, decided to hire a class of police officers in 2001. All had to graduate from the Providence Police Academy to be eligible. Two sessions were held. To be qualified, the applicants to the academy had to pass a series of tests and be deemed qualified after an interview. Those judged most qualified were sent a letter informing them that they had been selected to attend the academy if they completed a medical checkup and a psychological exam. The letter for the applicants to the 61st Academy, dated October 15, stated that it was a “conditional offer of employment.”

Meanwhile, a new chief of police was appointed in Providence. He changed the selection process, which caused some who had received the letter to be rejected. Audito and 13 newly rejected applicants (who had completed the examination) sued the City of Providence in federal district court, seeking a halt to the 61st Academy unless they attended. The plaintiffs alleged in part that the city was in breach of its contract.

**Justice Torres**

[T]he October 15 letter is a classic example of an offer to enter into a unilateral contract. The October 15 letter expressly stated that it was a “conditional offer of employment” and the message that it conveyed was that the recipient would be admitted into the 61st Academy if he or she successfully completed the medical and psychological examinations, requirements that the city could not lawfully impose unless it was making a conditional offer of employment.

Moreover, the terms of that offer were perfectly consistent with what applicants had been told when they appeared [for their interviews]. At that time, [Police Major Dennis] Simoneau informed them that, if they “passed” the [interviews], they would be offered a place in the academy if they also passed the medical and psychological examinations.

The October 15 letter also was in marked contrast to notices sent to applicants by the city at earlier stages of
the selection process. Those notices merely informed applicants that they had completed a step in the process and remained eligible to be considered for admission into the academy. Unlike the October 15 letter, the prior notices did not purport to extend a “conditional offer” of admission.

The plaintiffs accepted the city’s offer of admission into the academy by satisfying the specified conditions. Each of the plaintiffs submitted to and passed lengthy and intrusive medical and psychological examinations. In addition, many of the plaintiffs, in reliance on the City’s offer, jeopardized their standing with their existing employers by notifying the employers of their anticipated departure, and some plaintiffs passed up opportunities for other employment.

The city argues that there is no contract between the parties because the plaintiffs have no legally enforceable right to employment. The city correctly points out that, even if the plaintiffs graduate from the Academy and there are existing vacancies in the department, they would be required to serve a one-year probationary period during which they could be terminated without cause. That argument misses the point. The contract that the plaintiffs seek to enforce is not a contract that they will be appointed as permanent Providence police officers; rather, it is a contract that they would be admitted to the Academy if they passed the medical and psychological examinations.

The federal district court ruled in favor of Audito et al.

CRITICAL THINKING ABOUT THE LAW

The offer of admission to the Police Academy under certain conditions does not provide a guarantee of an employment contract. It does, however, provide the opportunities promised if the applicants fulfill certain conditions.

1. When the new police chief changed the rules for employment, why was he not permitted to do so legally?
   
   Clue: The reasoning here is similar to the reasoning whenever one party to an agreement decides it does not like the contract it previously formed.

2. What is the relevant rule of law in this case?
   
   Clue: What requirements are imposed once one makes an offer to enter into a unilateral contract?

Void, Voidable, and Valid Contracts. A contract is void if at its formation its object is illegal or it has serious defects in its formation (e.g., fraud). If Jones promises to pay Smith $5,000 to kill Clark, the contract is void at its formation because killing another person without court sanction is illegal. A contract is voidable if one of the parties has the option of either withdrawing from the contract or enforcing it. If Jones, a 17-year-old in a state where the legal age for entering an enforceable contract is 18, executes an agreement with Smith, an adult, to buy a car, Jones can rescind (cancel) the contract before he is 18 or shortly thereafter. A valid contract is one that is not void, is enforceable, and meets the six requirements discussed later in this chapter.

Executed and Executory Contracts. An executed contract is one of which all the terms have been performed. In our earlier example, if Jones agrees to buy Smith's land for $5,000, and Smith delivers clear title and a deed and Jones gives Smith $5,000, the necessary terms (assuming no fraud) have been carried out or performed. In contrast, an executory contract is one of which all the terms have not been completed or performed. If Jones agrees to paint Smith's house for $2,500 and Smith promises to pay the $2,500 upon completion of the paint job, the contract remains executory until the house is completely painted. The importance of complete performance will be shown in Chapter 11's discussion of discharge and remedies for a breach of contract.

Quasi-Contract. A quasi-contract is a court-imposed agreement to prevent unjust enrichment of one party when the parties had not really agreed to an enforceable contract. For example, while visiting his neighbor, Johnson, Jones sees a truck pull up at his own residence. Two people emerge and begin cutting his lawn and doing other landscaping work. Jones knows that neither he nor his wife contracted to have this work performed; nevertheless, he likes the job that the workers are doing, so he says nothing. When the landscapers

void contract A contract that at its formation has an illegal object or serious defects.

voidable contract A contract that gives one of the parties the option of withdrawing.

valid contract A contract that meets all legal requirements for a fully enforceable contract.

executed contract A contract of which all the terms have been performed.

quasi-contract A court-imposed agreement to prevent the unjust enrichment of one party when the parties had not really agreed to an enforceable contract.
finish, they put a bill in Jones's mailbox and drive off. It turns out that the landscapers made an honest mistake: They landscaped Jones's property when they were supposed to landscape Smith's. Jones refuses to pay the bill, arguing that he did not contract for this work. He even calls the landscapers unflattering names. The court orders Jones to pay, finding that he was unjustly enriched. (Jones would not have had to pay if he had not been in a position to correct the mistake before it took place. That is, Jones would not have had to pay had this mistaken landscaping occurred while he and his wife were vacationing in Paris.)

It should be noted that the receiver of the service must only pay for the value of the service, not necessarily the contract price, if he was in a position to stop the erroneous service.

Elements of a Legal Contract

A valid contract has six elements: (1) legal offer, (2) legal acceptance, (3) consideration, (4) genuine assent, (5) competent parties, and (6) a legal object. When these six elements are present, a legally enforceable contract usually exists.

LEGAL OFFER

The contractual process begins with a legal offer. “I will pay you $2,000 for your 1978 Cutlass,” Smith says to Jones. Smith has initiated a possible contract and is known as the offeror. Jones is the offeree. For Smith’s offer to be valid, by common-law principles, it must meet three requirements:

1. The offer must show objective intent to enter into the contract. The court will look at the words, conduct, writing, and, in some cases, deliberate omissions of the offer. The court will not concern itself with subjective measurements, such as what was in the person’s mind at the time of entering into the contract. It simply asks whether a reasonable person who listened to Smith’s statements would conclude that there was a serious intent to make an offer.

2. The offer must be definite; that is, there must be some reference to subject matter, quantity of items being offered, and price of the items. In Smith’s offer, all three references are present. Article 2 of the UCC, because it is intended to govern daily transactions in goods, is less stringent. It allows the price and other terms—but not subject matter or quantity—to remain open or to be based on an industry standard of “reasonableness.” Suppose, for example, that X offers to sell “20 widgets that are needed” to Y at a “reasonable price with specific terms to be negotiated.” This is an example of the more open-ended approach to legal offers taken by UCC Section 2-204. The courts also weigh industry custom and prior dealings to determine whether the terms are definite.

3. The offer must be communicated to the party (offeree) intended by the offeror. Smith’s offer was communicated directly to Jones, but what of an offer by Bank X to pay for information leading to the arrest and conviction of Y, a robber? Z does not know of the reward, but several days after it is offered, she sees Y running out of a store with something in his hand. Z apprehends Y. Should she get the reward from Bank X? The bank’s offer of a reward was not communicated to her, so the technical requirements of contract law have not been met. Most state courts, however, and many state statutes, would allow Z to collect, for it is public policy to encourage citizens to assist in apprehending criminals.
Methods of Termination of an Offer. Generally, the common law provides five methods of terminating an offer.

1. **Lapse of time.** The failure of the offeree to respond within a reasonable time (e.g., 30 days) will cause an offer to lapse.

2. **Death of either party.** The death of the agent of a corporation, however, will not terminate the contract, because in most cases the company will continue.

3. **Destruction of the subject matter.** If the item contracted for cannot be replaced because of an accident or occurrence that is not the fault of the offeror, the offer may be terminated.

4. **Rejection by the offeree.** If the offeree does not accept the offer, it is terminated.

5. **Revocation by the offeror.** If the offeror withdraws the offer before the offeree accepts it, the offer is terminated.

The UCC differs somewhat from the common law in methods of termination of an offer. Here are some examples.

---

**Justice Lesfmann**

We reject the claim that Winograd's contractual undertaking to pay $175,000 to Keaton should be invalidated for lack of specificity concerning the terms of the contract. The basic terms of this very simple agreement were clear.

---

In 1993, John Keaton decided to open a barbecue restaurant in Jersey City, New Jersey, and entered into a six-year lease with George Williams to occupy a portion of Williams's building. After Williams died, Morris Winograd, the owner of Satellite Entertainment Center, Inc., bought the building. Winograd planned to renovate the entire premises to open a new restaurant and bar. In September 1995, Winograd asked Keaton how much it would cost to buy his business. Keaton named a price of $175,000. Keaton later claimed, and had witnesses to corroborate the claim, that Winograd said he would pay that amount. He wanted Keaton out by the end of the year, and he wanted Keaton to manage the new enterprise. Keaton vacated the premises by December. In January, Winograd began paying Keaton a salary but did not pay him the $175,000, despite repeated requests.

In April 1997, Winograd terminated Keaton. In a subsequent claim in a New Jersey state court against Satellite and Winograd, Keaton (plaintiff) sought the $175,000. Winograd denied agreeing to pay Keaton anything. The court ruled in Keaton's favor. Winograd appealed to a state intermediate appellate court, claiming in part that the alleged agreement should not be enforced because it did not include the essential terms of an enforceable contract.

First, the price was firm: it was $175,000. So too was the description of what Winograd was purchasing. He was buying all of Keaton's business, including whatever tangible assets, inventory or "good will" might be involved. However, none of those assets were particularly significant to Winograd. Thus, it is not surprising that the parties did not, for example, itemize with specificity the inventory or the furniture of Keaton's business which was to be turned over to Winograd. To Winograd, those details were unimportant. The critical point, and the real reason for Winograd's payment of $175,000, was Keaton's agreement to vacate the property by the end of 1995, which he did.

Winograd also argues that the contract was too vague for enforcement because there was no description of the interest rate or the due date of the payment for the right to interest. He claims further that without a specified due date, the [payment] should be regarded as due on demand.

It is a settled principle that when the essential parts of a contract are spelled out, a court will not refuse to enforce that contract because some of its less critical terms have not been articulated. In such a case, the court will imply a reasonable missing term or, if necessary, will receive evidence to provide a basis for such an implication. And that is particularly true when there has been part performance of the contract, or—as here—where one of the parties (Keaton) has fully performed his part of the bargain.

Here the heart of the contract is the dollar amount to be paid to Keaton and Keaton's obligation to vacate the premises for Winograd's use. The incidental terms do not bar enforcement of the essential agreement between the parties.

*Affirmed* for the Plaintiff.
Rejection by the Offeree. At common law, a counteroffer by the offeree constitutes rejection (method 4 in the preceding list) and brings about a termination of the offer. For example, suppose Jones offers to sell his house for $200,000 and no more or less. If Smith offers Jones $185,000, Smith has terminated the original offer and now has set forth a counteroffer ($185,000), which Jones can either accept or reject.

UCC Section 2-207 allows for modification by offerees when dealing with the sale of goods. For example, in the case of nonmerchants, such as Smith and Jones, a counteroffer by the offeree (Smith) does not constitute a rejection, because there is still a clear intent to contract, but the additional term added by the offeree will not become part of the contract. For example, suppose Smith offers to sell his bicycle to Jones for $300. If Jones tells Smith that he will buy his bicycle for the amount of $300 if Smith paints it black, a contract exists even though the painting of the bicycle was not part of the original offer by Smith.

If both parties to a contract for goods are merchants, under Section 2-207, terms added to a contract by an offeree will become additional terms and part of an enforceable contract unless one of the following conditions exists: (1) the added terms are material to the contract; or (2) the offeror limited the term of the original offer to the offeree by placing it in writing; or (3) one of the parties objects to any added term within a reasonable period of time.

Revocation by the Offeror. At common law, the offer is terminated if the offeror notifies the offeree that the offer is no longer good before the offeree accepts it (revocation; method 5 in the preceding list). An offeree can forestall that type of termination by paying an offeror an amount of money to keep the offer open for a time. This tactic is called an option, and usually it will exist for 30 days. During this time, the offeror can neither sell the property to another nor revoke the offer. Under UCC Section 2-205, a firm offer made by a merchant in writing, and signed by the merchant with another, must be held open for a definite period (three months). The firm offer cannot be revoked, and no consideration is required (the offeree need not buy an option).

LEGAL ACCEPTANCE

Legal acceptance involves three requirements that must be met. For an acceptance to be valid,

1. an intent to accept must be shown by the offeree;
2. the intent must be communicated by proper means; and
3. the intent must satisfy, or “mirror,” the terms of the offer.

Intent to Accept. There must be objective intent (words, conduct, or writing) similar to that required of a legal offer. If Jones offers to sell Smith his 1978 Cutlass for $2,000 and Smith responds by stating, “I’ll think it over,” there is no objective intent to accept because there exists no present commitment on the part of Smith. In general, silence does not constitute acceptance unless prior conduct of the parties indicates that they assume it does.

Communication of Acceptance. In general, any “reasonable means of communication” may be used in accepting an offer, and acceptances are generally binding upon the offeror when dispatched. Both industry custom and the subject matter will determine “reasonableness” in the eyes of a court. If, however, the offeror requires that acceptance be communicated only in a certain form (e.g., letter), any other form that is used by the offeree (e.g., telegram) will delay the effectiveness of the acceptance until it reaches the offeror. If the offer states that “acceptance must be by mail” and the mails are used, the acceptance is effective upon deposit at the post office. If a telegram is used instead of mail,
the acceptance will not be effective until it reaches the offeror. The strictest interpretation of this rule (known as the “mailbox rule”) states that any acceptance at variance with the terms of the offer cannot form a contract even when actually received by the offeror.

Determining whether there has been a valid acceptance is not always easy, as shown by the following case involving Pamela Lee Anderson, of *Baywatch* and (more recently) *Dancing with the Stars*, fame.

**CASE 10-4**

The Private Movie Company, Inc. v. Pamela Lee Anderson et al.
Superior Court of California, County of Los Angeles (1997)

The plaintiff, Private Movie Company (Efraim), sued the defendant, Pamela Lee Anderson (Lee), for $4.6 million, alleging that she breached both an oral and a written contract so that she could work on a different project. The plaintiff claimed that an oral contract existed on November 18, 1994, when the parties agreed on all of the principal terms of a “deal,” at the conclusion of a “business meeting” at the offices of defendant’s personal manager. The plaintiff claimed that a written contract was entered into on December 21, 1994, when the plaintiff’s lawyer sent the defendant copies of a “long-form” contract. The plaintiff claimed that this contract was a written embodiment of the oral agreement reached on November 18, 1994.

The somewhat confusing facts that were testified to, and disputed, at trial made it difficult for the judge to determine whether a contract existed. The events began in October 1994, when plaintiff’s attorney, Blaha, sent the plaintiff’s script to the defendant’s agent. After several conversations, an offer was also sent to her agent. At trial, Efraim testified that Lee had said she loved the script and the character, but she was concerned about the nudity and sexual content of the script. Efraim said that he told Lee that the script would be rewritten and he would do whatever she wished regarding the nudity.

On November 18, a business meeting was held by Efraim, his attorney, the defendant’s agents (Joel and Stevens) and manager (Brody), and the director, to negotiate a contract. Those present at the meeting testified that agreement was reached on a specific makeup person, security, trailer to be provided for Lee, start date, and expenses, and per diem. The issue of limiting the amount of nudity used in the theatrical trailer or any of the advertising material was raised, and apparently was resolved by an understanding that Brody (defendant’s manager) would provide a list of dos and don’ts and that Private Movie would abide by them. The structure of the agreement was also discussed, with an understanding that there would be two contracts—an acting contract and a consulting contract—thereby allowing Private Movie to save money relating to payment of benefits. The issue of the sexual content or simulated sex in the movie script was not raised at the meeting, nor was the issue of any script rewrites brought up. At the end of the meeting, Efraim asked the defendant’s agent whether the deal was closed if Lee’s compensation was increased to $200,000. The agent said yes.

A few days later, Efraim had his attorney draft the agreement with the increased compensation. Several drafts were exchanged between the attorney and the defendant’s agent, all containing the following nudity clause:

*Nudity. The parties hereto acknowledge that the Picture will include “nude and/or simulated sex scenes.” Player has read the screenplay of the Picture prior to receipt of the Agreement and hereby consents to being photographed in such scenes, provided that such “nude and simulated sex scenes” will not be [handled] nor photographed in a manner different from what has been agreed to unless mutually approved by Artist and producer.*

The rewritten script was sent to the defendant on December 27, 1994. The plaintiff’s attorney testified that he called the defendant on December 29, 1994, and she said the script was great, but she wanted a different makeup artist and would split the difference in cost. The defendant testified that she recalled no such phone call. She said that she reviewed the script on January 1, 1995, saw that the simulated sex scenes remained, and called her manager to tell him she would not do the film.

The plaintiff found a less well-known actress to make the film and brought his action against the defendant.

**Justice Horowitz**

When the parties orally or in writing agree that the terms of a proposed contract are to be reduced to writing and signed by them before it is to be effective, there is no binding agreement until a written contract is signed. If the parties have orally agreed on the terms and conditions of a contract with the mutual intention that it shall thereupon become binding, but also agree that a formal written agreement to the same effect shall be prepared and signed, the oral agreement is binding regardless of whether it is subsequently reduced to writing.
Whether it is the intention of the parties that the agreement should be binding at once, or when later reduced to writing, or to a more formal writing, is an issue to be determined by reference to the words the parties used, as well as all of the surrounding facts and circumstances.

One of the essential elements to the existence of a contract is the consent of the parties. This consent must be freely given, mutual, and communicated by each party to the other.

Consent is not mutual unless the parties all agree upon the same thing in the same sense. Ordinarily, it is the outward expression of consent that is controlling. Mutual consent arises out of the reasonable meaning of the words and acts of the parties, and not from any secret or unexpressed intention or understanding. In determining if there was mutual consent, the Court considers not only the words and conduct of the parties, but also the circumstances under which the words are used and the conduct occurs.

Parties may engage in preliminary negotiations, oral or written, before reaching an agreement. These negotiations only result in a binding contract when all of the essential terms are definitely understood and agreed upon even though the parties intend that formal writing including all of these terms shall be signed later.

An acceptance of an offer must be absolute and unconditional. All of the terms of the offer must be accepted without change or condition. A change in the terms set forth in the offer, or a conditional acceptance, is a rejection of the offer.

Plaintiff has presented no testimony that Efraim, on 11/18/94, the date [on] which Plaintiff alleged that an oral contract was created, personally agreed to perform in the movie Hello, She Lied. Plaintiff, therefore, has the burden of proving that Joel and/or Stevens, her “agent” and “manager,” had the authority to bind her to an oral written contract.

The parties do not and did not agree on the definition of “simulated sex.” Clearly the performance of simulated sexual scenes in the film was important and material to both Lee and Efraim. Efraim stated that he would abide by whatever Lee wanted in this regard.

Nudity and sexual content are material deal points that must be resolved before there can be a binding contract. An agreement concerning sexual content or simulated sex was not reached in this instance. Lee did not agree to the terms relating to simulated sex or to the script offered by the Plaintiff.

Plaintiff’s letter of 1/13/95 to Lee claims she “agreed to perform simulated sex scenes, and the exact type of nudity had been agreed upon in detail.” Efraim claimed in deposition that Lee agreed to perform simulated sex scenes and agreed to the draft contract to confirm that fact. Blaha testified that Paragraph 9 was a correct statement of the agreement. In deposition he stated it was a mistake. The rewritten script has three or four scenes that depict simulated sex. It is obvious that the “offer” made by Plaintiff concerning this issue was not complete and unqualified, nor was there any acceptance of this issue that was complete and unqualified.

Brody and Joel testified to their opinion that they thought they had “closed the deal” on 11/18/94 or shortly thereafter. Such perceptions have very little legal relevance. Brody testified that he had authority to negotiate this contract. Joel never spoke with Lee concerning the transaction and did not negotiate points such as script rewrite or sexual content.

Plaintiff has failed to prove by a preponderance of the evidence that Lee entered into an oral or written contract to perform in the movie Hello, She Lied.

Judgment in favor of Defendant, Lee.

---

**CRITICAL THINKING ABOUT THE LAW**

We know that language is not usually clear. Words convey information but not always the information that the speaker or writer intends. **Ambiguity** characterizes those words and phrases that do not have a clear meaning. These ambiguous terms might result in another person’s misinterpreting what the writer or speaker actually meant. In contract law, ambiguity could create problems between an offeror and offeree, as the two parties might not be in agreement on the same terms of the contract if the contract contains ambiguous language. In Case 10-4, the parties thought they understood each other. Key ambiguous phrases, however, created confusion in the contract negotiations and, consequently, raised concerns about whether there was actual consent by both parties.

As business managers, it is imperative that you demand clear definitions in the contracts that you offer and accept. The following questions pertaining to Case 10-4 prompt you to consider the importance of ambiguity in contract law.

1. **What key ambiguous phrases did the court discuss?**

   **Clue:** Find the legal term in dispute that the judge defined. Also, look for ambiguity in the specific elements of the contractual negotiations between the plaintiff and the defendant.

2. **How did the ambiguity in the alleged contract affect the court’s reasoning?**

   **Clue:** Do you think the court would have ruled differently in Case 10-4 had the ambiguity not existed?
Satisfying, or "Mirroring," the Terms of the Offer. Under the common law, to be valid, the acceptance must satisfy, or "mirror," the terms of the offer. For example, if Jones offers to sell Smith his Cutlass for $2,000 and Smith responds by saying, "I'll give you $1,800," this is not a legal acceptance but a counteroffer by Smith, which then must be accepted by Jones in order for the terms of the counteroffer to be satisfied and a contract to arise. Under UCC Section 2-207, acceptance does not have to be a mirror image of the offer. Terms can be added to the contract without constituting a counteroffer if they meet one of the three conditions listed in the section on methods of termination of an offer.

Internet and E-Contracts: Acceptance Online. Parties now enter into many agreements online. Section 2-213 of the UCC deals with electronic communication of an acceptance by an offeree. This UCC section provides that "receipt of an electronic communication has a legal effect; it has that effect even though no individual is aware of its receipt," but "in itself does not establish that the content sent corresponds to the content received." Thus, receipt is required for acceptance by electronic communication, and receipt occurs when the e-mail or other message arrives, even if the receiver does not know it has arrived. Also, the parties are left to use other means of proof to establish that all of the e-mail messages made it from one party to another. The company or offeror must list all the terms of the offer that the offeree is about to enter into. The offeree (buyer) must click on "I agree" or "I agree to the terms." Usually, terms set out by the offeror (seller) include cost, payment, warranties, arbitration provisions, and other substantive terms. As “click-on,” “click-through,” or “click-warp” agreements have become customary in many industries, there is little dispute between parties as to the formation of a contract thereby.

CONSIDERATION

Consideration is defined as a bargained-for exchange of promises in which a legal detriment is suffered by the promisee. For example, Smith promises Jones that if she gives up her job with Stone Corporation, he will employ her at Brick Corporation. The two requirements of consideration are met: (1) Smith (promisor) has bargained for a return promise from Jones (promisee) that she will give up her job; (2) when Jones gives up her job, she has lost a legal right, the contractual right to her present job with Stone Corporation. The reader should note that legal detriment (giving up a legal right or refraining from exercising a legal right) must take place. Economic detriment is not necessary. For example, a student agrees not to go to any bars during fall semester in exchange for his mother's promise to give him $500. The student's giving up his right to go to bars is a legal detriment because he now cannot do something he previously could legally do.

Adequacy of Consideration. In general, the courts have not been concerned with the amount of consideration involved in a contract, especially in a business context. Even if one party makes a bad deal with another party—that is, if the consideration is inadequate—the courts will usually refuse to interfere. Unless a party can show fraud, duress, undue influence, or mistake, the court will not intervene on behalf of a plaintiff. However, sufficiency of consideration, as opposed to adequacy, will be examined by the court. Sufficiency of consideration requires both a bargained-for exchange of promises and legal detriment to the promisee.

Preexisting Duty Rule. In defining consideration, we said that a legal detriment to a promisee requires the giving up of a legal right or the refraining from exercising a right. Logically, the courts have then declared that if a party merely agrees to do what he or she is required to do, there exists no detriment to the promisee. For example, Smith contracted with Jones for Jones to build him a house by April 1, 1988, for $150,000. On February 1, 1988, Jones came to Smith and said that, because
of the number of jobs he had, he would not be able to finish by April unless Smith agreed to a bonus of $10,000. Smith agreed to the bonus, and the house was completed by April 1. Smith then refused to pay the bonus, claiming that there was a preexisting duty on the part of Jones because he had a contractual duty to finish by April 1. Jones took him to court, but lost the suit because no consideration existed for the bonus agreement. There is an important exception to the preexisting duty rule: The UCC, which applies to the sale of goods, states that an agreement modifying the original contract needs no consideration to be binding.

Promises Enforceable without Consideration. The courts have enforced certain contracts when the requirements of consideration were not met, using the doctrine of promissory estoppel to do so. This doctrine requires (1) a promise justifiably relied on by the promisee, (2) substantial economic detriment to the promisee, and (3) an injustice that cannot be avoided except by enforcing the contract.

Consider this hypothetical example. An elderly couple pledged in writing to leave $1 million to their family church for a building fund if the church raised another $1 million. The church accepted the offer, raised the matching funds, and contracted with an architect and builder. The couple died and, in their will, left the money to another church. When the family church sued the deceased’s estate on the basis of the promissory estoppel doctrine, the court awarded it the full amount pledged, even though a bargained-for exchange of promises did not exist. The family church justifiably relied upon the couple’s promise, causing substantial economic injury to the church, and injustice could not be avoided in any other way.

Liquidated and Unliquidated Debts. A liquidated debt exists when there is no dispute about the amount or other terms of the debt. If A owes B and C $500,000, and B and C agree to accept $100,000 as settlement for the debt, they are not precluded from suing A later on for the balance. The courts reason that the first agreement by A to pay a particular amount ($500,000) to B and C was supported by consideration. The second agreement to pay $100,000 was not because A had a preexisting duty to pay $500,000, and there was, therefore, no legal detriment on A’s part to support B and C’s agreement to accept the lesser amount.

An unliquidated debt exists when there is a dispute between the parties as to the amount owed by the debtor. If there is an agreement similar to the preceding one, except that the amount A originally owed B and C is in dispute, the general rule is that consideration exists for the second agreement, and the creditors cannot come back and sue for the balance of what they thought they were owed. B and C would have no claim for the full $500,000, but would be limited to $100,000. The rationale is that new consideration was given for the second agreement. There exists a legal detriment because B and C are giving up a legal right to sue for an unspecified debt. The debtor is also giving up a legal right because there is uncertainty as to what he or she owes in an unliquidated debt situation.

Promises That Lack Consideration

<table>
<thead>
<tr>
<th>Type of Consideration</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Illusory promises</td>
<td>A contract providing that only one of the parties need perform, only if he or she choose to do so; the contract is not supported by consideration.</td>
</tr>
<tr>
<td>Moral obligation</td>
<td>Contracts based on love or affection lack consideration. A majority of the states hold that deathbed promises may constitute moral obligation but lack legal binding consideration.</td>
</tr>
<tr>
<td>Preexisting duty</td>
<td>A promise lacks consideration if a person promises to perform an act or do something she already has an obligation to do. For example, many states have statutes that prevent law enforcement officers from collecting rewards when apprehending a criminal who has a reward on his or her head. Also, as noted earlier, the original terms of a contract cannot be changed or modified unless unforeseen difficulties exist. Also, some exceptions are granted by the UCC.</td>
</tr>
<tr>
<td>Illegal consideration</td>
<td>A contract is not supported by consideration if the promise is supported by an illegal act. “I agree to pay you $10,000 if you burn my house down.” Arson is unlawful and a promise to do such an act is unsupported by legal consideration.</td>
</tr>
</tbody>
</table>
GENUINE ASSENT

When two parties enter into a legally enforceable contract, it is presumed that they have entered of their own free will and that the two parties understand the content of the contract in the same way. If fraud, duress, undue influence, or mutual mistake exists, genuine assent, or a “meeting of the minds,” has not taken place, and grounds for rescission (cancellation) of the contract exist. Table 10-1 lists the factors that prevent genuine assent.

Fraud. Fraud consists of (1) a misrepresentation of a material (significant) fact, (2) made with intent to deceive the other party, (3) who reasonably relies upon the misrepresentation, (4) and as a result is injured. For example, Smith enters into a contract to sell a house to Jones. The house is 12 years old, and Smith knows that the basement is sinking. She fails to tell Jones. After Jones moves in, she finds that the house is sinking about two feet a year. In this case, there was a misrepresentation of a material fact, because Smith had a duty to disclose the fact that the house was sinking, but did not do so. Furthermore, there existed knowledge of the fact with intent to deceive. The law does not require that an evil motive exist, but only that the selling party (Smith) knew and recklessly disregarded the fact that the house was sinking. Reliance existed on the part of Jones, who thought the house was habitable, and of course injury to Jones took place because the house was not worth what she paid for it. The cost of preventing further sinking of the house would be part of the damages involved. Note that this example illustrates fraud based on a unique set of facts.

Duress. Another factor that prevents genuine assent of the parties is duress, defined as any wrongful act or threat that prevents a party from exercising free will when executing a contract. The state of mind of the party at the time of entering into the contract is important. If Smith, when executing a contract with Jones to sell a house, holds a gun on Jones and threatens to shoot Jones if he refuses to sign the contract, grounds exist for rescission of the contract. Duress is not limited to physical threats, however. Threats of economic ruin or public embarrassment also constitute duress.

COMPARATIVE LAW CORNER

"Unconscionability, Just Laws and Genuine (Mutual) Assent"

Genuine assent requires a “meeting of minds.” Historically, at common law, the parties were thought to have freedom to contract. Certain conditions were important for such freedom to contract to exist. First, it was thought that parties were usually most knowledgeable of the terms; second, the parties had equal bargaining power; third, the legislature was unable to anticipate the details for all situations regarding which contracts were negotiated. If any or all of these conditions did not exist, courts created exceptions to the freedom-to-contract rule; thus, unconscionability came into existence.

At Roman law (civil), covering much of Europe, Asia, and Latin America, the just price is the market price for similar goods. For example, German and French laws relieve a party from its obligation under contract law if there is not a just price. Such just price has its origin in early Roman law; and today it is defined as a contract for goods whose price may not deviate by more than half from the “just price.”

The importance of unconscionability at common law and just price at Roman law remains today. Contracts of nations and regions are to be enforced in courts with special interpretations of terms that have different meaning. When billions of dollars are at stake, unconscionability and just price are terms that become significant in forming contracts, as well as in enforcing them.

P

Case 10-5

Stambovsky v. Ackley and Ellis Realty
Supreme Court, Appellate Division, State of New York
169 A.D.2d 254 (1991)

Plaintiff Stambovsky purchased a home from Ackley, who was represented by Ellis Realty. After entering the contract but before closing, Stambovsky learned that the house was said to be possessed by poltergeists, reportedly seen by Ackley and her family on numerous occasions over the previous nine years. As a resident of New York City, Stambovsky was unaware that apparitions seen by the Ackleys were reported in the Reader's Digest and the local press of Nyack, New York. In 1989, the house was also included on a five-home walking tour, in which the house was described as “a riverfront Victorian (with ghost).” Stambovsky brought an action for rescission of the contract, arguing that the reputation of the house impaired the present value of the property and its resale value. He argued that the failure of the Ackleys and Ellis Realty Company to disclose the nature of the house as haunted was fraudulent in nature. The defendants argued that the principle of caveat emptor (buyer beware) applied in the state and that the real estate broker, as agent for the seller, is under no duty to disclose to a potential buyer the phantasmal reputation of the premises and that, in his pursuit of a legal remedy for fraudulent misrepresentation against the seller, plaintiff hasn’t a ghost of a chance. I am nevertheless moved by the spirit of equity to allow the buyer to seek rescission of the contract of sale and recovery of his down payment. New York law fails to recognize any remedy for damages incurred as a result of the seller’s mere silence, applying instead the strict rule of caveat emptor. Therefore, the theoretical basis for granting relief, even under the extraordinary facts of this case, is elusive if not ephemeral.

“Pity me not, but lend thy serious hearing to what I shall unfold.” (William Shakespeare, Hamlet, Act I, Scene V [Ghost].)

From the perspective of a person in the position of plaintiff herein, a very practical problem arises with respect to the discovery of a paranormal phenomenon: “Who you gonna call?” as the title song to the movie Ghostbusters asks. Applying the strict rule of caveat emptor to a contract involving a house possessed by poltergeists conjures up visions of a psychic or medium routinely accompanying the structural engineer and Terminix man on an inspection of every home subject to a contract of sale. It portends that the prudent attorney will establish an escrow account lest the subject of the transaction come back to haunt him and his client—or pray that his malpractice insurance coverage extends to supernatural disasters. In the interest of avoiding such untenable consequences, the notion that a haunting is a condition which can and should be ascertained upon reasonable inspection of the premises is a hobgoblin that should be exorcised from the body of legal precedent and laid quietly to rest.

The doctrine of caveat emptor requires that a buyer act prudently to assess the fitness and value of his purchase and operates to bar the purchaser who fails to exercise due care from seeking the equitable remedy of rescission. For the purposes of the instant motion to dismiss the action, the plaintiff is entitled to every favorable inference that may reasonably be drawn from the pleadings; specifically, in this instance, that he met his obligation to conduct an inspection of the premises and a search of available public records with most meticulous inspection and the search would not reveal the presence of poltergeists at the premises or unearth the property’s ghoulish reputation in the community. Therefore, there is no sound policy reason to deny plaintiff relief for failing to discover a state of affairs that the most prudent purchaser would not be expected to even contemplate.

The case law in this jurisdiction dealing with the duty of a vendor of real property to disclose information to the buyer is distinguishable from the matter under review. The most salient distinction is that existing cases invariably deal with the physical condition of the premises and other factors affecting its operation. No case has been brought to this court’s attention in which the property value was impaired as the result of the reputation created by information disseminated to the public by the seller (or, for that matter, as a result of possession by poltergeists). Where a condition that has been created by the seller materially impairs the value of the contract and is peculiarly within the knowledge of the seller or unlikely to be discovered by a prudent purchaser exercising due care with respect to the subject transaction, nondisclosure constitutes a basis for rescission as a matter of equity. Any other outcome places upon the buyer not merely the obligation to exercise care in his purchase but rather to be omniscient with respect to any fact that may affect the bargain. No practical purpose is served by imposing such a burden upon a purchaser. To the contrary, it encourages predatory business practice and offends the principle that equity will suffer no wrong to be without a remedy.

In the case at bar, defendant seller deliberately fostered the public belief that her home was possessed. Having undertaken to inform the public at large, to whom she has no legal relationship, about the supernatural occurrences on her property, she may be said to owe no less a duty to her contract vendee. It has been remarked that the occasional modern cases that permit a seller to take
unfair advantage of a buyer’s ignorance but has created and perpetuated a condition about which he is unlikely to even inquire, enforcement of the contract (in whole or in part) is offensive to the court’s sense of equity. Application of the remedy of rescission, within the bounds of the narrow exception to the doctrine of caveat emptor set forth herein, is entirely appropriate to relieve the unwitting purchaser from the consequences of a most unnatural bargain.

Reversed in favor of Plaintiff, Stambovsky.

**Dissenting Opinion**

The parties herein were represented by counsel and dealt at arm’s length. This is evidenced by the contract of sale, which contained various riders and a specific provision that all prior understandings and agreements between the parties were merged into the contract, that the contract completely expressed their full agreement and that neither had relied upon any statement by anyone else not set forth in the contract. There is no allegation that defendants, by some specific act, other than the failure to speak, deceived the plaintiff. Nevertheless, a cause of action may be sufficiently stated where there is a confidential or fiduciary relationship creating a duty to disclose, and there was a failure to disclose a material fact, calculated to induce a false belief. Plaintiff herein, however, has not alleged and there is no basis for concluding that a confidential or fiduciary relationship existed between these parties to an arm’s length transaction such as to give rise to a duty to disclose. In addition, there is no allegation that defendants thwarted plaintiff’s efforts to fulfill his responsibilities fixed by the doctrine of caveat emptor.

**CRITICAL THINKING ABOUT THE LAW**

Although judges frequently rely on legal precedent, there is no fixed standard by which judges must give a certain weight to precedent. In other words, judges differ in the degree to which they show deference to legal precedent and legislative acts. Consequently, several judges viewing the same case and same set of facts could reach conflicting decisions. As you learned in the chapter about the American legal system, judges work on the basis of different philosophies: some believe in judicial restraint and others believe in judicial activism. These underlying philosophies are in part responsible for the varying degrees of importance that judges give to the four primary ethical norms (see Chapter 1). In turn, the degree of importance that a judge attaches to each of these ethical norms plays a significant role in the shaping of a judge’s reasoning and the court’s conclusion. The following questions pertaining to Case 10-5 encourage you to consider the importance of primary ethical norms in a judge’s reasoning.

1. Which primary ethical norm was guiding the judge’s reasoning in the majority opinion?
   **Clue:** Consider the factors the judge discussed in favoring the plaintiff’s interests over the defendant’s interests.

2. To further illustrate the significance of ethical norms, to which ethical norm did the dissenting judge give highest priority?
   **Clue:** Similar to the first question, why do you think the judge elevated the defendant’s interests over the plaintiff’s interests?

3. What missing information would help you better evaluate the court’s reasoning?
   **Clue:** Find the reasons the plaintiff provides for rescission of the contract. What omitted evidence could have made the plaintiff’s case more convincing?

**Undue Influence.** If one party exerts mental coercion over the other party, there is undue influence and, therefore, no genuine assent. There are two court-established requirements for undue influence: (1) There must be a dominant-subservient relationship between the contrasting parties (e.g., a doctor and patient, lawyer and client, or any trusting relationship). (2) This dominant-subservient relationship must allow one party to influence the other in a mentally coercive way. An example of coercion that meets these requirements is a dying patient’s contracting with a family doctor to sell his family land at an unreasonably low price in order to pay the doctor bills.
Mistake. A mistake also prevents a meeting of the minds, or genuine assent. If both parties made an error as to a material fact, a mutual, or bilateral, mistake has occurred, and as a general rule the courts will rescind such contracts. If, however, an error is made by only one party to the contract, a unilateral mistake has occurred, and the courts generally will not grant the mistaken party a rescission of the contract. An exception to this rule is made if the nonmistaken party knew or should have known of the mistake. For example, if five contractors bid on a $10 million hospital project and Smith's bid is $2 million below all other bids because of an accountant's error, the hospital should realize the error before accepting the bid, especially if Smith immediately notifies the hospital of the mathematical error and the contract is executory in nature. A mistake of future value or quality of an object is enforceable by either party; each party has assumed that there may be a change in value.

COMPETENT PARTIES

The fifth essential element of a legally enforceable contract is competency of the parties. A person is presumed to be competent at the time of entering into a contract, so most people who raise the defense of a lack of capacity must prove that, at the time the contract was entered into, the individual did not have the ability to understand the nature of the transaction and the consequences of entering into it. This defense often arises when contracts involve minors or insane or intoxicated persons.

Minors. A minor is a person under the legal age of majority. The states differ as to age of majority for entering into enforceable contracts. The age of majority for contractual capacity should not be confused with the age at which one can drink or can vote in state and federal elections. Contracts made by minors are voidable and can be disaffirmed by the minor at any time before the minor becomes of a majority age or shortly thereafter. If the minor fails to disaffirm a contract, he or she will be considered to have ratified (approved) it and is, thus, legally bound. For example, Smith, at age 17 years, 3 months, entered into a contract with Jones to buy the latter's automobile for $2,000. In the state in which the contract was executed, the majority age was 18. After using the automobile for 2 years and 1 month, Smith returned the auto and asked for his $2,000 back, minus depreciation on the car, because he was only 17 when he entered the contract and he claimed that, therefore, the contract was voidable. Smith was not allowed to disaffirm his contract because he had ratified the agreement by failing to disaffirm it before he turned age 18 or shortly thereafter.

A minor is generally liable for the reasonable value (not the contract or the market value) of necessaries (food, clothing, shelter), which enable the minor to live in a manner to which he or she is accustomed. To avoid the issues of what constitutes a necessary, prudent businesspeople check purchasers' ages very carefully and require a parent or guardian to cosign a loan when the borrower is a minor. For example, a student who is a minor for contractual purposes is not able to obtain a loan at a bank without a parent's signature, and merchants generally check to see if a charge card in the possession of a minor is issued in a parent's name.

Statutes That Make Minors Liable for Some Contracts

At common law, state statutes and some case law make minors liable for certain contracts. They cannot assent to the common-law doctrine of disaffirmance with regard to the following:

- Contracts to support children, especially when a minor is emancipated
- Contracts to enlist in the armed forces
- Contracts for life insurance
• Contracts for medical, surgical, and pregnancy care
• Contracts for health insurance
• Contracts for sports and entertainment when a court has approved the contracts

**Insanity.** If a person is adjudicated by a court of law to be insane, or is de facto (in fact) insane at the time of entering into a contract, the individual will be allowed to disaffirm a contract. Court-appointed guardians may also disaffirm such agreements.

**Intoxication.** A person who is intoxicated to the degree that understanding the nature of the contract and its consequences is impossible will be able to disaffirm a contract in all cases but those involving necessaries. Courts will look closely at the degree of intoxication. To disaffirm, the intoxicated individual must return the item bought. In the case of necessaries, the intoxicated individual is not allowed to disaffirm, but is held liable for the reasonable value of such items.

**LEGAL OBJECT**

The sixth necessary element of a contract is a legal object. This means that the subject matter of the agreement must be lawful. If it is not, the contract is void at its inception. Contracts that are in violation of state or federal statutes, as well as those in violation of case law, are void as a matter of public policy.

**Statutory Law.** State statutes that forbid wagering agreements (betting) and usurious (defined as exorbitant) finance charges or interest rates on loans, as well as those aimed at licensing and regulation, have been the subject of much adjudication. For example, if Smith practices law in a state without being admitted to practice before its highest state court, the courts will generally not enforce any contracts Smith made with clients for services rendered. Smith may also be subject to criminal charges. State statutes require licensing of nurses, doctors, accountants, real estate agents, electricians, and many other groups (the list varies from state to state), so as to protect the public from incompetents. Some opponents of these statutes argue that they were enacted at the behest of interest groups to decrease the supply of individuals in a particular profession or trade and, hence, prevent competition. Whatever their origin, however, courts will not enforce contracts made by unlicensed providers of services for which licensure is required.

**Online Fantasy Sports: Luck or Skill?**

Online fantasy sports leagues are called “gambling,” millions play (estimates vary from 20 million to 40 million). Participants (owners) build teams based on real-life players (usually football). At the end of a week, performances of real-life players are translated into points and the points of all the players on a team are totaled at the end of a season. The winner may win money and prizes. Participants pay a fee to play and use the site facilities.

In some instances, money is paid into a “pot,” and at the end of the (football) year, each owner of a fantasy team with the most points wins the “pot.”

Are these games one of chance (luck), or of skill? It could be argued that fantasy games are games of chance because events beyond the participants' control (e.g., injury to a key player such as a quarterback) could determine the outcome for a participant's team.

If you are a day trader in securities, you are betting on stocks that you buy in a one-day period. When you buy and sell such securities (stocks, bonds, commodities), are you gambling? You are in fact “betting” that the value of the securities will go up. Is
Case Law. Often, when there is a question as to whether a contract has a lawful object, statutory law does not clearly indicate whether the contract is void or unenforceable. For example, agreements not to compete are found to be contrary to the public policy of fostering competition, and there are federal and state antitrust laws (statutes) making price-fixing between competitors illegal and void. However, when an otherwise lawful contract of employment contains a no-competition clause, pursuant to which an employee agrees not to become employed by a competitor of his or her employer, the courts will look at whether the restriction on the employee is for a reasonable time and area. In addition, it will look at the relative bargaining power of the employer and employee and the hardship on the employee who is contractually forbidden to work for another employer in the same industry. As the following case shows, each factual situation is carefully examined, and the standard of reasonableness is used to determine whether the contract is enforceable.

CASE 10-6

Moore v. Midwest Distribution, Inc.
Arkansas Court of Appeals
65 S.W.3d 490 (2002)

Moore began working in the product display business in 1997 for Hubb Group (HG). In 1999, HG terminated his contract. Moore went to work for Midwest Distribution, Inc., which also set up product displays as a contractor for HG. Midwest asked Moore to sign a “Service Work for Hire Agreement” under which Moore agreed that, for one year after the termination of his employment, he would not “provide, or solicit or offer to provide to any present or former Customer of Contractor, or become directly or indirectly interested in any person or entity which provides, or solicits or offers to provide, any services to such Customers.” The agreement applied “to those geographical areas in which the Contractor acts as independent contractor including, but not limited to, the State of Arkansas, Illinois, Iowa, Kansas, Missouri, Nebraska, New Mexico, Oklahoma, Texas, and any other state that contractor has granted a contract or agreement within.” Moore then quit this job to work for Jay Godwin, who also contracted with HG. Midwest Distribution filed a suit in an Arkansas state court against Moore, seeking to enjoin him from providing services to Godwin. The court issued a temporary injunction. Moore appealed to the state court of appeals.

Justice Crabtree

The test of reasonableness of contracts in restraint of trade is that the restraint imposed upon one party must not be greater than is reasonably necessary for the protection of the other and not so great as to injure a public interest. Where a covenant not to compete grows out of an employment relationship, the courts have found an interest sufficient to warrant enforcement of the covenant only in those cases where the covenantee provided special training, or made available trade secrets, confidential business information or customer lists, and then only if it is found that the covenantee was able to use information so obtained to gain an unfair competitive advantage.

In the present case, appellee’s [Midwest] president, Kevin Barrett, testified that appellant [Moore] had been provided with no special training. In addition, he stated that appellant had not been provided with any trade secrets, confidential business information, or customer lists. Further, Mr. Barrett testified that appellant was not using information he obtained from appellee to gain an unfair advantage over appellee, except how to install “fixtures and stuff.” We hold that appellant did not use any information to gain an unfair competitive advantage over appellee. As such, we hold that appellee did not have a legitimate interest to be protected by the agreement.

We are also persuaded that the geographical area included in the agreement is too broad. The geographical area in a covenant not to compete must be limited in order to be enforceable. The restraint imposed upon one party must not be greater than is reasonably necessary for protecting the other party. In determining whether the geographic restriction is reasonable, the trade area of the
Contracts That Must Be in Writing

Most contracts need not be in writing. They are enforceable as long as the six elements of a contract exist. The statute of frauds, which originated in England in 1677, however, requires certain business contracts to be in writing. Originally, those contracts listed in this section, and some other nonbusiness contracts, were required to be in writing because they were thought to be the most likely situations in which perjury would occur. Today, each state requires by statute that various contracts be written in order to be enforceable.

In most states, the requirements for a written contract include some evidence of writing and the signature of the party being sued. The writing should reasonably outline the terms and state who are the parties to the agreement. Contracts governed by UCC Section 2-201 are not subject to these requirements. The party suing may have the only evidence of writing with his or her signature on it. Often, between merchants, confirmation memoranda summarize oral agreements and are satisfied by only one party. The nonsigning party must simply review the memorandum. The statute of frauds is satisfied if the nonsigning party agrees to its content.

The business-related contracts discussed in this section are those that most frequently fall within the statute of frauds. They therefore must be in writing to be enforceable.

CONTRACTS FOR THE SALE OF AN INTEREST IN LAND

An “interest in land” includes mortgages, easements (an easement is a contract that allows a party to cross your land, for example, with electrical wires), and, of course, the land itself and the buildings on it. Leases for longer than one year usually have to be in writing.

A notable exception to the requirement that contracts for sale of an interest in land must be written is partial performance. For example, if substantial improvements have been made on a piece of property by a lessee in reliance on an oral commitment by the lessor to sell, the oral contract will be enforced. The case below illustrates the importance of contracts performable within one year, and the concept of reasonableness.

CONTRACTS TO PAY THE DEBTS OF ANOTHER

If Smith promises to pay Jones’s debt to the bank should Jones be unable to pay it, this contract must be in writing, under the statute of frauds. In this situation, Smith has secondary liability to the bank. If, however, Smith tells the bank that she will act as a surety for Jones’s debt, Smith has a primary liability to the bank. This agreement is not within the statute of frauds and, therefore, may be enforced even if it is only oral.

In the first situation, Smith’s promise was conditional in nature. That is, on condition that Jones does not pay, the bank may look to Smith, but first it must look to Jones. In the second situation, the bank may first look to Smith. It does not have to go to Jones at all because it has a guarantor or surety agreement with Smith.
CONTRACTS NOT PERFORMABLE IN ONE YEAR

A contract must be in writing if it specifies that it will last longer than one year (years run generally from the formation of the contract rather than the beginning of performance). For example, in most states, a baseball player who agrees to play for a team for three years at $2 million a year must sign a written contract in order for the agreement to be enforceable. If, however, no date is set in the contract for the completion of performance, the contract need not be in writing. For example, an agreement to provide help for a person until that person dies does not fall within the statute of frauds, and thus does not have to be in writing to be enforceable.

SALE OF GOODS OF $500 OR MORE

Under UCC Section 2-201, contracts for the sale of goods of $500 or more (generally the price of the goods is the determinant, not the value) fall within the statute of frauds and must be in writing to be enforceable. There are three
CHAPTER 10 • The Law of Contracts and Sales—I

283

1. Oral agreements used to prove a subsequent modification of a written agreement are admissible.
2. Oral agreements to clear up ambiguity in the written agreement are admissible.
3. Oral agreements to prove fraud, mistake, illegality, duress, undue influence, or lack of capacity are admissible.
4. Oral agreements concerning collateral matters not germane to the written agreement are admissible.

1. Oral agreements used to prove a subsequent modification of a written agreement are admissible.
2. Oral agreements to clear up ambiguity in the written agreement are admissible.
3. Oral agreements to prove fraud, mistake, illegality, duress, undue influence, or lack of capacity are admissible.
4. Oral agreements concerning collateral matters not germane to the written agreement are admissible.

exceptions to this rule: (1) one of the parties to a suit admits in writing or in court to the existence of an oral contract; (2) a buyer accepts and uses the goods; (3) the contract is between merchants, and the merchant who is sued received a written confirmation of the oral agreement and did not object within 10 days. In all of these instances, the oral contract will be enforced even if it is for goods worth $500 or more.

NONBUSINESS CONTRACTS

Nonbusiness-related contracts that must be in writing to be enforceable are (1) contracts in consideration of marriage and (2) contracts of an executor or administrator to answer for the debts of a deceased person.

Parol Evidence Rule

The parol (oral) evidence rule states that when parties have executed a written agreement, which is complete on its face, oral agreements made before or at the same time as the written agreement that vary, alter, or contradict the written agreement are invalid. Most state courts do not even allow such oral agreements to be introduced in evidence. For example, suppose that Smith enters into a written contract with Jones to sell him a two-year-old Chevy Citation for $5,000 and the contract terms state that “all warranties are excluded.” At the time of signing, Smith orally tells Jones, “Don’t worry, we’ll warranty all parts and labor.” This oral agreement made at the time of execution will not be allowed into evidence because it varies from the written agreement. Exceptions to the parol evidence rule are set out in Table 10-2.

Under UCC Section 2-202, written memoranda that are intended to be a final expression of the parties’ agreement cannot be contradicted by prior or contemporaneous oral agreement, but may be explained or supplemented orally by course of dealing or usage of trade, by course of performance, or by

<table>
<thead>
<tr>
<th>TABLE 10-2</th>
</tr>
</thead>
<tbody>
<tr>
<td>EXCEPTIONS TO THE PAROL EVIDENCE RULE</td>
</tr>
</tbody>
</table>

**Accounting**

Land is treated specially, not just in the law but in other disciplines as well. As you may recall from your accounting class, land is classified as a long-term operational asset. One distinguishing characteristic of land is that it is not subject to depreciation or depletion. In other words, land is considered to have an infinite life because it is not destroyed by use. If an organization makes a basket purchase, or acquires several assets in a single transaction, the amount paid should be carefully divided between the land and the other assets on the organizational financial statements. Therefore, the balance sheet will reflect the nondepreciable nature of the land, while allowing noticeable depreciation or depletion of the other assets purchased.

evidence of consistent additional terms. This UCC rule allows the courts to admit into evidence oral testimony with regard to written agreements that would ordinarily be inadmissible under case law.

Third-Party Beneficiary Contracts and Assignment of Rights

TYPES OF THIRD-PARTY BENEFICIARY CONTRACTS

So far, our discussion has focused on contracts between two parties (usually Smith and Jones). Two parties, however, may enter into a contract with the clear intent to benefit a third party; in these cases, there is a third-party beneficiary contract. The third party is not a party to the contract but merely a beneficiary of it. These contracts are divided into:

1. **Intended beneficiary contracts.** Two parties to a contract (promisor and promisee), either by words, writing, or actions, intend to bring benefits to a third party by virtue of an enforceable contract.

2. **Incidental beneficiary contracts.** There is no intent to bring benefits to the third party. The benefit is unintentional and the incidental beneficiary cannot sue to enforce such a contract.

A **donee–beneficiary contract** exists when the purpose of the promisee in obtaining a promise from the promisor is to make a gift to a third person. For example, Liberty Insurance Company (promisor) promises to pay Smith (third party) a sum of $100,000 upon the death of Jones (promisee) in exchange for Jones’s payment of a yearly premium. Under this third-party donee–beneficiary contract, Smith may sue Liberty Insurance Company if it fails to pay the $100,000 upon the death of Jones.

A third-party **creditor–beneficiary contract** exists when the purpose of the promisee in requiring a promisor’s performance to be made to a third person is to fulfill a legal obligation of the promisee to the third person. For example, Smith (promisee) works for Jones (promisor) in exchange for Jones’s promise to pay Taylor $6,000 that Smith owes to Taylor. Under this third-party creditor–beneficiary contract, if Smith does the work and Jones refuses to pay, Taylor may sue both Jones and Smith.

Note that insurance contracts and all forms of creditor collection agreements are third-party beneficiary contracts. These types of agreements are obviously very important in our economy.

ASSIGNMENT OF RIGHTS

An **assignment** is the present transfer of an existing right. Contracts between two parties may be assigned to a third party under certain conditions. Suppose that B, a manufacturing company, sells A, a retail company, 600 bicycles at $100 apiece on credit. A, known as the obligor-promisor, agrees to pay B, the obligee-promisee-assignor, $60,000. A does not pay, and therefore B has the right to sue A; but B has another choice: to assign this right to C, a collection agency, and receive immediate cash from C. In effect, B is assigning to C, known as the assignee, A’s promise to pay in the future in exchange for receiving cash from C now (see Exhibit 10-1). C has the right to sue both A and B. That is, if the collection agency is unable to collect the money from the retailer A, it may sue not only retailer A but also the manufacturer, B, to recover the cash it advanced in anticipation of collecting the debt.

The conditions attached to most assignments are that unless the obligor (A) receives notice of assignment by the obligee-assignor (B), the obligor has no duty to the assignee (C). Once that notice is received, however, the assignee “stands in the shoes” of the obligee.
SUMMARY

A contract is defined as a legally enforceable exchange of promises. The sources of contract law are case law from state and federal courts and statutory law from the federal and state legislatures, particularly from the UCC. Contracts may be classified as express or implied; unilateral or bilateral; void, voidable, or valid; executed or executory; and quasi.

The six necessary elements of a legal contract are (1) a legal offer, (2) a legal acceptance, (3) a consideration, (4) genuine assent, (5) competent parties, and (6) a legal object. The UCC differs somewhat from the common law in its requirements for contracts. Table 10-3 outlines some of the differences.

Some types of contracts fall within the statute of frauds and, therefore, must be in writing to be enforceable. The parol evidence rule invalidates most oral agreements made before or at the same time as a written contract if the oral agreements alter or contradict the terms of the written contract.

Third-party beneficiary contracts may be of either the donor–beneficiary or the creditor–beneficiary type. A contract made between two parties may be assigned to a third party under certain conditions.

TABLE 10-3 COMPARISON BETWEEN COMMON LAW AND THE UCC

<table>
<thead>
<tr>
<th>Area of Comparison</th>
<th>Common Law</th>
<th>UCC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract application</td>
<td>Real property, services, and employment contracts</td>
<td>Contracts for the sale of goods</td>
</tr>
<tr>
<td>Requirements for offer</td>
<td>Includes subject matter, price, and quantity</td>
<td>Includes subject matter and quantity</td>
</tr>
<tr>
<td>Option agreements</td>
<td>Requires consideration for all option agreements</td>
<td>No consideration needed</td>
</tr>
<tr>
<td>Requirements for acceptance</td>
<td>Terms of acceptance are mirror image of offer</td>
<td>Mirror image not necessary; additional terms allowed if one of three requirements is met</td>
</tr>
<tr>
<td>Requirements for consideration</td>
<td>Consideration required for contract to be enforceable except under doctrine of promissory estoppel</td>
<td>Consideration not needed for modifications</td>
</tr>
<tr>
<td>Statute of frauds (contracts that must be in writing)</td>
<td>Real estate contracts, contracts not performable within one year.</td>
<td>Sale of goods of $500 or more, with three exceptions</td>
</tr>
</tbody>
</table>
**CASE PROBLEMS**

10-12 The law firm of Traystman, Coric, and Keramidas represented Andrew Daigle in a divorce in Norwich, Connecticut. Scott McGowan, an attorney with the firm, handled the two-day trial. After the first day of the trial, McGowan demanded that Daigle sign a promissory note for the amount that Daigle then owed to the firm, or McGowan would withdraw from the case and Daigle would be forced to get another attorney or to continue the trial by himself. Daigle said that he wanted another attorney, Martin Rutchik, to see the note. McGowan urged Daigle to sign it and assured him that a copy would be sent to Rutchik. Feeling that he had no other
choice, Daigle signed the note. When he did not pay, the law firm filed a suit in a Connecticut state court against him. Daigle asserted that the note was unenforceable because he had signed it under duress. *Traystman, Coric, & Keramidas v. Daigle*, 84 Conn. App. 843, 855 A.2d 996 (2004).

**10-13** AES was formed in 1996, at which time it hired eight employees. At a meeting of these employees in 1997, they expressed concern that the company might not survive, as it was using outdated equipment. At that meeting, a company executive asked the employees to remain with the firm and stated that the company was likely to merge with another firm, and if it did, the original eight employees would receive 5 percent of the value of the sale or merger as a reward for staying. In 2001, AES was bought by another firm, and the seven employees who had stayed sought to collect their 5 percent. The company refused to pay on the ground that there was no contract. Did the company and employees have a bilateral or a unilateral contract? Explain. *Vanegas v. American Energy Services*, 302 S.W.3d 299; 53 Tex. Sup. J. 204 (2009).

**10-14** The plaintiffs entered into an oral agreement with the New York University Medical Center for an in vitro fertilization procedure that would not result in an autistic child. They subsequently signed a written agreement stating that a certain percentage of children are born with physical and mental defects and that these are beyond the control of the physician. When one of the twins born as a result of the procedure was autistic, the plaintiffs sued for breach of the oral agreement. The lower court granted summary judgment in favor of the Medical Center. Why do you think this award was upheld on appeal? *Scaliel et al. v. New York University Medical Center*, 805 N.Y.S.2d 62 (N.Y. App. Div., 1st Dept., 2005).

**10-15** Locke was a physical education teacher and an umpire represented by the Southeast Alabama Umpires Association. The contract between the Umpires Association and the Ozark City Board of Education provided that the city would provide police protection at all games at which the Association’s umpires were working. One evening, Locke was working at a high school game and no police protection was provided. At that game, a player’s parent attacked him, punching him several times in the face. He subsequently sued the board for failing to provide police protection. The board argued that he was not entitled to sue because he was not a party to the contract. The trial court found that he was an unintended beneficiary and granted the board summary judgment. What do you think the outcome was on appeal? Why? *Locke v. Ozark Board of Education*, 970 So. 2d 1247 (Ark. 2005).

**10-16** The National Collegiate Athletic Association (NCAA) regulates intercollegiate amateur athletics among the more than 1,200 colleges and universities with which it contracts. Among other things, the NCAA maintains rules of eligibility for student participation in intercollegiate athletic events. Jeremy Bloom, a high-school football and track star, was recruited to play football at the University of Colorado (CU). Before enrolling, he competed in Olympic and professional World Cup skiing events, becoming the World Cup champion in freestyle moguls. During the Olympics, Bloom appeared on MTV and was offered other paid entertainment opportunities, including a chance to host a show on Nickelodeon. Bloom was also paid to endorse certain ski equipment and contracted to model clothing for Tommy Hilfiger. On Bloom’s behalf, CU asked the NCAA to waive its rules restricting student-athlete endorsement and media activities. The NCAA refused, and Bloom quit the activities to play football for CU. He filed a suit in a Colorado state court against the NCAA, however, asserting breach of contract on the ground that NCAA rules permitted these activities if they were needed to support a professional athletic career. The NCAA responded that Bloom did not have standing to pursue this claim. What contract was allegedly breached in this case? Is Bloom a party to this contract? If not, is he a third-party beneficiary of it? Explain. *Bloom v. National Collegiate Athletic Association*, 93 P.3d 621 (Colo. Ct. App. 2004).

**THINKING CRITICALLY ABOUT RELEVANT LEGAL ISSUES**

Megawidget Corporation wants to buy 1,000 widget parts from Douglas Dealer. Megawidget’s president, Mega Buyer, sends an e-mail message to Douglas placing an order for the 1,000 widget parts at $10,000. Douglas e-mails back and clicks on a button on his computer screen, which is an icon of a little hand shaking. Mega receives the e-mail and also clicks on the handshake icon on his computer. A week later, Mega finds out that he can buy the widget parts cheaper from Dealing Dan. Mega wants to rescind his contract with Douglas, and so claims that, under Article 2 of the UCC, his contract with Douglas had to be in writing to be valid; that is, the e-mail was not a written contract and the “handshake” via icon was
meaningless. Discuss the outcome of this contract dispute using a critical thinking approach.

1. What is the legal issue in this case? Explain.
2. What language in what section of Article 2 of the UCC is relevant in deciding this case? Is the language ambiguous? Explain.

3. What information seems to be missing from this case exposition? Explain.

ASSIGNMENT ON THE INTERNET

This chapter provides information on the numerous requirements of traditional contract law. New ways of deciding contract disputes, however, may be needed as the Internet allows more people to enter into contracts through cyberspace. Using the links that follow, or by visiting www.jurisdiction.com/ecom3.htm, discover three new issues of contract law that arise out of electronic contracts that are not addressed in this chapter.

Then, use your critical thinking skills to apply the existing law to these new issues. Will the existing law resolve the new issues? What direction do you predict courts will take on the questions you have discovered?

ON THE INTERNET

www.loc.gov From this site you can find links to a wealth of information about contracts.
www.law.cornell.edu/topics/contracts.html This site will provide even more links to information about contract law.
www.lectlaw.com/formb.htm A site that provides multiple contract examples and forms.
www.legaldocs.com This site provides information about how to prepare contracts and contains legal forms to use as templates for your own contracts.
www.findlaw.com/01topics/07contracts/gov_agencies.html This site contains links to government agencies that regulate contracts.
www.biercekenerson.com/Articles/E-Contracts.htm Court cases involving electronic contracts are increasing, and this Web site contains a number of the more important cases that are setting precedent.

FOR FUTURE READING

In our discussion of the law of contracts in Chapter 10, we were concerned that agreements be enforceable. We noted that without enforceability of contract law by a court, there would be no predictability for enterprises that produce and sell goods. Without this there would be no security and financial stability for a firm. We would see the risk of loss increase and entrepreneurship decline if contracts were not enforceable at all levels of the manufacturing, marketing, and distribution of services and goods.

In this chapter we carefully examine the methods by which a contract can be discharged (particularly through performance), as well as the remedies that are possible for firms and individuals who are injured by a breach of contract for the sale of goods (Articles 2 and 2A of the Uniform Commercial Code [UCC]). E-contracts are highlighted and the concepts underlying them are distinguished from traditional contract principles. This chapter also addresses the international dimensions of contracts and sales agreements.

CRITICAL THINKING ABOUT THE LAW

In Chapter 10, we emphasized the importance of predictability and stability for those who enter into contracts. Nevertheless, we do not want parties to jump immediately to the conclusion that they have a contract every time they talk about an exchange. Instead, we want to make it possible for people to talk about an exchange without having actually made a commitment to the exchange. Why?

To aid your critical thinking about issues surrounding contract formation and performance, let’s look at a fact pattern involving concert tickets.

Jennifer and Juan were recently involved in a breach-of-contract case. Juan had two extra tickets to a Garth Brooks concert, and he agreed to sell these tickets to Jennifer. After they had agreed on the price, Juan promised to give the tickets to Jennifer the next day. The next day, however, Jennifer did not want the tickets. Jennifer had discovered that it was an outdoor, afternoon concert. Jennifer argued that she should not have to buy the tickets because she is allergic to sunlight and unable to spend any extended period of time outside. The judge ruled in favor of Jennifer.

1. What ethical norms seem to dominate the judge’s thinking (see Chapter 1)?

Clue: We have said that security is one reason for enforcing contracts. Review your list of ethical norms. Which norms seem to conflict with security in this case?
Methods of Discharging a Contract

When a contract is terminated, it is said to be discharged. A contract may be discharged by performance (complete or substantial), mutual agreement, conditions precedent and subsequent, impossibility of performance, or commercial impracticability.

DISCHARGE BY PERFORMANCE

In most cases, parties to an agreement discharge their contractual obligation by doing what was required by the terms of the agreement. Many times, however, performance is substantial rather than complete. Traditional common law allowed suits for breach of contract if there was not complete performance of every detail of the contract. Today, however, the standard is substantial performance. This standard requires (1) completion of nearly all the terms of the agreement, (2) an honest effort to complete all the terms, and (3) no willful departure from any of the terms.

Courts usually find substantial performance when there is only a minor breach of contract. For example, A, a contractor, agreed to build a house with five bedrooms for B. By the terms of the agreement, each of the rooms was to be painted blue. By mistake, one was painted pink, and B refused to pay A the $10,000 balance due on the house. The court awarded A $10,000 minus the cost of painting the wrongly painted room, finding that the departure from the contract terms was slight and unintentional and, therefore, insufficient for B to refuse to perform (pay) as agreed to in the contract.

If the breach is material, the injured party may terminate the contract and sue to recover damages. A material breach is substantial and, usually, intentional. Today, courts allow a party to “cure” a material breach if the time period within which a contract is supposed to be performed has not lapsed. The following classic case concerns a dispute over whether there was a minor or a material breach of contract by a home builder and which of two rules the court should use to measure damages.

CASE 11-1

Plante v. Jacobs
Supreme Court of Wisconsin
103 N.W.2d 296 (1960)

Plaintiff-appellee Plante sued defendants-appellants the Jacobs to obtain a lien on their property to recover $26,765 owed Plante by the Jacobs. Plante had agreed to build a house on a lot owned by the Jacobs according to specifications. A dispute arose when the misplacement of a wall caused the living room to be smaller than specified. The amount unpaid was approximately 25 percent of the contract price. It would have cost $4,000 to tear down the wall and rebuild. Real estate experts claimed that the value of the house was not affected by the smaller width of the living room.
The plaintiff conceded that he had failed to provide gutters and downspouts, a sidewalk, closet clothes poles, and other small items amounting to $1,601.95. He claimed, however, that he had substantially performed the contract. The defendants argued that Plante had not substantially performed and, therefore, there was a material breach of the contract. The lower court ruled in favor of Plante for $4,152.90. The Jacobs appealed.

**Justice Hallows**

Substantial performance as applied to construction of a house does not mean that every detail must be in strict compliance with the specifications and the plans. Something less than perfection is the test of specific performance unless all details are made the essence of the contract. This was not done here. There may be situations in which features or details of construction of special or of great personal importance, . . . which if not performed, would prevent a finding of substantial performance of the contract. In this case the plan was a stock floor plan. No detailed construction of the house was shown on the plan. There were no blueprints. The specifications were standard printed forms with some modifications and additions written in by the parties. Many of the problems that arose during the construction had to be solved on the basis of practical experience. No mathematical rule relating to the percentage of the price, of cost of completion, or of completeness can be laid down to determine substantial performance of a building contract. Although the defendants received a house with which they are dissatisfied in many respects, the trial court was not in error in finding the contract was substantially performed.

The next question is what is the amount of recovery when the plaintiff has substantially, but incompletely, performed. For substantial performance the plaintiff should recover the contract price less the damages caused the defendant by the incomplete performance. Both parties agree the correct rule for damages due to faulty construction amounted to such incomplete performance is the difference between the value of the house if it had been constructed in strict accordance with the plans and specifications. This is the diminished-value rule. The cost of replacement or repair is not the measure of such damage, but is an element to take into consideration in arriving at value under some circumstances. The cost of replacement or the cost to make whole the omissions may equal or be less than the difference in value in some cases and, likewise, the cost to rectify a defect may greatly exceed the added value to the structure as corrected. The defendants argue that under this rule their damages are $10,000. The plaintiff on review argues the defendants’ damages are only $650. Both parties agree the trial court applied the wrong rule to the facts.

The trial court applied the cost-of-repair or replacement rule as to several items, stating when there are a number of small items of defect or omission, which can be remedied without the reconstruction of a substantial part of the building or a great sacrifice of work or material already wrought in the building, the reasonable cost of correcting the defect should be allowed.

The trial court disallowed certain claimed defects because they were not proven. This finding was not against the great weight and clear preponderance of the evidence and will not be disturbed on appeal. Of the remaining defects claimed by the defendants, the court allowed the cost of replacement or repair except as to the misplacement of the living-room wall. Whether a defect should fall under the cost-of-replacement rule or be considered under the diminished-value rule depends upon the nature and magnitude of the defect. This court has not allowed items of such magnitude under the cost-of-repair rule as the trial court did.

Viewing the construction of the house as a whole and its cost we cannot say, however, that the trial court was in error in allowing the cost of repairing the plaster cracks in the ceilings, the cost of mud jacking and repairing the patio floor, and the cost of reconstructing the non-weight-bearing and nonstructural patio wall. Such reconstruction did not involve an unreasonable economic waste.

The item of misplacing the living-room wall under the facts of this case was clearly under the diminished-value rule. There is no evidence that defendants requested or demanded the replacement of the wall in the place called for by the specifications during the course of construction. To tear down the wall now and rebuild it in its proper place would involve a substantial destruction of the work, if not all of it, which was put into the wall and would cause additional damage to other parts of the house and require replastering and redecorating the walls and ceilings of at least two rooms. Such economic waste is unreasonable and unjustified. The rule of diminished value contemplates the wall is not going to be moved. Expert witnesses for both parties, testifying as to the value of the house, agreed that the misplacement of the wall had no effect on the market price. The trial court properly found that the defendants suffered no legal damage, although the defendants’ particular desire for specified room size was not satisfied.

It would unduly prolong this opinion to detail and discuss all the disputed items of defects of workmanship or omissions. We have reviewed the entire record and considered the points of law raised and believe the findings are supported by the great weight and clear preponderance of the evidence and the law properly applied to the facts.

_Affirmed_ in favor of Plaintiff, Plante.

**CRITICAL THINKING ABOUT THE LAW**

Although rules of law provide guidance for courts’ reasoning in subsequent cases, judges are not tightly bound by these rules. As you already read, common law previously required complete performance to discharge a contract. Common law, however, evolved to require only substantial performance, but the shift to a less strict requirement for contract performance does not occur arbitrarily. Judges who lessened the requirements for discharge by performance provided
Uniform Commercial Code and Performance and Convention on International Sale of Goods. The substantial performance doctrine does not apply to the sale of goods. The performance of a sale or lease contract under UCC Section 2-301 requires the seller or lessor to transfer and deliver what is known as conforming goods (perfect tender rule). The buyer or lessee must accept and pay for the conforming goods. The UCC states an exception to the perfect tender rule. If the goods or tender of delivery fail to conform to the contract in any respect, the buyer has the following options: (1) reject all the goods, (2) accept all that are tendered, or (3) accept any number of units the buyer chooses to and reject the rest. The buyer must generally give notice to the seller of any defect in the goods or tender of delivery and then allow the seller a reasonable time to cure the defect.

Seventy nations are signatories to the United Nations Convention on the International Sale of Goods (CISG), and goods are sold worldwide under the authority of the CISG. Under that convention, all four of the following conditions must be met to show an exception to the perfect tender rule: (1) the buyer has resorted to another remedy, such as avoidance or price reduction; (2) the seller failed to deliver or, in the case of nonconforming goods, the nonconformity was so serious that it constituted a fundamental breach; (3) the buyer gave timely notice to the seller that the goods were nonconforming; and (4) the buyer made a timely request that the seller provide substitute goods. As in the civil-law nations, the court may grant specific performance without regard to whether money damages are inadequate.

DISCHARGE BY MUTUAL AGREEMENT

After a contract is formed, the parties may agree that they should rescind (cancel) the contract because some unforeseen event took place that makes its fulfillment financially impracticable. For example, if A agrees to build B a house for $150,000, and then, while building the basement, runs into an unforeseen and uncorrectable erosion factor, both parties may want to cancel the agreement, with restitution to A for expenditures on the basement construction. The contract is then said to be discharged by mutual agreement.
CHAPTER 11 • The Law of Contracts and Sales—II

Sometimes the parties wish to rescind an original agreement and substitute a new one for it. This type of discharge by mutual agreement is called accord and satisfaction. If the parties wish to substitute new parties for the original parties to the agreement, this is called novation. Note that novation does not change the contractual duties; it merely changes the parties that will perform those duties. Suppose a rock star (original party) is unable to perform at a concert because of illness, and a star of the same stature (substitute party) agrees to appear instead. If all parties, including the concert impresario, agree to the substitution, there is discharge by mutual agreement.

DISCHARGE BY CONDITIONS PRECEDENT AND SUBSEQUENT

**Condition Precedent.** A **condition precedent** is a particular event that must take place in order to give rise to a duty of performance. If the event does not take place, the contract may be discharged. For example, when Smith enters into a contract with Jones to sell a piece of real estate, a clause in the agreement requires that title must be approved by Jones’s attorney before closing and execution of the contract for sale. If Jones’s attorney does not give this approval before the closing, then Jones is discharged from the contract. The following case illustrates discharge of a contract by a condition precedent.

**CASE 11-2**

**Architectural Systems, Inc. v. Gilbane Building Co.**

U.S. District Court, Maryland

Carley Capital Group (Carley) was the owner of a project in the city of Baltimore known as “Henderson’s Wharf.” The project was designed to convert warehouses into residential condominiums. On September 4, 1987, Carley hired Gilbane Building Company (Gilbane) to be the general contractor and construction manager for the project. Gilbane hired Architectural Systems, Inc. (ASI), as the subcontractor to perform drywall and acoustical tile work on the project. The subcontract included the following clause: “It is specifically understood and agreed that the payment to the trade contractor is dependent, as a condition precedent, upon the construction manager receiving contract payments from the owner.”

Gilbane received periodic payments from Carley and paid ASI as work progressed. By late 1988, ASI had satisfactorily performed all of its obligations under the subcontract and submitted a final bill of $348,155 to Gilbane. Gilbane did not pay this bill because it had not received payment from Carley. On March 10, 1989, Carley filed for bankruptcy. ASI sued Gilbane, seeking payment.

**Justic Young**

ASI argues that it did not assume the credit risk simply by the inclusion of the statement “as a condition precedent” in the subcontract. It may not be sound business practice to accept such a business proposal but that is what occurred. The provision unambiguously declares that Gilbane is not obligated to pay ASI until it first received payment by the owner. The cause for the owner’s non-payment is not specifically addressed and could be due to a number of causes, including insolvency.

A provision that makes a receipt of payment by the general contractor a condition precedent to its obligation to pay the subcontractor transfers from the general contractor to the subcontractor the credit risk of non-payment for any reason (at least for any reason other than the general owner’s own fault), including insolvency of the owner.

**Decision** in favor of Gilbane.

**Condition Subsequent.** A **condition subsequent** is a particular future event that, when it follows the execution of a contract, terminates the contract. For example, a homeowner’s insurance contract may discharge the insurer from responsibility for coverage in the event of an “act of war” (condition subsequent).
DISCHARGE BY IMPOSSIBILITY OF PERFORMANCE

In early common law, when disruptive unanticipated events (e.g., war) occurred after the parties entered into a contract, the contract was considered enforceable anyway. Thus, if a shipping line could not transport goods it had agreed to transport because of a wartime blockade, or if it could transport the goods but had to take a more expensive route to do so, it (or its insurance carrier) was required to pay damages or absorb the costs of the longer route. Courts today take the view that if an unforeseeable event makes a promisor’s performance objectively impossible, the contract is discharged by impossibility of performance.

Objectively impossible is defined as meaning that no person or company could legally or physically perform the contract.

This defense to nonperformance is used most frequently in three circumstances. First is the death or illness of a promisor whose personal performance is required to fulfill the contract when no substitute is possible. For example, suppose that a world-renowned artist is commissioned to paint an individual’s portrait. If the artist dies, the contract is discharged because there is no substitute for the artist. Second is a change of law making the promised performance illegal. For example, if A enters into a contract with B to sell B her home to be used for residential purposes, and subsequent to their agreement the property is zoned commercial, the contract will be discharged. The final circumstance is the destruction of the subject matter. If A enters into a contract with B to buy all the hay in B’s barn and the barn burns down with the hay in it before shipment takes place, the contract is discharged because performance is impossible.

DISCHARGE BY COMMERCIAL IMPRACTICABILITY

The courts have sought to enlarge the grounds for discharge of a contract by adding the concept of commercial impracticability, defined as a situation in which performance is impracticable because of unreasonable expense, injury, or loss to one party. In effect, a situation that was not foreseeable, or the nonoccurrence of which was assumed at the time the contract was executed, in fact occurs, making performance of the contract unreasonably expensive or injurious.

LINKING LAW AND BUSINESS

Management and Production

Quality is defined as the extent to which a product functions as intended. The measure of excellence for a product is ranked primarily by the purchaser on the basis of certain characteristics and features, but the managers must oversee production processes to ensure that quality standards are being met. Managers are continuing to realize that an improvement in the quality of products leads to greater productivity for the organization. By emphasizing greater quality, a firm will probably spend less time and money on repairing defective products. Also, manufacturing quality products reduces the chance of production mistakes and inefficient use of materials.

One method of providing greater assurance that an organization is producing quality products is with statistical quality control. This is a process by which a certain percentage of products for inspection is determined to ensure that organizational standards for quality are met. Organizations that place a strong emphasis on quality, possibly by implementing an effective statistical quality control strategy, are less likely to be faced with having their goods rejected under the perfect tender rule or facing litigation for a breach of contract over defective products. Thus, a serious and consistent emphasis on quality reaps many benefits for an organization.

to a party. For example, a plastics manufacturer becomes extremely short of raw materials because of a war and an embargo on oil coming from the Middle East. The manufacturer's contracts with retailers for plastic goods will be discharged in most cases if the court finds that the manufacturer could not have anticipated the war and had no alternative source of materials costing about the same price.

The contract dispute in the following case arose out of the cancellation of a wedding reception due to a power failure. Is a power failure sufficient to invoke the doctrine of commercial impracticability?

CASE 11-3

Facto v. Pantagis
Superior Court of New Jersey, Appellate Division
915 A.2d 59 (2007)

Leo and Elizabeth Facto contracted with Snuffy Pantagis Enterprises, Inc., for the use of Pantagis Renaissance, a banquet hall in Scotch Plains, New Jersey, for a wedding reception in August 2002. The Factos paid the $10,578 price in advance. The contract excused Pantagis from performance “if it is prevented from doing so by an act of God (e.g., flood, power failure, etc.) or other unforeseen events or circumstances.” Soon after the reception began, there was a power failure. The lights and the air-conditioning shut off. The band hired for the reception refused to play without electricity to power their instruments, and the lack of lighting prevented the photographer and videographer from taking pictures. The temperature was in the 90s, the humidity was high, and the guests quickly became uncomfortable. Three hours later, after a fight between a guest and a Pantagis employee, the emergency lights began to fade, and the police evacuated the hall. The Factos filed a suit in a New Jersey state court against Pantagis, alleging breach of contract, among other things. The Factos sought to recover their prepayment, plus amounts paid to the band, the photographer, and the videographer. The court concluded that Pantagis did not breach the contract and dismissed the complaint. The Factos appealed to a state intermediate appellate court.

Justice Skillman

Even if a contract does not expressly provide that a party will be relieved of the duty to perform if an unforeseen condition arises that makes performance impracticable, a court may relieve him of that duty if performance has unexpectedly become impracticable as a result of a supervening event. In deciding whether a party should be relieved of the duty to perform a contract, a court must determine whether the existence of a specific thing is necessary for the performance of a duty and its destruction or deterioration makes performance impracticable. A power failure is the kind of unexpected occurrence that may relieve a party of the duty to perform if the availability of electricity is essential for satisfactory performance.

The Pantagis Renaissance contract provided: “Snuffy’s will be excused from performance under this contract if it is prevented from doing so by an act of God (e.g., flood, power failure, etc.), or other unforeseen events or circumstances.” Thus, the contract specifically identified a “power failure” as one of the circumstances that would excuse the Pantagis Renaissance’s performance. We do not attribute any significance to the fact the clause refers to a power failure as an example of an “act of God.” This term has been construed to refer not just to natural events such as storms but to comprehend all misfortunes and accidents arising from inevitable necessity which human prudence could not foresee or present. Furthermore, the clause in the Pantagis Renaissance contract excuses performance not only for “acts of God” but also “other unforeseen events or circumstances.” Consequently, even if a power failure caused by circumstances other than a natural event were not considered to be an “act of God,” it still would constitute an unforeseen event or circumstance that would excuse performance.

The fact that a power failure is not absolutely unforeseeable during the hot summer months does not preclude relief from the obligation to perform. Absolute unforeseeability of a condition is not a prerequisite to the defense of impracticability. The party seeking to be relieved of the duty to perform only needs to show that the destruction, or deterioration of a specific thing necessary for the performance of the contract makes performance impracticable. In this case, the Pantagis Renaissance sought to eliminate any possible doubt that the availability of electricity was a specific thing necessary for the wedding reception by specifically referring to a “power failure” as an example of an “act of God” that would excuse performance.

It is also clear that the Pantagis Renaissance was “prevented from” substantial performance of the contract. The power failure began less than forty five minutes after the start of the reception and continued until after it was scheduled to end. The lack of electricity prevented the band from playing, impeded the taking of pictures by the photographer and videographer and made it difficult...
for guests to see inside the banquet hall. Most significantly, the shutdown of the air-conditioning system made it unbearably hot shortly after the power failure began. It is also undisputed that the power failure was an area-wide event that was beyond the Pantagis Renaissance’s control. These are precisely the kind of circumstances under which the parties agreed [in their contract] that the Pantagis Renaissance would be excused from performance.

Where one party to a contract is excused from performance as a result of an unforeseen event that makes performance impracticable, the other party is also generally excused from performance.

Therefore, the power failure that relieved the Pantagis Renaissance of the obligation to furnish plaintiffs with a wedding reception also relieved plaintiffs of the obligation to pay the contract price for the reception.

Nevertheless, since the Pantagis Renaissance partially performed the contract by starting the reception before the power failure, it is entitled to recover the value of the services it provided to plaintiffs.

Reversed for Facto.

Remedies for a Breach of Contract

The fact that a court will enforce a contract does not mean that one party will automatically sue if the other breaches. Businesspeople need to consider several factors before they rush to file a lawsuit: (1) the likelihood of the suit’s succeeding; (2) whether they wish to maintain a business relationship with the breaching party; (3) the possibility of arbitrating the dispute through a third party, thus avoiding litigation; and (4) the cost of arbitration or litigation as opposed to the revenues to be gained from enforcing the contract.

Remedies for a breach of contract are generally classified according to whether the plaintiff requests monetary damages (“legal” remedies) or nonmonetary damages (equitable remedies). Remedies for breach set out by the CISG include: (1) avoidance or cancellation of contract, (2) right to remedy or cure, (3) setting of additional time or extension, (4) price/reductions, (5) money damages, and (6) specific performance.

MONETARY DAMAGES (“LEGAL” REMEDIES)

Monetary damages (often referred to as exemplary damages) include compensatory, punitive, nominal, and liquidated damages.

Compensatory Damages. The purpose of compensatory damages is to place the injured (nonbreaching) party to a contract in the position in which that party would have been in had the terms of the contract been performed. For example, if a firm contracted to buy 8,000 widgets at $10 apiece to be delivered by August 15, the buyer has a right to go out and buy the widgets from another source if they are not delivered by the contract date. Suppose the widgets bought from the other source cost $10.50 apiece. In that case, the buyer can sue for the 50-cent difference in price per unit plus court costs. If the buyer cannot obtain widgets anywhere else, it can sue for lost profits.

The courts have set out three standards that the plaintiff-buyer must meet in order to recoup lost profits:

1. The plaintiff-buyer must show that it was reasonably foreseen by the defendant-seller that if it did not deliver the promised goods, the buyer would have no alternative source and, thus, would lose profits.
2. The plaintiff-buyer must show the amount of the damages with reasonable certainty; the buyer cannot just speculate about what this amount is.
3. The plaintiff-buyer must show that it did everything possible to mitigate the damage—that is, it looked for other possible sources of the goods.

In the landmark case that follows, a famous actress and dancer litigated a contract that involved the mitigation of damages.
Shirley Parker v. Twentieth Century Fox Film Corp.
Supreme Court of California
474 P.2d 689 (1970)

Shirley Parker is the legal name of well-known actress Shirley MacLaine, who contracted with Twentieth Century Fox Film Corporation to play the female lead in a picture entitled Bloomer Girl, a musical. The film corporation decided against making the film, and so notified Parker, but offered to employ her in another film, Big Country. The compensation was the same, but the latter picture was a Western to be shot in Australia as opposed to a musical. Parker was given one week to accept. She didn’t, and sued Twentieth Century Fox, seeking recovery of $750,000 plus interest. The defendants argued against the awarding of damages to Parker because, they claimed, she failed to mitigate her damages by accepting the part in Big Country. The trial court awarded summary judgment to Parker. Twentieth Century Fox appealed.

Justice Burke

The complaint sets forth two causes of action. The first is for money due under the contract; the second, based upon the same allegations as the first, is for damages resulting from defendant’s breach of contract. Defendant, in its answer, admits the existence and validity of the contract, that plaintiff complied with all the conditions, covenants and promises and stood ready to complete the performance, and that defendant breached and “anticipatorily repudiated” the contract. It denies, however, that any money is due to plaintiff either under the contract or as a result of its breach, and pleads as an affirmative defense to both causes of action plaintiff’s allegedly deliberate failure to mitigate damages, asserting that she unreasonably refused to accept its offer of the leading role in Big Country.

Plaintiff moved for summary judgment under Code of Civil Procedure Section 437c, the motion was granted, and summary judgment for $750,000 plus interest was entered in plaintiff’s favor. This appeal by defendant followed.

As stated, defendant’s sole defense to this action, which resulted from its deliberate breach of contract, is that in rejecting defendant’s substitute offer of employment, plaintiff unreasonably refused to mitigate damages.

The general rule is that the measure of recovery by a wrongfully discharged employee is the amount of salary agreed upon for the period of service, less the amount the employer affirmatively proves the employee has earned or with reasonable effort might have earned from other employment. However, before projected earnings from other employment opportunities not sought or accepted by the discharged employee can be applied in mitigation, the employer must show that the other employment was comparable, or substantially similar, to that of which the employee has been deprived; the employee’s rejection of or failure to seek other available employment of a different or inferior kind may not be resorted to in order to mitigate damages.

In the present case defendant has raised no issue of reasonableness of efforts by plaintiff to obtain other employment; the sole issue is whether plaintiff’s refusal of defendant’s substitute offer of Big Country may be used in mitigation. Nor, if the Big Country offer was of employment different or inferior when compared with the original Bloomer Girl employment, is there an issue as to whether or not plaintiff acted reasonably in refusing the substitute offer. Despite defendant’s arguments to the contrary, no case cited or that our research has discovered holds or suggests that reasonableness is an element of a wrongfully discharged employee’s option to reject, or fail to seek, different or inferior employment lest the possible earnings therefrom be charged against him in mitigation of damages.

Applying the foregoing rules to the record in the present case, with all intention in favor of the party opposing the summary judgment motion—here, defendant—it is clear that the trial court correctly ruled that plaintiff’s failure to accept defendant’s tendered substitute employment could not be applied in mitigation of damages because the offer of the Big Country lead was of employment both different and inferior, and that no factual dispute was presented on that issue. The mere circumstances that Bloomer Girl was to be a musical review calling upon plaintiff’s talents as a dancer as well as an actress, and was to be produced in the City of Los Angeles, whereas Big Country was a straight dramatic role in a “Western Type” story taking place in an opal mine in Australia, demonstrates the difference in kind between the two employments; the female lead as a dramatic actress in a western-style motion picture can by no stretch of imagination be considered the equivalent of or substantially similar to the lead in a song-and-dance production.

Additionally, the substitute Big Country offer proposed to eliminate or impair the director and screenplay approvals accorded to plaintiff under the original Bloomer Girl contract, and thus constituted an offer of inferior employment. No expertise or judicial notice is required in order to hold that the deprivation or infringement of an employee’s rights held under an original employment contract converts the available “other employment” relied upon by the employer to mitigate damages, into inferior employment, which the employee need not seek or accept.

In view of the determination that defendant failed to present any facts showing the existence of a factual issue with respect to its sole defense—plaintiff’s rejection of its substitute employment offer in mitigation of damages—we need not consider plaintiff’s further contention that for various reasons, plaintiff was excused from attempting to mitigate damages.

Affirmed in favor of Plaintiff, Parker.
Punitive Damages. Damages in excess of compensatory damages that the court awards for the sole purpose of deterring the defendant and others from doing the same act again are known as punitive damages. They are infrequently awarded in contract cases.

Nominal Damages. Sometimes the court awards a very small sum (usually $1) in nominal damages to a party that is injured by a breach of contract but cannot show real damages. In these cases, the court generally enables the injured party to recover court costs, though not attorney’s fees.

Liquidated Damages. Liquidated damages are usually set in a separate clause in the contract. The clause generally stipulates that the parties agree to pay so much a day for every day beyond a certain date that the contract is not completely performed. Liquidated damages clauses are frequently found in general contractors’ agreements with individuals, corporations, and state or local agencies in situations in which it is essential that a building project be completed on time. Such clauses help the contracting parties avoid going to court and seeking a judicial determination of damages—with all the attendant delays and expenses. The concept of liquidated damages is illustrated in Case 11-5.

The UCC (Sections 2-715(1) and 2A-504) permits parties to a sale or lease contract to establish in advance damages that will be paid upon a breach of contract. These liquidated damages will substitute for actual damages.

**Case 11-5**

**Arrowhead School District No. 75, Park County, Montana v. James A. Klyap, Jr.**

Supreme Court of Montana


Arrowhead School District No. 75 is located in Park County, south of Livingston, Montana, and consists of one school, Arrowhead School (School). For the 1997–98 school year, the School employed about 11 full-time teachers and several part-time teachers. During that school year, the School employed Klyap as a new teacher instructing mathematics, language arts, and physical education for the sixth, seventh, and eighth grades. In addition, Klyap, through his
own initiative, helped start a sports program and coached flag football, basketball, and volleyball.

The School offered Klyap a contract for the 1998–99 school year in June 1998, which he accepted. This contract provided for a $20,500 salary and included a liquidated damages clause. The clause calculated liquidated damages as a percentage of annual salary determined by the date of breach; a breach of contract after July 20, 1998, required payment of 20 percent of salary as damages. Klyap also signed a notice indicating that he accepted responsibility for familiarizing himself with the information in the teacher’s handbook that also included the liquidated damages clause.

On August 12, Klyap informed the School that he would not be returning for the 1998–99 school year even though classes were scheduled to start on August 26. The School then sought to enforce the liquidated damages clause in Klyap’s teaching contract for the stipulated amount of $4,100.

After Klyap resigned, the School attempted to find another teacher to take Klyap’s place. Although at the time Klyap was offered his contract the School had 80 potential applicants, only two viable applicants remained available. Right before classes started, the School was able to hire one of those applicants, a less experienced teacher, at a salary of $19,500.

The District Court determined that the clause was enforceable because the damages suffered by the School were impractical and extremely difficult to fix. Specifically, the court found that the School suffered damages because it had to spend additional time setting up an interview committee, conducting interviews, training the new, less experienced teacher, and reorganizing the sports program. The district court also found that such clauses are commonly used in Montana and that the School had routinely and equitably enforced the clause against other teachers. After concluding that the School took appropriate steps to mitigate its damages, the court awarded judgment in favor of the School in the amount of $4,100. Klyap appealed.

Justice Nelson

The fundamental tenet of modern contract law is freedom of contract; parties are free to agree mutually to terms governing their private conduct as long as those terms do not conflict with public laws. This tenet presumes that parties are in the best position to make decisions in their own interest. Normally, in the course of contract interpretation by a court, the court simply gives effect to the agreement between the parties in order to enforce the private law of the contract. When one party breaches the contract, judicial enforcement of the contract ensures [that] the nonbreaching party receives expectancy damages, compensation equal to what that party would receive if the contract were performed. By only awarding expectancy damages rather than additional damages intended to punish the breaching party for failure to perform the contract, court enforcement of private contracts supports the theory of efficient breach. In other words, if it is more efficient for a party to breach a contract and pay expectancy damages in order to enter a superior contract, courts will not interfere by requiring the breaching party to pay more than was due under their contract.

Liquidated damages are, in theory, an extension of these principles. Rather than wait until the occurrence of breach, the parties to a contract are free to agree in advance on a specific damage amount to be paid upon breach. This amount is intended to predetermine expectancy damages. Ideally, this predetermination is intended to make the agreement between the parties more efficient. Rather than requiring a post-breach inquiry into damages between the parties, the-breaching party simply pays the nonbreaching party the stipulated amount. Further, in this way, liquidated damages clauses allow parties to estimate damages that are impractical or difficult to prove, as courts cannot enforce expectancy damages without sufficient proof.

After reviewing the facts of this case, we hold that while the 20% liquidated damages clause is definitely harsher than most, it is still within Klyap’s reasonable expectations and is not unduly oppressive. First, as the School pointed out during testimony, at such a small school teachers are chosen in part depending on how their skills complement those of the other teachers. Therefore, finding someone who would provide services equivalent to Klyap at such a late date would be virtually impossible. The anticipation of this difficulty was borne out when only two applicants remained available and the School hired a teacher who was less experienced than Klyap. As a teacher, especially one with experience teaching at that very School, Klyap would have to be aware of the problem finding equivalent services would pose.

Second, besides the loss of equivalent services, the School lost time for preparation for other activities in order to attempt to find equivalent services. As the District Court noted, the School had to spend additional time setting up an interview committee and conducting interviews. Further, the new teacher missed all the staff development training earlier that year so individual training was required. And finally, because Klyap was essential to the sports program, the School had to spend additional time reorganizing the sports program as one sport had to be eliminated with Klyap’s loss. These activities all took away from the other school and administrative duties that had been scheduled for that time.

Finally, although the School testified it had an intent to secure performance and avoid the above damages by reason of the clause, such an intent does not turn a liquidated damages clause into a penalty unless the amount is unreasonably large and therefore not within reasonable expectations.

Therefore, because as a teacher Klyap would know teachers are typically employed for an entire school year and would know how difficult it is to replace equivalent services at such a small rural school, it was within Klyap’s reasonable expectations to agree to a contract with a 20% of salary liquidated damages provision for a departure so close to the start of the school year.

Accordingly, we hold the District Court correctly determined that the liquidated damages provision was enforceable.

Affirmed for the School.
EQUITABLE REMEDIES

When dollar damages are inadequate or impracticable as a remedy, the injured party may turn to nondollar or **equitable remedies**. Equitable remedies include rescission, reformation, specific performance, and injunction.

**Rescission.** Rescission is defined as the canceling of a contract. Plaintiffs who wish to be put back in the position they were in before entering into the contract often seek rescission. In cases of fraud, duress, mistake, or undue influence (discussed in Chapter 10), the courts will generally award rescission.

**Reformation.** The correction of terms in an agreement so that they reflect the true understanding of the parties is known as reformation. For example, if A enters into an agreement to sell B 10,000 widgets at $.50 per unit when the figure should have been $5.50 per unit, A may petition the court for reformation of the contract.

**Specific Performance.** A court order compelling a party to perform in such a way as to meet the terms of the contract calls for specific performance. Courts are reluctant to order specific performance unless (1) a unique object is the subject matter of the contract (e.g., an antique or artwork) or (2) real estate is involved. To obtain a specific performance order, the plaintiff must generally show that dollar damages (damages “at law”) are inadequate to compensate for the defendant’s breach of contract. Even then, a court will often refuse to grant the order if it is incapable of supervising performance or is unwilling to do so. For these reasons, specific performance in contract cases is infrequently granted.

**Injunctions.** Injunctions are temporary (e.g., 30 days) or permanent orders of the court preventing a party to a contract from doing something. The plaintiff must show the court that dollar damages are inadequate and that irreparable harm will be done if the injunction is not granted. For instance, an opera singer contracts with an opera company to sing exclusively for the company and then later decides to sing for other opera companies, the court may grant an injunction to prevent her from singing for the other companies. Injunctions, like specific performance, are seldom granted in contract law cases.

**EQUIPMENT REMEDIES**

**Nonmonetary damages** awarded for breach of contract when monetary damages would be inadequate or impracticable.

**Cancellation of a contract.**

**Correction of terms in an agreement so that they reflect the true understanding of the parties.**

**A court order compelling a party to perform in such a way as to meet the terms of the contract.**

**Temporary or permanent court order preventing a party to a contract from doing something.**
REMEDIES FOR BREACH OF A SALES CONTRACT (GOODS)

Remedies for the Seller. Under the UCC, remedies for the seller resulting from the buyer's breach include the following:

- The right to recover the purchase price if the seller is unable to sell or dispose of goods (Section 2-709(1))
- The right to recover damages if the buyer repudiates a contract or refuses to accept the goods (Section 2-708(1))

Remedies for the Buyer. If a seller breaches a sales contract by failing to deliver conforming goods or repudiating the contract prior to delivery, the buyer has a choice of remedies under the UCC:

- The right to obtain specific performance when the goods are unique or remedy at law is inadequate (Section 2-716(1))
- The right to recover damages after cancellation of the contract
- The right to reject the goods if the goods or tender fail to conform to the contract, or the right to keep some goods and reject the others
- The right to recover damages for accepted goods if the seller is notified of the breach within a reasonable time (Section 2-714(11))
- The right to revoke an acceptance of goods under certain circumstance (Section 2-608(1), (2))

In the case that follows, the issue is whether two years after the sale of goods is a reasonable period of time in which a buyer may discover a defect in goods and notify the seller.

CASE 11-6

Fitl v. Strek
Supreme Court of Nebraska
690 N.W.2d 625 (2005)

In September 1995, James Fitl attended a sports-card show in San Francisco, California, where he met Mark Strek, an exhibitor at the show, who was doing business as Star Cards of San Francisco. Later, on Strek's representation that a certain 1952 Mickey Mantle Topps baseball card was in near-mint condition, Fitl bought the card from Strek for $17,750. Strek delivered it to Fitl in Omaha, Nebraska, where Fitl placed it in a safe-deposit box. In May 1997, Fitl sent the card to Professional Sports Authenticators (PSA), a sports-card grading service. PSA told Fitl that the card was ungradable because it had been discolored and doctored. Fitl complained to Strek, who replied that Fitl should have initiated a return of the card within “a typical grade period for the unconditional return of a card . . . 7 days to 1 month” of its receipt. In August, Fitl sent the card to ASA Accugrade, Inc. (SAS), another grading service, for a second opinion on its value. ASA also concluded that the card had been refinished and trimmed. Fitl filed a suit in a Nebraska state court against Strek, seeking damages. The court awarded Fitl $17,750, plus his court costs. Strek appealed to the Nebraska Supreme Court.

Justice Wright

Strek claims that the lower court erred in determining that notification of the defective condition of the baseball card 2 years after the date of purchase was timely pursuant to [UCC] 2-607(3)(a).

The [trial] court found that Fitl had notified Strek within a reasonable time after discovery of the breach. Therefore, our review is whether the [trial] court’s finding as to the reasonableness of the notice was clearly erroneous.

Section 2-607(3)(a) states, “Where a tender has been accepted the buyer must within a reasonable time after he discovers or should have discovered any breach notify the seller of breach or be barred from any remedy.” [Under UCC1-204(2)] “[w]hat is a reasonable time for taking any action depends on the nature, purpose, and circumstances of such action.”

The notice requirement set forth in Section 2-607(3)(a) serves three purposes. The most important one is to enable the seller to make efforts to cure the breach by making adjustments or replacements in order to minimize the
E-Contracts

In Chapter 10, and in this chapter, we have examined the traditional principles governing contracts for the sale of real and personal property, as well as the sale and lease of goods as defined by the UCC. E-contracts are now an everyday part of a cyberspace era. Although many of the traditional contract principles apply to contracts entered into online, they should include these minimum provisions:

- Remedies that are available to the buyer if any of the goods contracted for are defective.
- A statement of the seller's referral policy.
- A statement of how the goods are to be paid for.
- A forum selection clause, which indicates the location and/or forum where a dispute will be settled should one arise.
- A disclaimer-of-liability provision by the seller for certain uses of a good sold.
- The manner in which an offer can be accepted (e.g., by “click on”). Similarly, an acceptance may be made under traditional principles or by the provisions of UCC Section 2-204 (previously discussed in Chapter 10).
- Click-on terms that indicate agreement to the terms outlined in an offer.
- Browse-wrap terms that are enforceable (or binding) without the offeree's active consent, as with click-on terms.

E-SIGNATURES

In the year 2000, Congress enacted a law entitled the Electronic Signatures in Global and National Commerce Act (E-SIGN),\(^1\) allowing consumers and businesses to sign contracts online and making e-signatures just as binding as ones in ink. Such contracts as those for bank loans and brokerage accounts may be entered into over the Internet 24 hours a day. This prevents delays that arise from the need for paper contracts to be written, mailed, signed, and then returned. With e-signatures, the cost of drawing up paperwork, mailing it, and storing agreements is eliminated in favor of electronic retention.

\(^1\) 15 U.S.C. § 700 et seq.
The law went into effect on October 1, 2000, but questions were raised as to whether people would be able to forge electronic signatures on everything from online purchases to credit card applications. The law does not specify what constitutes a digital signature. Possible requirements include (1) a password that must be entered into a form on a Web page, with the Web site having to confirm that it belongs to a certain person; or (2) the use of hardware such as thumbprint scanning devices that plug into personal computers and transmit the thumbprint over the Internet to a business, which would keep it on file for authentication purposes.

Laws governing e-signatures differ from state to state. Some states, such as California, prohibit documents from being signed with e-signatures, whereas others do not. In 1999, the National Conference of Commissioners on Uniform State Law and the American Law Institute set out the Uniform Electronic Transcription Act (UETA), which sought to bring uniformity to this area of the law. The UETA, which has been adopted in whole or in part by more than 40 states, indicates that a signature may not be denied legal enforceability solely because of its electronic form.

**THE UNIFORM COMPUTER INFORMATION TRANSACTION ACT**

Prior to World War II, the common law of contracts was sufficient to handle most of the transactions in a mainly agricultural society. As the distribution and manufacturing of goods came to dominate commerce, the UCC was drafted by the National Conference of Commissioners on Uniform State Law, a consortium of lawyers, judges, businesspeople, and legal scholars. Individual states gradually adopted all or part of the UCC. For purposes of the law of contracts, Article 2 (Sales) and 2A (Leases) are highly significant, as shown in this and the preceding chapter.

As the world of computers and electronic commerce developed in the 1980s and 1990s, the common law of contracts and the UCC did not provide adequate guidelines, because the cyberspace economy is largely based on electronic contracts and the licensing of information. Questions developed as to how to enforce e-contracts, as well as what consumer protection should be provided. Therefore, in July 1999, the National Conference of Commissioners issued the Uniform Computer Information Transaction Act (UCITA).

**Scope of the UCITA.** It should be emphasized that the UCITA deals only with information that is electronically disseminated. Under this act, a *computer information transaction* is an agreement to create, transfer, or license computer information. It does not cover licenses of information for traditional copyrighted materials such as books or magazines.

Many of the provisions of the UCITA are similar to Article 2 of the UCC. For example, a licensing agreement may be interpreted by the courts using the express terms of the agreement, as well as course of performance and usage. There are, however, several differences regarding licensing agreements under the UCITA:

- The party who sells the right to use a piece of software (licensor) can control the right of use by the buyer (licensee). In a mass market this is extremely important. An exclusive license means that for its duration, the licensor will not grant any other person rights to the same information. This is a matter of serious negotiation both nationally and internationally, with firms as well as with governments.
- If a contract requires a fee of more than $5,000, it is enforceable only if it is authenticated. To *authenticate* means to sign a contract or execute an

---

2 UETA §§ 102(8) and (25).
3 UCITA § 102.
electronic symbol, sound, or message attached to or linked with the record. Authentication may be attributed to a party’s agent. Authentication may be proven if a party uses information or if he or she engages in operations that authenticate the record.

The Business Community: Criticisms of the UCITA. The UCITA would benefit software makers because it favors click-wrap agreements, and there would be uniformity to such agreements. This still leaves the question of enforcement of such agreements when they are between other business entities or governments.

Debate exists among those who want uniformity and critics who believe software makers would use uniformity to argue that they are not responsible for defect in the software they sell. For example, who would be held responsible for a software virus? Will consumers read the fine-print disclaimers? Some would argue that problems associated with e-contracts are similar to those encountered in dealing with contracts for real property, goods, and personal property.

Global Dimensions of Contract and Sales Law

As more nations in Europe, Latin America, and Asia have shifted toward market-oriented economies, international trade has increased, and, along with it, contracts implementing transactions between foreign entities (either governments or private companies) and U.S. companies have increased. International and regional treaties lowering or eliminating tariffs have hastened the trend to free trade. (See Chapter 9 for a detailed description of recent trade pacts.)

Given this accelerating tendency toward free trade, the United Nations Commission on International Trade Law drafted the Convention on Contracts for the International Sale of Goods4 to provide uniformity in international transactions. The CISG covers all contracts for the sale of goods in countries that have ratified it. An estimated two-thirds of all international trade is conducted among the 70 nations that were signatories to the CISG as of April 2009.5 Parties to a contract can choose to adhere to all or part of the CISG, or they may select other laws to govern their transactions.

On January 1, 1988, the CISG was approved as a treaty and incorporated into U.S. federal law. As a treaty, it overrides conflicting state laws dealing with contracts. Each of the 50 states is now examining conflicts between the Uniform Commercial Code (as adopted in the state) and the CISG, which supersedes it.

Some of the differences between the CISG and the UCC are highly significant. For example, under the CISG, a contract is formed when the seller (offeror) receives the acceptance from the offeree, whereas under the UCC, a contract is formed when the acceptance is mailed or otherwise transmitted. To take another example, under the CISG, a sales contract of any amount is enforceable if it is oral, whereas the UCC requires a written contract for a sale of goods of $500 or more.

Present and future business managers must become knowledgeable about these and other differences between the UCC and the CISG if they are to avoid costly and time-consuming litigation as international transactions in goods increase. You might want to review Chapter 9 at this point to refresh your memory about the methods and details of international transactions.

---

SUMMARY

Contracts are discharged by performance, mutual agreement, conditions precedent and subsequent, and sometimes through impossibility of performance. Remedies for breach of contract include dollar remedies such as lost profits, punitive, nominal, and liquidated damages. Often, when dollar damages are insufficient, the court will rely on equitable remedies (nondollar damages) such as rescission, restitution, specific performance, and reformation.

E-contracts require some minimum provisions that may differ slightly from common-law principles. With the help of statutory and case law, e-contracts are now becoming part of everyday business transactions. Contract laws became more uniform with the ratification by many nations of the Convention on Contracts for the International Sale of Goods. This has wide implications for the conduct of international transactions.

REVIEW QUESTIONS

11-1 Describe the criteria used by the courts in determining lost profits.
11-2 What is the CISG? Why is it important to present and future businesspeople?
11-3 What is meant by “impossibility of performance”?
11-4 What is the standard a court uses to award dollar damages when lost profits are involved?
11-5 Why should a party who has not breached a contract be required to mitigate the damages of the breaching party?
11-6 What are some provisions that should be included in e-contracts?

REVIEW PROBLEMS

11-7 Silver was a journeyman electrician who was occasionally employed by AOC Corporation, an apartment management company. He did some electrical work for AOC over a four-month period and submitted a bill for $893. The defendant refused to pay, claiming that the contract lacked a legal object because the plaintiff was not licensed as an electrical contractor in Detroit or the state of Michigan. The state licensing statute exempted “minor work,” and the plaintiff claimed that his work rewiring a hallway in an apartment building managed by AOC was “minor.” What critical thinking skills would you use to speculate on who might win this case?

11-8 Ace contracted with Jones to do certain remodeling work on the building owned by Jones. Jones supplied the specifications for the work. The contract price was $70,000. After the work was completed, Jones was dissatisfied and had Clay, an expert, compare the work done with the specifications provided. Clay testified that Ace had done the work improperly and that it would cost about $6,000 to correct Ace’s mistakes. If Jones refuses to pay any amount to Ace, what recourse, if any, does Ace have against Jones? Explain.

11-9 On January 4, General Contractors, Inc., entered into a contract with Julius and Penelope Jones to construct a house fit for occupancy by June 1. What is the legal consequence if General Contractors fails to complete the house by June 1 but does finish it by June 20? What would be the consequence if the contract stated that with regard to the June 1 deadline, “time is of the essence”? Suppose further that by May 10, no work had yet been started by General Contractors. When Julius contacts him, General Contractors’ president states that due to other projects still pending, he is unable to build the house until late November. What legal recourse, if any, do Julius and Penelope have against General Contractors?
11-10 A contractor agreed to build a skating rink for the plaintiff at a price of $180,000. The rink was to be completed by December 1 and was designed to replace a similar but older rink that the plaintiff rented for $800 a month. A clause in the contract awarded the plaintiff “$100 per day in liquidated damages” for each day after December 1 that the rink was not completed. Was this a valid liquidated damages clause? Explain.

11-11 On April 15, Don Construction contracted to build a house for Jessup. The contract price was $55,000. The agreement contained a provision stating that the builder would deduct $1,000 a day from the contract price for each day the house was not completed after August 15. It was not completed until September 15. Don Construction refused to deduct $30,000 from the contract price. Jessup refused to sue. Don Construction sued, claiming that the $1,000 a day was a penalty clause, not a liquidated damages clause. What was the result? Explain.

11-12 Julius W. Erving (Dr. J) entered into a four-year contract to play exclusively for the Virginia Squires of the American Basketball Association. After one year, he left the Squires to play for the Atlanta Hawks of the National Basketball Association. The contract signed with the Squires provided that the team could have his contract set aside for fraud. The Squires counterclaimed and asked for arbitration. Who won? Explain.

11-13 TWA had a sale/leaseback agreement with Connecticut National Bank. Because of the Gulf War, air travel was decreased and TWA was having trouble making its payments. Discuss the extent to which TWA could use commercial impracticability or impossibility as a defense for nonpayment.

CASE PROBLEMS

11-14 The Thompsons signed a retail installment contract with Lithia Dodge for the purchase of a new pickup truck. The interest rate was listed as 3.9 percent, and provided that the contract was not binding until the financing was completed, and that any disputes arising under the contract were to be resolved by arbitration. A week after the contract was signed, Lithia’s finance manager told the Thompsons that the 3.9 percent financing rate had been rejected by the company, and they would have to pay a rate of 4.9 percent. The Thompsons did not want that interest rate, so they asked for the pickup they had traded in to be returned to them. Lithia could not return the pickup because they had already sold it, so the Thompsons sued Lithia. The company argued that the matter should go to arbitration because the contract had a binding arbitration clause. The trial court agreed and the Thompsons appealed. The trial court’s decision was overturned on appeal and the case was allowed to go to trial. Why did the court not find that the binding arbitration clause bound the parties? Thompson v. Lithia Chrysler Dodge of Great Falls, 185 P.3d 332 (Mont. 2008).

11-15 In November 1997, Cover-It, Inc., hired Khalid Shah to work as its structural engineering manager. Shah agreed to work a flexible schedule of 35 hours per week. In exchange, he would receive an annual salary of $70,000 for 5 years, a 2 percent commission on the sales of products that he designed, 3 weeks of paid vacation after 1 year, a company car, time off to attend to prior obligations, and certain other benefits. Either party could terminate the contract with 90 days’ written notice, but if Cover-It terminated the contract, Shah would receive monthly payments for the rest of the five-year term. In June, 1998, Shah went on vacation and did not return until September. In mid-October, Brian Goldwitz, Cover-It’s owner and president, terminated Shah’s contract. Shah filed a suit in a Connecticut state court against Cover-It and others. The court determined that Shah had breached the contract and rendered a judgment in the defendants’ favor. Shah appealed to a state intermediate appellate court. What was the result? Explain. Shah v. Cover-It, 86 Conn. App. 71, 859 A.2d 959 (2004).

11-16 Allen and Pat McCain own Green Park Inn, Inc., which operates the Green Park Inn. In 1996, they leased the Inn to GMAFCO, LLC, which is owned by Gary and Gail Moore. The lease agreement provided that, in case of a default by GMAFCO, Green Park, Inc., would be entitled to $500,000 as “liquidated damages.” GMAFCO defaulted on the February 2000 rent. Green Park Inn, Inc., gave GMAFCO an opportunity to cure the default, but GMAFCO made no further payments and returned possession of the property to the lessor. When Green Park Inn, Inc., sought the stated liquidated damages, the Moores refused to pay. Green Park Inn, Inc., filed suit in a North Carolina state court against the Moores, GMAFCO, and their bank to obtain the $500,000. The defendants contended in part that the lease clause requiring payment of “liquidated damages” was an unenforceable penalty provision. The court ordered the defendants to pay Green Park Inn,

11-17 Adolf and Ida Krueger contracted with Pisani Construction, Inc., to erect a metal building as an addition to an existing structure. The two structures were to share a common wall, and the frames and panel heights of the new building were to match those of the existing structure. Shortly before completion of the project, however, it became apparent that the roofline of the new building was approximately three inches higher than that of the existing structure. Pisani modified the ridge caps of the buildings to blend the rooflines. The discrepancy had other consequences, however, including misalignment of the gutters and windows of the two buildings, which resulted in an icing problem in the winter. The Kruegers occupied the new structure but refused to make the last payment under the contract. Pisani filed a suit in a Connecticut state court against the Kruegers and others to collect the last payment. Did Pisani substantially perform its obligations? *Pisani Construction, Inc. v. Krueger*, 68 Conn. App. 361, 791 A.2d 634 (2002).

**THINKING CRITICALLY ABOUT RELEVANT LEGAL ISSUES**

Judges should start offering punitive awards in breach-of-contract cases. Punitive damages are awarded for the sole purpose of deterring the defendant and others from doing the same act again. Our courtrooms are flooded with enough cases. Businesses know that they can get away with breaching their contracts. If we start imposing punitive damages, however, these businesses will alter their behavior.

This change would specifically affect those businesses that make it a practice to breach a contract whenever necessary. People are losing faith in the security of a contract. A survey of 100 first-year business students suggested that contracts are little respected and rarely followed in business.

1. What is the conclusion offered in this argument, and the reasons supporting the conclusion?
2. The author cites a survey of 100 first-year business students who suggested that contracts are "little respected and rarely followed in business." Do you see any problems with this evidence?
3. What additional information do you need to evaluate this argument?
4. What arguments could you make that are the opposite of those made by the author of this essay?

**ASSIGNMENT ON THE INTERNET**

This chapter briefly introduces the UCITA as a means of regulating the increasing volume of e-commerce and electronic contracts. Not everyone, however, is in favor of the UCITA. Using the Internet, search for articles and opinions that present multiple perspectives about how the UCITA influences business operations.

You can begin by visiting the Americans for Fair Electronic Commerce Transactions (AFECT) site ([www.ucita.com](http://www.ucita.com)). What arguments does it present...
against UCITA? Then visit the Virginia Technology Council [leg.vptc.org/UCITA/consumer.html] to read positions in favor of UCITA.

Now draft a brief response to what you have read. Would you support or oppose wider enactment of UCITA? Why? Would you recommend that any changes be made if your state was considering adopting parts of UCITA? What would those changes be?

ON THE INTERNET

cisgw3.law.pace.edu/cisg/text/database.html The CISG can be found at this page, maintained by the Institute of Commercial Law.
www.law.cornell.edu/ucc/2/overview.html This site contains the part of the Uniform Commercial Code relevant to contracts and sales.
www.lectlaw.com/files/bul08.htm This site provides more information on nonperformance and breach of contract.
www.law.cornell.edu/topics/contracts.html Use this site to access recent contract law cases.
www.law-counsel.com/Legal_information/contract_law This site addresses some common questions about international contract law.

FOR FUTURE READING


The Law of Torts

- THE GOALS OF TORT LAW
- DAMAGES AVAILABLE IN TORT CASES
- CLASSIFICATIONS OF TORTS
- INTENTIONAL TORTS
- NEGLIGENT TORTS
- STRICT LIABILITY TORTS
- GLOBAL DIMENSIONS OF TORT LAW

We said in Chapter 2 that the law is divided into criminal law and civil law. The division, however, is not airtight. Although a given set of actions may constitute a crime or a wrong against the state and thus may give rise to a criminal prosecution, the same set of actions may also constitute a tort, a civil wrong that gives the injured party the right to bring a lawsuit against the wrongdoer to recover compensation for the injuries. We define a tort as an injury to another's person or property.

This chapter discusses torts as if they were the same across the country—and, in general, they are—but keep in mind that tort law is state law and so may vary somewhat from state to state. The total amount of tort litigation has been declining since 1996. Even so, tort law is and will continue to be an important area of law and an essential subject for the student of the legal environment of business, because managers who do not have a basic understanding of tort law are placing themselves and the company's stakeholders at risk.

The Goals of Tort Law

Tort cases are commonly referred to as personal injury cases, although a tort case may involve harm solely to property. The primary goal of tort law is to compensate innocent persons who are injured or whose property is injured as a result of another's conduct, but tort law also fulfills other important societal goals. It discourages private retaliation by injured persons and their friends. It promotes citizens' sense of a just society by forcing responsible parties to pay for the injuries they have caused. Finally, it deters future wrongs because potential wrongdoers are aware that they will have to pay for the consequences of their harmful acts.

For example, if Sam takes Judy's car without her permission and wrecks it, he has committed a tort. If there were no tort law, she would get no compensation from Sam and would have to use her own money to have the car repaired or to buy a new one. She would feel that she lived in an unjust world. She might even be tempted to seek revenge against Sam by breaking his car window.

---

Damages Available in Tort Cases

The victim of a tort may sue the wrongdoer, known as the tortfeasor, and has the potential to recover from among three types of damages: compensatory, nominal, and punitive (Table 12-1). All three types of damages were defined and discussed in Chapter 11 in relation to breaches of contract. Here we describe their specific application to tort cases.

**COMPENSATORY DAMAGES**

The most common type of damages sought in tort cases are compensatory damages. *Compensatory damages* are designed to make the victim whole again, that (or something else even more personal). Others, seeing what Sam has gotten away with, would be less likely to be careful with other people's property in the future. Because we have tort law, however, Judy can sue Sam and receive compensation from him for the damage he did to her car. She will then feel that she has received justice and will not be inclined to take any private retaliatory actions against Sam. Others, knowing that Sam had to pay for the harm he caused, may be deterred from committing torts themselves.

<table>
<thead>
<tr>
<th>Type</th>
<th>Purpose</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensatory</td>
<td>To put the plaintiff in the position he or she would have been in had the tort never occurred</td>
<td>Sufficient to cover all losses caused by the tort, including compensation for pain and suffering</td>
</tr>
<tr>
<td>Nominal</td>
<td>To recognize that the plaintiff has been wronged</td>
<td>A nominal amount, usually $1–$5</td>
</tr>
<tr>
<td>Punitive</td>
<td>To punish the defendant</td>
<td>Determined by the severity of the wrongful conduct and the wealth of the defendant</td>
</tr>
</tbody>
</table>
is, to put the victim in the position he or she would have been in had the tort never taken place. They include compensation for all of the injuries that the tortfeasor caused to the victim and his or her property. Typical items covered by this class of damages are medical bills, lost wages, property repair bills, and compensation for pain and suffering. Note that attorneys' fees are not considered an item of compensatory damages, even though it would be virtually impossible for a victim to bring suit without the services of an attorney. Because the plaintiffs in personal injury cases usually must pay their attorneys by giving them a portion of the compensatory damages they are awarded, some people argue that compensatory damages do not fully compensate tort victims.

**NOMINAL DAMAGES**

Sometimes the plaintiff is unable to prove damages that would necessitate compensation. In such a case, the court may award the victim *nominal damages* (damages in name only). The sum of such awards is minuscule, usually $1, but recovery of nominal damages may be important because it allows the plaintiff to seek punitive damages. Punitive damages cannot be awarded alone; they must accompany an award of compensatory or nominal damages.

An illustration of an instance in which nominal damages were of utmost importance is the case of the death-row inmate in South Carolina who received nominal damages of only 10 cents from his case against prison guards. This sum allowed the plaintiff—in this case, the inmate—to seek punitive damages. This award, however, was important for other reasons as well. For example, it may change the prison guards’ behavior in the future. Also, because the inmate won, even though the damages were only nominal, perhaps the public will see the case as involving an important legal issue.

**PUNITIVE DAMAGES**

When the act of the tortfeasor is flagrant, unconscionable, or egregious, the court may award the victim *punitive damages*. These damages are designed not only to punish the tortfeasor for willfully engaging in extremely harmful conduct, but also to deter others from engaging in similar conduct. Punitive damages are considered by some legal scholars to be especially useful in deterring manufacturers from making unsafe products. If there were no possibility of incurring punitive damages, manufacturers might calculate how much money they would have to spend fighting and settling lawsuits resulting from the sale of a defective product and then calculate the cost of making a safer product. If it turned out to be cheaper to produce the defective product and compensate injured victims than to make a safer product, rational manufacturers would be likely to produce the defective product. The risk of incurring punitive damages, however, is often sufficient to convince manufacturers to produce the safe product.

Some people disagree with this reasoning. They claim that the costs of compensatory damages alone are a sufficient incentive to produce only safe products. They further argue that the almost unrestricted ability to award punitive damages gives juries too much power.

In recent years, there have been many attempts by insurance companies and tort reform groups to limit the amount of punitive damages that can be assessed. These advocates of tort reform have tried repeatedly to get the courts to strike down punitive damages as unconstitutional on the ground that such damages violate defendants’ due process rights. This argument was unsuccessful until the 1994 case of *Honda Motor Co. v. Oberg.* This case, in which the U.S. Supreme

---

3 114 S. Ct. 2331 (1994).
Court struck down a punitive damages award as being a violation of due process, was unusual in two respects. First, the punitive damages were more than 500 times the amount of the compensatory damages. Second, the state law had no provision for judicial review of the amount of the punitive damages award, whereas every other state allows such a review. It was Oregon’s denial of judicial review of the amount of punitive damages that the high court said violated the Due Process Clause. Because of its unusual facts, *Honda v. Oberg* was not very instructive as to when punitive damages are so excessive as to violate due process. In the following case, the Supreme Court finally set forth a workable test.

**Case 12-1**

**BMW of North America, Inc. v. Gore, Jr.**

United States Supreme Court

Plaintiff Ira Gore, Jr., brought an action against BMW’s American distributor and the dealer who had sold him a car, alleging that the dealer’s failure to disclose that the car had been repainted after being damaged before delivery constituted suppression of a material fact. The failure to notify the plaintiff was consistent with the company policy not to advise its dealers, and hence the dealers’ customers, of predelivery damage to new cars when the cost of repair amounted to less than 3 percent of the car’s suggested retail price. The jury returned a verdict finding BMW liable for compensatory damages of $4,000. In addition, the jury assessed $4 million in punitive damages, based on a determination that the nondisclosure policy constituted “gross, oppressive or malicious” fraud. The Alabama circuit court affirmed. The distributor and manufacturer appealed. The Alabama Supreme Court conditionally affirmed the punitive damages award after reducing it to $2 million.

**Justice Stevens**

The Due Process Clause of the Fourteenth Amendment prohibits a State from imposing a “grossly excessive” punishment on a tortfeasor. The question presented is whether a $2 million punitive damages award . . . exceeds the constitutional limit.

Punitive damages may properly be imposed to further a State’s legitimate interests in punishing unlawful conduct and deterring its repetition. In our federal system, States necessarily have considerable flexibility in determining the level of punitive damages that they will allow in different classes of cases and in any particular case. Most States that authorize exemplary damages afford the jury similar latitude, requiring only that the damages awarded be reasonably necessary to vindicate the State’s legitimate interests in punishment and deterrence. Only when an award can fairly be categorized as “grossly excessive” in relation to these interests does it enter the zone of arbitrariness that violates the Due Process Clause of the Fourteenth Amendment.

For that reason, the federal excessiveness inquiry appropriately begins with an identification of the state interests that a punitive award is designed to serve. We therefore focus our attention first on the scope of Alabama’s legitimate interests in punishing BMW and deterring it from future misconduct.

No one doubts that a State may protect its citizens by prohibiting deceptive trade practices and by requiring automobile distributors to disclose presale repairs that affect the value of a new car. But the States need not, and in fact do not, provide such protection in a uniform manner. That diversity demonstrates that reasonable people may disagree about the value of a full disclosure requirement.

We may assume, arguendo, that it would be wise for every State to adopt Dr. Gore’s preferred rule, requiring full disclosure of every presale repair to a car, no matter how trivial and regardless of its actual impact on the value of the car. But while we do not doubt that Congress has ample authority to enact such a policy for the entire Nation, it is clear that no single State could do so, or even impose its own policy choice on neighboring States. Similarly, one State’s power to impose burdens on the interstate market for automobiles is not only subordinate to the federal power over interstate commerce, but is also constrained by the need to respect the interests of other States. We think it follows from these principles of state sovereignty and comity that a State may not impose economic sanctions on violators of its laws with the intent of changing the tortfeasors’ lawful conduct in other States.

The award must be analyzed in the light of the same conduct, with consideration given only to the interests of Alabama consumers, rather than those of the entire Nation. When the scope of the interest in punishment and deterrence that an Alabama court may appropriately consider is properly limited, it is apparent for reasons that we shall now address that this award is grossly excessive. Elementary notions of fairness enshrined in our constitutional jurisprudence dictate that a person receive fair notice not only of the conduct that will subject him to punishment but also of the severity of the penalty that a
State may impose. Three guideposts, each of which indicates that BMW did not receive adequate notice of the magnitude of the sanction that Alabama might impose for adhering to the nondisclosure policy, lead us to the conclusion that the $2 million award against BMW is grossly excessive: the degree of reprehensibility of the nondisclosure; the disparity between the harm or potential harm suffered by Dr. Gore and his punitive damages award; and the difference between this remedy and the civil penalties authorized or imposed in comparable cases.

Perhaps the most important indicium of the reasonableness of a punitive damages award is the degree of reprehensibility of the defendant’s conduct. As the Court stated nearly 150 years ago, exemplary damages imposed on a defendant should reflect “the enormity of his offense.” Thus, we have said that “nonviolent crimes are less serious than crimes marked by violence or the threat of violence.” Similarly, “trickery and deceit” are more reprehensible than negligence.

In this case, none of the aggravating factors associated with particularly reprehensible conduct is present. The harm BMW inflicted on Dr. Gore was purely economic in nature. The presale refinishing of the car had no effect on its performance or safety features, or even its appearance for at least nine months after his purchase. BMW’s conduct evinced no indifference to or reckless disregard for the health and safety of others. To be sure, infliction of economic injury, especially when done intentionally through affirmative acts of misconduct, or when the target is financially vulnerable, can warrant a substantial penalty. But this observation does not convert all acts that cause economic harm into torts that are sufficiently reprehensible to justify a significant sanction in addition to compensatory damages.

Dr. Gore contends that BMW’s conduct was particularly reprehensible because nondisclosure of the repairs to his car formed part of a nationwide pattern of tortious conduct. Certainly, evidence that a defendant has repeatedly engaged in prohibited conduct while knowing or suspecting that it was unlawful would provide relevant support for an argument that strong medicine is required to cure the defendant’s disrespect for the law.

Dr. Gore’s second argument for treating BMW as a recidivist is that the company should have anticipated that its actions would be considered fraudulent in some, if not all, jurisdictions. This contention overlooks the fact that actionable fraud requires a material misrepresentation or omission. This qualifier invites line drawing of just the sort engaged in by States with disclosure statutes and by BMW. We do not think it can be disputed that there may exist minor imperfections in the finish of a new car that can be repaired (or indeed, left unrepairs) without materially affecting the car’s value. There is no evidence that BMW acted in bad faith when it sought to establish the appropriate line between presumptively minor damage and damage requiring disclosure to purchasers. For this purpose, BMW could reasonably rely on state disclosure statutes for guidance. In this regard, it is also significant that there is no evidence that BMW persisted in a course of conduct after it had been adjudged unlawful on even one occasion, let alone repeated occasions.

Finally, the record in this case discloses no deliberate false statements, acts of affirmative misconduct, or concealment of evidence of improper motive.

We accept, of course, the jury’s finding that BMW suppressed a material fact which Alabama law obligated it to communicate to prospective purchasers of repainted cars in that State. But the omission of a material fact may be less reprehensible than a deliberate false statement, particularly when there is a good faith basis for believing that no duty to disclose exists. That conduct is sufficiently reprehensible to give rise to tort liability, and even a modest award of exemplary damages, does not establish the high degree of culpability that warrants a substantial punitive damages award. Because this case exhibits none of the circumstances ordinarily associated with egregiously improper conduct, we are persuaded that BMW’s conduct was not sufficiently reprehensible to warrant imposition of a $2 million exemplary damages award.

The second and perhaps most commonly cited indicium of an unreasonable or excessive punitive damages award is its ratio to the actual harm inflicted on the plaintiff. The principle that exemplary damages must bear a reasonable relationship to compensatory damages has a long pedigree.

In Haslip we concluded that even though a punitive damages award of “more than four times the amount of compensatory damages” might be “close to the line,” it did not cross the line into the area of constitutional impropriety. TXO refined this analysis by confirming that the proper inquiry is, “whether there is a reasonable relationship between the punitive damages award and the harm likely to result from the defendant’s conduct as well as the harm that actually has occurred.” Thus, in upholding the $10 million award in TXO, we relied on the difference between that figure and the harm to the victim that would have ensued if the tortious plan had succeeded. That difference suggested that the relevant ratio was not more than 10 to 1.

The $2 million in punitive damages awarded to Dr. Gore by the Alabama Supreme Court is 500 times the amount of his actual harm as determined by the jury. Moreover, there is no suggestion that Dr. Gore or any other BMW purchaser was threatened with any additional potential harm by BMW’s nondisclosure policy. The disparity in this case is thus dramatically greater than those considered in Haslip and TXO.

Of course, we have consistently rejected the notion that the constitutional line is marked by a simple mathematical formula, even one that compares actual and potential damages to the punitive award. Indeed, low awards of compensatory damages may properly support a higher ratio than high compensatory awards, if, for example, a particularly egregious act has resulted in only a small amount of economic damages. A higher ratio may also be justified in cases in which the injury is hard to detect or the monetary value of noneconomic harm might have been difficult to determine.

Comparing the punitive damages award and the civil or criminal penalties that could be imposed for comparable misconduct provides a third indicium of excessiveness. [A] reviewing court should accord substantial deference to legislative judgments concerning appropriate sanctions for
the conduct at issue. In this case the $2 million economic sanction imposed on BMW is substantially greater than the statutory fines available in Alabama and elsewhere for similar malfeasance.

We cannot accept the conclusion of the Alabama Supreme Court that BMW’s conduct was sufficiently egregious to justify a punitive sanction that is tantamount to a severe criminal penalty.

As in Haslip, we are not prepared to draw a bright line marking the limits of a constitutionally acceptable punitive damages award. Unlike that case, however, we are fully convinced that the grossly excessive award imposed in this case transcends the constitutional limit.

Reversed and remanded in favor of Appellant, BMW.

The impact of the BMW case has spread beyond tort cases. For example, the BMW test handed down for determining whether a punitive award is excessive—by looking at (1) the reprehensibility of the conduct, (2) the ratio of punitive damages to compensatory damages, and (3) comparable civil and criminal penalties for the same crime—has been used to hold as unreasonable a punitive damages award in a discrimination case.

In 2003, the U.S. Supreme Court reaffirmed and attempted to clarify the BMW rule when holding in State Farm v. Campbell that a punitive damages award was grossly excessive and violated the Due Process Clause. In Campbell, the plaintiffs sued their auto insurance carriers alleging bad-faith failure to settle a claim against them within policy limits. The jury found in favor of the plaintiffs, awarding $2.6 million in compensatory damages. The jury further awarded $145 million in punitive damages, primarily because of evidence that State Farm’s conduct was part of a long-standing pattern and practice of dishonest and fraudulent acts against policyholders.

The trial court reduced the punitive award to $25 million, but the Utah Supreme Court, in an extensive opinion evaluating the evidence, reinstated the jury’s verdict. The U.S. Supreme Court granted review of whether the punitive damages award violated the standards of BMW v. Gore by a constitutionally excessive ratio to compensatory damages and by punishing the defendant in part for out-of-state conduct not directly affecting the plaintiffs.

The Supreme Court reiterated from Gore v. BMW that the most important indicium of the reasonableness of a punitive damages award is the degree of reprehensibility of the defendant’s conduct, and noted that the reprehensibility of a defendant is determined by considering whether “the harm caused was physical as opposed to economic; the tortious conduct evinced an indifference to or a reckless disregard of the health or safety of others; the target of the conduct had financial vulnerability; the conduct involved repeated actions or was an isolated incident; and the harm was the result of intentional malice, trickery, or deceit, or mere accident.”

The Court also noted that punitive damages should be awarded only if the defendant’s culpability, after having paid compensatory damages, is so reprehensible as to warrant the imposition of further sanctions to achieve punishment or deterrence.

In applying the first prong of the BMW case, the high court found that although the defendant’s direct conduct against the plaintiff was reprehensible enough to warrant some modest punitive damages, the trial court erred in allowing the jury to consider the defendant’s out-of-court conduct toward other policyholders, and without this improperly considered evidence of out-of-state conduct, the defendant’s conduct in failing to settle the claim within its policy limits was not sufficiently reprehensible to warrant such a large punitive damages award.

Although the Court once again refused to draw a line as to what ratio of compensatory to punitive damages was acceptable, it did give some additional

---

5 Id. at 1516.
guidance by saying that “[o]ur jurisprudence and the principles it has now established demonstrate . . . that, in practice, few awards exceeding a single-digit ratio between punitive and compensatory damages, to a significant degree, will satisfy due process.”

Although this significant Supreme Court decision involving punitive damages appears to have led to even more damage awards being overturned, most people fail to recognize that even before BMW and Campbell, most multimillion-dollar damages awards by juries making headlines and fueling the debate over limiting punitive damages were rarely paid and certainly not promptly paid. In September 1995, for example, a federal jury in Alaska slapped Exxon Corporation with the largest punitive damages award ever imposed on a corporation: $5 billion awarded to 32,000 people who were injured by the Exxon Valdez oil spill in March 1989. The award was five times the economic loss of $500 million suffered by the plaintiffs. Before the time for filing posttrial material had closed, Exxon had filed a total of 22 motions. Eventually, the appellate court ordered the trial judge to reduce the “excessive” award, so District Court Judge Holland reduced the punitive damages award to $4 billion—but in 2006, the appellate court said that the reduction was insufficient and further reduced the award to $2.5 billion. In late 2007, the U.S. Supreme Court refused to hear the final appeal of Exxon in this case. See Table 12-2 for some examples of appeals courts’ reductions of extravagant punitive damages awarded by juries.

State courts tend to take a more active role in limiting punitive damages. For example, on February 2, 1994, the Texas Supreme Court handed down a decision in the case of Transportation v. Moriel that is expected to make it more difficult for plaintiffs in that state to recover punitive damages, and many commentators believe that the ruling will influence decision makers in other states. Moriel suffered a broken pelvis and became impotent as a result of having a stack of countertops fall on him while he was working. He sued the insurance company when it delayed payment on some of his medical bills. The jury awarded Moriel $101,000 in compensatory damages, with $100,000 of that total being for mental anguish, and $1 million in punitive damages. The state court of appeals affirmed the verdict. The Texas Supreme Court struck down the punitive damages award, holding that an insurance company’s refusal to pay a claim does not justify punitive damages unless the failure to pay was in bad faith and the insurer knew that its action would probably bring about extraordinary harm such as “death, grievous physical injury or genuine likelihood of financial catastrophe.”

Another example of a state’s attempt to limit punitive damages is California Governor Arnold Schwarzenegger’s proposal to place a 75 percent tax on punitive damages. Schwarzenegger argued that a tax would still achieve the desired ends of punishing defendants and deterring future bad acts, while also promoting the public good more directly with more tax money. Governor Schwarzenegger signed this plan into law, and the law took effect on August 16, 2004. However, when the plan came up for renewal in 2006, it turned out that the law had failed to bring in even one dollar in tax revenue for the state. Governor Schwarzenegger thus advocated that the bill not be renewed at the time, but rather that the state take time to figure out what happened before trying a similar proposal again.

Many pieces of legislation designed to reform tort law have been proposed at both the federal and the state levels during the past several years. The majority of

---

6 Id. at 1524.
7 879 S.W.2d 10 (Tex. 1994).
**TABLE 12-2 SOME MAJOR PUNITIVE DAMAGE AWARDS IN RECENT YEARS**

<table>
<thead>
<tr>
<th>Case</th>
<th>Jury Award</th>
<th>Ultimate Resolution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Geragos v. Borer</td>
<td>Attorney Geragos was defending Michael Jackson. Geragos chartered a private plane from XtraJet, Inc., to fly with Jackson from Las Vegas to Santa Barbara, so that Jackson could surrender for his arrest. Borer, the owner of XtraJet, installed hidden cameras on the plane, and then attempted to sell the recordings of Jackson and Geragos on their flight. When Geragos found out, he sued Borer, claiming, among other things, invasion of privacy, misappropriation of name and likeness, and unfair business practices. He received an award for $2.25 million in compensatory damages and $9 million in punitive damages. On appeal in 2010, compensatory damages were reduced to $150,000 and punitive damages to $600,000. The judge found the punitive award to be so excessive under the circumstances as to violate due process. He believed that a ratio of no more than 4 to 1 was appropriate given that Borer’s conduct was not as reprehensible as other forms of punishable conduct, in that he did not endanger anyone’s health or safety, he did not target a financially vulnerable victim, and he had never engaged in similar misconduct in the past.</td>
<td></td>
</tr>
<tr>
<td>Frankson v. Browne &amp; Williamson</td>
<td>A jury awarded the widow Gladys Frankson $350,000 in compensatory damages and $20 million in punitive damages following the death of her husband, who died from lung cancer caused by his using the defendant’s cigarettes. In June 2004, the Supreme Court of New York did not strictly follow the 4:1 ratio in <em>State Farm v. Campbell</em>, but it held that the punitive damages were still excessive and reduced the punitive damages award to $5 million if the plaintiff agreed to the new amounts. Otherwise, the judge directed a new trial on the issue of punitive damages.</td>
<td></td>
</tr>
<tr>
<td>Diamond Woodworks, Inc. v. Argonaut Insurance Co.</td>
<td>A jury awarded compensatory damages and $14 million in punitive damages to an employee who was denied insurance benefits after being injured at his place of employment. The trial court reduced the punitive damages to $5.5 million, but the appellate court granted the defendant’s motion for a new trial only if the defendant agreed to a remittitur of $1 million in punitive damages, in accordance with the 4:1 ratio established in <em>State Farm v. Campbell</em>.</td>
<td></td>
</tr>
<tr>
<td>Conroy v. Owens-Corning Fiberglass</td>
<td>A jury awarded $3.57 million in compensatory damages and $54 million in punitive damages to the families of three men who contracted mesothelioma from long-term workplace exposure to asbestos. On appeal, punitive damages were reduced from $18.2 million per plaintiff to $1 million and one cent per plaintiff. The plaintiffs then settled for an undisclosed amount. The trial court reduced the award by 77 percent to $640,000. The parties subsequently settled the case for an undisclosed amount.</td>
<td></td>
</tr>
<tr>
<td>Liebeck v. McDonald’s</td>
<td>A jury awarded Stella Liebeck $2.9 million in damages, including $2.7 million in punitive damages for extensive burns she received when she spilled hot coffee (170°F) on her legs. Jurors were influenced by McDonald’s having known that prior customers had received severe burns from its coffee and its ongoing failure to warn customers about its unusually hot product.</td>
<td></td>
</tr>
</tbody>
</table>
According to the Federal Judicial Center, the law did have one very swift and certain impact on the courts: It sharply increased the number of class action suits filed in and removed to the federal courts. Under the law, the federal courts have jurisdiction over class action cases in which (1) the aggregate value of the claims exceeds $5 million; (2) there are at least 100 class members; (3) any member of the plaintiff class is a citizen of a state different from any defendant; and (4) two-thirds or more of the class members and primary defendants are not members of the state in which the action was originally filed.

Tort reform advocates at the state level have been more successful thus far. Almost every state has passed some sort of tort reform legislation. Since 1986, 34 of these state tort reform laws limited punitive damages awards in some fashion. Many of these reform efforts, however, have been struck down by the courts.

### COMPARATIVE LAW CORNER

**Punitive Damages in Japan**

Punitive damages have been a major source of contention in the United States. Tort reformists in the United States argue fervently for caps on the amount of punitive damages. Other groups argue that large punitive damages are necessary to discourage large corporations from committing torts, because compensatory damages are often less expensive than ceasing to commit torts. Very few people in the United States, however, argue for the complete elimination of punitive damages.

The view of punitive damages is very different in Japan. Japan’s Supreme Court has ruled many times that punitive damages violate Japan’s public policy. Recently, the Japanese legislature passed a law forbidding the acceptance of punitive damages in foreign courts as well. Although Japan’s lack of punitive damages is not entirely unusual (many European countries do not have a system of punitive damages either), the reinforcement of this ban on punitive damages is atypical. Many of the other European countries that lack systems of punitive damages are moving toward having damages beyond compensation and acceptance of foreign awards of punitive damages.

Not everyone in Japan is against punitive damages, however. Some Japanese businesses have indicated that they would like some sort of punitive damages in cases of patent infringement. Most of the companies that favor an expansion of infringement damages are secondary industries, such as pharmaceuticals, rather than major industries such as automobiles. The major industries seem content with the damages system in its current form.

### LINKING LAW AND BUSINESS

**Marketing**

The establishment of torts for the purpose of deterring future crimes relates to a familiar concept in the field of marketing. This idea, *advertising*, is defined as the “presentation and promotion of ideas, goods, or services by an identified sponsor.” Advertisers hope that what they are promoting will gain acceptance by the general public. Similarly, the law of torts is created to promote fair and just behavior among civilians. One intent of torts is that potential wrongdoers will refrain from injuring other persons or their property because of the consequences entailed in tort laws.


---

Classifications of Torts

There are three classifications of torts: intentional, negligent, and strict liability. The primary distinguishing feature among them is the degree of willfulness of the wrongful conduct. **Intentional torts** are those wherein the defendant took some purposeful action that he or she knew, or should have known, would harm the plaintiff. **Negligent torts** involve carelessness on the part of the defendant. Finally, **strict liability torts** involve inherently dangerous actions and impose liability on the defendant regardless of how careful he or she was. Defenses for the various categories of torts differ, as do the types of damages generally awarded (Table 12-3).

Intentional Torts

Intentional torts, the most “willful” torts, include a substantial number of carefully defined wrongful acts. What each of these acts has in common is the element of intent. Intent here does not mean a specific determination to cause harm to the plaintiff; rather, it means the determination to do a specific physical act that may lead to harming the plaintiff’s person, property, or economic interests.

Intentional torts can be divided into three categories based on the interest being harmed: torts against persons, torts against property, and torts against economic interests. The following sections discuss a number of specific torts that fall into each category, along with the defenses to each.

**INTENTIONAL TORTS AGAINST PERSONS**

There are a number of torts against persons. We will discuss five of the most common ones: assault and battery, defamation, privacy torts, false imprisonment, and intentional infliction of emotional distress.

**Assault and Battery.** Torts against persons consist of harm to another’s physical or mental integrity. One of the most common torts against the person is assault. An **assault** is the intentional placing of another in fear or apprehension of an immediate, offensive bodily contact. All of those elements must be present for an assault to exist. Thus, if the defendant pointed a gun at the plaintiff and threatened to shoot and the plaintiff believed the defendant would shoot, an assault would have taken place. If the plaintiff, however, thought that the defendant was joking when making the threat, there was no assault because there was no apprehension on the part of the plaintiff. Likewise, a threat to commit harm in a week is not an assault because there is no question of immediate bodily harm. A threat made with an unloaded gun, as long as the plaintiff does not know the defendant is incapable of carrying out the threat, however, is an assault.

An assault is frequently, but not always, followed by a **battery**, which is an intentional, unwanted, and offensive bodily contact. Punching someone in the nose is a battery, whereas accidentally bumping into someone on a crowded street is not. The term **bodily contact** has been broadly interpreted to include such diverse situations as the defendant’s using a projectile, such as a gun, to make physical contact with the plaintiff, and a defendant’s pulling a chair out from under the plaintiff. A number of well-known figures, such as the boxer Mike Tyson, have been sued for battery.

**Defenses to Battery.** The most common defense to a battery is self-defense. If one is attacked, one may repel the attacker—but with only that degree...
### TABLE 12-3 CATEGORIES OF TORTS

<table>
<thead>
<tr>
<th>Type</th>
<th>Description and Examples</th>
<th>Common Defenses</th>
<th>Type of Damages Usually Awarded</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Intentional Torts</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Against Persons</td>
<td>Purposeful action that results in harm</td>
<td>Specific to subtype</td>
<td>Compensatory damages for medical bills, lost wages, and pain and suffering</td>
</tr>
<tr>
<td>Assault and battery</td>
<td></td>
<td>• Self-defense</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Defense of another</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Defense of property</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Truth</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Privilege, absolute (congressional and courtroom speech)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Privilege, conditional (speech concerning public figures or in employment context)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Defamation</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Invasion of privacy</td>
<td>• Waiver by plaintiff of right to privacy</td>
<td>Compensatory damages for any resultant economic loss and pain and suffering</td>
</tr>
<tr>
<td></td>
<td>False imprisonment</td>
<td>• Posted warnings of observation</td>
<td>Compensatory damages for treatment of physical injuries and lost time at work</td>
</tr>
<tr>
<td></td>
<td>Intentional infliction of emotional distress</td>
<td>• Shopkeepers’ privilege</td>
<td>Compensatory damages for the treatment of physical illness resulting from the emotional distress</td>
</tr>
<tr>
<td></td>
<td>Trespass to realty</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Trespass to personality</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Conversion</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Against property</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Disparagement</td>
<td>• Truth</td>
<td>Compensatory damages for actual economic loss</td>
</tr>
<tr>
<td></td>
<td>Intentional interference with a contract</td>
<td>• No knowledge of contract</td>
<td>Compensatory damages for loss of expected benefits from the contract</td>
</tr>
<tr>
<td></td>
<td>Unfair competition</td>
<td>• Independent origination</td>
<td>Compensatory damages for lost profits</td>
</tr>
<tr>
<td></td>
<td>Misappropriation</td>
<td>• Denial of discussion of idea</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Careless action that results in harm</td>
<td>• No duty</td>
<td>Compensatory damages for injuries, including medical bills, lost time from work, harm to property, and pain and suffering</td>
</tr>
<tr>
<td><strong>Against economic interests</strong></td>
<td></td>
<td>• No breach of duty</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• No causation (actual or proximate)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• No damages suffered by plaintiff</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Contributory negligence by plaintiff</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Pure comparative negligence</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Modified comparative negligence</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Assumption of risk</td>
<td></td>
</tr>
<tr>
<td><strong>Negligent Torts</strong></td>
<td>Action that is so inherently dangerous that no amount of due care can make it safe</td>
<td></td>
<td>Compensatory damages for personal injury and harm to property</td>
</tr>
</tbody>
</table>

of force reasonably necessary to protect oneself. In most states, if a third person is in trouble, one may defend that person with the same degree of force that one would reasonably use to defend oneself, so long as the third party is unable to act in his or her own defense and there is a socially recognized duty to defend that person. This situation is often referred to as *defense of another*.

A third defense that may be raised against a charge of battery is defense of property. A person can use reasonable force to defend home and property from an intruder. Deadly force in defense of property, however, is rarely, if ever, considered justified.
Defamation. Another tort that most people have heard of is defamation. **Defamation** is the intentional publication (communication to a third party) of a false statement that is harmful to the plaintiff’s reputation. If the defamation is published in a permanent form—for example, in a piece of writing or on television—the tort is called **libel**; if it is spoken, it is called **slander**.

Once a plaintiff proves the elements of a case of libel, “general” damages are presumed as a matter of law. These damages provide the plaintiff with compensation for harms that are hard to quantify but that would almost certainly arise from libel, such as feelings of humiliation and loss of standing in the community. In the case of slander, however, the plaintiff must prove “special” damages, which means that to recover damages, the plaintiff must demonstrate an actual monetary loss resulting or flowing from the slanderous statement.

There is an exception to this limitation on damages, however, and the exception is for statements that constitute **slander per se**. These are statements that are considered by their very nature to be so obviously harmful to a person that no proof of special damages is needed. Traditionally, statements are considered slander per se if they are statements that say (1) one has a loathsome communicable disease; (2) one has committed improprieties in the performance of his or her profession; (3) one has committed or been imprisoned for a serious crime; and (4) an unmarried female is not chaste.

One example of a libel case is the Warnaco claim against Calvin Klein. On the **Larry King Live** television show, Calvin Klein accused Warnaco, the company that manufactures Calvin Klein jeans and underwear, of making and selling substandard Calvin Klein products. In response, Warnaco brought a libel claim against Calvin Klein personally.11 Another example of a libel case is Lance Armstrong’s suit against a British writer whose book alleged that Armstrong took performance-enhancing drugs during his journey in winning a world-record six Tour de France titles.12

There are limits on what is considered defamation. For instance, someone can say something that is potentially harmful to another’s reputation but not suffer any consequences for saying it if the statement is merely one of opinion and not a statement of a fact. For example, in a 1997 case, Randolph Cook claimed to have had a past relationship with Oprah Winfrey. During that relationship, he claimed, Winfrey used cocaine regularly. Cook contacted several media outlets with his claim. After Winfrey heard about this, she called Cook a liar, both privately and publicly. Cook sued Winfrey for defamation, among other things, but because calling someone a liar is only an opinion, and one cannot be sued for stating one’s opinion, the case was dismissed.13 Likewise, it was not defamatory for employees of Apple Computer Company to refer to the famous astronomer Carl Sagan as “butthead astronomer.”14

Defamation has become a little more confusing since people began communicating over the Internet. This medium of communication has generated two questions. First, when does a false statement made over this information network constitute defamation? Second, who can be held liable if defamation does exist? Both the legislatures and the courts have been grappling with these issues. The following case illustrates one court’s approach.

---

The plaintiff, Nemet Chevrolet, Ltd., is in the business of selling and servicing automobiles. The defendant, Consumeraffairs.com, Inc., operates a Web site where consumers can comment on the quality of goods and services, including those at Nemet Chevrolet. Nemet felt that several of the postings on the defendant’s Web site were false and harmful to its business reputation, so it filed suit alleging defamation. The defendant filed a motion to dismiss, under Federal Rule 12(b)(6), for failure to state a claim upon which relief could be granted. According to the defendant, the statements on its Web site are protected by the Communications Decency Act of 1996 (CDA), which prevents plaintiffs from holding Internet service providers liable for the publication of information created and developed by others. The district court granted the motion with leave to amend the complaint. The plaintiff amended, but the defendant filed another 12(b)(6) motion to dismiss. The district court again granted the dismissal. The plaintiff appealed.

**Circuit Judge Agee**

Recognizing that the Internet provided a valuable and increasingly utilized source of information for citizens, Congress carved out a sphere of immunity from state lawsuits for providers of interactive computer services to preserve the “vibrant and competitive free market” of ideas on the Internet. The CDA bars the institution of a “cause of action” or imposition of “liability” under “any State or local law that is inconsistent” with the terms of §230. As relevant here, §230 prohibits a “provider or user of an interactive computer service” from being held responsible “as the publisher or speaker of any information provided by another information content provider.” Assuming a person meets the statutory definition of an “interactive computer service provider,” the scope of §230 immunity turns on whether that persons’ actions also make it an “information content provider.” The CDA defines an “information content provider” as “any person or entity that is responsible, in whole or in part, for the creation or development of information provided through the Internet or any other interactive computer service.”

Taken together, these provisions bar state-law plaintiffs from holding interactive computer service providers legally responsible for information created and developed by third parties. Congress thus established a general rule that providers of interactive computer services are liable only for speech that is properly attributable to them. State law plaintiffs may hold liable the person who creates or develops unlawful content, but not the interactive computer service provider who merely enables that content to be posted online.

To further the policies underlying the CDA, courts have generally accorded §230 immunity a broad scope. This Circuit has recognized the “obvious chilling effect” the “specter of tort liability” would otherwise pose to interactive computer service providers given the “prolific” nature of speech on the Internet. Section 230 immunity, like other forms of immunity, is generally accorded effect at the first logical point in the litigation process. As we have often explained in the qualified immunity context, “immunity is an immunity from suit rather than a mere defense to liability” and “it is effectively lost if a case is erroneously permitted to go to trial.” We thus aim to resolve the question of §230 immunity at the earliest possible stage of the case because that immunity protects websites not only from “ultimate liability,” but also from “having to fight costly and protracted legal battles.”

Nemet does not dispute that Consumeraffairs.com is an interactive computer service provider under the CDA. What Nemet contends is that Consumeraffairs.com is also an information content provider as to the twenty posts and, therefore, cannot qualify for §230 immunity. In other words, Nemet’s argument is that its amended complaint pleads sufficient facts to show Consumeraffairs.com is an information content provider for purposes of denying statutory immunity to Consumeraffairs.com at this stage in the proceedings.

... We must determine ... whether the facts pled by Nemet, as to the application of CDA immunity, make its claim that Consumeraffairs.com is an information content provider merely possible or whether Nemet has nudged that claim “across the line from conceivable to plausible.”

In the amended complaint, Nemet recited the specific language from each customer about his or her automobile complaint for each of the twenty posts it claimed were defamatory. Then, Nemet pled as to each of the posts as follows:

*Upon information and belief, Defendant participated in the preparation of this complaint by soliciting the complaint, steering the complaint into a specific category designed to attract attention by consumer class action lawyers, contacting the consumer to ask questions about the complaint and to help her draft or revise her complaint, and promising the consumer that she could obtain some financial recovery by joining a class action lawsuit. Defendant is therefore responsible, in whole or in part, for developing the substance and content of the false complaint . . . about the Plaintiffs.*

...In short, Nemet argues [that] the language . . . shows Consumeraffairs.com’s culpability as an information content provider either through (1) the “structure and design of its website,” or (2) its participation in “the preparation of” consumer complaints: *i.e.,* that Consumeraffairs.com “solicit[ed]” its customers’ complaints, “steered” them into “specific category[ies] designed to attract attention by
consumer class action lawyers, contact[ed] customers to ask "questions about" their complaints and to "help" them "draft or revise" their complaints, and "promis[ed]" customers would "obtain some financial recovery by joining a class action lawsuit."

We first examine the structure and design of the website argument, which encompasses all the facts pled in the Development Paragraph except for the claim Consumersaffairs.com asked questions and "help[ed] draft or revise her complaint.

Even accepting as true all of the facts Nemet pled as to Consumersaffairs.com’s liability for the structure and design of its website, the amended complaint “does not show, or even intimate, that Consumersaffairs.com contributed to the allegedly fraudulent nature of the comments at issue. Thus,. . . Nemet’s pleading not only fails to show it is plausible that Consumersaffairs.com is an information content provider, but not that it is even a likely possibility.

We now turn to the remaining factual allegations, common to all twenty posts from the Development Paragraph,

that Consumersaffairs.com is an information content provider because it contacted “the consumer to ask questions about the complaint and to help her draft or revise her complaint.” Nemet fails to make any cognizable argument as to how a website operator who contacts a potential user with questions thus “develops” or “creates” the website content. Assuming it to be true that Consumersaffairs.com contacted the consumers to ask some unknown question, this bare allegation proves nothing as to Nemet’s claim [that] Consumersaffairs.com is an information content provider.

The remaining claim, of revising or redrafting the consumer complaint, fares no better. Nemet has not pled what Consumersaffairs.com ostensibly revised or redrafted or how such affected the post. . . .

Moreover, in view of our decision in Zeran, Nemet was required to plead facts to show [that] any alleged drafting or revision by Consumersaffairs.com was something more than a website operator performs as part of its traditional editorial function. It has failed to plead any such facts. . . . § 230 forbids the imposition of publisher liability on a service provider for the exercise of its “editorial and self-regulatory functions.”

We thus conclude that the Development Paragraph failed, as a matter of law, to state facts upon which it could be concluded that it was plausible that Consumersaffairs.com was an information content provider. Accordingly, as to the Development Paragraph, the district court did not err in granting the Rule 12(b)(6) motion to dismiss because Nemet failed to plead facts sufficient to show [that] Consumersaffairs.com was an information content provider and not covered by CDA immunity.

Even if the facts pled in the Development Paragraph are insufficient for Rule 12(b)(6) purposes, Nemet separately argues that as to eight of the twenty posts, the amended complaint pled other facts which show [that] Consumersaffairs.com is an information content provider. Thus, Nemet argues [that] the motion to dismiss should not have been granted as to these eight posts. . . . Nemet’s sole factual basis for the claim that Consumersaffairs.com is the author, and thus an information content provider not entitled to CDA immunity, is that Nemet cannot find the customer in its records based on the information in the post.

Because Nemet was unable to identify the authors of these comments based on “the date, model of car, and first name” recorded online, Nemet alleges that these comments were “fabricated” by Consumersaffairs.com “for the purpose of attracting other consumer complaints.” But this is pure speculation and a conclusory allegation of an element of the immunity claim. . . . Nemet has not pled that Consumersaffairs.com created the allegedly defamatory eight posts based on any tangible fact, but solely because it [Nemet] can’t find a similar name or vehicle of the time period in Nemet’s business records. Of course, the post could be anonymous, falsified by the consumer, or simply missed by Nemet. There is nothing but Nemet’s speculation which pleads Consumersaffairs.com’s role as an actual author in the Fabrication Paragraph.

On appeal, Nemet argues that its supporting allegations nonetheless . . . [present] adequate facts that Consumersaffairs.com is the author of the eight posts, but each is meritless. These allegations include (1) that Nemet has an excellent professional reputation, (2) none of the consumer complaints at issue have been reported to or acted upon by the New York City Department of Consumer Affairs, (3) Consumersaffairs.com’s sole source of income is advertising and this advertising is tied to its webpage content, and (4) some of the posts on Consumersaffairs.com’s website appeared online after their listed creation date. Nemet’s allegations in this regard do not allow us to draw any reasonable inferences that would aid the sufficiency of its amended complaint.

That Nemet may have an overall excellent professional reputation, earned in part from a paucity of complaints reported to New York City’s Department of Consumer Affairs, does not allow us to reasonably infer that the particular instances of consumer dissatisfaction alleged on Consumersaffairs.com’s website are false. Furthermore, Nemet’s allegations in regard to the source of Consumersaffairs.com’s revenue stream are irrelevant, as we have already established that Consumersaffairs.com’s development of class-action lawsuits does not render it an information content provider with respect to the allegedly defamatory content of the posts at issue. Finally, the fact that some of these comments appeared on Consumersaffairs.com’s website after their listed creation date does not reasonably suggest that they were fabricated by Consumersaffairs.com. Any number of reasons could cause such a delay, including Consumersaffairs.com’s review for inappropriate content. . . .

Viewed in their best light, Nemet’s well-pled allegations allow us to infer no more than “the mere possibility” that Consumersaffairs.com was responsible for the creation or development of the allegedly defamatory content at issue. Nemet has thus failed to nudge its claims that Consumersaffairs.com is an information content provider for any of the twenty posts across the line from the “conceivable to plausible.” As a result, Consumersaffairs.com is entitled to §230 immunity and the district court did not err by granting the motion to dismiss.

Judgment Affirmed.
Defenses to Defamation. There are two primary types of defenses to a defamation action: truth and privilege. It is often stated that truth is an absolute defense. In other words, if I make an honest statement that harms the reputation of the defendant, there has been no defamation. For the ordinary plaintiff, however, a defendant cannot use the excuse that he or she thought the statement was true. Only when a possible privilege exists is the defendant’s incorrect belief about the truth of the statement important.

Privilege is the second type of defense in a defamation action. Most privileges arise under certain circumstances in which our society has decided that encouraging people to speak is more important than protecting people’s reputations.

There are two types of privilege: (1) absolute and (2) qualified or conditional. When an absolute privilege exists, one can make any statement, true or false, and cannot be sued for defamation. There are very few situations in which such a privilege exists. The Speech and Debate Clause of the U.S. Constitution gives an absolute privilege to individuals speaking on the House and Senate floors during congressional debate. This privilege encourages the most robust debate possible over potential legislation. Another absolute privilege arises in the courtroom during a trial.

The other type of privilege is a qualified or conditional privilege. A conditional privilege provides that one will not be held liable for defamation unless the false statement was made with malice. Malice has a special meaning in a defamation case: it means knowledge of the falsity of the statement or reckless disregard for the truth. In other words, the defendant either knew that the statement was false or could easily have discovered whether it was false.

The conditional privilege most often used is the public figure privilege. People in the public eye, such as politicians, often find themselves the victims of false rumors. When a defendant has made a false statement about a public figure—a person who has thrust herself or himself into the public eye and who generally has access to the media—the defendant will raise the public figure privilege as a defense to charges of defamation. If the defendant proves that the plaintiff is a public figure, the plaintiff will have to additionally prove that the defamation was made with malice (defined as knowledge of the falsity or reckless disregard for the truth) in order to recover for defamation.
The reason for this privilege to comment freely about public figures as long as statements are made without malice is to encourage open discussion about persons who have a significant impact on our lives. Also, because public figures generally have access to the media, they are in a position to defend themselves and, therefore, need less protection than an ordinary private citizen.

A libel or slander case brought by a public figure sometimes appears quite complex. First, the public figure plaintiff proves that the defendant made a false statement that harmed the plaintiff’s reputation. Then the defendant must prove that the plaintiff is in fact a public figure. Then the burden of proof shifts back to the plaintiff, who must prove that the statements were made with malice (Exhibit 12-1).

There are two kinds of public figures: public figures for all purposes and public figures for a limited purpose. The public figure for all purposes was defined in the foregoing paragraph. Movie stars, musicians, and politicians fall into that category. The public figure for a limited purpose is a private figure who achieves substantial media attention for a specific activity. That person is then considered a public figure but only for matters related to that activity. For example, the leader of an antiabortion group would be considered a public figure for matters related to abortion. Thus, if the activist brought a defamation suit against a defendant who falsely stated that the activist had undergone three abortions as a teenager, the activist would have to prove that the defendant knew the statement was false, or acted recklessly, without even trying to check the veracity of the claim. In contrast, had the defendant claimed that the activist stole money from at least three former employers, no public figure privilege would arise, and it would not be necessary for the activist to prove that the claim had been made with malice.

Some people are trying to argue that the public figure privilege should also apply in another context: when the defamatory statement is published over the Internet. The rationale for this privilege is twofold. First, remember that part of the reason for the public figure privilege is that the public figure who has been defamed has access to the media and, therefore, has the ability to defend himself or herself. Likewise, when a person is defamed over the Internet, the defamed party can respond with a few keystrokes. Thus, there is less need for the stronger legal protection we ordinarily give to the private party. A second reason is that we want to encourage free expression and the exchange of ideas on the Internet. Requiring a plaintiff to prove malice would encourage such free discussion because people would not have to worry about making errors when they speak about others.

Another use of the conditional privilege arises with respect to job recommendations. To encourage employers to give honest assessments of their former employees, an employer who makes a false statement about a former worker can be held liable only if the statement is made with malice.

**Privacy Torts.** Although truth may be an absolute defense to defamation, one is not necessarily allowed to reveal everything one knows about another person.
The recently developed tort of invasion of privacy is used to allow a person to keep private matters confidential. Just as defamation has two forms, libel and slander, the tort of invasion of privacy is really four distinct torts: (1) public disclosure of private facts, (2) false light, (3) appropriation, and (4) invasion of privacy.

**Public disclosure of private facts** occurs when the defendant makes public a fact about the plaintiff that the plaintiff is entitled to keep private. The disclosure must be unwarranted, and the plaintiff must not have waived his or her right to privacy. For example, if the defendant worked in a clinic and revealed the names of women who had obtained abortions at the clinic, the defendant would be liable for public disclosure of private facts.

**False light** occurs when you do not actually make a defamatory statement about someone, but by your actions you place the person in a false light. For example, a neighborhood newsletter publishes a story captioned “Gang Warfare Growing in Our Community,” and between the caption and the article is an untitled photo of four girls sitting on the hood of a car. The photo is clear enough that the girls’ identities are obvious. If these girls are not gang members, they have been placed in a false light and may sue the publisher. Often, illustrations in tabloids may lead to false-light claims. The following case provides an illustration of a false-light claim that comes not from a tabloid but rather from a comedy film.

**CASE 12-3**

**Ellen Johnston v. One America Productions, Inc.**
United States District Court for the Northern District of Mississippi, Delta Division

Ellen Johnston is angry that she appears, without her permission, in the movie *Borat*. The scene at issue in this case is near the end of the movie on Borat’s way to California, when he stops at an actual Pentecostal camp meeting held in Clarksdale, Mississippi. In the scene, Borat seeks redemption at the camp meeting, during which he acts as if he has been converted by the minister and begins speaking in tongues along with other Pentecostals doing the same. While Borat appears to be experiencing this religious conversion, several members of the camp meeting, including Johnston, are shown in the film raising their arms in praise to God for Borat’s conversion. Johnston is seen in the film for approximately three seconds. Johnston argues that her unknowing appearance in *Borat* portrays her in a false light by suggesting that she knowingly participated in a mocking of her Pentecostal religion. The defendants responded to the suit by filing a motion to dismiss for failure to state a claim.

**Judge Pepper**

The Court in *Bell Atlantic Corp. v. Twombly* formulated the proper standard [for evaluating a motion to dismiss] in the following way:

> While a complaint attacked by a Rule 12(b)(6) motion to dismiss does not need detailed factual allegations, a plaintiff’s obligation to provide the “grounds” of his “entitle[ment] to relief” requires more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do. Factual allegations must be enough to raise a right to relief above the speculative level, [and] “the pleading must contain something more . . . than . . . a statement of facts that merely creates a suspicion [of] a legally cognizable right of action,” on the assumption that all the allegations in the complaint are true (even if doubtful in fact).

Thus, the court must determine whether the defendants have established that the plaintiff’s factual allegations in her Complaint, taken as true, are enough to raise a right to relief above the speculative level.

Motions to dismiss are viewed with disfavor and are rarely granted. In deciding a motion to dismiss under Rule 12(b)(6), the district court accepts as true those well-pleaded factual allegations in the complaint. The complaint must be liberally construed, with all reasonable inferences drawn in the light most favorable to the plaintiff. However, [the court] will not strain to find inferences favorable to the plaintiff.

As the Mississippi Supreme Court and the Fifth Circuit have done in matters involving invasion of privacy torts, this court will consult Section 652E of the Restatement (Second) of Torts regarding the false light theory. . . . [T]here are several statements contained in the comments to Section 652E that are particularly relevant to this case.

Comment A states that “it is essential to the rule stated in this Section that the matter published concerning the plaintiff is not true.” Regarding false light’s relation to
defamation, comment b states: “It is not, however, necessary to an action for invasion of privacy that the plaintiff be defamed. It is enough that he is given unreasonable and highly objectionable publicity that attributes to him characteristics, conduct or beliefs that are false, and so is placed before the public in a false position.”

Comment c, regarding what is highly offensive to a reasonable person, states in pertinent part:

The rule stated in this Section applies only when the publicity given to the plaintiff has placed him in a false light before the public, of a kind that would be highly offensive to a reasonable person. In other words, it applies only when the defendant knows that the plaintiff, as a reasonable man, would be justified in the eyes of the community in feeling seriously offended and aggrieved by the publicity. . . . It is only when there is such a major misrepresentation of his character, history, activities or beliefs that serious offense may reasonably be expected to be taken by a reasonable man in his position, that there is a cause of action for invasion of privacy.

The defendants argue that the plaintiff was not portrayed in a false light because it is true that she voluntarily raised her hands [in] religious praise in response to the character Borat’s apparent conversion to her religion. The plaintiff counters, however, that the issue is not whether she does and did raise her hands in praise upon the conversion of another; rather, the issue is whether she is reasonable to believe that viewers of the movie would question whether she knowingly and voluntarily participated in a mocking of her religion.

Considering the elements of the tort of false light invasion of privacy and the Restatement comments quoted above, the court concludes that in light of the standards for Rule 12(b)(6) motions to dismiss, it is beyond mere speculation that there are jury questions of (1) whether the Pentecostal scene portraying the plaintiff waving her arms in religious praise in response to Borat’s apparent conversion would be highly objectionable to a reasonable person in the plaintiff’s position such that a person in the plaintiff’s position would believe others would believe she willingly participated in a mocking of her religion; and (2) whether “the defendant [knew] that the plaintiff, as a reasonable [person], would be justified in the eyes of the community in feeling seriously offended and aggrieved by the publicity.”

In any event, the nature of the film Borat is different from a purely fictional work since, although the viewer is aware that the plot itself is fictional and that the characters of Borat and his producer are fictional, the viewer is also aware that the vast majority, if not all, of the other people featured in the movie are non-public figures who are not actors and are likely unaware that Borat is not a Kazakhstani reporter filming a documentary for Kazakhstan. Such details would need to be developed during discovery.

Defendants’ motion to dismiss is denied.

**CRITICAL THINKING ABOUT THE LAW**

False-light claims raise many interesting questions about how to determine the effects of harm that happen inside the mind of the plaintiff and those who know the plaintiff, as well as the extent and form of the knowledge possessed by the person allegedly placing another in a false light.

1. **What is the logic for the rule of law governing the granting of a motion to dismiss?**
   **Clue:** Consider the effects of having a rule of law that makes it easy to attain a motion to dismiss.

2. **Can you construct a set of facts that would have led to a successful motion to dismiss in this case?**
   **Clue:** Study the last paragraph where the court explains what must be uncovered during discovery for this case to be decided.

Although the Johnston case is beneficial in that it shows how a court engages in an analysis of what is necessary to prove a claim of false light, it is important to note that the case does not record the final opinion. The excerpted case only discusses the defendants’ motion to dismiss, which they lost. To successfully prove her claim of false light, however, not only must Johnston meet the criteria outlined in Judge Pepper’s decision, but she must also prove the element of damages if she is to recover from the defendants. At the time this book went to press, no ruling or agreement had been reached regarding Johnston’s claim of false light.

**Appropriation** of a person’s name for commercial gain occurs when a defendant uses another’s name or likeness without that person’s permission for commercial gain. This tort, for example, prohibits a cereal company from putting an athlete’s picture on its cereal box without obtaining the athlete’s permission.
Spam, or unsolicited commercial e-mail, constitutes more than one-half of all electronic mail traffic. The flooding of these unwanted messages prompted Congress to impose regulations on such messages. For instance, Congress passed the Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003 (the CAN-SPAM Act), which took effect in January 2004. The act states, “Most of these messages are fraudulent or deceptive in one or more respects.” Consequently, Congress created three provisions for spammers. First, spammers must clearly label their messages as advertisements, avoiding misleading or untruthful subject lines that function simply to entice readers to view such messages. Second, spammers must provide a clear and convenient opt-out option in their messages, whereby recipients may reject future e-mails from these spammers. Third, spammers must send messages from legitimate return addresses, while also including the sender’s postal address. These three restrictions on spammers, however, do not apply in situations in which a recipient has given prior affirmative consent to receive spam messages.

Congress created this federal act to preempt most state laws against spammers while making exceptions for state laws related to deceptive information in commercial electronic mail. The Federal Trade Commission, along with other federal and state agencies and attorneys general, can bring suit against spammers. Violations of the CAN-SPAM Act could result in civil and criminal penalties, including heavy fines and possible imprisonment.

The final privacy tort is invasion of privacy, which occurs when someone invades another’s solitude, seclusion, or personal affairs when that person has the right to expect privacy. One example of invasion of privacy is wiretapping and using someone’s password to gain access to the person’s electronic mail messages. In another example, an owner of an ice skating rink who installed two-way mirrors in the women’s dressing room would have committed an invasion of privacy, because the skaters should be able to expect a certain degree of privacy in a dressing room. Of course, the degree of privacy one may reasonably expect varies greatly. For example, if one is trying on clothes in a department store fitting room where signs are posted saying that the “area is under observation to deter shoplifting,” it would not be unreasonable for the store to have authorized security guards of the same sex as the dressing-room occupants observing the dressing rooms.

False Imprisonment. False imprisonment is the intentional restraint or confinement of a person against that person’s will and without justification. The tort protects our freedom of movement. The confinement cannot be by moral force alone. There must be either physical restraint, such as locking a door; physical force, such as holding someone down; or threats of physical force.

Most cases of false imprisonment are brought against security guards and retailers. In fact, this tort is brought so frequently against retailers who have detained a person suspected of shoplifting that it has become known as the “shopkeepers’ tort.” In most states, retailers who detain suspected shoplifters for questioning are entitled to raise “the shopkeepers’ privilege.” Under this privilege, a merchant who has reason to believe that a person has shoplifted may detain the person for questioning about the incident. The detention must be conducted in a reasonable manner, and the suspect can be held for only a reasonable time.

Even if one is successful in bringing an action for false imprisonment, damages are often not easy to prove. Obviously, a person who is physically restrained might have medical bills for treatment of physical injuries, but most cases do not involve physical harm. Usually, plaintiffs ask for a monetary award to compensate them for time lost from work, pain and suffering from the mental distress, and humiliation.
Occasionally, however, as in the 2006 case of *Jackson v. Rich’s*, the store personnel’s behavior leaves the jury no choice but to award the plaintiff a huge verdict. Jackson was leaving the store after buying some clothes for her terminally ill son when Rich’s plainclothes detectives stopped her and told her that she had been caught shoplifting. Remembering the kidnapping and murder a few years earlier of a woman who had been abducted from the same parking lot, Jackson was terrified and offered to let the men search her bag. They said they could do that only in the store’s detention room. She refused to go with them and attempted to use her cell phone to call 911. They took her phone and said they were the police. They handcuffed her and escorted her, crying, through the store, then handcuffed her to a bar in the store’s detention center so that she could not move. She asked to call the police again, but they still refused. A manager then came in and examined her receipt and told the men that they could unhook her and let her go. He then apologized and offered her a discount on her purchase.

After two hours of deliberation, the jury awarded Jackson $1.2 million in compensatory damages for emotional distress. The plaintiff had testified that as a result of the incident, she no longer can go shopping alone, wear anything tight around her wrists, or be in close quarters. She gets frightened when anyone gets too close to her.

The jury felt that the security men’s approach was overkill, when all they needed to do was ask to see what was in the bag, especially because she had offered to show it to them. According to store policy, they should not approach anyone unless they have shoplifting on tape. In Jackson’s case, before leaving the store, she had seen a shirt that she thought might match the shorts she had just bought. She took the shorts out of the bag to compare them and then put the shorts back into the bag. The security officers saw her putting the shorts back into the bag and jumped to the conclusion that she had been shoplifting.

Before arguments for punitive damages could be made in the case, the defendants settled for a confidential amount.

**Intentional Infliction of Emotional Distress.** This tort arises when the defendant engages in outrageous, intentional conduct that is likely to cause extreme emotional distress to the party toward whom such conduct is directed. For example, a debt collector calls a debtor and tells the debtor that he is a police officer and he is sorry to inform the debtor that his wife has just been killed in an auto accident, and her last words to the medic at the scene of the crash were, “God must be punishing me for our not paying our debts.” Such conduct would most likely be interpreted as the intentional infliction of emotional distress.

In most states, to recover damages for intentional infliction of emotional distress, the plaintiff must demonstrate some physical symptoms caused by his or her emotional distress. For example, in the preceding example, if the plaintiff had high blood pressure and after hearing the message had a heart attack, the heart attack would provide the necessary physical basis to prove his injury. Other physical symptoms commonly arising from emotional distress include headaches, a sudden onset of high blood pressure, hives, chills, inability to sleep, or inability to get out of bed.

Although some people argue that the requirement of physical harm puts an undue burden on the plaintiff, others fear that without the requirement of physical symptoms of harm, it would be too easy to successfully recover damages in a situation in which there is not any real harm. For example, critics point to the 1998 suit filed against Dennis Rodman of the Chicago Bulls for intentional infliction of emotional distress as an illustration of abuse of the tort. Rodman and

---

a friend were playing craps at the Mirage Hotel in Las Vegas. While playing, Rodman allegedly rubbed the dealer’s bald head for good luck. The dealer claimed that this act caused him “embarrassment, indignity, degradation, and anger.” Because of the severe results of Rodman’s head-rubbing, the dealer sought damages in excess of $10,000.16

INTENTIONAL TORTS AGAINST PROPERTY

The second category of intentional torts involves damage to property. **Trespass to realty**, also called **trespass to real property**, occurs when a person intentionally enters the land of another or causes an object to be placed on the land of another without the landowner’s permission. Trespass to realty also occurs when one originally enters another’s land with permission, is told to leave, and yet remains on the land. It is no defense to argue that one did not know that the land belonged to another; the intent refers to intentionally being on that particular piece of land.

**Trespass to personalty** occurs when one intentionally interferes with another’s use and enjoyment of his or her personal property. It is usually of short duration, but the trespasser is liable for any harm caused to the property or any loss suffered by the true owner as a result of the trespasser’s having used the property.

**Conversion** is a more extreme wrong. It occurs when the defendant deprives the owner of his or her use and enjoyment of personal property. Traditionally, the tort required the defendant’s permanent removal of the property from the owner’s possession and control, such that the item could not be recovered or restored to its original condition. Today, however, a serious deprivation, even if not permanent, may constitute conversion. The plaintiff usually recovers damages for the full value of the converted item.

If I take my neighbor’s car for a drive without permission, but I return it unharmed before the owner knows I have it, I have committed trespass to personalty, but the true owner suffers no damages. If I take the car and hit a tree, damaging the bumper, before I return the car, I have again committed trespass to personalty and will be liable for the cost of repairing the car. If I take the car and sell it to a salvage firm that tears the car apart and sells its parts, I have committed conversion and will be liable for replacing the car.

INTENTIONAL TORTS AGAINST ECONOMIC INTERESTS

Torts against economic interests are the torts that most commonly arise within the business context. One such tort is **disparagement**.

To win a disparagement case, a plaintiff must prove four elements. First, the defendant made a false statement of a material fact about the plaintiff’s business, product, or service. In general, the types of statements that are actionable are statements about the quality, honesty, or reputation of the business, as well as statements about the ownership of the business property. The second element is publication. Remember, **publication** in the context of any kind of defamation action means communication to a third party. So, if the defendant makes disparaging comments about the plaintiff’s business in a public address to a consumer group or in an advertisement, the defendant has published the statement.

Third, there must be harm to the reputation of the business, product, or service. Finally, there must be actual economic loss as a result of the false statements. Proving the economic loss that provides a basis for compensatory damages is not always easy. Usually, damages will be based on a decrease in profits that can be linked to the publication of the false statement. An alternative, albeit...

---

TABLE 12-4
ELEMENTS OF DISPARAGEMENT

1. A false statement of a material fact about the plaintiff’s product or service
2. Publication
3. Damage to the reputation of the product or service
4. Economic loss

a less common way to prove damages, is to demonstrate that the plaintiff had been negotiating a contract with a third party, but the third party lost interest shortly after publication of the false statement. The profits the plaintiff would have made on the contract would be the damages. Table 12-4 lists the elements of disparagement.

In 13 states, a closely related tort has been created: food disparagement. Dubbed “veggie libel” and “banana bills” by their critics, these laws provide ranchers and farmers a cause of action when someone spreads false information about the safety of a food product. The first major test of one of these laws came in a $6.7 million case filed by a rancher in a federal district court against talk-show host Oprah Winfrey and one of her guests. They were discussing the potential for U.S. cattle to contract mad cow disease, and, at one point, Oprah said that was it—the conversation had stopped her from ever eating a burger again. After the broadcast, which the show’s producers said tried to show both sides of the issue, the price of cattle futures fell.

The Texas law at issue provides that anyone who says that a perishable food product is unsafe, knowing the statement is false, may be required to pay damages to the producer of the product. The defendants originally asked that the case be dismissed on the ground that the law unconstitutionally interferes with free speech. The judge dismissed the food-disparagement claims on the grounds that the cattlemen did not prove that “knowingly false” statements were made and that a perishable food was not involved. The jury then decided there was no case under traditional business disparagement law either.

Another tort against economic interests is the tort of intentional interference with a contract, a complex and difficult tort to prove. To prove the tort of intentional interference with a contract, the plaintiff must demonstrate that:

1. The plaintiff had a valid contract with a third party.
2. The defendant knew of the contract and its terms.
3. The defendant took action knowing that it was highly likely to cause the third party to breach the contract with the plaintiff.
4. The defendant undertook the action for the purpose of causing the third party to breach the contract.
5. The third party did in fact breach the contract.
6. As a result of the breach, the plaintiff was injured.

Some of the most common cases concerning intentional interference with contracts in the business setting involve employers taking employees from another firm when they know that the employees have contracts for a set period of time. Luring an employee from a successful competitor is often a delicate situation. There is no problem if the employee does not have a contract for a fixed period of time, but if the employee is indeed bound by a contract of employment for a fixed term or by a contractual agreement not to work for a competitor for a set period of time, then pursuit of the employee opens a second employer with knowledge of the contract to liability.

A third tort against economic interest is unfair competition. Our legal system assumes that individuals go into business for the purpose of making a profit. Competition is supposed to drive inefficient firms out of business because the more efficient firms will be able to provide less expensive goods and services. For this system to work, however, firms must be in business to make a profit. Therefore, it is unlawful for a person to go into business for the purpose of causing a loss of business to another without regard for his or her own profit.

For example, assume that Mark wants to open a painting business but his father wants him to go to college. When Mark opens his business, his father starts a competing firm and is able to underbid every job his son bids because the
father is willing to lose money. He just wants to force his son out of business. The father in this example is engaging in unfair competition.

Misappropriation is another tort against economic interest that is difficult to prove. **Misappropriation** occurs when a person presents an unsolicited idea for a product, service, or even method of marketing to a business with the expectation of compensation if the idea is used by the firm and the firm subsequently uses the idea without compensating the individual. The individual may then have the basis for an action for misappropriation.

The firm may always defend on the ground that it had already independently come up with the idea that the plaintiff proposed. The firm may also deny that the idea was even discussed. It is, therefore, extremely important that anyone offering an unsolicited idea to a firm have that idea and the offer to the firm documented.

**Negligent Torts**

**ELEMENTS OF NEGLIGENCE**

The second classification of torts is negligent torts. **Negligence** results not from the willful wrongdoing of a party but from carelessness. A person is said to be **negligent** when her or his behavior falls below the standard of care necessary to protect others from an unreasonable risk of harm. To prove negligence, a plaintiff must establish four elements: (1) duty, (2) breach of duty, (3) causation, and (4) damages. Failure to establish any one of those elements precludes recovery by the plaintiff.

The first element to be proved is duty. The **duty** is the standard of care that the defendant owes the plaintiff. Under certain circumstances, a law establishes the duty of care for a particular party, but the courts generally use a “reasonable person” standard. Under this standard, the defendant must have exercised the degree of care and skill that a reasonable person would have exercised in similar circumstances to protect the plaintiff from an unreasonable risk of injury.

The reasonable-person standard is an objective standard; it is an illustration of how members of society would expect an individual to act in a certain situation. Thus, the reasonable person is careful and wise. In negligence cases, a judge or jury must determine what the reasonable person would do in a similar situation and compare this standard to the actions of the individual in the case before it.

One of the reasons that a future business manager should be knowledgeable about duty of care is that courts generally expect businesses to meet a reasonable duty of care for customers who enter onto the businesses’ property. Thus, businesses must warn customers about potential risks they might encounter while on the property, or even better, make sure that the property is safe for customers. Even if a business attempts to warn its customers about potential hazards, the business might still be considered negligent. For example, in a case decided in Los Angeles, a woman sued the House of Blues restaurant because she tripped over lumber that was being stored on the front porch of the restaurant. Although the lumber was marked with yellow construction tape, the woman received $91,366 in damages.

The next element to be proved is a breach of duty. Once the plaintiff establishes the duty required of the defendant under the circumstances, the plaintiff must show that the defendant’s conduct was not consistent with that duty. For example, a reasonable person does not leave a campfire burning unattended in the woods. A defendant who builds a campfire and then goes home without putting out the campfire has breached her or his duty of care to the owner of the

---

campground and to other campers whose safety is endangered by the unguarded campfire.

The third element is causation. Causation is really two elements: actual cause and proximate cause. Actual cause is a factual matter of whether the defendant’s conduct resulted in the plaintiff’s injury. The breach of the duty must have resulted directly in the plaintiff’s harm. To ascertain whether the breach of duty was the actual cause of the plaintiff’s harm, one must ask, “If the defendant had obeyed his or her duty, would the plaintiff still have been injured?” If the answer is no, then the defendant’s breach was the actual cause of the plaintiff’s harm.

Proximate cause is a question of how far society wishes to extend liability. In the majority of states, proximate cause is defined as foreseeability. Proximate cause exists if both the plaintiff and the type of injury incurred by the plaintiff are foreseeable. For example, it is foreseeable that if a tire falls off a car, the car may run off the road and hit a pedestrian. It is not foreseeable that the pedestrian is carrying dynamite, which he will throw when he sees the car speeding toward him, causing the dynamite to explode, causing vibrations that shatter a window six blocks away, and causing glass shards to fly and cut a secretary. Neither the secretary nor the secretary’s injury would be foreseeable, so the secretary would not succeed in a suit for negligence against the manufacturer of the car in most states, because of the lack of proximate cause. Proximate cause, however, would not prevent the pedestrian from suing in this example, because a pedestrian is a foreseeable victim when a car goes out of control.

In a minority of states, the courts do not differentiate between actual and proximate cause; once actual cause is proved, proximate cause is said to exist. Thus, in the minority of states, both the pedestrian and the secretary in the preceding example would be able to recover.

Damages, or compensable injury, are the final element. The defendant’s action must have resulted in some harm to the plaintiff for which the plaintiff can be compensated. A party cannot bring an action in negligence seeking only nominal damages. One example of negligence involved the tragic death of R&B vocalist Aaliyah Dana Haughton, who died August 25, 2001, in an airplane accident, following the completion of her music video titled “Rock the Boat.”18 Blackground Records, which had entered into a recording agreement with Aaliyah, brought suit against Instinct Productions, a company that produced Aaliyah’s music video and made transportation arrangements for the filming. Blackground sued Instinct for negligence, claiming that Blackground and Instinct shared a long, trusting relationship, from which Instinct owed a duty to Blackground to provide safe transportation for Aaliyah. Blackground argued that Instinct breached this duty, causing foreseeable economic harm to Blackground, whose financial success depended primarily on Aaliyah. The trial court ruled in favor of Blackground, awarding it damages. On appeal, however, the case was reversed, and the appellate court labeled Blackground’s lawsuit as frivolous.

In any negligence case, the plaintiff must show that the defendant owed a duty of care to the plaintiff and breached that duty, causing foreseeable harm to the plaintiff for which the plaintiff is seeking compensation. Place yourself in the plaintiff’s position to see that proving negligence is often difficult. Frequently, direct proof of the defendant’s negligent conduct does not exist because it was destroyed and there were no witnesses to the negligent act. To make it easier for plaintiffs to recover in negligence cases, most courts have adopted two doctrines that may apply in such situations: res ipsa loquitur and negligence per se.

---

**Res ipsa loquitur** literally means “the thing speaks for itself.” The plaintiff uses this doctrine to allow the judge or jury to infer that the defendant’s negligence was the cause of the plaintiff’s harm when there is no direct evidence of the defendant’s lack of due care. To establish *res ipsa loquitur* in most states, the plaintiff must demonstrate that:

1. The event was of a kind that ordinarily does not occur in the absence of negligence.
2. Other responsible causes, including the conduct of third parties and the plaintiff, have been sufficiently eliminated.
3. The indicated negligence is within the scope of the defendant’s duty to the plaintiff.

Proof of these elements does not require a finding of negligence; it merely permits such a finding.

One of the earliest uses of *res ipsa loquitur* was the case of *Escola v. Coca-Cola*. In this case, the plaintiff, a waitress, was injured when a bottle of Coca-Cola that she was removing from a case exploded in her hand. From the facts that (1) bottled soft drinks ordinarily do not spontaneously explode and (2) the bottles had been sitting in a case, undisturbed, in the restaurant for approximately 36 hours before the plaintiff simply removed the bottle from the case, the jury reasonably inferred that the defendant’s negligence during filling of the bottle resulted in its explosion. The plaintiff, therefore, could recover without direct proof of the defendant’s negligence. The doctrine has subsequently been used in numerous accident cases in which there was no direct evidence of negligence. Note that the jury does not have to infer negligence, but it may. The defendant’s best response to the use of this doctrine is to try to demonstrate other possible and plausible causes of the accident.

Another doctrine that may aid the plaintiff is *negligence per se*. If a statute is enacted to prevent a certain type of harm and a defendant violates that statute, causing that type of harm to befall the plaintiff, the plaintiff may use proof of the violation of the statute as proof of negligence. For example, it is unlawful to sell certain types of glue to minors because they may inhale it to obtain a euphoric feeling. Such a use of the glue may lead to severe health problems or death. If a retailer sold such glue to a minor who died from sniffing the glue, proof of the sale in violation of the statute establishes negligence per se by the retailer.

**DEFENSES TO NEGLIGENCE**

Although the courts have created the two foregoing doctrines to help plaintiffs establish their cases, the courts also accept certain defenses that will relieve a defendant from liability, even if the plaintiff has successfully established the elements of negligence.

Initially, all states made available a strong defense to negligence: *contributory negligence*. Under this defense, the defendant must prove that (1) the plaintiff did not exercise the degree of care that one would ordinarily exercise to protect oneself from an unreasonable risk of harm and (2) this failure contributed to causing the plaintiff’s own harm. Proof of such contributory negligence is an absolute bar to recovery. In other words, once the defendant proves that the plaintiff was contributorily negligent, the defendant wins the lawsuit and will not have to pay any damages to the plaintiff. Because of the harshness of this defense, many states adopted the last-clear-chance doctrine (Exhibit 12-2). Under this doctrine, once the defendant establishes
EXHIBIT 12-2
APPLICATION OF THE LAST-CLEAR-CHANCE DOCTRINE

The plaintiff establishes the negligence of the defendant by proving:
- duty,
- breach of duty,
- causation (actual and proximate), and
- damages.

The defendant establishes contributory negligence of the plaintiff by proving that the plaintiff failed to exercise the degree of care one would ordinarily exercise to protect oneself from an unreasonable risk of harm.

The plaintiff uses the last-clear-chance doctrine and proves that the defendant had the last chance to prevent the harm from occurring.

Judgment for Plaintiff

cumulative negligence
A defense that allocates recovery based on percentage of fault allocated to plaintiff and defendant; available in either pure or modified form.

assumption of the risk
A defense to negligence based on showing that the plaintiff voluntarily and unreasonably encountered a known risk and that the harm the plaintiff suffered was the harm that was risked.

contributory negligence
A defense that allocates recovery based on percentage of fault allocated to plaintiff and defendant; available in either pure or modified comparative negligence.

comparative negligence
A defense to negligence based on showing that the plaintiff voluntarily and unreasonably encountered a known risk and that the harm the plaintiff suffered was the harm that was risked.

The adoption of this doctrine, however, still left a lot of situations in which an extremely careless defendant caused a great deal of harm to a plaintiff who was barred from recovery because of minimal contributory negligence. Thus, today, most states have replaced the contributory negligence defense with either pure or modified comparative negligence. Under a pure comparative negligence defense, the court determines the percentage of fault of the defendant, and that is the percentage of damages for which the defendant is liable. Damages under modified comparative negligence are calculated in the same manner, except that the defendant must be more than 50 percent at fault before the plaintiff can recover. Twenty-eight states have modified comparative negligence, 13 have pure comparative negligence, and 9 have contributory negligence. Remember, every state adopts one of these three defenses. The parties do not get to pick from among them. If a party resides in a state that uses a defense that is not favorable to that party, however, he or she can always argue that the state should change its law to accept a different defense. For example, a plaintiff residing in a state that still allows the contributory negligence defense might try to argue that the state should follow the trend and modernize its law by moving to modified comparative negligence and abolishing the contributory negligence defense.

Another defense that may be used in a negligence case is assumption of the risk, in which the defendant must show that the plaintiff voluntarily and unreasonably encountered a known risk. To successfully use this defense, the defendant must establish that the harm suffered was indeed the risk assumed. For example, in one case, a plaintiff was using a grinding wheel while wearing only his eyeglasses, not the safety goggles provided by his employer to keep the pieces of stone chips and dust from flying into his eyes. The defective grinding wheel exploded into three pieces, and one piece flew into the plaintiff’s eye, blinding him. When the plaintiff sued the defendant manufacturer, the defendant raised the defense of assumption of the risk. The court struck down that
attempted use of the defense, noting that the wearing of safety goggles was not intended to prevent harm from exploding grinding wheels and that if any risk was assumed by the plaintiff, it was the risk of getting a small stone chip in his eye. As the plaintiff could not have known that the wheel would explode, he could not have assumed the risk.

Although it involves neither contributory negligence nor assumption of the risk, the following case demonstrates an interesting defense where the argument was essentially that the accident was “unavoidable.”

CASE 12-4

Vicki Lynn Shultz v. Cheney School District No. 360
Supreme Court of Washington, Department Two
371 P.2d 59 (1962)

Vicki Lynn Shultz was a passenger on a school bus that veered off the road when the bus driver was stung in the neck by a bee that remained lodged in the driver’s collar. As the driver tried to remove the bee, he momentarily lost control of the bus, resulting in his driving into a ditch. When the bus hit the ditch, Shultz was thrown from her seat into the aisle. Shultz brought negligence charges against the school district due to the conduct of the bus driver. The jury at trial found in favor of the defendant. Shultz appealed.

Judge Rosellini

This is a personal injury action in which the jury returned a verdict for the defendant. The evidence showed that the plaintiff fell or was thrown from her seat in the defendant’s school bus when it was driven off the highway into a ditch. This occurred because the attention of the driver was diverted momentarily from the road when a bee flew in the window and stung him on the neck. He ducked his head and tried with his left hand to extricate the bee from under his collar. While he was thus engaged the bus veered to the left and onto the shoulder of the road, a distance of about 75 feet.

At this point the driver raised his head and perceived what had happened. He endeavored to turn the bus back onto the road, but because of the soft condition of the shoulder, he was unable to do so and the bus went down into a shallow ditch, tilting first to the left and then to the right before it could be stopped. It was this motion of the bus that caused the plaintiff to fall into the aisle.

There was no contention that the driver was operating the bus in a negligent manner before the bee stung him. But the plaintiff urged in the trial court, and now urges here, that the evidence showed that he was negligent as a matter of law in failing to keep the bus under control after that incident. The testimony was that only a few seconds passed between the moment of the bee sting and the moment the driver discovered that the bus had veered across the highway. He testified that the sting startled him and that the bee continued to buzz under his collar after it had stung him.

We think the trial court correctly decided that it was for the jury to determine whether his action in lowering his head and endeavoring with one hand to remove the bee was instinctive or whether reasonable care required him to maintain control of the bus in spite of this painful distraction. It is not a question that can be decided as a matter of law.

The defendant, by its answer, denied negligence and affirmatively alleged that the accident was unavoidable. Error is assigned to the giving of an instruction defining “unavoidable accident.”

The plaintiff does not quarrel with the instruction as a correct statement of the law, but contends first that it was inapplicable in this case because the defendant was negligent as a matter of law, and second that such an instruction should never be given because it is misleading and superfluous.

For the reason previously stated in this opinion, there is no merit to the first of these contentions. As to the second, it is well established in this jurisdiction that an instruction on unavoidable accident is proper when the evidence shows or justifies an inference that an unavoidable accident has occurred, as that term has been defined.

The argument that the instruction is superfluous and misleading has been thoroughly considered in Cooper v. Pay-N-Save Drugs. After analyzing the authorities, this court announced the following rule:

[I]t is proper to give the instruction if there is affirmative evidence that an unavoidable accident occurred; stated negatively, it is error to give the instruction if there is no evidence of an unavoidable accident or if the only issue possible under the facts is that of negligence and contributory negligence. . . .

In this case, the defendant was not negligent as a matter of law. It affirmatively alleged and introduced evidence that the accident was unavoidable. The jury could find the defendant liable if it found that the accident was the result of the driver's negligence, or it could find, as it did, that the driver lost control of his vehicle momentarily because of his instinctive reaction to the sudden and unexpected
Tort law provides a means for an injured party to obtain compensation from the party whose actions caused the injury. Tort law provides three types of damages. Compensatory damages, which are the most common, are designed to put the plaintiff in the position he or she would have been in had the tort not occurred. Nominal damages, available only in intentional tort cases, are a minimal amount, and that his acts under the circumstances were not negligent. Implicit in this finding is a determination that the accident was unavoidable in the exercise of due care. The instruction was proper under the evidence. 

Affirmed in favor of Cheney School District No. 360.

Judge Foster, Dissenting
For the reasons stated by the Supreme Court of California in Butigan v. Yellow Cab Co., the instruction on unavoidable accident should be banished from the law. I therefore dissent.

The dissent, presented in its entirety, is short and to the point. Judge Foster argues that the defense of “unavoidable accident” is simply never acceptable. Although this defense is not in wide use, the ramifications of such a defense for the legal system are worth considering.

Strict Liability Torts
A third type of tort is a strict liability tort. Under this theory, the defendant is engaged in an activity that is so inherently dangerous under the circumstances of its performance that no amount of due care can make it safe. The activity, however, does have some social utility, so we do not want to prohibit it entirely. Consequently, we allow people to engage in such activities, but hold them strictly liable for any damages caused by engaging in these activities. Inherently dangerous activities include blasting in a populated area and keeping nondomesticated animals. As you will see in Chapter 13, in today’s society, strict liability has had perhaps its greatest impact on cases involving products that are considered unreasonably dangerous.

Global Dimensions of Tort Law
With the increasing globalization of business, it is becoming more common for citizens of foreign countries to temporarily reside in the United States, as well as for U.S. citizens to reside abroad for long periods of time. There are also a number of people with dual citizenship. It is, therefore, a realistic possibility that one might get a tort judgment in the United States and need to enforce that judgment in a foreign nation.

Although many European nations are signatories to treaties regarding enforcement of foreign judgments, the United States has not signed any such treaties. Therefore, the extent to which a U.S. judgment will be enforced in a foreign nation depends on that nation’s laws. For example, some nations will review the judgment to ensure that it does not offend their country’s notion of due process.

One area in which at least two nations have been unwilling to fully enforce U.S. judgments is with respect to punitive damages awards. Both a German federal court and an English court have ruled that punitive damages awards violate their nation’s public policy interest in maintaining a purely compensatory tort system. They have, therefore, refused to enforce U.S. punitive damages awards. As international business and, thus, international litigation continue to grow, the U.S. business manager will have to become increasingly familiar with the policies of foreign courts.

SUMMARY

Tort law provides a means for an injured party to obtain compensation from the party whose actions caused the injury. Tort law provides three types of damages. Compensatory damages, which are the most common, are designed to put the plaintiff in the position he or she would have been in had the tort not occurred. Nominal damages, available only in intentional tort cases, are a minimal amount,
such as $1, and signify that the defendant’s behavior was wrongful but caused no harm. Punitive damages are assessed in addition to compensatory damages or nominal damages when the defendant’s conduct is egregious. Punitive damages are designed primarily to punish the defendant and deter such conduct in the future.

Torts are classified as intentional, negligent, or strict liability, depending on the degree of willfulness required for the tort. The most willful are the intentional torts, which are further categorized by the interest that is injured. Intentional torts against the person include assault, battery, defamation, intentional infliction of emotional distress, false imprisonment, and the privacy torts. Intentional torts against property include trespass to realty, trespass to personality, and conversion. Intentional torts against economic interests include disparagement, intentional interference with contractual relations, misappropriation, and unfair competition.

Negligence can be thought of as the tort of carelessness. To prove negligence, one must prove four elements: (1) duty of care, (2) breach of duty, (3) causation, and (4) damages. Negligence per se and res ipsa loquitur are two doctrines that may help the plaintiff prove negligence. Defenses to negligence include contributory negligence, modified and pure comparative negligence, and assumption of the risk.

Strict liability occurs when one causes injury to another by engaging in an unreasonably dangerous activity.

Given the globalization of business, it is becoming increasingly likely that one might need to enforce a tort judgment rendered in the United States in a foreign country. The enforceability of such a judgment depends on that foreign nation’s laws; in several nations, including Germany and England, punitive damages awards will not be enforced.

REVIEW QUESTIONS

12-1 Evaluate the arguments for and against restricting the availability of punitive damages. Explain why you tend to agree more with one position than the other.

12-2 Distinguish intentional torts from negligent torts.

12-3 Define an assault and a battery, and explain how the two are related.

12-4 Explain why it is harder to win a defamation action if you are a public figure.

12-5 Explain the relationship between trespass to personality and conversion.

12-6 Your state is proposing to pass a food-disparagement law. Construct the strongest arguments you can in support of and in opposition to such a law. Explain how emphasizing the importance of different ethical norms could lead to a different attitude toward the proposed law.

REVIEW PROBLEMS

12-7 Karen writes Bob a long letter in which she falsely accuses him of stealing her bike. Bob is outraged because no one has ever questioned his character in that way before. He is so incensed that he shows the letter to several colleagues, as well as to his boss.

A few weeks later, he applies for a promotion and is turned down. When he asks his boss why he lost the promotion, his boss, very reluctantly, says that a number of people were concerned about Bob’s integrity in light of the recent accusations about his involvement in a bicycle theft. Bob sues Karen for defamation and intentional infliction of emotional distress. Why will he probably succeed or fail on each claim?

12-8 Madeline enters into a contract with Canyon Canoes to go on a weeklong canoe trip down a river. The contract states that, although the firm provides experienced guides and high-quality equipment, they are
not insurers of the adventurers’ safety. The firm cannot be responsible for harm resulting from ordinary dangers of outdoor activities. Madeline is injured when the Coleman stove she was provided with explodes. The explosion was caused by an inadequate repair that had been made by Canyon Canoes. The company raises the defense of assumption of the risk when she sues it for negligence. Is this a valid defense? Why or why not?

12-9 Action Advertising hired Alice Jones as an account executive. She signed an employment contract under which she agreed to work for the agency for a one-year term for an annual salary of $45,000. After the manager of Creative Ads saw an exceptional set of ads that Jones had created, he called Jones, asking her whether she would be interested in changing jobs. When Jones explained that she was bound by contract for six more months, the manager said that the contract was unenforceable and further offered to double her salary if she came to work for him, because he did not believe that she was being paid what she was worth. If Jones quits and goes to work for Creative, is there a tort? If so, what would the remedy be? If not, why not?

12-10 Sam was driving in excess of the speed limit and ran a red light at 11:00 p.m. He hit Suzanne’s car, which was crossing the intersection when he ran the red light. Sam had not seen Suzanne’s car because of his excess speed and also because she was driving a black car and had not turned on her headlights. Suzanne suffered extensive injuries and sued Sam for negligence. Detail the manner in which she tried to prove her case and describe how Sam attempted to defend himself. How do you think the court would resolve this dispute? How would the state in which the case arose affect the outcome?

12-11 Bill is having marital difficulties and has an affair with Sara, from whom he contracts herpes. Hoping to work out his marital problems, he does not inform his wife of his infection. Four years later, Bill and his wife, Eva, divorce. A month later, before she has had any relationships with other men, Eva discovers that she has herpes. Knowing she could have contracted the disease from only one person, she sues her husband for negligence, battery, and intentional infliction of emotional distress. What arguments would she make to support each of these causes of action? Explain how you believe the court would respond to each argument.

12-12 Devo Dynamite is imploding a building. Despite taking every known safety precaution and imploding the building at a time when the least traffic is likely to be in the area, the implosion is not perfect, and Ron, a passerby, is injured by a piece of flying debris. What tort may Devo be accused of committing? Explain why Ron is either likely or unlikely to be successful in his legal action.

**CASE PROBLEMS**

12-13 On January 22, 2007, Nyokia Stokes got into a conflict with another third-grader at her school. That evening, the conflict transferred to the parents when the other girl’s mother and a male companion went to Nyokia’s home and threatened her. The police were called but deferred to the school. On January 23, 2007, a principal observed what looked like a fight among several adult women in the office of the school. The women were yelling, pulling out hair, and rolling around on the ground. At the principal’s urging, the police arrested the four women. After criminal charges were dropped, the four women brought a claim for false arrest against the principal and the Board of Education of the City of Chicago. The district court granted summary judgment to the defendants and plaintiffs appealed.

On appeal, the Stokes argue that because they were not the aggressors in the fight, the principal did not have probable cause to swear out the criminal complaints that caused their arrests. In this jurisdiction, probable cause exists if, at the time of the arrest, the circumstances known to the defendant are sufficient to cause a reasonable and prudent person to believe that the person committed an offense. Did the principal have probable cause? What reasons would you use to support your argument? Stokes v. Board of Education of Chicago, 599 F.3d 617 (7th Cir. 2010).

12-14 Oprah Winfrey was sued for, in pertinent part, intentional infliction of emotional distress after making statements about Lerato Nomvuyo Mzamane’s performance as headmistress of the Oprah Winfrey Leadership Academy for Girls (OWLAG). OWLAG is a private academy in South Africa that provides education for children from impoverished families. After learning that one of the individuals working at the school had been abusive toward the students, Winfrey made statements to the effect that she had “lost confidence in [Mzamane’s] ability to run the school,” that Mzamane had failed to take student complaints “seriously,” that the abusers thought
they were "protected by [Mzamane]," and other similar statements.

Winfrey moved for summary judgment. How do you think the court ruled? Does it matter whether this is a jurisdiction that requires a physical injury to succeed on a claim for intentional infliction of emotional distress? Are there any other claims that the plaintiff could or may have pursued in this case? Mzamane v. Winfrey, 2010 U.S. Dist. LEXIS 23491 (2010).

12-15 Schiquita Rogers rented a car through Enterprise. Rogers presented an unexpired license at the time of her rental. Rogers, however, failed to inform Enterprise that her license had been suspended. Enterprise does not routinely check to see if a license is suspended when it rents cars and thus did not know Rogers’s license was suspended at the time of her rental. The day after Rogers rented the car, she ran a stop sign and was involved in a car accident. Rogers struck Lealue Annette Cousin, causing injuries to Cousin’s leg necessitating $40,000 in surgery costs. Cousin sued Enterprise, alleging negligence per se for renting a car to a person with a suspended license. The trial court granted Enterprise’s motion for summary judgment and Cousin appealed. How should the court have ruled on appeal? Why? Cousin v. Enterprise Leasing Co., 948 So. 2d 1287 (Miss. 2007).

12-16 Dr. Gregory B. Nazar removed a malignant tumor from Roe Branham’s brain on February 27, 2000. The surgery was a success, but shortly afterward Branham began to experience pain in his head. The pain was dismissed as being a side effect of the surgery. The pain continued for several weeks, and a medical assessment uncovered a Durahook (a small, metallic object used to hold soft tissues apart) that was left in Branham’s scalp during the surgery. On August 10, 2000, the hook was surgically removed without complications. The second procedure cost Branham $11,900. What would Branham have to prove to win a case based on medical malpractice? Who ultimately won the case? Nazar v. Branham, 291 S.W.3d 599 (Ky. 2009).

12-17 J. Scott Shain has been a youth football coach for years. The Racine Raiders, a minor league football team, allows youth football teams to play short scrimmages during the Raiders’ halftime. Shain’s team was playing, as were numerous other teams, on the Raiders’ field. To accommodate all of the teams, the Raiders’ field was subdivided into smaller fields with little to no space in between the fields. While Shain was coaching on one of the small fields, two players involved in a play on the field behind Shain collided with him, causing him to injure his knee. Shain filed suit against the Raiders, Racine Youth Sports, and their insurers, alleging negligence. If you were defense counsel in the case, what defense would you use? What would you need to prove to win your case? Shain v. Racine Raiders Football Club, 726 N.W.2d 346 (Wis. Ct. App. 2006).

12-18 Gene Klein, also known as Gene Simmons, is a bass player for KISS, a rock band. For three years he was involved in a monogamous relationship with Georgeann Walsh Ward. Simmons and KISS were featured in a documentary entitled “When KISS Ruled the World,” which was produced by Viacom International and aired on a VH1 network four times. In that piece, Simmons boasts of his sexual prowess and his ability to sleep with any woman he wanted. At the beginning of the segment, the caption “24 Hour Whore” appears on the screen, followed shortly by a photograph of the plaintiff with Simmons. Simmons exclaims: “I was a 24 hour whore. All I ever thought about was sex.” Simmons then lists some of the casual sexual encounters he shared with women, such as a hotel maid who came to clean the room and a nurse in his doctor’s office. The plaintiff sued Simmons and Viacom, alleging defamation per se and violation of her right to privacy (appropriation) due to the use of her photographs in the documentary without her knowledge or consent. The defendants moved to dismiss the complaint for failure to state a cause of action. Why should the trial court either grant or deny the defendant’s motion? Ward v. Klein et al., 10 Misc. 2d 648, 809 N.Y.S.2d 828 (2005).

12-19 Matthew Barrett was skiing at Mt. Brighton when he struck a snowboard rail that was located in an area intended for use exclusively by snowboarders. No signs were posted to indicate that the area was intended for snowboarders only. The snowboard rail was bright yellow and located above the level of snow on the ground, but Barrett did not see the rail until he was about to hit it. Barrett sued Mt. Brighton for negligence in not posting warnings about the rail, as well as not posting signs indicating the section of the slopes that was intended for snowboard use only. Mt. Brighton filed a motion to dismiss, arguing the defense of assumption of the risk. How did the court decide the case? Why? Barrett v. Mt. Brighton, Inc., 474 Mich. 1087, 712 N.W.2d 154 (2006).

12-20 In 2001, someone sent letters laced with anthrax to members of Congress and news organizations. The individuals who handled the mail died from contact with the anthrax. Throughout the subsequent months, an editorial columnist for The New York Times, named Nicholas Kristof, wrote a series of articles that implicated a biodefense research scientist named Dr. Steven J. Hatfill as a suspect in the anthrax
attacks. When the articles were written, the FBI had indicated that it considered Hatfill a suspect, but had not arrested him. In his final article, Kristof demanded that the FBI either exculpate or arrest Hatfill.

Hatfill filed suit against the New York Times Company, alleging that the articles were defamatory in that reasonable readers would assume that Hatfill had actually committed the crimes. The district court granted the defendant’s motion for summary judgment. Hatfill appealed. Is Hatfill required to show actual malice? If so, can he succeed on his defamation claim? Hatfill v. The New York Times Co., 532 F.3d 312 (4th Cir. 2008).

THINKING CRITICALLY ABOUT RELEVANT LEGAL ISSUES

In 2004, at Governor Schwarzenegger’s urging, California adopted a budget measure that involved taxing punitive damages awards 75 percent. What this measure did was to take a punitive damages award in a civil suit, give 25 percent of the award to the plaintiff, and then put the other 75 percent of the award in a state fund to be used for state needs. California was right to enact this legislation, and other states would be wise to do so as well. Governor Schwarzenegger has been an innovative leader, and even though he did not sign the bill to renew the legislation in 2006, he said that the idea was still good, but the legislation needed work before he would renew the law. Following the governor’s lead, other states should enact similar legislation to help meet state budgetary needs.

The idea of taxing punitive damages and giving a large percentage of the money to the state is useful because so many parties benefit from the arrangement. The plaintiff still receives some of the punitive damages, the tortfeasor is still punished for the wrongdoing that sparked the civil suit, and the taxpayers benefit from the state’s having more money to spend on its citizens. Besides, the purpose of punitive damages is to punish the tortfeasor, not to benefit the plaintiff, and California’s law still allows tortfeasors to be punished for their egregious behavior. The punitive element is still there, but what is different is that more people benefit from the tortfeasor’s wrongdoing, not just the one party that brought suit against the tortfeasor. The plaintiff is still compensated through compensatory damages, so she is not losing money she is owed. Rather, she no longer is awarded a windfall that was meant as punishment for another, not as reward for her injury.

Some critics argue that the tax is a bad idea because juries will be more likely to award higher punitive damages in order to bring in more tax revenue for the state. Higher damages, however, would help to further punish wrongdoers, as well as aid the state’s needs. Also, the critics fail to account for the fact that the vast majority of punitive damage awards are greatly reduced on appeal; thus, any initial raise in the damages assessed would probably be reduced on appeal, essentially making no difference in the final amount of punitive damages against the tortfeasor. The policy should make no significant change in the amount of damages awarded but will instead benefit more people, which should be the goal of any good state policy.

1. What are the issue and conclusion of this essay?
2. Is significant information missing from the preceding argument?
   Clue: What pieces of information would better aid you in deciding whether you agree with the author?
3. What ethical norm does the author appear to rely upon most in making the preceding argument?
4. Write an essay that someone who holds an opinion opposite to that of the essay the author might write.
   Clue: What other ethical norms could influence an opinion on this issue?

ASSIGNMENT ON THE INTERNET

Now that you have a basic understanding of tort law, use the Internet and your critical thinking skills to evaluate arguments for tort reform. Find at least two Web sites, other than those that follow, with opposing views on the issue of tort reform. What is the primary argument of each one? What ethical norms support each argument?

After evaluating the arguments of others, formulate your own position about one aspect or area of tort reform. What ethical norms did you use in formulating your position?

The following links may be helpful in searching for other sites with positions on tort reform.
ON THE INTERNET

www.newsbatch.com/tort.htm News Batch is a Web site dedicated to helping explain policy issues in such a manner that the general public has a better chance of understanding and following policy debates. News Batch integrates many charts and graphs into its policy summaries in an attempt to facilitate understanding of important policy issues. News Batch also supplies multiple links to other pro and antitort reform sites.

www.ncsl.org/standcomm/sclaw/medmaloverview.htm The National Conference of State Legislatures collects information at both the state and federal levels about medical malpractice tort reform efforts.

www.whatistortreform.com What Is Tort Reform is a Web site that helps you figure out exactly what “tort reform” is. The Web site contains links to other sites that help explain relevant topics related to the issue of tort reform.

www.injuryboard.com/view.cfm/Topic=1255 Injury Board is a Web site dedicated to personal injury issues. Its Web site provides information about medical and legal issues surrounding personal injury. In addition, the Web site briefly summarizes arguments on both sides of the tort reform debate.

www.law.cornell.edu/wex/index.php/Tort Use the links at this Web site to explore recent court cases involving torts.

www.findlaw.com/01topics/22tort This site provides several links to tort-law resources, such as state and local laws, cases, and several databases.

FOR FUTURE READING


When consumers enter a store to purchase a product, they assume that the product will do the job the manufacturer claims it will do without injuring anyone, and the consumer may not be aware that each year more than 33.4 million injuries and around 28,200 deaths result from the use of products purchased in the United States.\(^1\) Deaths, injuries, and property damage from consumer products incidents cost the nation more than $700 billion annually.\(^2\) Estimates of the number of resultant product liability cases range as high as 1 million a year. Also, the verdicts for defective-product or product liability cases are increasing from year to year. The total of the five largest awards for product defect cases in 2009 was 52% larger than the total in 2008. In fact, the largest award from a 2009 product defect case amounted to around $300 million, from the Philip Morris tobacco case. Also, in 2008, only 1 of the 50 largest awards were the result of a verdict in a product defect case, but in 2009, 5 of the 50 largest judgments were awarded in product defect cases.\(^3\)

Consequently, today’s businessperson is likely to become involved in some aspect of product liability litigation. This chapter discusses the most significant aspects of this area of law, known as product liability, to help the student function as a prudent consumer and businessperson.

Product liability law developed out of tort law, discussed in Chapter 12. This chapter begins by introducing the three primary theories of recovery in product liability cases and the defenses raised in such cases. These sections are followed by an introduction to enterprise liability, a concept that has slightly broadened the potential reach of product liability cases. Closely related to product liability is service liability, discussed in the next-to-last section. The final section discusses global implications of product liability law.

---


Manufacturers owe a certain responsibility to consumers. Consumers should be able to reasonably use a product without its causing harm to them or others. After you read the following scenario, answer the critical thinking questions that will enhance your thinking about product liability law.

Katherine purchased a can of hair spray from her local drugstore. When she removed the cap from the hair spray can, the can exploded in her hands. She suffered third-degree burns on her hands and face and was unable to work for three months.

Katherine sued the hair spray manufacturer after she discovered that another woman had suffered an identical accident when using the same brand of hair spray. The jury awarded Katherine $750,000 in compensatory damages.

1. Katherine’s lawyer described a previous case in which an individual was injured because a product exploded. Two years earlier, a woman walking down a row of hair care products in a supermarket had been injured when three cans of hair spray spontaneously exploded. She lost her sight because of the explosion, and a jury awarded her $2.2 million in damages. Katherine’s lawyer argued that because the previous woman had been compensated, Katherine should be awarded $2 million in damages for her injuries. Do you think the earlier case is similar enough to Katherine’s case for Katherine to recover damages? Why?
   
   Clue: How are the cases similar and different? How does the fact that Katherine purchased the product affect your thinking about the earlier case?

2. The manufacturer argued that because it places a warning on the hair spray cans, it is free from responsibility for injury. The can states, “Warning: Flammable. Contents under pressure.” The jury, however, ruled in favor of Katherine. What ethical norm seems to have shaped the jury’s thought?
   
   Clue: Study the list of ethical norms in Chapter 1. The manufacturer argued that it should not have to assume responsibility because the can has a warning. What ethical norm is consistent with offering greater protection for the consumer?

3. What additional information about this case would make you more willing to state your own opinion about the situation?
   
   Clue: What information about the product would change your thinking about the responsibility of the manufacturer? For example, suppose that Katherine discovered that an identical accident had occurred with the same brand of hair spray. How might knowing the date that the similar accident occurred influence your thinking about Katherine’s case?

### Theories of Recovery in Product Liability Cases

Product liability law developed out of tort law. A glance at the three primary theories of recovery in product liability cases—negligence, breach of warranty, and strict product liability—reveals a relationship between product liability and tort law. A plaintiff usually brings an action alleging as many of these three grounds as possible.

#### NEGLIGENCE

Plaintiffs in product liability cases have traditionally used theories of negligence. To be successful, the plaintiff must prove the elements of negligence explained in Chapter 12: (1) that the defendant manufacturer owed a duty of care to the plaintiff, (2) that the defendant breached that duty of care, (3) that this breach of duty caused the plaintiff’s injury, and (4) that the plaintiff suffered actual, compensable injury.

**The Privity Limitation.** An early problem with using negligence to recover for an injury caused by a defective product was establishing duty. Originally, a
plaintiff who was not the purchaser of the defective product could not establish a duty of care and, thus, could not recover. This limitation was based on the concept of privity, which means that one is a party to a contract. In the earliest known product liability case, Winterbottom v. Wright, the British court in 1842 established the rule that to recover for an injury caused by a defective product, the plaintiff must establish privity. In other words, before a manufacturer or seller of a defective good could owe a duty to the plaintiff, the plaintiff must have purchased that good directly from the defendant who manufactured it. Because plaintiffs rarely purchase goods from the manufacturer, few such suits were initially brought.

Gradually, especially in cases of defective food, courts began to eliminate the privity requirement, essentially abolishing it in the 1916 case of MacPherson v. Buick Motor Co. In MacPherson, the court held the remote manufacturer of an automobile with a defective wheel liable to the plaintiff when the wheel broke and the plaintiff was injured. Judge Cardozo stated that the presence of a sale does not control the duty; if the elements of a product are such that it is harmful to individuals if negligently made, and if the manufacturer knows that the product will be used by other than the purchaser, then “irrespective of contract, the manufacturer of this thing is under a duty to make it carefully.” The holding in the MacPherson case, which was quickly followed by similar holdings in other states, eliminated the privity requirement, thereby allowing a negligent manufacturer to be held responsible for a defective product that caused injuries to someone with whom the defendant manufacturer had no contract.

Eradication of the privity requirement and the subsequent increase in the liability of producers and sellers reflected a shift in social policy toward placing responsibility for injuries on those who market a product that could foreseeably cause harm if proper care were not taken in its design, manufacture, and labeling. Increasingly, the courts indicated that defendants should be responsible for their affirmative acts when they knew that such actions could cause harm to others. Also, because the manufacturer and seller derive economic benefits from the sale and use of the product, it seemed fair to impose liability on them if they earned profits from a defectively made product.

Thus, abolition of the privity limitation opened the door for negligence as a theory of liability when people were injured because of a product manufacturer’s or seller’s lack of care. A number of negligent acts or omissions typically give rise to negligence-based product liability actions; these are listed in Exhibit 13-1. We will discuss the most common ones: negligent failure to warn and negligent design.

**Negligent Failure to Warn.** Most of the negligence-based product liability actions result from a failure to warn or inadequate warning. To bring a successful negligence case for failure to warn, the plaintiff must demonstrate that the defendant knew or should have known that, without a warning, the product would be dangerous in its ordinary use or in any reasonably foreseeable use.

---

**EXHIBIT 13-1**

**COMMON NEGLIGENT ACTIONS LEADING TO PRODUCT LIABILITY CASES**

- Negligent failure to warn
- Negligent provision of an inadequate warning
- Negligent design
- Negligent manufacture
- Negligent testing or failure to test
- Negligent advertising

---

^5 217 N.Y. 382, 111 N.E. 1050 (1916).
determining whether a reasonable manufacturer would have given a warning in a particular situation, the courts frequently consider the likelihood of the injury, the seriousness of the injury, and the ease of warning.

There is generally no duty to warn of dangers arising from unforeseeable misuses of a product or from obvious dangers. A producer, for example, need not give a warning that a sharp knife could cut someone. Similarly, some plaintiffs have argued that fast-food restaurants, like McDonald’s, are liable to consumers for consumers’ obesity-related health problems, because the restaurants failed to warn customers of the unhealthful attributes of fast food. In *Pelman v. McDonald’s*, the plaintiff alleged that McDonald’s failed to warn customers of the “ingredients, quantity, qualities and levels of cholesterol, fat, salt and sugar content and other ingredients in those products, and that a diet high in fat, salt, sugar and cholesterol could lead to obesity and health problems.” In his decision dismissing the plaintiff’s claims against McDonald’s, Judge Sweet specifically stated that “this opinion is guided by the principle that legal consequences should not attach to the consumption of hamburgers and other fast food fare unless consumers are unaware of the dangers of eating such food.” Because consumers know, or reasonably should know, the potential negative health effects of eating fast food, the plaintiff’s claim was dismissed. But if future plaintiffs can allege that McDonald’s food is dangerous in a manner not known to consumers, their claims may survive.

A defendant may give a warning in a manner not clearly calculated to reach those whom the defendant should expect to use the product. If the product is to be used by someone other than the original purchaser, the manufacturer is generally required to put some sort of warning on the product itself, not just in a manual that comes with the product. If children or those who are illiterate are likely to come into contact with the product and risk harm from its use, picture warnings may be required.

Products designed for intimate bodily use, especially drugs and cosmetics, often give rise to actions based on negligent failure to warn because the use of these products frequently causes adverse reactions. When a toxic or allergic reaction causes harm to the user of a cosmetic or an over-the-counter drug, many courts find that there is no duty to warn unless the plaintiff proves that (1) the product contained an ingredient to which an appreciable number of people would have an adverse reaction; (2) the defendant knew or should have known, in the exercise of ordinary care, that this was so; and (3) the plaintiff’s reaction was due to his or her membership in this abnormal group.7

Other courts, however, determine negligence by looking at the particular circumstances of the case and by weighing the amount of danger to be avoided against the ease of warning. For example, in a 1995 case against McNeil Consumer Products Company, a jury awarded more than $8.8 million to a man who suffered permanent liver damage as a result of drinking a glass of wine with a Tylenol capsule. Although the corporation had known for years that combining a normal dose of Tylenol with a small amount of wine could cause massive liver damage in some people, the company failed to put a warning to that effect on the label. The jury did not accept the company’s argument that the reaction was so rare that no warning was necessary.8

Marketing of prescription drugs is unique because the manufacturer almost never communicates directly with the user; instead, it communicates with the physician who prescribes the drug. In these cases, the courts generally hold that drug manufacturers have a duty to provide adequate warnings to physicians to

---

enable them to decide whether to prescribe the drug or disclose the risk to the patient. The manufacturer must warn the physician of any chance of a serious adverse reaction, no matter how small. Prescription drugs are frequently the subject of product liability cases, as described in Exhibit 13-2.

<table>
<thead>
<tr>
<th>PRODUCT</th>
<th>CASE STATUS AND LEGAL CLAIMS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Avandia (prescription drug used to control blood sugar in Type II diabetics)</td>
<td>In May 2007, the <em>New England Journal of Medicine</em> released a study linking Avandia to a greatly increased risk of heart attack or heart-related death. The FDA put out a safety alert and more research is being done on the safety of Avandia. The first lawsuit as a result of this new information was filed in June 2007 and experts expect more to follow. As of May 2010, Avandia, manufacturers made a $60 million settlement to end approximately 700 lawsuits; however, this was only the first settlement Avandia manufacturers are expected to make in regard to the drug’s side effects.</td>
</tr>
<tr>
<td>Baycol (prescription drug to lower cholesterol)</td>
<td>Plaintiffs reportedly experienced rhabdomyolysis, a kidney disorder in which toxic muscle cells are released into the bloodstream. Patients can then develop fatal organ failure. Plaintiffs frequently bring claims of failure to warn or for a defectively designed drug. The manufacturer voluntarily removed Baycol from the market because of the legal claims it had spawned. As of January 2007, the court status update estimated that there were approximately 1,200 active cases. The status update also indicated that the manufacturer, Bayer, has settled 3,000-plus cases for more than $1.1 billion.</td>
</tr>
<tr>
<td>Fen-phen (Redux) (drug to treat obesity)</td>
<td>Some patients experienced heart-valve disease after using fen-phen to lose weight. In January 2004, a $3.75 billion trust was created as a settlement between patients and the drug manufacturer, American Home Products, to compensate patients injured by fen-phen use. Under the settlement agreement, eligible patients may be entitled to compensation, diet drug prescription refunds, and echocardiography screenings.</td>
</tr>
<tr>
<td>Paxil (antidepressant) (similar claims have been brought regarding Zoloft, another antidepressant)</td>
<td>Patients taking Paxil reportedly had withdrawal reactions and problems: anxiety, agitation, confusion, dizziness, fatigue, headache, insomnia, irritability, nausea, palpitations, sweating, sleep disturbances, sensory disturbances, tremor, and vision distortion. As of April 2004, there were about 1,500 Paxil withdrawal plaintiffs in more than 30 states. These cases were consolidated into multidistrict litigation. Plaintiffs frequently bring the following claims: intentional misrepresentation, fraud, negligence, strict liability, and breach of warranty. Paxil has also been linked to increased suicide risk in teens and has faced many lawsuits on that front.</td>
</tr>
<tr>
<td>Prempro (prescription drug to relieve menopausal symptoms)</td>
<td>Researchers determined that women taking Prempro were more likely to suffer breast cancer, stroke, heart disease, blood clots, and dementia. After this research, the FDA approved new labels emphasizing these increased risks; however, Prempro still remains on the market. Approximately 6 million women had been taking Prempro before the researchers announced the increased health risks associated with Prempro use. The first of the lawsuits against the manufacturer was heard in August 2006 and several suits have been found for the plaintiffs since then, with millions in damages awarded. In one court case in 2010, a woman was awarded $9.54 million; another case in 2007 yielded the astounding verdict of $134 million. As of 2010, many cases are ongoing.</td>
</tr>
<tr>
<td>Vioxx (NSAID, COX-2 inhibitor)</td>
<td>Vioxx is a painkiller marketed to treat pain from osteoarthritis. Vioxx has been linked to increased risk of heart attacks and strokes among users. In 2004, the manufacturer pulled Vioxx from the market in response to results of an FDA study. As of July 2007, the manufacturer still faced more than 27,000 lawsuits. A $4.85-billion fund was created by Merck, the manufacturer, to cover those suits. Specifically, a $4-billion fund was created to cover those who had suffered heart attacks after using the drug, and another $850-million fund for those who suffered strokes as a result of using the drug. As of 2010, many lawsuits are still pending.</td>
</tr>
<tr>
<td>Product/Drug</td>
<td>Description</td>
</tr>
<tr>
<td>-------------</td>
<td>-------------</td>
</tr>
<tr>
<td>Zicam (nasal gel)</td>
<td>Over-the-counter nasal gel to remedy the common cold</td>
</tr>
<tr>
<td>Accutane</td>
<td>Drug intended to treat severe acne</td>
</tr>
<tr>
<td>Fosamax</td>
<td>Anti-osteoporosis drug</td>
</tr>
<tr>
<td>Zyprexa/Seroquel</td>
<td>Drugs to treat schizophrenia</td>
</tr>
<tr>
<td>Ortho Evra</td>
<td>Birth-control patch</td>
</tr>
<tr>
<td>Yaz</td>
<td>Birth control</td>
</tr>
</tbody>
</table>
Initially, almost all successful product liability actions based on negligence were for breach of the duty to warn. The range of successful actions was so limited because people believed that competition and an open market provided the best means for ensuring that products will have optimal safety features. Believers in the sanctity of the market feel that the manufacturer’s job is to see that the purchaser is an informed purchaser and is not deceived about the safety of a product.9

**Negligent Design.** The foregoing attitude generally prevailed until approximately 1960, when the courts began, in a limited number of cases, to impose liability based on negligence in the sale of defectively designed products. Such liability is imposed only when a reasonable person would conclude that despite any warnings given with the product, the risk of harm outweighed the utility of the product as designed. Courts have found a wide variety of products to be negligently designed, including weed killers, gas stations, BB guns, airplanes, and traffic signs. One example of negligent design can be found in a 2010 case against Boston Scientific Corp.’s Guidant unit. The corporation was sued because it did not warn medical professionals and the United States Food and Drug Administration that some of the implantable heart defibrillators it was producing would short-circuit. The short-circuiting defects resulted in the deaths of many patients who had the medical device implanted. Furthermore, company officials had been aware of the defects for at least three years but refused to disclose the information. The corporation pled guilty and agreed to a settlement of $296 million. Thus, the design of the product was considered faulty, as the resulting deaths could have been prevented through the disclosure of the defects and spending resources on modifications and further testing.

In bringing an action for negligence in design, a plaintiff must generally prove that the product design (1) is inherently dangerous, (2) contains insufficient safety devices, or (3) consists of materials that do not satisfy standards acceptable in the trade.

Usually an action for product liability based on negligence is accompanied by a strict liability claim, which is easier to prove. With the growing use of strict liability and the broad range of defenses to negligence, negligence has become less important as a theory of liability.

**Negligence Per Se.** As stated in Chapter 12, violation of a statutory duty is considered negligence per se. This concept is used in negligence-based product liability cases.

When a statute establishes product standards, the manufacturer has a duty to meet those standards. A manufacturer that does not meet those standards has breached its duty of care. As long as the plaintiff can establish that the breach of the statutory duty caused injury, the plaintiff can recover under a theory of negligence per se.

Statutes that might be violated and lead to negligence per se actions include the Flammable Fabrics Act of 1953; the Food, Drug, and Cosmetics Act of 1938; and the Hazardous Substances Labeling Act of 1960.

**Defenses to a Negligence-Based Product Liability Action.** All of the defenses discussed in the negligence section of Chapter 12 are available in product liability cases based on negligence. Remember that the plaintiff’s own failure to act reasonably can provide a defense. Depending on the state in which the action is brought, the plaintiff’s negligence will allow the defendant to raise the defense of contributory, modified comparative, or pure comparative negligence. If contributory negligence is proved, the plaintiff is barred

---

from recovery. In a state where the defense of pure comparative negligence is allowed, the plaintiff can recover for only that portion of the harm attributable to the defendant's negligence. In a state that follows modified contributory negligence, the plaintiff can recover the percentage of harm caused by the defendant as long as the jury finds that the plaintiff's negligence was responsible for less than 50 percent of the harm. So, if a jury finds the defendant to be responsible for 60 percent of the plaintiff's harm, the plaintiff could recover nothing in a contributory negligence state, but could recover damages for 60 percent of his or her injuries in a modified or pure comparative negligence state. If the defendant were only 40 percent responsible, however, the plaintiff would be able to recover 40 percent of his or her injuries only in the pure comparative negligence state and nothing in the other two.

Another defense available in product liability cases based on negligence is assumption of the risk. A plaintiff is said to assume the risk when he or she voluntarily and unreasonably encounters a known danger. If the consumer knows that a defect exists but still proceeds unreasonably to make use of the product, he or she is said to have voluntarily assumed the risk of injury from the defect and cannot recover.

In deciding whether the plaintiff did indeed assume the risk, the trier of fact may consider such factors as the plaintiff's age, experience, knowledge, and understanding. The obviousness of the defect and the danger it poses are also relevant factors. If a plaintiff knows of a danger but does not fully appreciate the magnitude of the risk, the applicability of the defense is a question for the jury. In many cases, an employee using an unsafe machine at work is not presumed to have assumed the risk, because most courts recognize that the concept of voluntariness is an illusion in the workplace. Earlier, however, employees attempting to sue manufacturers of defective machines for injuries at work were defeated by this defense.

In many states, misuse of the product is raised as a defense in negligence-based product liability cases. To constitute a valid defense, such misuse must be unreasonable or unforeseeable. A defendant raising the defense of product misuse is really arguing that the harm was caused not by the defendant's negligence but by the plaintiff's failure to use the product in the manner in which it was designed and intended to be used.

Statutory defenses are also available to defendants. To ensure that there will be sufficient evidence from which a trier of fact can make a decision, states have statutes of limitations that limit the time within which all types of civil actions may be brought. In most states, the statute of limitations for tort actions, and thus for negligence-based product liability cases, is two to four years from the date of injury. Maine, however, has a six-year statutes of limitations. Kentucky, Louisiana, and Tennessee are the only states with one-year statutes of limitations. If the injured party is a minor, the statute of limitations does not start running until the injured party reaches age 18.

States also have statutes of repose, which bar actions arising more than a specified number of years after the product was purchased. Statutes of repose are usually much longer than statutes of limitations; they are often at least 10 years, and frequently are 25 or 50 years. Statutes of repose may seem unduly harsh on consumers who may be injured as a result of a latent defect in a product. In contrast, to make the manufacturer liable in perpetuity may be unduly harsh on manufacturers and sellers, because of the resulting uncertainty about possible liability. Those who worry about the seller's liability, however, should remember that the older the product is, the more difficult it will be for the plaintiff to prove negligence on the part of the defendant.

A defendant may use the state-of-the-art defense to demonstrate that the alleged negligent behavior was reasonable, given the available scientific knowledge existing at the time the product was sold or produced. In a case based on the defendant's negligent defective design of a product, the state-of-the-art
defense refers to the technological feasibility of producing a safer product at the time the product was manufactured. In cases of negligent failure to warn, the state-of-the-art defense refers to the scientific knowability of a risk associated with a product at the time of its production. This defense is valid in a negligence case because the focus is on the reasonableness of the defendant’s conduct. Nevertheless, demonstrating that, given the state of scientific knowledge, there was no feasible way to make a safer product does not always preclude liability. The court may find that the defendant’s conduct was still unreasonable because even in the product’s technologically safest form, the risks posed by the defect in the design so outweighed the benefits of the product that the reasonable person would not have produced a product of that design.

An earlier section showed that failure to comply with a safety standard may lead to the imposition of liability. An interesting question is whether the converse is true: Does compliance with safety regulations constitute a defense? There is no clear answer to that question. Sometimes, however, compliance with federal laws may undergird a defense that use of state tort law is preempted by a federal statute designed to ensure the safety of a particular class of products. The following case illustrates one situation in which the Court had to determine whether a corporation could be found guilty of product liability after the company had complied with government safety standards.

CASE 13-1
Donna S. Riegel v. Medtronic, Inc.
Supreme Court of the United States
128 S. Ct. 999, 552 U.S. 312 (2008)

In 2007, Charles Riegel and his wife sued a medical device manufacturer, Medtronic. Charles had a catheter produced by Medtronic placed in his coronary artery after he suffered a heart attack. However, during his heart surgery part of the catheter burst. Charles and his attorney claimed that because of the malfunction he suffered other health problems. Charles and his wife sued the catheter manufacturer, claiming that Medtronic was negligent in the production and distribution of the medical device. In turn, Medtronic argued that because the Food and Drug Administration had determined that Medtronic’s manufacturing and design of the devices complied with existing safety standards, it was protected from suit for product liability. The district courts and the Second Circuit both sided with Medtronic. The Riegels appealed, and the case went to the Supreme Court.

Justice Scalia
The Medical Device Amendments of 1976 (MDA) created a scheme of federal safety oversight for medical devices while sweeping back state oversight schemes. We consider whether the pre-emption clause enacted in the Medical Device Amendments of 1976 bars common-law claims challenging the safety and effectiveness of a medical device given premarket approval by the Food and Drug Administration (FDA).

The Federal Food, Drug, and Cosmetic Act (FDCA) has long required FDA approval for the introduction of new drugs into the market. Until [passage of the Medical Device Amendments], however, the introduction of new medical devices was left largely for the States to supervise as they saw fit. . . . The devices receiving the most federal oversight are those in Class III, which include replacement heart valves, implanted cerebella stimulators, and pacemaker pulse generators.

The Federal Government has established “requirement[s] applicable . . . to” Medtronic’s catheter within §360k(a)(1)’s meaning. In Medtronic, Inc. v. Lohr, the Court interpreted the MDA’s pre-emption provision in a manner “substantially informed” by an FDA regulation, 21 CFR §808.1(d), which says that state requirements are pre-empted only when the FDA “has established specific counterpart regulations or there are other specific requirements applicable to a particular device” under federal law.

Premarket approval is a “rigorous” process. . . . The FDA spends an average of 1,200 hours reviewing each application, and grants premarket approval only if it finds there is a “reasonable assurance” of the device’s “safety and effectiveness.” . . . The premarket approval process includes review of the device’s proposed labeling. The FDA evaluates safety and effectiveness under the conditions of use set forth on the label, and must determine that the proposed labeling is neither false nor misleading.
The United States Court of Appeals for the Second Circuit . . . concluded that Medtronic was “clearly subject to the federal, device-specific requirement of adhering to the standards contained in its individual, federally approved” premarket approval application.

Since the MDA expressly pre-empts only state requirements “different from, or in addition to, any requirement applicable . . . to the device” under federal law, we must determine whether the Federal Government has established requirements applicable to Medtronic’s catheter. If so, we must then determine whether the Riegels’ common-law claims are based upon New York requirements with respect to the device that are “different from, or in addition to” the federal ones, and that relate to safety and effectiveness.

Premarket approval . . . imposes “requirements” under the MDA. The FDA may grant premarket approval only after it determines that a device offers a reasonable assurance of safety and effectiveness. The FDA requires a device that has received premarket approval to be made with almost no deviations from the specifications in its approval application, for the reason that the FDA has determined that the approved form provides a reasonable assurance of safety and effectiveness.

We turn, then, to the second question: whether the Riegels’ common-law claims rely upon “any requirement” of New York law applicable to the catheter that is “different from, or in addition to” federal requirements and that “relates to the safety or effectiveness of the device or to any other matter included in a requirement applicable to the device.” Safety and effectiveness are the very subjects of the Riegels’ common-law claims, so the critical issue is whether New York’s tort duties constitute “requirements” under the MDA.

The Riegels contend that the duties underlying negligence, strict-liability, and implied-warranty claims are not pre-empted even if they impose “‘requirements,’ because general common-law duties are not requirements maintained “with respect to devices.” The language of the statute does not bear the Riegels’ reading. The MDA provides that no State “may establish or continue in effect with respect to a device . . . any requirement” relating to safety or effectiveness that is different from, or in addition to, federal requirements. The Riegels’ suit depends upon New York’s “continu[ing] in effect” general tort duties “with respect to” Medtronic’s catheter.

For the foregoing reasons, the judgment of the Court of Appeals is Affirmed.

**CRITICAL THINKING ABOUT THE LAW**

1. **Does Justice Scalia see the general tort duties as imposing duties different from those requirements imposed by the rigorous FDA review process?**
   
   **Clue:** For the Court to have decided that the Riegels’ claim was preempted by the MDA, what would the Court have had to believe about the requirements imposed by a potential tort action against the defendant?

2. **The Court claims that the Riegels and their attorney have misread the MDA. This disagreement emphasizes the importance of reading comprehension. What ambiguity are the plaintiffs claiming that the Court says is not present?**
   
   **Clue:** Reexamine the dispute about the meaning of the word requirement.

Each preemption case requires careful scrutiny of the purpose of the statute. Automobile manufacturers have attempted to use the preemption defense, but have met with limited success. For example, in 2000, a passenger who was wearing a seat belt was injured in an automobile accident, and sued Honda under state tort law, arguing that had the car had a driver’s-side air bag in addition to the seat belt, she would not have been so seriously injured. The U.S. Supreme Court agreed that the state action was preempted by Honda’s compliance with the Federal Motor Vehicle Safety Standard Act, which required auto manufacturers to equip some, but not all, of their vehicles with passive restraints.

Oil companies have had mixed results in cases in which they have argued that the Clean Air Act preempts their liability for methyl tertiary butyl ether (MTBE) water contamination. In an attempt to reduce air pollution in certain areas, Congress mandated that gasoline contain an oxygenate, which allows gasoline to burn more cleanly. Congress, however, did not require that a
particular oxygenate be used. Most oil companies added the oxygenate MTBE to gasoline. Unfortunately, even very small amounts of MTBE can contaminate drinking water: It affects the smell and taste of water and may cause health problems. Public water utilities and private individuals, faced with millions of dollars in cleanup costs, began suing oil companies for damages to resolve the water contamination. In response, oil companies, raising the preemption defense, argue that because the government required them to add an oxygenate to gasoline, oil companies should not be responsible for the water contamination. Plaintiffs argue that oil companies chose to use MTBE; other oxygenates, such as ethanol, were available. Several courts have concluded that the Clean Air Act preempts oil companies’ liability, but other courts have reached the opposite conclusion, emphasizing the fact that oil companies had a choice. Furthermore, these courts hold that the purpose of the Clean Air Act was to address air pollution, and the MTBE water contamination is a problem too far removed from the purposes of the Clean Air Act to preempt product liability claims associated with MTBE.

**STRICT LIABILITY IN CONTRACT FOR BREACH OF WARRANTY**

The Uniform Commercial Code (UCC) provides the basis for recovery against a manufacturer or seller on the basis of breach of warranty. A **warranty** is a guarantee or a binding promise. Warranties may be either **express** (clearly stated by the seller or manufacturer) or **implied** (automatically arising out of a transaction). Either type may give rise to liability (see Exhibit 13-3). Two types of implied warranties may provide the basis for a product liability action: warranty of merchantability and warranty of fitness for a particular purpose.

**Implied Warranty of Merchantability.** The **implied warranty of merchantability** is a warranty or guarantee that the goods are reasonably fit for ordinary use. This warranty arises out of every sale, unless it is expressly and clearly excluded. According to the UCC, to meet the standard of merchantability, the goods

1. must pass without objection in the trade under the contract description;
2. must be of fair or average quality within the description;
3. must be fit for the ordinary purpose for which the goods are used;
4. must run, with variations permitted by agreement, of even kind, quality, and quantity within each unit and among all units involved;
5. must be adequately contained, packaged, and labeled as the agreement may require; and
6. must conform to any affirmations or promises made on the label or the container.10

If the product does not conform to those standards and, as a result of this nonconformity, the purchaser or his or her property is injured, the purchaser

---

**EXHIBIT 13-3**

<table>
<thead>
<tr>
<th>EXPRESS WARRANTIES</th>
<th>IMPLIED WARRANTIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Written or oral description of the good</td>
<td>Of merchantability</td>
</tr>
<tr>
<td>Promise or affirmation of fact about the good</td>
<td>Of fitness for a particular purpose</td>
</tr>
<tr>
<td>Sample or model of the good</td>
<td></td>
</tr>
</tbody>
</table>

10 UCC § 2-314.
may recover for breach of implied warranty of merchantability. For example, some health care workers are using this theory to try to recover damages because they have developed latex protein toxic syndrome. When HIV rates began climbing, health workers uniformly used latex gloves to prevent transmission of the disease. Some health workers, however, started to develop an allergy to the proteins in the rubber latex. For some people, the allergy became so severe that they could not tolerate being in a room with a single latex balloon; consequently, they could no longer work in a profession that required them to wear latex gloves. These plaintiffs argue that glove manufacturers knew of the dangers of latex allergies but did not attempt to minimize the amount of protein in the gloves.

The UCC expressly provides that an injury to a person or property proximately caused by a breach of warranty is a recoverable type of consequential damage. The use of this warranty is limited, however, in two respects: (1) It is made only by one regularly engaged in the sale of that type of good, and (2) the seller may sometimes avoid liability by expressly disclaiming liability or by limiting liability to replacement of the defective goods. The UCC, however, has restricted applicability of the latter limitation by a provision declaring that a limitation of consequential damages for injury to a person in the case of consumer goods is prima facie “unconscionable.” Unconscionability is a concept meaning gross unfairness. Under the UCC, unconscionable contract clauses are unenforceable. Thus, if a disclaimer is unconscionable, it will not be enforced.

Privity is not a problem in an action based on breach of warranty, because of UCC Section 2-318. This section allows states to adopt one of three alternatives to allow nonpurchasers to recover for breach of warranty. The most liberal alternative allows any person injured by the defective product to sue. One issue that frequently arises in product liability cases involving breach of the warranty of merchantability is whether this warranty is breached when the alleged breach arises from a naturally occurring characteristic of the product. This problem typically arises in cases involving food. Is it a breach of the warranty of merchantability when there is a bone in a fish fillet or a pit in an olive jar labeled “pitted olives”? The following case sets forth the two tests that are used in various jurisdictions.

**COMPARATIVE LAW CORNER**

**Warranties and Guarantees in the United Kingdom**

Product liability laws in the United Kingdom are similar to many laws in the United States. There is a difference, however, in some of the language used to describe those laws. A consumer may sue under breach of implied or express warranty in the United States. In the United Kingdom, a **warranty** is a legally binding assurance that any manufacturing defects that appear in a product during a certain time period will be addressed. The consumer buys the warranty and it serves as an insurance policy for the product.

A guarantee in the United Kingdom is similar to an express warranty in the United States. A **guarantee** is a free promise made to the consumer by the producer to repair any manufacturing problems found within a certain amount of time. Guarantees are also legally binding.

A consumer who would sue under breach of implied warranty in the United States would sue under breach of contract under the Sale of Goods Act in the United Kingdom. If a product is not fit for its purpose or not of satisfactory quality, problems covered by implied warranties in the United States, the Sale of Goods Act would apply in the United Kingdom. These legal distinctions are important to know before doing business or purchasing goods in the United Kingdom.
CASE 13-2

Williams v. Braum Ice Cream Store, Inc.
Oklahoma Court of Appeals
534 P.2d 700 (1974)

Plaintiff Williams purchased a cherry-pecan ice cream cone from the defendant’s shop. While eating the ice cream, she broke her tooth on a cherry pit that was in the ice cream. She sued defendant Braum Ice Cream Stores, Inc., for breach of implied warranty of merchantability. The trial court ruled in favor of the defendant, and the plaintiff appealed.

Judge Reynolds

There is a division of authority as to the test to be applied where injury is suffered from an object in food or drink sold to be consumed on or off the premises. Some courts hold there is no breach of implied warranty on the part of a restaurant if the object in the food was “natural” to the food served. These jurisdictions recognize that the vendor is held to impliedly warrant the fitness of food, or that he may be liable in negligence in failing to use ordinary care in its preparation, but deny recovery as a matter of law when the substance found in the food is natural to the ingredients of the type of food served. This rule, labeled the “foreign-natural test” by many jurists, is predicated on the view that the practical difficulties of separation of ingredients in the course of food preparation (bones from meat or fish, seeds from fruit, and nutshell from the nut meat) is a matter of common knowledge. Under this natural theory, there may be a recovery only if the object is “foreign” to the food served. How far can the “foreign-natural test” be expanded? How many bones from meat or fish, seeds from fruit, nutshells from the nut meat or other natural indigestible substances are unacceptable under the “foreign-natural test”?

The other line of authorities hold[s] that the test to be applied is what should “reasonably be expected” by a customer in the food sold to him.

[State law] provides in pertinent part as follows:

1. . . . 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. Under this section, the serving for value of food or drink to be consumed either on the premises or elsewhere is a sale.

2. Goods to be merchantable must be at least such as
   a. are fit for the ordinary purposes for which such goods are used; . . .

In Zabner v. Howard Johnson’s Inc. . . . the Court held:

The “foreign-natural” test as applied as a matter of law by the trial court does not recommend itself to us as being logical or desirable. The reasoning applied in this test is fallacious because it assumes that all substances which are natural to the food in one stage or another of preparation are, in fact, anticipated by the average consumer in the final product served. . . .

Categorizing a substance as foreign or natural may have some importance in determining the degree of negligence of the processor of food, but it is not determinative of what is unfit or harmful in fact for human consumption. A nutshell natural to nut meat can cause as much harm as a foreign substance, such as a pebble, piece of wire, or glass. All are indigestible and likely to cause injury. Naturalness of the substance to any ingredients in the food served is important only in determining whether the consumer may reasonably expect to find such substance in the particular type of dish or style of food served.

The “reasonable expectation” test as applied to an action for breach of implied warranty is keyed to what is “reasonably” fit. If it is found that the pit of a cherry should be anticipated in cherry-pecan ice cream and guarded against by the consumer, then the ice cream was reasonably fit under the implied warranty.

In some instances, objects which are “natural” to the type of food but which are generally not found in the style of the food as prepared, are held to be the equivalent of a foreign substance.

We hold that the better legal theory to be applied in such cases is the “reasonable expectation” theory, rather than the “naturalness” theory as applied by the trial court. What should be reasonably expected by the consumer is a jury question, and the question of whether plaintiff acted in a reasonable manner in eating the ice cream cone is also a fact question to be decided by the jury.

Reversed and remanded in favor of Plaintiff, Williams.

Implied Warranty of Fitness for a Particular Purpose. A second implied warranty that may be the basis for a product liability case is the implied warranty of fitness for a particular purpose, which arises when a seller knows that the purchaser wants to purchase a good for a particular use. The seller tells the consumer that the good can be used for that purpose, and the buyer reasonably relies on the seller’s expertise and purchases the product. If the
CRITICAL THINKING ABOUT THE LAW

The criteria selected are important in determining the outcome of a case. Put simply, depending on the court’s selection from many possible criteria, it can reach multiple conclusions. Judging a case according to criteria X, Y, and Z can yield a vastly different decision than if the same case were judged according to criteria A, B, and C.

Case 13-2 illustrates the foregoing assertion. The trial court had made a legal decision based on criterion X, namely, the “foreign-natural” test. The appeals court, however, held that the trial court must redecide the case, this time on the basis of criterion Y, or the “reasonable expectation” test.

The critical thinking questions enable you to examine carefully the key differences between the two tests, including the possible implications. The larger project of the questions is to increase your awareness of the extent to which a legal decision is dependent upon the criteria chosen to reach that decision.

1. What is the fundamental difference between the natures of the two tests discussed by the court in Case 13-2?
   
   Clue: Reread the discussion of the two tests to formulate your answer.

2. Which of the two tests is more likely to yield ambiguous reasoning when applied?
   
   Clue: Refer to your answer to question 1.

Express Warranties. The seller or the manufacturer may also be held liable for breach of an express warranty, which is created by a seller in one of three ways: by describing the goods, by making a promise or affirmation of fact about the goods, or by providing a model or sample of the good. If the goods fail to meet the description, fail to do what the seller claimed they would do, or fail to be the same as the model or sample, the seller has breached an express warranty. For example, if a 200-pound man asks a seller whether a ladder will hold a 200-pound man without breaking, the seller who says that it will is affirming a fact and is thus expressly warranting that the ladder will hold a 200-pound man without breaking. If the purchaser takes the ladder home, climbs up on it, and it breaks under his weight, causing him to fall to the ground, he may bring a product liability action against the seller on the basis of breach of an express warranty.

A memorable example of an express warranty is the claim many companies made that their software was “Y2K compliant.” When the nation was in fear of a possible chaotic result of the date change to the year 2000, many computer companies came out with “Year 2000–compliant” software. This claim, however, was usually written outside of the contract and, therefore, was an express warranty. Because businesses had the potential to lose a lot of money after Y2K, they felt that they needed someone to help reimburse what they might lose. Many decided that the easiest targets would be these “Y2K-safe”
Software companies, because the businesses could sue on the basis of breach of an express warranty.11

**Defenses to Breach-of-Warranty Actions.** Two common defenses used in cases based on breach of warranty arise from the UCC; they make sense in a commercial setting when a transaction is between two businesspeople, but they make little—if any—sense in the context of a consumer injury. Therefore, the courts have found ways to limit the use of these defenses in product liability cases in most states.

The first such defense is that the purchaser failed to give the seller notice within a reasonable time after he or she knew or should have known of the breach of warranty, as required by the UCC. Obviously, most consumers would not be aware of this rule, and as a result, many early breach-of-warranty cases were lost. Most courts today avoid this requirement by holding (1) that a long delay is reasonable under the particular circumstances, (2) that the section imposing the notice requirement was not intended to apply to personal injury situations, or (3) that the requirement is inapplicable between parties who have not dealt with each other, as when a consumer is suing a manufacturer.

The second defense is the existence of a **disclaimer**. A seller or manufacturer may relieve itself of liability for breach of warranty in advance through the use of disclaimers. The disclaimer may say (1) that no warranties are made (as is), (2) that the manufacturer or seller warrants only against certain consequences or defects, or (3) that liability is limited to repair, replacement, or return of the product price.

Again, these disclaimers make sense in a commercial context, but seem somewhat harsh in the case of consumer transactions. Thus, the courts do not look with favor on disclaimers. First, the disclaimer must be clear; in many cases, courts have rejected the defendant’s use of a disclaimer as a defense on the ground that the retail purchaser either did not see the disclaimer or did not understand it. Thus, a businessperson using disclaimers to limit liability must be sure that the disclaimers are very plainly stated on an integral part of the product or package that will not be removed before retail purchase by the consumer. In some cases, however, despite clear disclaimers, courts have held disclaimers to consumers invalid, stating either that these disclaimers are unenforceable adhesion contracts resulting from gross inequities of bargaining power and are, therefore, unenforceable; or that they are unconscionable and contrary to the policy of the law. The UCC, in fact, now contains a provision stating that a limitation of consequential damages for injury to a person in the case of consumer goods is prima facie unconscionable.

The statute of limitations may also be used defensively in a case based on strict liability for breach of warranty. Under the UCC, the statute of limitations runs four years from the date on which the cause of action arises. In an action based on breach of warranty, the cause of action, according to the UCC, arises at the time of the sale. This rule would severely limit actions for breach of warranty, as defects often do not cause harm immediately. Section 2-725(2) of the UCC, however, changes the time that the cause of action arises to the date when the breach of warranty is or should have been discovered when a warranty “explicitly extends to the future performance of the goods, and the discovery of the breach must await the time of performance.” This section, when applicable, makes the statute of limitations less of a potential problem for the plaintiff. In a few states, courts have simply decided to apply the tort statute of limitations, as running from the date of injury or the date when the defect was or should have been discovered, to all product liability cases grounded in breach of warranty.

---

STRICT LIABILITY IN TORT

The third and most prevalent theory of product liability used during the past three decades is strict liability in tort, established in the 1963 case of *Greenman v. Yuba Power Products Co.*\(^{12}\) and incorporated in Section 402A of the *Restatement (Second) of Torts*. This section reads as follows:

1. One who sells any product in a defective condition, unreasonably dangerous to the user or consumer or his family 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 consumer or user 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.

Under this theory, the manufacturer, distributor, or retailer may be held liable to any reasonably foreseeable injured party. Unlike causes of action based on negligence or, to a lesser degree, breach of warranty, product liability actions based on strict liability in tort focus on the product, not on the producer or seller. The degree of care exercised by the defendant is not an issue in these cases. The issue in such cases is whether the product was in a “defective condition, unreasonably dangerous” when sold. To succeed in a strict liability action, the plaintiff must prove that

1. the product was defective when sold;
2. the defective condition rendered the product unreasonably dangerous; and
3. the product was the cause of the plaintiff’s injury.

The defect is usually the most difficult part of the case for the plaintiff to establish. A product may be defective because of (1) some flaw or abnormality in its construction or marketing that led to its being more dangerous than it otherwise would have been, (2) a failure by the manufacturer or seller to adequately warn of a risk or hazard associated with the product, or (3) a design that is defective. For example, in 1966, Mr. Dolinski purchased a bottle of Squirt from a vending machine and drank most of the contents. He soon felt ill and discovered a decomposed mouse and mouse feces at the bottom of the bottle. He suffered physical and mental distress and avoided soft drinks after this experience. Under strict liability in tort, he sued that bottle manufacturer and distributor, Shoshone Coca-Cola Bottling Company, and a jury awarded him $2,500. Moreover, this case was the first case in which the Nevada state courts recognized the doctrine of strict liability.\(^{13}\)

A defect in manufacture or marketing generally involves a specific product that does not meet the manufacturer’s specifications. Proof of such a defect is generally provided in one or both of two ways: (1) experts testify as to the type of flaw that could have caused the accident that led to the plaintiff’s injury; (2) evidence of the circumstances surrounding the accident lead the jury to infer that the accident must have been caused by a defect in the product. Notice in the following case how the court makes an analogy to *res ipsa loquitur* when finding the existence of a defect caused by the defendant.

---

\(^{12}\) 59 Cal. 2d 57 (1962).

\(^{13}\) Dolinski v. Shoshone Coca-Cola, 82 Nev. 439, 420 P.2d 855 (1966)
Richard Welge loved to sprinkle peanuts on his ice cream sundaes. Karen Godfrey, with whom Welge boarded, bought a 24-ounce vacuum-sealed plastic-capped jar of Planters peanuts for him at a Kmart. To obtain a $2 rebate from the maker of Alka-Seltzer, Godfrey needed proof of her purchase of the jar of peanuts. So, using an X-Acto knife, she removed the part of the label that contained the bar code. She then placed the jar on top of the refrigerator. About a week later, Welge removed the plastic seal from the jar, uncapped it, took some peanuts, replaced the cap, and returned the jar to the top of the refrigerator. A week after that, he took down the jar, removed the plastic cap, spilled some peanuts into his left hand to put on his sundae, and replaced the cap with his right hand—but as he pushed the cap down on the open jar, the jar shattered. His hand, continuing in its downward motion, was severely cut and, he claimed, became permanently impaired.

Welge filed product liability actions against Kmart, which sold the jar of peanuts to Godfrey; Planters, which manufactured the product (filled the glass jar with peanuts and sealed and capped it); and Brockway, which manufactured the glass jar and sold it to Planters. After pretrial discovery, the defendants moved for summary judgment. The district judge granted the motion on the ground that the plaintiff had failed to exclude possible causes of the accident other than a defect introduced during the manufacturing process. The plaintiff appealed.

**Justice Posner**

No doubt there are men strong enough to shatter a thick glass jar with one blow. But Welge’s testimony stands uncontradicted that he used no more than the normal force that one exerts in snapping a plastic lid onto a jar. So the jar must have been defective. No expert testimony and no fancy doctrine are required for such a conclusion. A nondefective jar does not shatter when normal force is used to clamp its plastic lid on. The question is when the defect was introduced. It could have been at any time from the manufacture of the glass jar by Brockway (for no one suggests that the defect might have been caused by something in the raw materials out of which the jar was made) to moments before the accident. But testimony by Welge and Godfrey . . . excludes all reasonable possibility that the defect was introduced into the jar after Godfrey plucked it from a shelf in the Kmart store. From the shelf she put it in her shopping cart. The checker at the check-out counter scanned the bar code without banging the jar. She then placed the jar in a plastic bag. Godfrey carried the bag to her car and put it on the floor. She drove directly home, without incident. After the bar-code portion of the label was removed, the jar sat on top of the refrigerator except for the two times Welge removed it to take peanuts out of it. Throughout this process it was not, so far as anyone knows, jostled, dropped, bumped, or otherwise subjected to stress beyond what is to be expected in the ordinary use of the product. Chicago is not Los Angeles; there were no earthquakes. Chicago is not Amityville either; no supernatural interventions are alleged. So the defect must have been introduced earlier, when the jar was in the hands of the defendants.

But, they argue, this overlooks two things. One is that Karen Godfrey took a knife to the jar. And no doubt one can weaken a glass jar with a knife. But nothing is more common or, we should have thought, more harmless than to use a knife or a razor blade to remove a label from a jar or bottle. People do this all the time with the price labels on bottles of wine. Even though mishandling or misuse, by the consumer or by anyone else (other than the defendant itself), is a defense . . . to a products liability suit . . . and even if, as we greatly doubt, such normal mutilation as occurred in this case could be thought a species of mishandling or misuse, a defendant cannot defend against a products liability suit on the basis of a misuse that he invited. The Alka-Seltzer promotion to which Karen Godfrey was responding when she removed a portion of the label of the jar of Planters peanuts was in the Kmart store. It was there, obviously, with Kmart’s permission. By the promotion Kmart invited its peanut customers to remove a part of the label on each peanut jar bought, in order to be able to furnish the maker of Alka-Seltzer with proof of purchase. If one just wants to efface a label one can usually do that by scraping it off with a fingernail, but to remove the label intact requires the use of a knife or a razor blade. Invited misuse is no defense to a products liability claim. Invited misuse is not misuse. . . .

Even so, the defendants point out, it is always possible that the jar was damaged while it was sitting unattended on the top of the refrigerator, in which event they are not responsible. Only if it had been securely under lock and key when not being used could the plaintiff and Karen Godfrey be certain that nothing happened to damage it after she brought it home. That is true—there are no metaphysical certainties—but it leads nowhere. Elves may have played ninepins with the jar of peanuts while Welge and Godfrey were sleeping; but elves could remove a jar of peanuts from a locked cupboard. The plaintiff in a products liability suit is not required to exclude every possibility, however fantastic or remote, that the defect which led to the accident was caused by someone other than one of the defendants. The doctrine of res ipsa loquitur teaches that an accident that is unlikely to occur unless the defendant was negligent is itself circumstantial evidence that the
defendant was negligent. The doctrine is not strictly applicable to a products liability case because[,] unlike an ordinary accident case[,] the defendant in a products case has parted with possession and control of the harmful object before the accident occurs. . . . But the doctrine merely instantiates the broader principle, which is as applicable to a products case as to any other tort case, that an accident can itself be evidence of liability. . . . If it is the kind of accident that would not have occurred but for a defect in the product, and if it is reasonably plain that the defect was not introduced after the product was sold, the accident is evidence that the product was defective when sold. The second condition (as well as the first) has been established here, at least to a probability sufficient to defeat a motion for summary judgment. Normal people do not lock up their jars and cans lest something happen to damage these containers while no one is looking. The probability of such damage is too remote. It is not only too remote to make a rational person take measures to prevent it; it is too remote to defeat a products liability suit should a container prove dangerously defective.

Of course, unlikely as it may seem that the defect was introduced into the jar after Karen Godfrey bought it if the plaintiffs’ testimony is believed, other evidence might make their testimony unworthy of belief—might even show, contrary to all the probabilities, that the knife or some mysterious night visitor caused the defect after all. The fragments of glass into which the jar shattered were preserved and were examined by experts for both sides. The experts agreed that the jar must have contained a defect but they could not find the fracture that had precipitated the shattering of the jar and they could not figure out when the defect that caused the fracture that caused the collapse of the jar had come into being. The defendants’ experts could neither rule out, nor rule in, the possibility that the defect had been introduced at some stage of the manufacturing process. The plaintiff’s expert noticed what he thought was a preexisting crack in one of the fragments, and he speculated that a similar crack might have caused the fracture that shattered the jar. This, the district judge ruled, was not enough.

But if the probability that the defect that caused the accident arose after Karen Godfrey bought the jar of Planters peanuts is very small—and on the present state of the record we are required to assume that it is—then the probability that the defect was introduced by one of the defendants is very high.

. . . The strict-liability element in modern products liability law comes precisely from the fact that a seller subject to that law is liable for defects in his product even if those defects were introduced, without the slightest fault of his own for failing to discover them, at some anterior stage of production. . . . So the fact that KMart sold a defective jar of peanuts to Karen Godfrey would be conclusive of KMart’s liability, and since it is a large and solvent firm there would be no need for the plaintiff to look further for a tortfeasor. This point seems to have been more or less conceded by the defendants in the district court—the thrust of their defense was that the plaintiff had failed to show that the defect had been caused by any of them—though this leaves us mystified as to why the plaintiff bothered to name additional defendants.

. . . Evidence of KMart’s care in handling peanut jars would be relevant only to whether the defect was introduced after sale; if it was introduced at any time before sale—if the jar was defective when KMart sold it—the source of the defect would be irrelevant to KMart’s liability. In exactly the same way, Planters’ liability would be unaffected by the fact, if it is a fact, that the defect was due to Brockway rather than to itself. To repeat an earlier and fundamental point, a seller who is subject to strict products liability is responsible for the consequences of selling a defective product even if the defect was introduced without any fault on his part by his supplier or by his supplier’s supplier.

. . . Here we know to a virtual certainty (always assuming that the plaintiff’s evidence is believed, which is a matter for the jury) that the accident was not due to mishandling after purchase but to a defect that had been introduced earlier.

Reversed and remanded in favor of Plaintiff, Welge.

When a plaintiff is seeking recovery based on a design defect, he or she is not impugning just one item, but an entire product line. If a product is held to be defectively designed in one case, a manufacturer or seller may recognize that this particular case may stimulate a huge number of additional lawsuits. Thus, defendants are very concerned about the outcome of these cases. Therefore, the availability of this type of action has a greater impact on encouraging manufacturers to produce safe products than does the availability of any other type of product liability action.

For example, hundreds of claims, ranging from property damage to personal injury and wrongful death, have been brought in federal and state courts against Firestone and Ford for Firestone’s ATX, ATX II, and Wilderness AT tires. Plaintiffs argue that the tires have a design defect that causes the treads to prematurely separate, leading to tire blowouts. Firestone issued a recall for these tires in August 2000, but plaintiffs argue that the recall was not sufficient to warn customers about the tire defects. Furthermore, plaintiffs allege that Firestone had
knowledge of the defects earlier but failed to disclose this knowledge. In an attempt to encourage efficiency, the federal cases have been consolidated to the Southern District Court in Indiana, at least for the purposes of discovery.

Although all the states agree that manufacturers may not market defectively designed products, there is no uniform definition of a defective design. Two tests have evolved to determine whether a product is so defective as to be unreasonably dangerous. The first test, set out in the Restatement (Second) of Torts, is the consumer-expectations test. This test asks the question: Did the product meet the standards that would be expected by a reasonable consumer? Such a test relies on the experiences and expectations of the ordinary consumer and, thus, is not answered by the use of expert testimony about the merits of the design.

The second is the feasible alternatives test, sometimes referred to as the risk-utility test. In applying this test, the court generally looks at seven factors, which are listed in the following case, as it sets forth the differences between the two tests.

CASE 13-4
Susan Calles v. Scripto-Tokai Corp. et al.
Supreme Court of Illinois
864 N.E.2d 249 (2007)

Susan Calles left three of her daughters—Amanda, age 11, and twins Jenna and Jillian, age 3—home while she ran an errand with her fourth daughter, Victoria, age 5. While she was out, Jenna started a fire with an Aim N Flame utility lighter Calles had recently purchased. Jillian suffered smoke inhalation and died less than a month later. Calles filed suit against Tokai, the designer and manufacturer of the Aim N Flame, and Scripto-Tokai, the distributor (collectively Scripto), on grounds of strict liability alleging, that the Aim N Flame was defectively designed and unreasonably dangerous because it lacked a child-resistant safety device. Scripto filed a motion for summary judgment, which was granted by the trial court. Calles appealed and the motion for summary judgment was reversed by the appellate court. Scripto appealed to the Illinois Supreme Court.

Justice Burke
In Illinois, two tests are employed when determining whether a product is unreasonably dangerous under a strict liability design-defect theory—the consumer-expectation test and the risk-utility test. . . . [S]trict liability is imposed upon a seller of “any product in a defective condition unreasonably dangerous to the user or consumer or to his property.”

Under the consumer-expectation test, a plaintiff must establish what an ordinary consumer purchasing the product would expect about the product and its safety. This is an objective standard based on the average, normal, or ordinary expectations of the reasonable person; it is not dependent upon the subjective expectation of a particular consumer or user.

Over time, the applicability of the consumer-expectation test to design-defect cases was questioned, primarily because it became apparent that consumers might not be aware of what to expect regarding the safety of certain products. Accordingly, this court in Lamkin v. Towner, adopted a second, alternative test for design defect cases known as the risk-utility, or risk-benefit, test.

In Lamkin, this court held that a plaintiff may demonstrate a product has been defectively designed “in one of two ways.” One way a plaintiff may demonstrate a design defect is to present evidence that the product fails to satisfy the consumer-expectation test. Alternatively, a plaintiff may demonstrate a design defect by presenting evidence that the risk of danger inherent in the challenged design outweighs the benefits of such design.

Consumer-Expectation Test
As noted above, under the consumer-expectation test, a plaintiff may prevail if he or she demonstrates that the product failed to perform as an ordinary consumer would expect when used in an intended or reasonably foreseeable manner. The purpose of a lighter, such as the Aim N Flame, is to produce a flame. Clearly then, the ordinary consumer would expect that, when the trigger is pulled, a flame would be produced. Here, the Aim N Flame was not used in its intended manner, i.e., by an adult. Thus, the question is whether it was used in a reasonably foreseeable manner. We find that it was.

An ordinary consumer would expect that a child could obtain possession of the Aim N Flame and attempt to use it. Thus, a child is a reasonably foreseeable user. Likewise, an ordinary consumer would appreciate the consequences that would naturally flow when a child obtains possession of a lighter. Specifically, an ordinary consumer would expect that the Aim N Flame, in the hands of a child, could cause the result that occurred here—the starting of a fire that led to injury to a child.
Under the facts of this case, the Aim N Flame performed as an ordinary consumer would expect—it produced a flame when used in a reasonably foreseeable manner, i.e., by a child. This leads to the inescapable conclusion that the ordinary consumer’s expectations were fulfilled. In other words, the Aim N Flame did not fail to perform as an ordinary consumer would expect when used in a reasonably foreseeable manner. Thus, as a matter of law, no fact finder could conclude that the Aim N Flame was unreasonably dangerous under the consumer expectation test. Therefore, Calles cannot prevail under this theory.

This does not end our analysis, however. Though the Aim N Flame satisfies the consumer-expectation test, it may, nonetheless, be deemed unreasonably dangerous under the risk-utility test.

**Risk-Utility Test**

Under the risk-utility test, a plaintiff may prevail in a strict liability design-defect case if he or she demonstrates that the magnitude of the danger outweighs the utility of the product, as designed.

Under the risk-utility test, a court may take into consideration numerous factors. In past decisions, this court has held that a plaintiff may prove a design defect by presenting evidence of “the availability and feasibility of alternate designs at the time of its manufacture, or that the design used did not conform with the design standards of the industry, design guidelines provided by an authoritative voluntary association, or design criteria set by legislation or governmental regulation.”

John W. Wade, dean and professor of law, emeritus, Vanderbilt University School of Law, has also identified several factors relevant when engaging in risk-utility analysis. These factors include:

1. “The usefulness and desirability of the product—its utility to the user and to the public as a whole.
2. The safety aspects of the product—the likelihood that it will cause injury, and the probable seriousness of the injury.
3. The availability of a substitute product which would meet the same need and not be as unsafe.
4. The manufacturer’s ability to eliminate the unsafe character of the product without impairing its usefulness or making it too expensive to maintain its utility.
5. The user’s ability to avoid danger by the exercise of care in the use of the product.
6. The user’s anticipated awareness of the dangers inherent in the product and their availability, because of general public knowledge of the obvious condition of the product, or of the existence of suitable warnings or instructions.
7. The feasibility, on the part of the manufacturer, of spreading the loss by setting the price of the product or carrying liability insurance.”

Wade’s factors have been adopted and relied upon by numerous jurisdictions, including our own appellate court.

Lastly, we find that when assessing the utility of a product, the following factors may also be relevant: (1) the appearance and aesthetic attractiveness of the product; (2) its utility for multiple uses; (3) the convenience and extent of its use, especially in light of the period of time it could be used without harm resulting from the product; and (4) the collateral safety of a feature other than the one that harmed the plaintiff.

Although we have listed a number of factors which courts may consider when assessing risk-utility, we do not mean to imply that the list is exclusive. The factors cited merely illustrate those that may assist a court and jury in evaluating whether a design is unreasonably dangerous. A plaintiff need not present proof on each of the factors. In the first instance, the court must balance factors it finds relevant to determine if the case is a proper one to submit to the jury. Once this threshold determination has been met, it is up to the fact finder to determine the importance of any particular factor, and its “relevance, and the relevance of other factors, will vary from case to case.”

After reviewing the evidence presented, we find the only factor which favors Calles and a finding of unreasonably dangerous is the second Wade factor—safety aspects. Calles presented specific and detailed evidence as to the likelihood of injury and the seriousness of injury from lighters with safety devices.

Factors which would favor Scripto and a finding that the product is not unreasonably dangerous are the first and sixth Wade factors—the utility of the Aim N Flame and the user’s awareness of the dangers. As to the utility of the Aim N Flame, it is both useful and desirable to society as a whole—it serves as an inexpensive alternative source of fire. Moreover, compared to other sources of fire, such as matches, it is more convenient and longer lasting since it is a multiuse product. The lighter may also be safer since it will extinguish if dropped on the floor while lit, unlike a match. With respect to the user’s awareness of the dangers, there is no question, based on Calles’ deposition testimony, that it was obvious to her that the lighter could come into the hands of a child and the dangers and risks that situation would pose.

Based on a review of the foregoing factors, reasonable persons could differ on the weight to be given the relevant factors, particularly where additional proofs are necessary, and thus could differ on whether the risks of the Aim N Flame outweigh its utility. Therefore, reasonable persons could differ as to whether the Aim N Flame is unreasonably dangerous, and we cannot say that Scripto was entitled to judgment as a matter of law. As such, we affirm the appellate court’s decision reversing the trial court’s decision granting summary judgment in favor of Scripto on the strict liability claims.

Appellate court judgment affirmed in favor of Calles.
Impact of the Restatement (Third) of Torts. Even though elements of Section 402A of the Restatement (Second) of Torts have come to be adopted in all states, and it is generally considered to be the foundation of modern product liability law, a lot of dissatisfaction has centered on this provision. That dissatisfaction resulted in what may be the biggest change in product liability law since the passage of Section 402A: the adoption, on May 20, 1997, of the American Law Institute’s Restatement (Third) of Torts: Product Liability, which is intended to replace Section 402A. Under the Restatement (Third), “one engaged in the business of selling or otherwise distributing products who sells or distributes a defective product is subject to liability for harm to persons or property caused by the defect.” The seller’s liability, however, is determined by a different standard, depending on which type of defect is involved: (1) a manufacturing defect, (2) a design defect, or (3) a defective warning.

When the defect is one in the manufacture, liability is strict. A manufacturing defect is said to exist when “the product departs from its intended design.” The new rule imposes liability in such a case regardless of the care taken by the manufacturer.

The Restatement (Third) adopts a reasonableness standard for design defects. It states that a product is defective in design when the foreseeable risks of the harm posed by the product could have been reduced or avoided by the adoption of a reasonable alternative design by the seller and the omission of the alternative design renders the product not reasonably safe.

In the comments, the Restatement (Third) lists a number of factors the court can use to determine whether a reasonable alternative design renders the product not reasonably safe:

These factors include the magnitude and probability of the foreseeable risks of harm, the instructions and warnings accompanying the product, and the nature and strength of consumer expectations regarding the product, including expectations arising from product portrayal and marketing . . . [;] the relative advantages and disadvantages of the product as designed and as it alternatively could have been designed . . . [;] the likely effects of the alternative design on product longevity maintenance, repair and esthetics, and the range of consumer choice among products.

Thus, the Restatement (Third) has in effect shifted to a risk-utility test.

CRITICAL THINKING ABOUT THE LAW

Case 13-4 provides another illustration of the importance of criteria selection in determining the outcome of a case. When Sperry–New Holland appealed the case, it did not focus on the facts or on the court’s conclusion. Instead, the appeal focused on the test used by the court to decide the case. The defendant’s appeal presumed that if the consumer-expectations test had been used instead of the risk-utility analysis, the decision likely would have been different.

The questions that follow will help you to think more critically about the court’s decision to use risk-utility analysis in Case 13-4.

1. To demonstrate your awareness of the guiding power of ethical norms, identify the primary ethical norm that would lead to the use of risk-utility analysis.

   **Clue:** To answer this question, you may want to reread the court’s discussion of each test.

2. In Case 13-4, the court selects risk-utility analysis as the test to apply in making its decision. What are its reasons for making this selection?

   **Clue:** You know the court’s holding. Every group of sentences that answers the question, “Why is that the holding?” provides a reason.
Regarding the third category, warning defects, the Restatement (Third) has likewise adopted a reasonableness standard:

*A product is defective because of inadequate instructions or warnings when the foreseeable risks of harm posed by the product could have been reduced or avoided by the provision of reasonable instructions or warnings by the seller . . . and the omission of the warnings renders the product not reasonably safe.*

**Defenses to a Strict Product Liability Action.** Product misuse, discussed as a defense to a negligence-based action, is also available in a strict product liability case. Assumption of the risk is likewise sometimes raised as a defense in a strict liability action.

Controversy, however, has arisen over whether the state-of-the-art defense should be allowed in cases in which the cause of action is based on strict liability. In most strict liability cases, courts have rejected the use of this defense, stating that the issue is not what the producers knew at the time the product was produced, but whether the product was defectively dangerous. In the 1984 case of *Elmore v. Owens Illinois, Inc.*, a claim arose from the plaintiff’s contracting asbestosis. The plaintiff’s job required him to handle a product manufactured by the defendant that contained 15 percent asbestos. The Supreme Court of Missouri ruled that the state of the art of a product has no bearing on the outcome of a strict liability claim, because the issue is the defective condition of the product, not the manufacturer’s knowledge, negligence, or fault.

The refusal of most courts to allow the state-of-the-art defense in strict liability cases makes sense if we consider the social policy reasons for imposing strict liability. One of the reasons for imposing strict liability is that the manufacturers or producers are best able to spread the cost of the risk; this risk-spreading function does not change with the availability of scientific knowledge.

The argument against this position, however, is equally compelling to some. If the manufacturer has indeed done everything as safely and carefully as available technology allows, it seems unfair to impose liability on the defendant. After all, how else could it have manufactured the product?

**LIABILITY TO Bystanders**

Sometimes the person injured by the defective product is not a purchaser, nor even an owner, of the product. The question arises as to whether strict product liability can be used by someone other than the owner or user of the product. On the grounds that the bystander is in even greater need of protection from defective products that are dangerous, and because he or she can do less to protect himself or herself from them, many courts have extended liability to foreseeable bystanders.

**Market Share Liability**

The focus of this chapter has been on product liability cases in which the plaintiff knows who produced the defective product. But when injuries from a product show up 10 or 20 years after exposure to the product, even if the injury can be traced to the defective product, the plaintiffs cannot always trace the product to any particular manufacturer. If a number of manufacturers produced the same product, the plaintiff may have no idea whose product was used, and may even have used more than one manufacturer’s product.

In this situation, the courts have to balance the interests of the plaintiffs in recovering for injuries caused by defective products against the manufacturers’
interests in not being held liable for injuries caused by a product they did not produce. The primary means used to resolve this dilemma today is the **market share theory**, created in 1980 by the California Supreme Court in the case of *Sindell v. Abbott Laboratories*.

In *Sindell*, the plaintiffs’ mothers had all taken a drug known as diethylstilbestrol (DES) during pregnancies that had occurred before the drug was banned. Because the drug had been produced 20 years before the plaintiffs suffered any effects from the drug their mothers had taken, it was impossible to trace the defective drug back to each manufacturer that had produced the drug that caused each individual’s problems. To balance the competing interests of the victims, who had suffered injury from the drug, and the defendants, who did not want to be held liable for a drug they did not produce, the court allowed the plaintiffs to sue all of the manufacturers who had produced the drug at the time the plaintiffs’ mothers used the drug. The judge then apportioned liability among the defendant-manufacturers on the basis of the share of the market they had held at the time the drug was produced.

Since *Sindell*, a number of other courts have applied and refined the market share theory, primarily in drug cases. One trial court judge in a Pennsylvania DES case laid out the factors that are generally necessary for applying market share liability: (1) all defendants are tortfeasors; (2) the allegedly harmful products are identical and share the same defective qualities; (3) plaintiff is unable, through no fault of his or her own, to identify which defendant caused his or her injury; and (4) the manufacturers of substantially all of the defective products in the relevant area and during the relevant time are named as defendants.

Other courts have modified the market share approach of *Sindell*. Attempts to extend the theory to products other than drugs have not met with much success. For example, in 2003, the court refused to allow the city of Gary to rely on market share theory to prove damages in a negligence action against handgun manufacturers, wholesalers, and dealers, because of the wide mix of lawful and unlawful conditions and the many potentially intervening acts by nonparties.

### Service Liability

Along with the growth in lawsuits for defective products, there has also been an increase in the number of lawsuits brought for defective services. These actions are generally brought when someone or someone’s property is harmed as a result of an inadequately performed service.

Unlike in the product liability area, strict liability has rarely been applied to services. The few cases in which a strict liability standard has been applied involved defendants that provided both a good and a service, such as a restaurant owner’s serving spoiled food.

Most service liability cases involve services provided by professionals, such as doctors, lawyers, engineers, real estate appraisers, and accountants. Actions against these professionals are generally referred to as **malpractice suits** and are usually based on a theory of negligence, breach of contract, or fraud. Malpractice actions against professionals are increasing at an extremely rapid rate. For example, by the early 1970s, only about 700 legal malpractice decisions had been reported; today, that many legal malpractice cases are brought each year.

---

**market share theory**
A theory of recovery in liability cases according to which damages are apportioned among all the manufacturers of a product based on their market share at the time the plaintiff’s cause of action arose.

**malpractice suits**
Service liability suits brought against professionals, usually based on a theory of negligence, breach of contract, or fraud.

15. 607 P2d 924 (Cal. 1980).
The businessperson, however, is most likely to become involved in a malpractice action involving accountant malpractice. The next section, therefore, explores the liability of accountants.

**ACCOUNTANTS’ LIABILITY**

One group that has seen increasing liability is accountants. Much of their potential liability has come from the securities laws. Accountants’ liability under these laws is discussed in Chapter 24.

Accountants’ liability for malpractice generally arises in actions for negligence, fraud, or breach of contract. In a malpractice action based on negligence, the plaintiff must prove the same elements discussed in previous sections on negligence: duty, breach of duty, causation, and damages.

The accountant’s duty is said to be that of using the degree of care, skill, judgment, and knowledge that can reasonably be expected of a member of the accounting profession. Two sets of standards have been developed by the American Institute of Certified Public Accountants, the professional accountants' association, that help determine reasonable care. A reasonable accountant should, at minimum, follow the Generally Accepted Accounting Principles (GAAP) and the Generally Accepted Auditing Standards (GAAS). These two codes provide standards against which to measure an accountant’s practices.

A major issue in accounting malpractice is the question of to whom the accountant’s duty is owed. States are not in agreement about to whom an accountant can be held liable. Of course, the accountant is always liable to his or her clients. Third parties who have relied on the accountant’s work, however, present a problem.

States use three alternative rules to define the parameters of the accountant’s liability to third parties. The first, and oldest, rule is often referred to as the *Ultramares Doctrine*. Under this rule, the accountant is liable only to those in a privity-of-contract relationship. In other words, only the party who contracted for the accountant’s work may sue. For example, if a client contacted an accountant to prepare a statement that the accountant knew was going to be used to secure a loan from the First Founding Bank, First Founding could not sue the accountant for malpractice in a state that followed the Ultramares Doctrine, because there was no contractual relationship between First Founding and the accountant.

A somewhat more liberal rule is found in Section 552 of the *Restatement (Second) of Torts*. This rule holds that accountants will be liable to a limited class of intended users of the information. Thus, the accountant owes a duty to the client and any class of persons the accountant knows is going to be receiving a copy of his or her work. Under this rule, First Founding could recover in the preceding example.

The broadest rule applies in an extremely limited number of states. The smallest minority of states holds the accountant liable to any reasonably foreseeable user of the statement the accountant prepares. Exhibit 13-4 illustrates the states that adhere to each rule.

The reasonably foreseeable user rule, which was adopted for accountants in the Florida state supreme court case of *First Florida Bank v. Max Mitchell & Co.*, has been used to extend liability to third parties adversely affected by the performance of other professionals. For example, it was cited to justify allowing a condominium association to sue an engineer who had been retained to inspect buildings and to make structural reports before an apartment building was converted into a condominium; it was also cited to allow a real estate appraiser to be sued by a bank that relied on an inaccurate appraisal of property.

---

18 588 So. 2d (Fla. 1990).
Global Dimensions of Product Liability Law

Businesspersons are concerned with the transnational aspects of product liability law primarily in two situations: (1) when they sell an imported product that causes injury to a consumer in the United States, and (2) when they manufacture and export a product that causes harm to a consumer in a foreign country. In both instances, the U.S. corporation may be subject to liability for the injury.

Liability for a defective product that injures a consumer may be imposed on everyone in the chain of distribution of the product, from the retailer to the manufacturer. In about 80 percent of the cases, it is the manufacturer on whom plaintiffs tend to concentrate, because the manufacturer is usually responsible for the defect and has the greatest assets. If the manufacturer of a defective product is a company located in another country, a U.S. importer, wholesaler, distributor, or retailer may find itself liable for the injuries caused by a defective imported product. When a manufacturer is located in a foreign country, the plaintiff often simply sues only the retailer and the wholesaler. Because they do business in the state where the consumer lives, the court can easily assert personal jurisdiction over them. The foreign corporation may sometimes argue successfully that the corporation does not have enough minimum contacts with the state to allow the assertion of jurisdiction over the foreign manufacturer under the state’s long-arm statute.

Even if the long-arm statute is satisfied, a potential problem arises in conjunction with service. Although the means of service acceptable in the United States are acceptable for serving corporations in most countries, the Hague Convention on the Service of Judicial and Extrajudicial Documents in Civil and Commercial Matters (adhered to by 28 countries, including most of the major trading partners of the United States) requires that the foreign defendant receive actual notice of the suit. This requirement is sometimes difficult to satisfy.

Still another consideration for the plaintiff is the collectability of the judgment. If the foreign defendant has no assets in the United States and refuses to pay, the plaintiff will be forced to ask the courts in the country where the manufacturer is located to execute a judgment against the defendant’s assets there. With all of these potential problems resulting from an action against a foreign manufacturer, a plaintiff is very likely simply to sue those U.S. businesses in the chain of distribution. The prudent businessperson who sells foreign goods should be aware of this potential liability problem.
In the case of U.S. products sold abroad, U.S. manufacturers may be brought before the foreign courts. Since the late 1970s, European and other foreign countries have been adopting increasingly strict product liability rules, holding manufacturers, distributors, and retailers liable for injuries caused by defective products on theories similar to those used in the United States, such as breach of warranty, negligence, and strict liability.

Each country has its own set of rules, so the prudent businessperson will become familiar with the rules of the country to which he or she is exporting a product. New Zealand’s Accident Compensation Act, for example, provides for almost automatic payment of compensation for pecuniary damages, such as medical expenses and lost wages, although it excludes most claims for pain and suffering.\(^\text{19}\)

Foreign importers, retailers, and wholesalers of goods manufactured in the United States are not at all reluctant to join U.S. manufacturers in lawsuits so as to distribute the cost of the judgment. Moreover, once a plaintiff has obtained a judgment over a U.S. corporation in a foreign state, the U.S. courts will generally enforce the judgment rendered by a foreign court as long as the principles used to obtain jurisdiction over the person were reasonably similar to those accepted in the United States and the substantive law reasonably conforms to our sense of justice. Thus, it is extremely important that businesspersons remember that selling a product overseas does not mean freedom from product liability considerations. Product standards for goods sold overseas should be just as high as for goods sold domestically. In fact, extra precautions may have to be taken. For example, warning labels and instructions should always be printed in the languages spoken in the countries where the goods will be sold.


---

**SUMMARY**

Product liability law grew out of tort law and relies on basic tort theories. A product liability action can be based on negligence, breach of warranty, or strict product liability. The easiest of these to prove is strict product liability.

A product liability action may be brought by any party who is injured by a defective product, even if he or she did not purchase the product. An action based on strict product liability may even be brought by a bystander.

The defendant may be a retailer, distributor, or manufacturer. Sometimes, when the producer of the product cannot be clearly identified, as in the case of a drug, the theory of enterprise liability (market share theory) may be used to bring an action against all manufacturers of that product.

Service liability is analogous to product liability but is for defective services. Another difference between the two is that negligence is generally the only theory of liability available in a service liability case. Most service liability cases involve professional malpractice, such as accountant or medical malpractice.

Just because a U.S. corporation intends goods for sale overseas, the goods should not be less safe than those produced for American consumption. The manufacturer of a shoddy exported product may find itself defending an action brought in a foreign court. Conversely, an importer in the United States should be especially careful about inspecting the imported goods, because a U.S. plaintiff may not want to sue the foreign producer, leaving the U.S. importer as the primary defendant.
CASE PROBLEMS

13-13 Thomas Woeste ordered raw oysters at Washington Platform Saloon and Restaurant. After eating the oysters, Woeste died as a result of contracting the bacterium *Vibrio vulnificus*. *Vibrio vulnificus* is a naturally occurring bacterium that grows in oysters harvested in warm water. It has minimal effects on healthy people, but can be dangerous to people with compromised immune systems. Woeste suffered from hepatitis C and cirrhosis of the liver, which made him susceptible to *Vibrio*. Woeste’s estate claimed that Washington Platform was both negligent and strictly liable for not providing adequate warning.

REVIEW QUESTIONS

13-1 Explain what privity is and what impact it had on the development of product liability law.
13-2 Explain the elements one would have to prove to bring a successful product liability case based on negligence.
13-3 Explain the defenses one can raise in a product liability case based on negligence.
13-4 Explain the various types of warranties that provide the basis for warranty liability cases based on breach of warranty.
13-5 Explain the difference between the foreign-natural and consumer-expectations tests.
13-6 Explain the defenses available in a breach-of-warranty case.

REVIEW PROBLEMS

13-7 Jack Clark was eating a chicken enchilada at Mexicali Rose restaurant when he swallowed a chicken bone. The bone lodged in his throat and had to be removed in the emergency room of a local hospital. What is the primary factor that will determine whether Mr. Clark’s product liability lawsuit is successful?

13-8 Five people died of carbon monoxide poisoning from a gas heater that had been improperly installed in a cabin by the owner, who had not extended the vent pipe far enough above the roofline. The instruction manual stated that the pipe had to be vented outside, but did not specify how far outside the vent pipe should extend, other than having a drawing that showed it extending beyond the roofline. The manual also said, “Warning: To ensure compliance with local codes, have installed by a gas or utility inspector.” Do the decedents’ estates have a product liability action for failure to warn? Why or why not?

13-9 The plaintiff was injured when a fire extinguisher failed to work when it was needed to put out a fire. Could the defendant manufacturer of the fire extinguisher raise the defense of contributory negligence against the plaintiff if the plaintiff’s negligence started the fire? Why or why not?

13-10 Mattie was injured when she lost control of the car she was driving because of a tire blowout. The tire was guaranteed by the manufacturer “against failure from blowouts.” The guarantee also limited the manufacturer’s liability to repair or replacement of any defective tire. Can Mattie sue under strict liability breach of warranty and recover damages for her injury? Why or why not?

13-11 Bob was waiting at the crosswalk for the light to turn green. As he stood there, a car that was stopped in the road next to him suddenly exploded, and Bob was injured by the blast. A defect in the engine caused the explosion. Will Bob be able to bring a strict product liability action against the manufacturer of the engine?

13-12 National Bank was deciding whether to loan money to Pateo Corporation. It asked Pateo to provide a copy of the company’s most recent audit. While doing the audit, the auditors, Hamble & Humphries, failed to follow up on evidence indicating that one of the firm’s managing partners might be siphoning money out of the corporation’s funds. Relying on the audit, the bank made the loan. Six months later Pateo went into bankruptcy, primarily because one partner had stolen funds from the corporation and had then fled the country. Can the bank bring an action against Hamble & Humphries? Why is your answer dependent on the state in which the case arose?
about the dangers of raw oysters. Washington Platform made a motion for summary judgment on the ground that it did provide a warning against eating raw seafood on its menu and that Woeste did not read the warning before ordering oysters. The motion for summary judgment was granted for Washington Platform and Woeste appealed. Discuss the outcome of Woeste’s appeal. Woeste v. Washington Platform Saloon & Restaurant, 836 N.E.2d 52 (Ohio Ct. App. 2005).

13-14 In 2002, Mayola Williams, the widow of a man who smoked as many as 3 packs of Marlboro cigarettes a day for almost 50 years, sued Philip Morris USA for the torts of negligence and fraud. Williams’s husband had eventually died from a smoking-related disease. Williams argued that the products produced by Philip Morris were a cause of her husband’s death. The case was important because it could have redefined how large punitive damages ought to be against tobacco and other large and powerful corporations in product liability cases. In 2006, the Supreme Court of Oregon awarded Williams $800,000 in compensatory damages and $79.5 million in punitive damages.

Philip Morris appealed the court’s decision, arguing that punitive damages should more equally fit the actual damages suffered. In other words, Philip Morris argued that the amount of the punitive damages should be based on the damages only the plaintiff in the instant case suffered, rather than any damages that other users of the product (who were not in court) might have suffered. What could be the dangers of punishing the defendant for the damage the defendant has caused to individuals who are not in court? How did the Supreme Court decide in this case? Philip Morris USA et al. v. Williams, et al., 127 S. Ct. 1057, 549 U.S. 346 (2007).

13-15 A class action case was filed against nine sellers of milk by several lactose-intolerant individuals. They claimed they had drunk the milk before they realized they were lactose intolerant and, consequently, suffered temporary gas and stomach discomfort. They argued that the sellers had failed to warn consumers about the dangers of lactose intolerance by putting warning labels on milk containers. They sought damages and an injunction requiring milk sellers to put a warning label on all milk packaging that read: “Warning—If you experience diarrhea or stomach cramps after consuming milk, you may be lactose intolerant. Check with your physician.” The district court dismissed the suit, and the plaintiffs appealed. Why do you believe the court of appeals either granted or denied the appeal? Mills v. Giant of Maryland, LLC, 508 F.3d 11 (D.C. Cir. 2007).

13-16 Christopher Nadel was in the car with his father, Paul, and his grandmother, Evelyn, when they pulled into Burger King for breakfast. Christopher was seated in the center of the front seat, between Paul and Evelyn; two of Christopher’s classmates were in the back seat. The group ordered several breakfast sandwiches at the drive-thru as well as two cups of coffee. Evelyn was burned on her right leg by the coffee when she tasted it to see how hot it was. As she was placing the coffee back in the carrier, Paul pulled out onto the street and Christopher began to scream that he was being burned. Either one or both cups of coffee had spilled onto Christopher’s foot and Christopher was subsequently treated for second-degree burns to his right foot.

The Nadels, on behalf of Christopher, sued the owner of the particular Burger King franchise that they stopped at and Burger King Corporation itself, alleging, among other claims, product liability for a defectively designed product and for failure to warn of the dangers of handling a liquid served as hot as their coffee.

Both the owner of the Burger King and Burger King Corporation moved for summary judgment and the trial court granted both motions. Burger King Corporation argued that it was immune to the product liability claims because it was not a manufacturer, seller, or supplier of the coffee. The Nadels appealed. Do you think the court of appeals agreed that Burger King Corporation was immune to the product liability claims? Why or why not? Nadel et al. v. Burger King Corp. & Emil, Inc., 119 Ohio App. 3d 578, 695 N.E.2d 1185 (1997).

13-17 Dow Agrosciences manufactured and marketed “Strongarm” pesticide. The pesticide was marketed as good to use anywhere peanuts were grown, when in actuality, the pesticide stunted the growth of the peanut plants when used in soil with a pH of 7.0 or greater. A group of Texas peanut farmers sued Dow after their crops were damaged by the pesticide, making state-law claims of strict liability, negligence, fraud, and breach of express warranty. Dow argued that the state-law claims were preempted by the Federal Insecticide, Fungicide, and Rodenticide Act (FIFRA) and won a motion for summary judgment in the district court. The farmers appealed and the appellant court also found for Dow. The farmers appealed to the Supreme Court.

FIFRA gives the EPA the right to regulate pesticides. The EPA requires that the labels on pesticides be free of false or misleading statements. FIFRA says that states may regulate the sale and use of pesticides, but the “[s]tate shall not impose or continue in effect any requirements for labeling or packaging in addition to or different from those required under [FIFRA].” How do you think the Supreme Court ruled on this appeal? Do you think the strict liability claims are preempted by FIFRA? Bates v. Dow Agrosciences LLC, 544 U.S. 431 (2005).
Danell Gomez had a surgical catheterization in 1999. A device known as an “Angio-Seal” was used to close the hole in Gomez’s artery. The Angio-Seal is regulated by the FDA under the Federal Medical Device Amendments. The Angio-Seal uses a plug of collagen to seal the hole, and uses an anchor to prevent the collagen from entering the artery. Gomez alleges that the anchor failed to prevent the collagen from entering Gomez’s artery and it formed a blockage in her femoral artery in her leg. Gomez underwent nine surgeries as a result of the blockage to her artery. She sued the manufacturer under Louisiana product liability law on several counts, but the defendant’s motion for summary judgment on the ground of federal preemption was granted.

Gomez appealed; the Fifth Circuit Court of Appeals affirmed most of the preemption claims, but reversed and remanded the summary judgment for Gomez’s claim of manufacturing defect. Gomez claimed that the Angio-Seal had been manufactured improperly and that the defect had caused the anchor to fail. Why would this claim not be preempted by the Federal Medical Device Amendments? Gomez v. St. Jude Medical Daig Division, Inc., 442 F.3d 919 (5th Cir. 2006).

THINKING CRITICALLY ABOUT RELEVANT LEGAL ISSUES

Government Protection against Unsafe Products

The recent scares caused by toxic products imported from China should be of concern to all retailers. The problematic products have varied from toy trains to toothpaste to tires. In 2006, the United States imported almost $290 billion worth of goods from China. Because such a huge number of our products are made in China, these incidents are a major concern for both consumers and retailers. Under product liability laws, consumers can sue retailers for selling them a defective or dangerous product.

The ability of consumers to sue the retailers for a product that was defectively made in another country is very harmful to the retailers. The retailers either must perform many expensive checks on their merchandise, which is increasingly coming from other countries, such as China, or they just have to trust that the merchandise is being made responsibly. This dilemma is very dangerous for businesses and could mean major expenses either from increased merchandise testing or from product liability lawsuits. For example, Foreign Tire Sales, Inc. (FTS), is being held responsible for the recall of defectively made tires, which it says it cannot afford without going into bankruptcy. Even though FTS did not make the tires, and the designs that it provided to the manufacturer were safe, FTS is being punished because it sold the tires.

Rather than waiting until the problem emerges, the FDA and other government agencies should check foreign goods as a preventative measure. Although the government obviously cannot increase regulations or inspections in Chinese factories, it can perform more inspections and require more extensive documentation when the products come into our country.

More inspections and regulation by the government will help protect business owners from product liability lawsuits, because it will remove the defective products before they reach consumers. The government should be responsible for inspecting these products because it is better able to inspect all of the foreign products; it has the money, the manpower, and the systems already in place. If the government can afford to check every shipment of toothpaste now, it should be able to increase checks before the toxic product reaches consumers.

The government should take the responsibility of protecting its citizens and its businesses. The government should protect its citizens from purchasing unsafe merchandise and protect its businesses from lawsuits over unsafe foreign merchandise.

1. How would you frame the issue and conclusion of this essay?
2. What evidence is used to support the author’s opinion?
3. What information is missing from this essay?
4. Write an essay on this topic from point of view different from that of the essay author.

Clue: How could the inclusion of any missing information change the conclusion of the essay?
ASSIGNMENT ON THE INTERNET

At the Legacy Tobacco Documents Library, legacy.library.ucsf.edu, you can find internal documents from the files of top tobacco companies. Within this site, at www.library.ucsf.edu/tobacco/litigation/summary.html, you can find a summary chart of tobacco lawsuits by state. Select one of the states to view the complaints filed in the case. Read the complaint to find out what claims (i.e., negligence, strict liability, breach of warranty) the plaintiff is bringing. Find out what type of relief the plaintiff is seeking (i.e., damages, injunction, etc.).

Earlier in this chapter, we discussed failure-to-warn claims against the fast-food industry, and we noted that Congress is considering banning all obesity-related claims against fast-food restaurants. Write a paper in which you compare the fast-food litigation to the tobacco litigation.

ON THE INTERNET

www.cpsc.gov This site is the home of the U.S. Consumer Product Safety Commission.
www.law.cornell.edu/wex/index.php/Products_liability This site contains a brief overview of product liability and provides several links to liability law as well as recent product liability court cases.
www.lawyersandsettlements.com A Web site with news on class action suits. Most class action suits are product liability cases.
news.findlaw.com/legalnews/us/pl Visit this site for the latest product liability news stories.
lawprofessors.typepad.com/products_liability This site is a blog written by law professors about product liability cases.
bextralawsuit.lawinfo.com/bextra-class-action.html This Web site is an example of a site that lawyers might use to gain (recruit) clients for a class action suit.
hcch.e-vision.nl/index_en.php This site contains information from the Hague Conference on Private International Law. Here you will also find links to additional sources on international product liability law.
europa.eu.int/comm/consumers/cons_safe/prod_safe/defect_prod/index_en.htm This Web site of the European Union’s Consumer Affairs contains information about product liability within the European Union.

FOR FUTURE READING

When people hear the word *property*, they generally think of physical objects: land, houses, cars. *Property*, however, is a bundle of rights and interests in relation to other persons with reference to a tangible or intangible object (Exhibit 14-1). The essence of the concept of property is that the state provides the mechanism to allow the owner to exclude other people.

By virtue of this right, persons with great amounts of property have an especially significant amount of power. Because possessing property facilitates the acquisition of even more property, the identification of those who possess a disproportionate amount of property rights provides insight into the dynamics of influence and authority in our society.

Property rights are not the same in every society, nor are they static. While reading this chapter, think about how property rights could be different and what impact that difference would have both on the legal environment of business and on society as a whole.

Because different types of property give their owners different rights, and because different bodies of law govern different types of property, we will discuss the three primary types of property in two separate chapters. Initially, this chapter focuses on real property, that is, land and anything permanently attached to it. The second half discusses personal property, both tangible (capable of being detected by the senses) and intangible (incapable of being detected by the senses). Chapter 15 shifts the focus to intellectual property, that is, things created primarily by mental rather than physical processes.
Property is often characterized as a bundle of rights. All of the rights in the bundle are not always held by one person. For example, when an owner leases a house to a tenant, the owner has transferred the rights to use and possess but has kept the rest of the rights.

CRITICAL THINKING ABOUT THE LAW

Property is directly related to the power one has in society. Some individuals argue that the government should offer more protection for property owners. Others argue that in a fair country, citizens would have similar amounts of property because property provides a basis for so many other decisions. Property rights actually exist as a matter of degree. A property owner has some rights, but he or she must tolerate some restrictions on those rights. The following questions will help you think critically about the link between property rights and power.

1. If a group of politicians passed a law to increase protection of property rights, what ethical norm probably led to this legislation?
   
   **Clue:** Review the list of ethical norms in Chapter 1. Which ethical norm seems most likely to motivate increased protection of property?

2. If a group of radical politicians proposed a law that reduced personal property protection and redistributed some property rights to the poor, what ethical norm was probably behind this action?
   
   **Clue:** Again, review the list of ethical norms.

3. In light of the variation in rights attached to the concept of property in different countries, the idea of property has ambiguity as one of its primary characteristics. What could nations do to eliminate any ambiguity associated with saying “This property is mine”?
   
   **Clue:** Take another look at the definition of property rights.

Real Property

**Real property** is land and everything permanently attached to it. One’s rights to a property depend on the type of interest one has in that property. The law provides the means to convey or transfer that interest. Although most conveyances
are voluntary, the government may require involuntary conveyances to benefit the public and may place restrictions on the use of property to protect the public health, safety, and welfare.

**DEFINITION OF REAL PROPERTY**

Many disputes have arisen over whether certain items are real or personal property. The law says that an item that is attached to the land is a part of the realty. What does “attached” mean? Usually, an item is considered attached if its removal would cause damage to the property. Thus, built-in appliances are generally a part of the real property, whereas freestanding ones are not. Sometimes, however, an item is not really permanently affixed to the land, but its functioning is said to be essential to the functioning of the structure. In such cases, the courts usually find the item to be part of the real property.

**Fixtures.** An item that is initially a piece of personal property but is later attached permanently to the realty is known as a *fixture* and is treated as part of the real property. Thus, if a person rents another’s property and installs a built-in microwave oven, the oven is a fixture and becomes part of the realty. The tenant may not remove the oven when he or she leaves. There are two exceptions to this rule.

First, the parties may agree that specific fixtures will be treated as personal property. To be enforceable, such an agreement must be in writing.

The second exception is for trade fixtures. A *trade fixture* is a piece of personal property that is affixed to realty in conjunction with the lease of a property for a business. When an entrepreneur opens an ice cream parlor in a leased building, the freezers he or she installs are trade fixtures. These are treated as personal property because of a presumption that neither party intends such fixtures to become a permanent part of the realty. The businessperson will need the freezers at any new location, and new business tenants will have different needs.

**EXTENT OF OWNERSHIP**

Any concept of land obviously includes the surface of the land, but legally, more is included. The landowner is entitled to the airspace above the land, extending to the atmosphere. Ownership of land also includes *water rights*, the legal ability to use water flowing across or underneath one’s property.

Water rights, however, are somewhat restricted, in that one cannot divert water flowing across the property in such a manner as to deprive landowners downstream of the use of water from the stream.

Ownership of land usually also encompasses the land below the surface, including *mineral rights*, the legal ability to dig or mine the minerals from the earth. These mineral rights, however, may be sold or given to someone other than the person who owns the surface of the land.

**Interests in Real Property**

Not all interests in land are permanent. The duration of one’s ownership depends on the type of estate one is said to hold. The estate that one has also determines what powers one has in regard to using the land. Exhibit 14-2 briefly summarizes these interests, which are described in detail in the following subsections.
FEE SIMPLE ABSOLUTE

The most complete estate is the fee simple absolute. When most people talk about owning property, they usually have in mind a fee simple absolute. If one has a **fee simple absolute**, one has all rights to own and possess that land. When the owner of a fee simple absolute interest dies, the interest passes to the owner’s heirs.

**CONDITIONAL ESTATE**

The interest of a **conditional estate** is the same as that of a fee simple absolute, except that it is subject to a condition, the happening or nonhappening of which will terminate the interest. For example, Rose may own a farm subject to the condition that Rose never grow cotton. Once Rose grows cotton, the condition has occurred, and the land either reverts to the former owner or is transferred in accordance with the terms of the **deed** (the instrument that is used to convey real property). Conversely, a conditional estate could be set up so that the holder would own the farm as long as the primary crop planted every year was corn. Failure to meet the condition would terminate the estate.

**LIFE ESTATE**

A **life estate** is the right to own and possess property until one dies. The use of a life estate may be more restricted than that of a fee simple absolute. The party who will take possession of the property upon the death of the holder of the life estate has an interest in making sure that the value of the property does not substantially decline as a result of neglect or abuse by the holder of the life estate. Thus, the life-estate holder is not allowed to waste the property, and cannot use the property in such a way as to destroy its value to future holders. Nor can the life tenant neglect to make necessary repairs to the property to prevent its destruction or deterioration.

**FUTURE INTEREST**

A person’s present right to possession and ownership of land in the future is a **future interest** and usually exists in conjunction with a life estate or a conditional estate. For example, Sam owns a life estate in Blueberry Farm, and, upon
Sam’s death, fee simple absolute ownership of the land will pass to Jane. Jane
has a future interest in Blueberry Farm. As a result of her interest, she may sue
Sam to enjoin him from engaging in waste of the property.

LEASEHOLD ESTATES

A leasehold is not an ownership interest. It is a possessory interest. One who
has a leasehold is entitled to exclude all others, including the property owner
under most circumstances, for the period of the lease and is entitled to use
the property for any legal purpose that is not destructive of other occupiers’ rights
or prohibited by the terms of the lease. The lease is the contract that transfers
the possessory interest. It generally specifies the property to be leased, the
amount of the rent payments and when they are due, the duration of the lease-
hold, and any special duties or rights of either party. It is signed by both parties.
The owner of the property is the lessor, or landlord. The holder of the lease is the
lessee, or tenant.

Although the rights and obligations of the landlord and the tenant may be
altered by the lease, some states have statutes requiring landlords to keep the
premises in good repair and allowing tenants to withhold their rent if the land-
lord fails to do so. The landlord may enter the property only in an emergency,
with permission of the tenant to make repairs, or with notice to the tenant near
the end of the leasehold to show the property to a potential tenant. If the tenant
fails to make the agreed-upon rental payments, the landlord may bring an action
to evict the tenant.

Unless prohibited by the lease, a tenant may move out of the property and
sublease it to another party. The initial tenant, however, still remains liable to the
landlord for payment of rent due for the entire term of the lease.

EASEMENTS

An easement is an irrevocable right to use some portion of another’s land for a
specific purpose. The party holding the easement does not own the land in ques-
tion but has only the right to use it. Easements generally arise in one of three
ways: express agreement, prescription, or necessity.

An easement by express agreement arises when the landowner ex-
pressly agrees to allow the holder of the easement to use the land in question
for the agreed-upon purpose. For example, a utility company may have an
easement to run power lines across one’s property. The easement should be
described on the deed to the property or recorded in the county office
that keeps property records to protect the holder of the easement when the
property is sold.

An easement by prescription arises under state law. When one openly uses
a portion of another’s property for a statutory period of time, an easement arises.
In many states, the time period is 25 years.

An easement by necessity arises when a piece of property is divided and,
as a result, one portion is landlocked. The owner of the landlocked portion has
an easement to cross the other parcel for purposes of entrance to and exit from
the land.

LICENSE

A license is a temporary, revocable right to be on someone else’s property.
When one opens a business, the public is given a license to enter the property
to purchase the good or services provided by the business.
CO-OWNERSHIP

We have been referring to the holders of interest in land in the singular. Ownership of land may also be held by multiple persons, as well as by business organizations. Whenever there is ownership by multiple parties, it is important to know what type of ownership exists, because different forms confer different rights on the owners.

The three types of co-ownership are tenancy in common, joint tenancy, and tenancy by the entirety. Regardless of which type of tenancy exists, all tenants have the equal right to occupy all the property. Their other interests are described here and are summarized in Table 14-1.

Tenancy in common is the most common form of joint ownership. Owners may own unequal shares of the property, may sell their interest without consent of the other owners, and may have their interest attached by a creditor. Upon the death of the tenant in common, his or her heirs receive the property interest.

Under joint tenancy, all are co-owners of equal shares and may sell their shares without the consent of other owners. Their interest can be attached by creditors. Upon the death of a joint tenant, his or her interest is divided equally among the remaining joint owners.

Tenancy by the entirety exists only when co-owners are a married couple. One cannot sell his or her interest without the consent of the other, and creditors of only one cannot attach the property. Upon the death of one, full ownership of the property passes to the surviving spouse. Upon divorce, tenancy by the entirety automatically becomes tenancy in common.

CONDOMINIUMS AND COOPERATIVES

Two forms of co-ownership that have become increasingly popular over the past 20 years are condominiums and cooperatives.

Condominiums. In a condominium ownership interest, the owner acquires title to a “unit” within a building, along with an undivided interest in the land, buildings, and improvements of the “common areas” of the development. When the condominium is developed, a Declaration of Covenants, Conditions, and Restrictions (called CC&Rs) is filed. This document contains the architectural and use restrictions for the condominium development, assessments, and instructions for forming the condominium association that will manage the condominium. The association has the power, as provided in the CC&Rs, to levy assessments against the unit owners in order to manage, maintain, insure, repair, and replace the common areas. The association likewise has the authority to fine unit owners who do not comply with the CC&Rs. The following case illustrates the type of conflict that often arises out of this form of ownership.

<table>
<thead>
<tr>
<th>Type</th>
<th>Division of Ownership</th>
<th>Rights of Owners’ Creditors</th>
<th>Ownership of Property upon Death</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tenancy in common</td>
<td>Equal or unequal shares</td>
<td>Can attach interest</td>
<td>Transferred to heirs</td>
</tr>
<tr>
<td>Joint tenancy</td>
<td>Equal shares</td>
<td>Can attach interest</td>
<td>Divided among other joint tenants</td>
</tr>
<tr>
<td>Tenancy by the entirety</td>
<td>Equal shares</td>
<td>Cannot attach interest</td>
<td>Goes to surviving spouse</td>
</tr>
</tbody>
</table>

TABLE 14-1

Joint Ownership
When Burton Stevens placed a portable hot tub on the deck of his townhouse, he was asked to remove it by the Elk Run Homeowners’ Association. Stevens refused and Elk Run filed suit against Stevens to have the hot tub removed. The district court ruled in favor of the homeowners’ association and ordered the hot tub removed. Stevens appealed.

Justice Kite

Facts

In 1993, a developer filed a Declaration of Covenants, Conditions and Restrictions (the covenants) and a plat for the Elk Run Townhouses development in Jackson. The covenants indicated that each townhouse was located on a separate lot, allowing for fee simple ownership of each townhouse by an individual owner. The covenants also established the Homeowners’ Association and provided that the individual lot owners were members of it. The members were to elect a management committee to govern the affairs of the association.

The covenants defined “common areas” as areas “designated as such on the applicable plat(s) for the project.” The plat identified decks, entryways, and parking areas as “limited common areas.” Other applicable provisions of the covenants stated:

1. Certain Additional Restrictions. The following additional restrictions are applicable to the lots and common areas. Each reference to “owners” includes their tenants and invitees.

   a. Keeping Outside Areas Clean and Sightly. The Owners shall not place or store anything within the common areas without the prior written consent of the Management Committee or its designee except in a facility specifically designated or approved for their storage. All owners shall keep their residences and their lots in a reasonably clean, safe, sightly and tidy condition.

   b. Obstructing Common Areas. Owners shall not obstruct common areas. Owners shall not place or store anything within the common areas without the prior written consent of the Management Committee or its designee except in a facility specifically designated or approved for such storage.

   c. Architectural Control. Except as otherwise expressly provided herein, no building, fence, wall, driveway, excavation or improvement of any kind shall be commenced, erected or maintained upon the property, nor shall any exterior addition to or change or alteration therein be made (including without limitation any closing in of a porch or balcony) by any owner other than Declarant, until the plans and specifications showing the nature, kind, shape, height, materials, and location of the same shall have been submitted to and approved in writing by the Management Committee, as to harmony of external design and location in relation to surrounding structures and topography, and in relationship to the quality and appearance of the project.

Mr. Stevens acquired Lot 12 of the Elk Run Townhouses Addition in 1998. His warranty deed stated that the property was subject to “taxes, reservations, covenants, encroachments, conditions, restrictions, rights-of-way and easements of sight and/or record.” After moving into his townhouse, Mr. Stevens placed a portable hot tub on his exterior deck. The Homeowners’ Association requested that Mr. Stevens remove the hot tub from his deck, but he refused.

Discussion

Mr. Stevens argues that the district court erred by granting summary judgment in favor of the Homeowners’ Association. He claims that the district court misinterpreted the covenants as requiring management committee approval prior to the placement of a portable hot tub on an exterior deck.

We turn first to Mr. Stevens’ argument that the district court erred by determining that paragraph 12(g) (architectural control) applied to the placement of a portable hot tub on his deck. The district court held that, under paragraph 12(g), Mr. Stevens was required to secure management committee approval before placing the hot tub on his deck because the deck was an improvement to the townhouse unit and placement of the hot tub amounted to a change and alteration of the deck.

We do not agree with the district court’s conclusion on this issue. When we read paragraph 12(g) in its entirety and within the context of the whole declarations document, we believe that the terms “alteration” and “change” clearly and unambiguously denote a degree of permanence. The declarant included “closing in of a porch or balcony” as an example of the type of alterations or changes which fall within the paragraph 12(g). The paragraph also specifically refers to buildings, fences, walls, and driveways. Each of these examples is a permanent and enduring modification to the premises.

Placing a portable hot tub on a deck does not affect the structure of the deck or townhouse. The hot tub could be moved by simply unplugging it and draining the water. Consequently, a portable hot tub is not the type of permanent...
altered or change addressed by the plain language of paragraph 12(g). The district court’s decision to the contrary was incorrect.

The district court also relied on paragraphs 12(a) and (b) of the covenants in concluding that management committee approval was required before the hot tub could be placed on the deck. Paragraphs 12(a) and (b) address keeping outside areas clean, sightly, and free of obstructions. Owners are prohibited from placing or storing “anything within the common areas without the prior written consent of the Management Committee or its designee except in a facility specifically designated or approved for their storage.”

Mr. Stevens claims that paragraphs 12(a) and (b) do not apply because his deck is designated on the plat as a “limited common area” rather than a “common area.” The plain and ordinary meaning of the term “limited common area” is an area reserved for an owner’s exclusive use, but subject to observation by others and, consequently, regulation by a homeowner’s association. Clearly, the grantor intended to include limited common areas like decks, entryways and parking areas within the regulation of paragraph 12(a) and (b). The obvious purpose of the provisions is to keep any areas that could be observed by the general public and other townhouse owners neat, orderly, and free of obstacles. Therefore, we hold that paragraphs 12(a) and (b) apply to decks.

Affirmed in favor of Plaintiff, Elk Run Homeowners’ Association.

CRITICAL THINKING ABOUT THE LAW

Despite the effort homeowners’ associations put into specifying what can and cannot be done on common areas or limited common areas, disputes about whether particular actions by homeowners are in conformity with the rules governing the residents or the homeowners are common. The courts, as in this case, pay close attention to the provisions in the agreement signed by the homeowner at the time of purchase.

1. What reasons does the court use in this case to find that the district court partially erred in its finding of summary judgment for the plaintiff?
   Clue: Look at the portion of the decision where the court discussed the contents of paragraph 12(g).

2. Could Stevens have avoided trouble by placing his hot tub outside the sight of the other homeowners?
   Clue: What is the content of 12(a) and (b) that Stevens violated?

Cooperatives. Whereas condominiums often involve developments consisting of multiple buildings, each of which contains two or more units, cooperatives are more commonly used for ownership interests in apartment buildings. In a cooperative, the investor resident acquires stock in the corporation that owns the facility and receives a permanent lease on one unit of the facility. A board of directors is generally elected from among the unit owners to manage the facility. All unit owners are bound by rules established by the cooperative’s board of directors. Commonly, the cooperative will provide that a member may be evicted for violation of the rules, and upon eviction, the cooperative will repurchase the evicted member’s unit.

Voluntary Transfer of Real Property

The value of property is heightened by the owner’s ability to transfer that property. In general, the owner may transfer the property to anyone for any amount of consideration or for no consideration. He or she may transfer all or any portion of the property.

To transfer property, however, the owner must follow the proper procedures. These are execution, delivery, acceptance, and (to protect the recipient of the property) recording (Exhibit 14-3). Unless something to the contrary is stated, it is presumed that a conveyance of ownership is the conveyance of a fee simple absolute.
The first step in a voluntary transfer is the execution of a deed. The deed, as shown in Exhibit 14-4, is the instrument of conveyance. A properly drafted deed:

1. Identifies the grantor (the person conveying the property) and the grantee (the person receiving the property)
2. Contains words that express the grantor’s intent to convey the property
3. Identifies the type and percentage of ownership
4. States the price paid for the property, if any
5. Contains a legal description of the physical boundaries of the property (not the street address)
6. Specifies any easements or restrictions on use of the land
7. Identifies any warranties or promises made by the grantor in conjunction with the conveyance

Once the properly drafted deed has been signed by the grantor and the grantee, it is said to have been executed. Many states require the signing of the deed to be witnessed or notarized (witnessed by an official of the state who certifies that she or he saw the parties sign the deed and was provided evidence that the signatories were who they purported to be).

General Warranty Deed. Two basic types of deeds are normally used to transfer ownership of property. The first, a general warranty deed, is preferred by grantees because it contains certain warranties or promises by the grantor. Although such covenants may vary slightly from state to state, they generally include the following:

1. The covenant of seisin—a promise that the grantor owns the interest that he or she is conveying
2. The covenant of the right to convey—a promise that the grantor has the right to convey the property
3. The covenant against encumbrances—a promise that there are no mortgages or liens against the property that are not stated in the deed
4. The covenant for quiet enjoyment—a promise that the grantee will not be disturbed by anyone who has a better claim to title of the property and a promise to defend the grantee’s title against such claims or to reimburse the grantee for any money spent in the defense or settlement of such claims
5. The covenant of further assurances—the promise that the grantor will provide the grantee with any additional documents that the grantee needs to perfect his or her title to the property
The other type of deed, which is more desirable from the grantor’s perspective, is the **quitclaim deed**. With such a deed, the grantor simply transfers to the grantee the interest that the grantor owns in the property being conveyed. The grantor makes no additional covenants. Obviously, most grantees would be very reluctant to accept a quitclaim deed.
DELIVERY

Once executed, the deed must be delivered, or transferred, to the grantee with the intent of transferring ownership to the grantee. The delivery may be made directly to the grantee or to a third party who has been instructed to transfer the deed to the grantee.

ACCEPTANCE

The final essential step is acceptance by the grantee. This is the grantee’s expression of intent to possess the property. Acceptance is presumed when the grantee retains possession of the deed.

RECORDING

Recording is not essential for the transfer of ownership, but it is so important to securing the grantee’s rights to the property that it should always be a part of the process of conveyance. Recording refers to the filing of the deed (as well as any other documents related to realty, such as mortgages) with the appropriate county office. This office varies by state and may be the county clerk’s office or the county recorder’s office. Recording gives the world notice of the transfer. It is significant because in many states, if there are two deeds allegedly conveying the same piece of property, the owner of the property is the one whose deed was recorded first.

Involuntary Transfer of Real Property

Transfer of ownership interests in property may also occur without the owner’s knowledge, or even against his or her will, by either adverse possession or condemnation.

ADVERSE POSSESSION

Most states provide that when a person openly treats realty as his or her own, without protest or permission from the real owner, for a statutorily established period of time, ownership is automatically vested in that person. Each state has its own exact requirements for adverse possession, but the necessary possession is often described as having to be actual (the party resides on or uses the land as would an owner), open (not secretive), and notorious (without the owner’s permission). Some state laws require specific acts such as the payment of real estate taxes. Others require that the adverse possessor have taken possession of the land “under color of title,” that is, thinking that he or she was the lawful possessor of the land.

CONDEMNATION

Condemnation is a process by which the government acquires the ownership of private property for a public use over the protest of the owner of the property. The property owner may have been contesting either the taking itself or the price that the government was willing to pay for the taking. Condemnation proceedings occur as a result of the government’s exercise of its right of eminent domain, which was briefly discussed in Chapter 5. Remember from the discussion of the Takings Clause that the right of eminent domain is the constitutional right of the government to take private property, upon payment of just compensation, for a purpose that will benefit the general welfare. This taking may be by any level of government or, in limited cases, by private companies fulfilling a public or governmental function.
Under eminent domain, the government offers to purchase the property. If the owner objects to the transfer or the price, the government institutes condemnation proceedings. If the court determines that the governmental purpose is legitimate, it then determines the fair market value of the property. Once this price has been paid, ownership is transferred to the government.

Sometimes the owner questions whether the taking is really for a public purpose. That question may be particularly difficult when the property to be acquired will be subsequently conveyed to another private individual, especially when the entity to whom the property is being transferred had previously attempted to purchase the property unsuccessfully. In the early 1980s, we started seeing an increasing number of cases in which city and state economic redevelopment agencies were using the power of eminent domain to take private property and transfer it to another private business for the ostensible public use of economic development or job creation.

The case that seemed to stimulate the increase in takings for economic redevelopment was the now-famous Michigan state supreme court case of Poletown Neighborhood Council v. City of Detroit and the Detroit Economic Development Corporation. In that case, the Detroit Economic Development Corporation sought to acquire a large parcel of land on which members of the Poletown Neighborhood Council resided and had small businesses. Once the development agency had acquired the land using the city’s eminent domain power, that property would be conveyed to General Motors to expand its plant. The plaintiffs, who did not want their community destroyed, sued the city and the development council on the ground that they were attempting to abuse their power of eminent domain to unconstitutionally take private property for a private use.

In decisions that surprised many legal scholars, the lower courts upheld the taking. The high court likewise held that the use of eminent domain was constitutional. The court said that the heart of this dispute was whether the proposed condemnation is for the primary benefit of the public or the private user, and it went on to say that once a legislature has declared that a particular government action meets a public need and serves a public purpose, that finding is entitled to deference from the court.

After this case, most courts appeared to give state agencies very broad latitude in cases involving takings for private development, finding public use when there is any plausible argument that the public will benefit from the new use. Moreover, this broad latitude was not just given in cases where individuals’ property was being taken. Increasingly, governments began using eminent domain to transfer property from one business to another.

As the number of these private property transfers continued to rise, a slowly increasing number of courts started backing off from giving so much deference to states in economic development situations. Finally, in the late summer of 2004, in County of Wayne v. Hathcock et al., the Michigan Supreme Court overturned the Poletown decision that had been the stimulus for the use of eminent domain in so many of these economic redevelopment situations.

In Hathcock, Wayne County, Michigan, was attempting to condemn private property to sell the property to a private business for the completion of the Pinnacle Project, which was supposed to bring hotels, conference centers, recreation areas, and other business to the metropolitan airport area. The property owners filed suit against Wayne County, claiming that the condemnation was an unfair taking because the Pinnacle Project did not constitute a public use. The trial court and the appeals court both ruled in favor of Wayne

The city of New London was faced with economic hard times and high unemployment, and the city's development corporation had come up with an integrated development plan that the city approved. The plan would allegedly create between 1,736 and 3,169 new jobs and generate a minimum of $680,544 in property tax revenues for the city. It would revitalize the city, including its downtown and waterfront areas. Using its development agent, the city purchased most of the property it needed for the project from willing sellers. A few property owners refused to sell, so the city initiated condemnation proceedings to take their property. The property owners argued that the taking of their properties would violate the public-use restriction in the Fifth Amendment's Takings Clause. The trial court granted a permanent restraining order prohibiting the taking of some of the properties, but allowing the taking of others. Relying heavily on the reasoning in Poletown, the high court in Connecticut ruled that the city could use its power of eminent domain to take the private property of a number of residents for the purpose of constructing a state park, new residences, research and development facilities, office space, and retail space. Kelo appealed.

As for the first proposition, the City would no doubt be forbidden from taking petitioners' land for the purpose of conferring a private benefit on a particular private party. ... Nor would the City be allowed to take property under the mere pretext of a public purpose, when its actual purpose was to bestow a private benefit. The takings before us, however, would be executed pursuant to a "carefully considered" development plan. The trial judge and all the members of the Supreme Court of Connecticut agreed that there was no evidence of an illegitimate purpose in this case. Therefore, the City's development plan was not adopted "to benefit a particular class of identifiable individuals."

On the other hand, this is not a case in which the City is planning to open the condemned land—at least not in its entirety—to use by the general public. Nor will the private lessees of the land in any sense be required to operate like common carriers, making their services available to all comers. But although such a projected use would be sufficient to satisfy the public use requirement, this "Court long ago rejected any literal requirement that condemned property be put into use for the general public." . . .

The disposition of this case therefore turns on the question [of] whether the City's development plan serves a "public purpose." Without exception, our cases have defined that concept broadly, reflecting our longstanding policy of deference to legislative judgments in this field. In Berman v. Parker (1954), this Court upheld a redevelopment plan targeting a blighted area of Washington, D.C., in which most of the housing for the area's 5,000 inhabitants was beyond repair. Under the plan, the area would be condemned and part of it utilized for the construction of streets, schools, and other public facilities. The remainder of the land would be leased.
Outrage over the decision in this case led many states to pass legislation to protect private property rights and limit the government’s ability to condemn property. In fact, shortly after *Kelo* was decided, a survey by the Saint Index, a polling organization specializing in land use issues, found that 81 percent of Americans opposed the decision. Since *Kelo*, more than 40 states have passed legislation limiting the government’s ability to take private property and give it to private business. Some of these laws have included tightening the definition of public use or closing loopholes such as vague definitions of “blight.” In 2005, the House of Representatives introduced a bill to prevent “economic development” from being used to justify giving property to private business under eminent domain. It stalled in the Senate; a similar bill was introduced in the summer of 2007, but died without passage at the end of the year. In June of 2006, President Bush banned federal agencies from using eminent domain solely for “private development,” but allowed takings for private owners who promise to use the land for both private and “public” development. New “anti-*Kelo* legislation” may still be introduced in the future.

**Restrictions on Land Use**

No one is allowed to use his or her land in a completely unrestricted manner. As previously indicated, the doctrine of waste prohibits some uses and abuses of land. There are other such restrictions, both voluntary and involuntary.

---


**Eminent Domain in Germany**

Germany, much like the United States, is a federal system and has both federal and state (Länder) regulations regarding eminent domain. The federal laws on eminent domain are very similar to the laws in the United States, with a few notable differences. Germany is a civil-law system, rather than a common-law system, so most of its rules on eminent domain are written into statutes, rather than determined through court cases.

The federal government may expropriate land for the public good as long as it provides compensation. Germany’s Basic Law says: “Such compensation shall be determined by establishing an equitable balance between the public interest and the interests of those affected.” Compensation in the German system is not based on fair market value alone, but must also take the interests of those affected into consideration. Germans may dispute the amount of compensation in the ordinary courts.

A taking requires that the government have the legal authority for the taking. The taking must also be appropriate for accomplishing the government’s purpose, and done in the least intrusive way possible. This requirement means that the government cannot take property before it needs it, and the government can take only the property it needs. The taking must also pass a balancing test, showing that the public’s interest is greater than the owner’s interest. This last requirement is absent from the U.S. eminent domain laws.

Another difference is that if the property is no longer needed by the German government, it must revert to its former owner. In the United States, once the government has provided just compensation for the property, it belongs to the government.

The last major characteristic of eminent domain in Germany is currently being debated in the United States, as a result of the *Kelo* case. In Germany, the state cannot take property for purely private purposes (taking property and giving it to private business to spur the economy), but provision of economic benefits, such as job creation, can be an acceptable taking.

---

ZONING

Zoning is the restriction of the use of property to allow for the orderly growth and development of a community and to protect the health, safety, and welfare of its citizens. Zoning may restrict the type of use to which land may be put, such as residential, commercial, industrial, or agricultural. Zoning laws may also regulate land use in geographic areas on the basis of such factors as the intensity (single or multifamily dwellings), the size, or the placement of buildings.

When a community enacts new zoning ordinances, generally there is a public hearing on the proposed change in zoning. Often, the community allows a nonconforming use of a particular property to remain when the zoning of an area changes. This exception to the zoning law occurs when the property in question was being used for a purpose not allowed under the new zoning statutes, but because of the prior use, the owner is allowed to continue using the property in the nonconforming manner.

A landowner who wished to use her or his land in a manner prohibited by zoning laws may seek a variance from the appropriate governmental unit, usually a zoning board or a planning commission. A variance is permission to use a piece of land in a manner prohibited by the zoning laws. Variances are generally granted to prevent undue hardship.

Sometimes, persons negatively affected by a zoning law challenge that ordinance. Zoning is allowed under the police power, the power of the state to regulate to protect the health, safety, and welfare of the public. To be a valid exercise of such power, the zoning ordinance must not be arbitrary or unreasonable. An ordinance is unreasonable if (1) it encroaches on the private property rights of landowners without a substantial relationship to a legitimate government purpose, or (2) there is no reasonable relationship between the ends sought to be obtained and the means used to attain those ends.

Zoning is also unreasonable if it totally destroys the economic value of a property holder’s land. In such cases, the zoning is really a constructive taking of the property, and the party whose land is so affected is entitled to just compensation. This type of challenge is frequently made, but is rarely successful.

OTHER STATUTORY RESTRICTIONS ON LAND USE

In addition to zoning ordinances, states often use their police power to pass laws affecting individuals’ use of their property. For example, some states have passed historic preservation statutes whereby certain buildings with historical importance are subject to certain restrictions. Owners of such structures may be required to keep the buildings in good repair or might be required to have any alterations to the buildings’ facades approved prior to modification.

Like zoning laws, any laws restricting people’s use of their property may be subject to constitutional challenge. In Dolan v. City of Tigard, the Court clarified and toughened its requirement that government planners produce specific justifications when they condition building permits on a party’s rendering a portion of the property for public use.\(^6\) Plaintiff Dolan sought a permit from defendant City of Tigard to expand her store and pave her parking lot. The city conditioned the grant of her permit on her dedication of a portion of her property for a public greenway to minimize flooding that would otherwise be likely to result from her construction and a pedestrian/bicycle pathway to decrease congestion in the business district. The U.S. Supreme Court ruled that the city had to show some evidence that the expansion of the permit would cause the problems that would be fixed by the new regulations, as well as that the regulations would fix those problems. Simply stating that a larger store could cause more congestion and that a bicycle path could help clear up that congestion was not enough.

\(^6\) 114 S. Ct. 2309 (1994).
Personal Property

All property that is not real property is personal property. As previously explained, personal property may be either tangible or intangible. Tangible property includes movable items, such as furniture, cars, and other goods. Intangibles include such items as bank accounts, stocks, and insurance policies.

Because most intangibles (with the exception of some of those classified as intellectual property, discussed in Chapter 15) are evidenced by writings, most of the following discussion applies to both tangible and intangible property. The primary concerns that arise in conjunction with personal property involve (1) the means of acquiring ownership of the property and (2) the rights and duties arising out of a bailment. Both are discussed here in detail.

VOLUNTARY TRANSFER OF PERSONAL PROPERTY

The most common means by which personal property is acquired is by its voluntary transfer as a result of either a purchase or a gift. Ownership of property is referred to as title, and title to property passes when the parties so intend. When there is a purchase, the acquiring party gives some consideration to the seller in exchange for title to the property. In most cases, this transfer of ownership requires no formalities, although in a few cases changes of ownership must be registered with a government agency. The primary transfers requiring such formalities include sales of motor vehicles, watercraft, and airplanes. Transfer of such property requires that a certificate of title be signed by the seller, taken to the appropriate governmental agency, and then reissued in the name of the new owner.

Gifts are distinguished from purchases in that no consideration is given for a gift. As the reader knows, a promise to make a gift is, therefore, unenforceable. Once properly made, however, a gift is an irrevocable transfer.

For a valid gift to occur, three elements must be present (Exhibit 14-5). First, there must be a delivery of the gift. This delivery may be actual, that is, the physical presentation of the gift itself; or it may be constructive, that is, the delivery of an item that gives access to the gift or represents it, such as handing over the keys to a car. Second, the delivery must be made with donative intent to make a present, as opposed to future, gift. The donor makes the delivery with the purpose of turning over ownership at the time of delivery. The final element is acceptance, a willingness of the donee to take the gift from the donor. Usually, acceptance is not a problem, although a donee may not want to accept a gift because he or she does not want to feel obligated to the donor or because he or she believes that ownership of the gift may impose some unwanted legal liability.

INvoluntary Transfers of Personal Property

Involuntary transfers involve the transfer of ownership of property that has been abandoned, lost, or mislaid. The finder of such property may acquire ownership rights to such property through possession.

Abandoned property is property that the original owner has discarded. Anyone who finds that property becomes its owner by possessing it.

Lost property is property that the true owner has unknowingly or accidentally dropped or left somewhere. He or she has no way of knowing how to retrieve it. In most states, the finder of lost property has title to the lost good against all except the true owner.

Mislaid property differs from lost property in that the owner has intentionally placed the property somewhere but has forgotten its location. The person who owns the realty on which the mislaid property was placed has the right to...
hold the mislaid property. The reason is that it is likely that the true owner will return to the realty looking for the mislaid property.

In some states, the law requires that before becoming the owner of lost or mislaid property, a finder must place an ad in a newspaper that will give the true owner notice that the property has been found, or must leave the property with the police for a statutorily established reasonable period of time. Some state laws require both.

**BAILMENTS**

A bailment of personal property is a special relationship in which one party, the bailor, transfers possession of personal property to another, the bailee, to be used by the bailee in an agreed-on manner for an agreed-on time period.

One example of a bailment is when a person leaves his or her coat in a coat-check room. The person hands the coat to the clerk and is given a ticket identifying the object of the bailment so that it can be reclaimed. The bailment may be gratuitous or for consideration. It may be to benefit the bailor, the bailee, or both. If the bailment is intended to benefit only the bailor, the bailee is liable for damage to the property caused by the bailee’s gross negligence. If the bailment is solely for the bailee’s benefit, then the bailee is responsible for harm to the property caused by even the slightest lack of due care on the part of the bailee. If the bailment is for the mutual benefit of both bailor and bailor, the bailee is liable for harm to the bailed property arising out of the bailor’s ordinary or gross negligence. If the property is harmed by an unpreventable “act of God,” there is no liability on the part of the bailee under any circumstances. These general rules notwithstanding, the parties to a bailment contract can limit or expand the liability of the bailee by contract. In general, conspicuous signs (e.g., “We are not responsible for lost items”) have been held sufficient to limit liability.

If the bailee is to receive compensation for the bailment, the bailee may retain possession of the bailed property until payment is made. In most states, when the bailor refuses to provide the agreed-on compensation to the bailee, the property may ultimately be sold by the bailee after proper notice and a hearing. The proceeds are first used to pay the bailee and to cover the costs of the sale. The remaining proceeds then go to the bailor.

In addition to the duty to pay bailees their agreed-on compensation, a bailor must also warn the bailee of any hidden defects in the bailed goods. If such a warning is not given and the defect injures the bailee, the bailor is liable to the bailee for the injuries.

**Global Dimensions of Property Law**

United States citizens are increasing purchasing property abroad. There are some advantages, as well as disadvantages. It is certainly a way to diversify your investments; when the real estate market falls here, it isn’t necessarily going to fall in China. Another advantage may be that you may gain certain rights in the country where you buy property. For example, if you purchase property in Dubai, you will automatically receive a visa that will allow you to do business there.

Of course, there are dangers, too. For example, it is probably best to invest in a place where the currency is fairly stable, because a huge slide in the value of the currency of the nation where you purchased the property could lead to a significant decline in the value of your asset, especially if you are suddenly forced to sell and the currency has declined since you purchased the property.

Another factor to consider when investing in real estate in a foreign country is the political stability of the country. If you are buying in the European Union, you can probably count on the laws remaining fairly stable, but in a country with a less stable political system, a coup could result in a dramatic
change in the laws of property ownership, which might even lead to your property being confiscated.

Regardless of where you choose to purchase property, however, before you invest, it is important to make sure you thoroughly understand the laws governing property ownership and transfer in that country because every country has its own set of laws. Do not assume that just because the law works one way in the United States it is the same in any other nation. In fact, you should not even assume before checking that you can buy property in the country of your dreams because some nations place significant restrictions on the ability of foreigners to buy their property. For example, Mexico's constitution forbids foreigners from owning any real estate within 30 miles from the coastline or 60 miles from any U.S. border.

One final point to keep in mind when thinking about buying real estate in foreign countries is that U.S. mortgage companies generally will not finance purchases of foreign real estate, so you will need to obtain financing in the country where you are buying. Therefore, you also need to become familiar with the country's laws regarding lending. As the world becomes a smaller place, however, buying property in foreign countries will become increasingly common.

SUMMARY

Property is a bundle of rights in relation to a tangible object, the most significant of which is probably the right to exclude others. Property can be divided into three categories: real property, land and anything permanently attached to it; personal property, tangible movable objects and intangible objects; and intellectual property, property that is primarily the result of one's mental rather than physical efforts. Real property can be transferred voluntarily or involuntarily. Voluntary transfers include transfer by gift or sale. Adverse possession and condemnation are the two involuntary means. Personal property likewise can be transferred voluntarily through a gift or sale. It may also be transferred involuntarily if it is lost or mislaid.

REVIEW QUESTIONS

14-1 Explain why each of the following is or is not real property.
   a. A fence
   b. A tree
   c. A house trailer
   d. A built-in oven
   e. A refrigerator

14-2 Define the primary estates in land.

14-3 Explain the circumstances under which each of the following types of ownership would be most desirable. Give reasons for your responses.
   a. Joint tenancy
   b. Tenancy in common
   c. Tenancy by the entirety

14-4 Explain how the ownership of land may be transferred.

14-5 Explain how a general warranty deed differs from a quitclaim deed.

14-6 What are the similarities and differences between condemnation and adverse possession?
REVIEW PROBLEMS

14-7 Carlos owns a life estate in Morganberry Farms. The farm consists of five acres, with a house and landscaping located on one half acre, and corn being raised on the other 4.5 acres. Carlos decides to cover one of the acres that was being used for corn with asphalt so that he can charge people to park on the property during the summer when local fairs and festivals are held in the area. The future owner of the estate hears of these plans and seeks an injunction prohibiting Carlos from asphalting over the acre. Why will the court either grant or deny the injunction?

14-8 The Hortons bought a home in a development that was subject to a set of CC&Rs, which included a restriction requiring homeowners to submit plans for changing their front landscaping for approval by the architectural control committee before any changes were made. Among the items included in a list of prohibited landscaping materials was artificial grass. The state was encouraging residents to save water by offering to pay residents $60 for every square foot of grass they replaced with either rock or artificial grass. The Hortons wished to take advantage of this option and submitted plans to replace their grass with artificial grass. When the architectural review committee refused to approve their plans, the Hortons decided to change their landscaping anyway. Are they within their legal rights to do so? What do you believe are the strongest arguments on each side?

14-9 The plaintiff owned land in an area zoned for buildable private parks. The city rezoned the land to allow only parks open to the public. This rezoning effectively prohibited the plaintiff from generating any sort of income from the land. Was the plaintiff correct in his contention that this constituted a deprivation of property without due process of law?

14-10 An athletic team wants to build a new sports arena in the middle of the downtown area. The team has bought enough land for the stadium, but needs more land to build an adjacent parking lot. The team asks the city to take the necessary property from the residents and transfer it to the team so they can build the arena. Would it be lawful for the city to do so? If so, how? If not, why not?

14-11 Judy worked the morning shift at Wild Oats. She bought a Pepsi but got too busy to drink it, so she left it on a shelf behind the counter to drink the next day. Cindy was working that afternoon. She got thirsty and asked her coworkers if the Pepsi belonged to any of them. When no one claimed it, she opened the bottle, saw some fine print on the underside of the cap, and read, “You have won a million dollars.” When Judy found out what happened, she confronted Cindy and claimed the prize as hers. Explain who should receive the prize money and why.

14-12 Hallman spent the night at the New Colonial Hotel. On inquiry, he was told that the bellboy would take care of his car. The bellboy took the car to a nearby parking lot and left the car and keys with the lot attendant. He gave Hallman a claim check bearing the name of the lot and stamped “New Colonial.” When Hallman went to pick up his car, the side window was broken and more than $500 worth of personal property was missing. Who was liable for the missing personalty and the damage to the car? Why?

CASE PROBLEMS

14-13 Welch lived next door to a vacant lot. She built a woodshed and landscaping on her property that partially encroached on that vacant lot. For seven years, the owners of the lot never objected, but when the Harrisons bought the lot in 2001, a survey they had done in conjunction with the purchase revealed the encroachment. The Harrisons sued Welch to establish their title to the entire lot and to enjoin Welch’s encroachment. Welch responded by seeking to establish title in the encroachment area by a prescriptive easement to maintain the woodshed and the landscaping. The trial court held for the Harrisons. Welch appealed. What do you think should have happened on appeal and why? Harrison v. Welch, 11 Cal. Rptr. 3d 92 (Cal. Ct. App. 2004).

14-14 Tim and Diana Gleason and Randy and Susan Estes allege that Albert Taub, a construction manager, trespassed on their property and removed large quantities of dirt (while destroying the vegetation) with a bulldozer for use on another property. Taub argued that the Gleasons and the Esteses did not have standing to sue, because that part of their property was actually a public easement and the ownership of the public was superior to the fee ownership and that only the public should be able to sue him. Moreover, he argued that the law allowed him to remove dirt and
vegetation because it improved the flow of water, the
original purpose of the easement. The trial court
granted Taub’s plea on lack of jurisdiction and his
motion for summary judgment on the grounds that he
had no duty to stay off the property and that he was
legally allowed to remove the dirt. The property own-
ers appealed. Did the court rule to allow Taub access
to the easement and its dirt? How do you think the
court decided and why? *Gleason v. Taub*, 180 S.W.3d
711 (Tex. App. 2005).

14-15 The CC&Rs for Marquesa at Monarch Beach
provided that all trees on a lot had to be trimmed so as
not to exceed the roof of the house unless the tree did
not obstruct views from other lots. The provision
further gave the determination of whether trees ob-
structed views to the sole judgment of the associa-
tion’s architectural committee. The association’s board
(including one member who had more than 20 palm
trees on his lot) took the position that, because trim-
mimg a palm tree would effectively require its removal,
the CC&R requirement did not apply to palm trees.
The board refused to enforce the “view” provision of
the CC&Rs against owners who had planted palm
trees. Individual homeowners whose views were inter-
fereed with by several palm trees sued the association
to force them to enforce the CC&R requirements. The
trial court held that the homeowners’ association was
exercising its discretion in exempting the palm trees.
How do you think the appellate court ruled, and why?

14-16 A church owns and occupies several lots
within a subdivision in the Country Club District in
Kansas City. When the church proposed the building
of a new parking lot, the nonprofit association over-
seeing the Country Club District filed suit to enforce
a restrictive covenant that precluded building on any
lots for anything other than “private residence pur-
poses.” The trial court ruled in favor of the association
and the church appealed, claiming that circumstances
had changed so as to make the restrictive covenant un-
enforceable. Was the church successful with its argu-
ment? Why or why not? *Country Club District Homes
Association v. Country Club Christian Church*, 118
S.W.3d 185 (Mo. Ct. App. 2003).

14-17 The plaintiff parked his motorcycle in the de-
fendant’s parking garage, from which it was allegedly
stolen. The plaintiff had parked his motorcycle with-
out assistance and retained his keys. The parties’ rela-
tionship was governed by a written “Garage
Agreement,” which provided that the plaintiff
“licensee” parked at his “own risk.” The plaintiff sued
to recover the value of his motorcycle. The trial court
found that there was no bailment and dismissed the
case. How do you think the appellate court ruled?

**Eminent Domain and Democracy**

A democracy is based on the idea that for many pur-
poses, the best decision-making framework is to re-
solve difficult issues by following the wishes of the
representatives of majority opinion. Therefore, when a
duly elected group of County Commissioners or a
local city council decide that a piece of land would be
best used for the public purpose of expanding employ-
ment opportunities in the community, it would seem
to follow that supporters of democracy would go
along quietly with the decision.

But there are few legal issues that cause more con-
lict than a dispute over the use of eminent domain.
The idea itself is not the problem. Almost all would
agree that there are certain functions in the com-
unity (a school perhaps) that are so crucial to its on-
going growth and development that we need to be able
to take land for a public purpose.

But what in the abstract seems so clear becomes a
nightmare, when it is my or your property that is be-
ing taken. That property may have been owned and
cherished by our family for decades; friendships and
comfort zones with local businesses may have flow-
ered as a result of numerous ongoing contacts. We do
not want to give up any of these things that make our
lives so comfortable.

In addition, when eminent domain is used, it is
not just something abstract like the community that
may benefit. Instead, specific people benefit. Regard-
less of how the eminent domain argument is made,
those who will benefit from the construction and later
uses of the land are special beneficiaries who have a
vested interest in translating their personal interest
into public-benefit arguments for purpose of activating
eminent domain. Those being forced to sell their land
are quick to point out the private benefits flowing
from this alleged public good.
Also lurking not so hidden in the background is a theme developed earlier in this chapter. The more powerful a group is, the more likely it is going to be the party pushing for the use of eminent domain. They, of course, word the issue in terms of the projected public benefit. But opponents wonder out loud whether they are not simply abusing their financial power to achieve yet one more advantage in a market economy where influence is often shaped by dollar votes.

Returning to the relationship between democracy and eminent domain, there are a number of questions that arise for a critical thinker pondering any eminent domain controversy.

1. What specific information would be needed to assist in making an intelligent decision about the issues raised in the potential tension between democracy and eminent domain?

2. What ambiguous words need to be clarified before an eminent domain controversy can be fairly decided?

3. How does this issue make it clear that the way a legal issue is framed or understood goes a long way toward telling us who will win the dispute?

4. How would you word the issue here if you were arguing on behalf of opponents to an eminent domain action?

   Clue: Think about what is required for a decision to be thoughtfully democratic? In other words, democracy relies on majority opinions, but some opinions are better formed than others. What would have to be true before you would support the decision of a majority of citizens?

ASSIGNMENT ON THE INTERNET

This chapter introduced you to government regulation and protection of various forms of property. One such regulation and protection used by the government is zoning. Using the following Web sites (www.megalaw.com/top/zoning.php would be most useful), find a recent court case in which a zoning law was challenged or where the plaintiff argued that a zoning law resulted in a taking of property.

Once you have found such a case, identify the court’s reasoning and the ethical norms underlying that reasoning. Was the particular zoning law found to be unreasonable? Now compare the reasoning of your case to that of Dolan v. City of Tigard. Are the ethical norms different or the same?

ON THE INTERNET

www.lucs.org The Land Use Controls site provides information about institutional controls in such areas as brownfields and Superfund sites.

www.megalaw.com/top/zoning.php Visit this site for recent court cases on zoning issues and links to local governments’ zoning laws and regulations.

FOR FUTURE READING


Introduction to Intellectual Property

*Intellectual property* consists of the fruits of one’s mind. The laws of intellectual property protect property that is primarily the result of mental creativity rather than physical effort. This category includes trademarks, trade secrets, patents, and copyrights, which are discussed in that order, in this chapter.

**Trademarks**

A trademark is a distinctive mark, word, design, picture, or arrangement used by the producer of a product that tends to cause consumers to identify the product with the producer.

---

**CRITICAL THINKING ABOUT THE LAW**

1. In Chapter 14 you studied real and personal property. Why might the legal rules for intellectual property be different in any fashion?
   
   *Clue:* Consider the different attitudes we might have toward the results from thinking and the output from physical exertion.

2. Some argue that intellectual property should be available for everyone once it is produced by someone’s mind. What ethical norm underlies this attitude toward sharing mental output?
   
   *Clue:* Should a person benefit because her mind creates an idea that other minds, for some reason, did not produce?

3. If an idea becomes a legal source of great wealth for a person, what information about the “discovery” would cause you to be more supportive of protecting the property right to the fruits of the discovery?
   
   *Clue:* The play and movie, *Amadeus,* suggest that Mozart’s brilliant compositions resulted more from his genius than from any hard work on his part.
Even though the description of a trademark is very broad, there has still been substantial litigation over precisely what features can and cannot serve as a trademark. A sound (NBC’s three chimes), a scent (plumeria blossoms or sewing thread), and even a color (green-gold of Qualitex dry-cleaning press pads) have all been found to constitute trademarks, because they distinguish the goods as unique and serve to identify their source.

A trademark used intrastate is protected under state common law. To be protected in interstate use, the trademark must be registered with the U.S. Patent Office under the Lanham Act of 1947. Several types of marks, listed in Table 15-1, are protected under this act.

If a mark is registered, the holder of the mark may recover damages from an infringer who uses that mark to pass off its own goods as those of the mark holder. The mark owner may also obtain an injunction prohibiting the infringer from using the mark. Only the latter remedy is available for an unregistered mark.

To register a mark with the Patent Office, one must submit a drawing of the mark and indicate when it was first used in interstate commerce and how it is used. The Patent Office conducts an investigation to verify these facts and will register a trademark as long as it is not generic, descriptive, immoral, deceptive, the name of a person whose permission has not been obtained, or substantially similar to another’s trademark.

It is sometimes difficult to determine whether a trademark will be protected, and once the trademark is issued, it is not always easy to predict when a similar mark will be found to infringe upon the registered trademark. The following case demonstrates a typical analysis used in a trademark-infringement suit.

**CASE 15-1**

**Toys “R” Us, Inc., v. Canarsie Kiddie Shop, Inc.**

District Court of the Eastern District of New York


Beginning in 1960, Plaintiff Toys “R” Us, Inc., sold children’s clothes in stores across the country. The firm obtained a registered trademark and service mark for Toys “R” Us in 1961 and aggressively advertised and promoted its products using these marks. In the late 1970s, Defendant Canarsie Kiddie Shop, Inc., opened two children’s clothing stores within two miles of a Toys “R” Us shop and contemplated opening a third. The owner of Canarsie Kiddie Shop, Inc., called the stores Kids “r” Us. He never attempted to register the name. Toys “R” Us sued for trademark infringement in the federal district court.

**Judge Glasser**

In assessing the likelihood of confusion and in balancing the equities, this Court must consider the now classic factors.

1. **Strength of the Senior User’s Mark**

“The term ‘strength’ as applied to trademarks refers to the distinctiveness of the mark, or more precisely, its tendency to identify goods sold under the mark as emanating from the particular, although possibly anonymous, source.” A mark can fall into one of four general categories, which, in order of ascending strength, are: (1) generic; (2) descriptive; (3) suggestive; and (4) arbitrary or fanciful. The strength of a mark is generally dependent both on its place upon the scale and on whether it has acquired secondary meaning.

A generic term “refers, or has come to be understood as referring to the genus of which the particular product is a species.” A generic term is entitled to no trademark protection whatsoever, since any manufacturer or seller has the right to call a product by its name.
A descriptive mark identifies a significant characteristic of the product, but is not the common name of the product. A mark is descriptive if it “informs the purchasing public of the characteristics, quality, functions, uses, ingredients, components, or other properties of a product, or conveys comparable information about a service.” To achieve trademark protection a descriptive term must have attained secondary meaning, that is, it must have “become distinctive of the applicant’s goods in commerce.”

A suggestive mark is one that “requires imagination, thought, and perception to reach a conclusion as to the nature of the goods.” These marks fall short of directly describing the qualities or functions of a particular product or service, but merely suggest such qualities. If a term is suggestive, it is entitled to protection without proof of secondary meaning.

Arbitrary or fanciful marks require no extended definition. They are marks which in no way describe or suggest the qualities of the product.

The Toys “R” Us mark is difficult to categorize.

The strength of the plaintiff’s mark must be evaluated by examining the mark in its entirety. . . . I agree that the Toys “R” Us mark serves to describe the business of the plaintiff, and in this sense is merely descriptive. This descriptive quality, however, does require some “imagination, thought, and perception” on the part of the consumer since the plaintiff’s mark, read quite literally, conveys the message, “we are toys,” rather than “we sell toys.”

Whether the “leap of imagination” required here is sufficient to render the mark suggestive rather than descriptive is a question with no clear-cut answer. Such an absolute categorization is not essential, however, since the defendants concede that through the plaintiff’s marketing and advertising efforts the Toys “R” Us mark has acquired secondary meaning in the minds of the public, at least in relation to its sale of toys. Such secondary meaning assures that the plaintiff’s mark is entitled to protection even if it is viewed as merely descriptive. Because I find that through the plaintiff’s advertising and marketing efforts the plaintiff’s mark has developed strong secondary meaning as a source of children’s clothing, it is sufficient for purposes of this decision to note merely that the plaintiff’s mark is one of medium strength, clearly entitled to protection, but falling short of the protection afforded an arbitrary or fanciful mark.

2. Degree of Similarity between the Two Marks

[T]he key inquiry is . . . whether a similarity exists which is likely to cause confusion. This test must be applied from the perspective of prospective purchasers. Thus, it must be determined whether “the impression which the infringing [mark] makes upon the consumer is such that he is likely to believe the product is from the same source as the one he knows under the trademark.” In making this determination, it is the overall impression of the mark as a whole that must be considered.

Turning to the two marks involved here, various similarities and differences are readily apparent. The patent similarity between the marks is that they both employ the phrase, “R” Us. Further, both marks employ the letter “R” in place of the word “are,” although the plaintiff’s mark uses an inverted capitalized “R,” while the defendants generally use a non-inverted lower case “r” for their mark.

The most glaring difference between the marks is that in one the phrase “R” Us is preceded by the word “Toys,” while in the other it is preceded by the word “Kids.” Other differences include the following: plaintiff’s mark ends with an exclamation point, plaintiff frequently utilizes the image of a giraffe alongside its mark, plaintiff’s mark is set forth in stylized lettering, usually multi-colored, and plaintiff frequently utilizes the words, “a children’s bargain basement” under the logo in its advertising.

I attach no great significance to the minor lettering differences between the marks, or to the images or slogans usually accompanying the plaintiff’s mark. . . . While the marks are clearly distinguishable when placed side by side, there are sufficiently strong similarities to create the possibility that some consumers might believe that the two marks emanated from the same source. The similarities in sound and association also create the possibility that some consumers might mistake one mark for the other when seeing or hearing the mark alone. The extent to which these possibilities are “likely” must be determined in the context of all the factors present here.

3. Proximity of the Products

Where the products in question are competitive, the likelihood of consumer confusion increases. . . . [B]oth plaintiff and defendants sell children’s clothing; . . . the plaintiff and defendants currently are direct product competitors.

4. The Likelihood That Plaintiff Will “Bridge the Gap”

“Bridge the gap” refers to two distinct possibilities: first, that the senior user presently intends to expand his sales efforts to compete directly with the junior user, thus creating the likelihood that the two products will be directly competitive; second, that while there is no present intention to bridge the gap, consumers will assume otherwise and conclude, in this era of corporate diversification, that the parties are related companies. . . . I find both possibilities present here.

5. Evidence of Actual Confusion

Evidence of actual confusion is a strong indication that there is a likelihood of confusion. It is not, however, a prerequisite for the plaintiff to recover.

6. Junior User’s Good Faith

The state of mind of the junior user is an important factor in striking the balance of the equities. In the instant case, Mr. Pomeranc asserted at trial that he did not recall whether he was aware of the plaintiff’s mark when he chose to name his store Kids “r” Us in 1977.

I do not find this testimony to be credible. In view of the proximity of the stores, the overlapping of their products,
and the strong advertising and marketing effort conducted by the plaintiff for a considerable amount of time prior to the defendants’ adoption of the name Kids “r” Us, it is difficult to believe that the defendants were unaware of the plaintiff’s use of the Toys “R” Us mark.

The defendants adopted the Kids “r” Us mark with knowledge of plaintiff’s mark. A lack of good faith is relevant not only in balancing the equities, but also is a factor supporting a finding of a likelihood of confusion.

7. Quality of the Junior User’s Product
If the junior user’s product is of a low quality, the senior user’s interest in avoiding any confusion is heightened. In the instant case, there is no suggestion that the defendants’ products are inferior, and this factor therefore is not relevant.

8. Sophistication of the Purchasers
The level of sophistication of the average purchaser also bears on the likelihood of confusion. Every product, because of the type of buyer that it attracts, has its own distinct threshold for confusion of the source or origin.

The goods sold by both plaintiff and defendants are moderately priced clothing articles, which are not major expenditures for most purchasers. Consumers of such goods, therefore, do not exercise the same degree of care in buying as when purchasing more expensive items. Further, it may be that the consumers purchasing from the plaintiff and defendants are influenced in part by the desires of their children, for whom the products offered by plaintiff and defendants are meant.

[A] powerful equitable argument against finding infringement is created when the junior user, through concurrent use of an identical trademark, develops goodwill in their [sic] mark. Defendants have not expended large sums advertising their store or promoting its name. Further, it appears that most of the defendants’ customers are local “repeat shoppers,” who come to the Kids “r” Us store primarily because of their own past experiences with it. In light of this lack of development of goodwill, I find that the defendants do not have a strong equitable interest in retaining the Kids “r” Us mark.

Conclusion on Likelihood of Confusion

[T]he defendants’ use of the Kids “r” Us mark does create a likelihood of confusion for an appreciable number of consumers.

In reaching this determination, I place primary importance on the strong secondary meaning that the plaintiff has developed in its mark, the directly competitive nature of the products offered by the plaintiff and defendants, the plaintiff’s substantially developed plans to open stores similar in format to those of the defendants’, the lack of sophistication of the purchasers, the similarities between the marks, the defendants’ lack of good faith in adopting the mark, and the limited goodwill the defendants have developed in their mark.

Judgment for the Plaintiff, Toys “R” Us.

CRITICAL THINKING ABOUT THE LAW

Legal reasoning and decision making almost always entail a reliance on tradition. In Case 15-1, the court’s deference to tradition is especially strong. In applying the “classic factors” to the case, the court judges the present case on the basis of the way in which an allegedly similar earlier case was judged.

The implications of relying on tradition in legal reasoning are quite significant. The questions that follow will help you to consider this significance more deeply.

1. To demonstrate your ability to recognize analogous reasoning, identify the implicit analogy that pervades the court’s reasoning in Case 15-1.
   
   **Clue:** Consider the source of the “classic factors.”

2. What important piece of missing information hinders your ability to make a sound critical judgment about the appropriateness of the court’s reasoning?
   
   **Clue:** Refer to your answer to Question 1; it is directly related to this question.

The potential for consumer confusion seems to be a very important consideration in a trademark-infringement case. In the “Dentyne Ice” chewing gum case, the court ruled that there was little possibility for consumer confusion between “Dentyne Ice” and “Icebreakers” because Dentyne was a common household name; thus, Dentyne did not infringe on Nabisco’s trademark.
TRADE DRESS

The term **trade dress** refers to the overall appearance and image of a product. Trade dress is entitled to the same protection as a trademark. To succeed on a claim of trade-dress infringement, a party must prove three elements: (1) the trade dress is primarily nonfunctional; (2) the trade dress is inherently distinctive or has acquired a secondary meaning; and (3) the alleged infringement creates a likelihood of confusion.

The main focus of a case of trade-dress infringement is usually on whether or not there is likely to be consumer confusion. For example, in a 1996 case, Tour 18, Limited, a golf course, copied golf holes from famous golf courses without permission of the course owners. In copying a hole from one of the most famous courses in the country, Harbour Town Hole 19, the defendant even copied the Harbour Town Lighthouse, which is the distinctive feature of that hole. In its advertising, Tour 18 prominently featured pictures of this hole, including the lighthouse. The operator of the Harbour Town course sued Tour 18 for trade-dress infringement. The court found that there was infringement and made Tour 18 remove the lighthouse and disclaim in its advertising any affiliation with the owner of the Harbour Town course.

Trade-dress violations occur over a wide range of products. Two very different examples of trade-dress infringement include *Bubba’s Bar-B-Q Oven v. Holland Co.*, and *Two Pesos v. Taco Cabana*. In the first case, Bubba’s had almost exactly copied the physical appearance of Holland Company’s very successful gas-fired barbecue grill, which the court found to be trade-dress infringement. In the second case, the court found that Taco Cabana’s trade dress consisted of “a festive eating atmosphere having interior dining and patio areas decorated with artifacts, bright colors, paintings and murals”; “a patio that has interior and exterior areas with the interior patio capable of being sealed off from the outside patio by overhead garage doors”; a stepped exterior of the building that has “a festive and vivid color scheme using top border paint and neon stripes”; and “bright awnings and umbrellas.” When Two Pesos opened a series of competing Mexican restaurants that mimicked those features almost exactly, the court found Two Pesos guilty of trade-dress infringement.

A claim of trade-dress infringement is often accompanied by a claim of trademark infringement. For example, the Chippendales name is protected as a trademark, and their dancers’ costume—cuffs and a collar—is protected as trade dress. Chippendales sued a European gaming machine manufacturer who had made and distributed “Chickendale’s” slot machines featuring dancing chickens wearing cuffs and collars. The case settled in 2010 with Chippendale’s receiving a cash settlement and the transfer of the mark Chickendale’s to them.

FEDERAL TRADEMARK DILUTION ACT OF 1995

Under the Lanham Act, trademark owners were protected from the unauthorized use of their marks on only competing goods or related goods where the use might lead to consumer confusion. Consequently, a mark might be used without permission on completely unrelated goods, thereby potentially diminishing the value of the mark. In response to this problem, a number of states passed trademark

---

2 175 F.3d 1013; Docket No. 98-1029 (4th Cir. 1999).
Trademarks and Domain Names

If a business has a very strong trademark, what better domain name to have than that trademark? Unfortunately, the same trademark may be owned by two companies selling noncompeting goods, yet there can be only one user of any single domain name.

Domain names are important because they are the way people and businesses are located on the Web. A domain name is made up of a series of domains separated by periods. Most Web sites have two domains. The first-level domain, the one that the address ends with, generally identifies the type of site. For example, if it is a government site, it will end in gov. An educational site will end in edu, a network site in net, an organization in org, and a business in com or biz. These top-level domain names are the same worldwide.

Until recently, these top-level domain names had to be in Latin language script. However, as of mid-2010, four countries (Egypt, the Russian Federation, Saudi Arabia, and the United Arab Emirates) have been authorized to use their own non-Latin language scripts in the top-level domain portion of their Internet address names.

The second-level domain is usually the name of whoever maintains the site. For a college, for example, it would be an abbreviation of the college, as in bgsu. Businesses generally use their firm name or some other trademark associated with their product, because that name will obviously make it easier for their customers to find them.

So, how does a firm go about securing a domain name that reflects its trademark? The Internet Corporation for Assigned Names and Numbers (ICANN) is the nonprofit corporation that is responsible for coordinating technical Internet functions, including the management of the domain name system. ICANN has accredited a number of companies, called registrars, to issue domain names to the public and place their owners’ information on the registry. Network Solutions, Inc. (NSI), which is funded by the National Science Foundation, was the first registrar, but has now been joined by several other firms. A list of ICANN-accredited registrars can be found at http://www.icann.org/en/registrars/accredited-list.html.

Anyone seeking to register a domain name should contact one of these registrars and provide the necessary contact information so that a domain name can be issued. A registrant must now state in its application that the name will not infringe on anyone else’s intellectual property rights, that the name is not being registered for an unlawful purpose, that statements in the registration agreement are complete and accurate, and that the domain name will not be knowingly used in violation of any law. Registrars have the flexibility to offer initial and renewal registrations in one-year increments, for up to 10 years.

Domain names may be cancelled or transferred when a complaint is filed with ICANN and the dispute is resolved against a registrant in an administrative proceeding held in accordance with the Uniform Domain Name Dispute Resolution Policy. Claims subject to dispute resolution include allegations that your domain name is confusingly similar to a trademark or service mark in which the complainant has rights and that your domain name has been registered and is being used in bad faith.a

Some firms have tried to get the domain name they desire by going to another country. That alternative is certainly a possibility. Many countries, however, require that a firm be incorporated within their borders before it can gain the right to the domain name there. Also, an additional problem is that trademark law relating to domain names is even more unclear abroad.

For the new entrepreneur, the best advice is to try simultaneously apply for federal trademark protection and register the domain name; for those not yet on the Web, the sooner you get your domain name, the more likely you are to get the name you want. Moreover, if you feel that your mark is being violated by another’s domain name, you may want to sue them for infringement, because the unauthorized use of another’s trademark in a domain name has been found to be illegal. You may, however, be in for quite a fight, because this is a new area of the law.


dilution laws, which prohibited the use of “distinctive” or “famous” trademarks, such as McDonald’s, even without a showing of consumer confusion.

In 1995, Congress made similar protection available at the federal level by passing the Federal Trademark Dilution Act of 1995 (FTDA). In one of the first cases decided under this law, the court said that the protection available under
this act extended not just to identical marks but also to similar marks. In that case, Ringling Brothers–Barnum & Bailey challenged Utah’s use of the slogan “The Greatest Snow on Earth” as diluting its famous slogan, “The Greatest Show on Earth.” In denying Utah’s motion to dismiss because the slogans were not identical, the court said that the marks need not be identical.

CASE 15-2

Supreme Court of the United States

Petitioners, Victor and Cathy Moseley, own and operate an adult novelty store named “Victor’s Secret” in a strip mall in Elizabethtown, Kentucky. An army colonel saw an advertisement for the store and thought petitioners were using a reputable trademark to promote unwholesome merchandise, so he sent a copy of the advertisement to respondents, the corporations that own the Victoria’s Secret trademarks. These corporations operate more than 750 Victoria’s Secret stores and spent more than $55 million advertising their brand in 1998.

Respondents asked petitioners to discontinue using the name, and they responded by changing the store’s name to “Victor’s Little Secret.” Respondents then filed a lawsuit containing four separate claims for (1) trademark infringement, alleging that petitioners’ use of their trade name was “likely to cause confusion and/or mistake”; (2) unfair competition, alleging misrepresentation; (3) “federal dilution” in violation of the FTDA; and (4) trademark infringement and unfair competition in violation of the common law of Kentucky. The dilution count was premised on the claim that petitioners’ conduct was “likely to blur and erode the distinctiveness” and “tarnish the reputation” of the Victoria’s Secret trademark.

Finding that the record contained no evidence of actual confusion between the parties’ marks, the district court concluded that “no likelihood of confusion exists as a matter of law” and entered summary judgment for the Moseleys on the infringement and unfair competition claims. With respect to the FTDA claim, however, the court ruled for V Secret Catalogue, and the Moseleys appealed. The Sixth Circuit affirmed, finding that respondents’ mark was “distinctive” and that the evidence established “dilution” even though no actual harm had been proved.

Justice Stevens

The Victoria’s Secret mark is unquestionably valuable and petitioners have not challenged the conclusion that it qualifies as a “famous mark” within the meaning of the statute. Moreover, as we understand their submission, petitioners do not contend that the statutory protection is confined to identical uses of famous marks, or that the statute should be construed more narrowly in a case such as this.

The District Court’s decision in this case rested on the conclusion that the name of petitioners’ store “tarnished” the reputation of respondents’ mark, and the Court of Appeals relied on both “tarnishment” and “blurring” to support its affirmance. Petitioners have not disputed the relevance of tarnishment, presumably because that concept was prominent in litigation brought under state antidilution statutes and because it was mentioned in the legislative history. . . . Indeed, the contrast between the state statutes, which expressly refer to both “injury to business reputation” and to “dilution of the distinctive quality of a trade name or trademark,” and the federal statute which refers only to the latter, arguably supports a narrower reading of the FTDA.

The relevant text of the FTDA provides that “the owner of a famous mark” is entitled to injunctive relief against another person’s commercial use of a mark or trade name if that use “causes dilution of the distinctive quality” of the famous mark. This text unambiguously requires a showing of actual dilution, rather than a likelihood of dilution.

This conclusion is fortified by the definition of the term “dilution” itself. That definition provides:

“The term ‘dilution’ means the lessening of the capacity of a famous mark to identify and distinguish goods or services, regardless of the presence or absence of—

“(1) competition between the owner of the famous mark and other parties, or

“(2) likelihood of confusion, mistake, or deception.”

The contrast between the initial reference to an actual “lessening of the capacity” of the mark, and the later reference to a “likelihood of confusion, mistake, or deception” in the second caveat confirms the conclusion that actual dilution must be established.

Of course, that does not mean that the consequences of dilution, such as an actual loss of sales or profits, must also be proved. . . . We do agree, however, with that court’s conclusion that, at least where the marks at issue are not identical, the mere fact that consumers mentally associate the junior user’s mark with a famous mark is not sufficient to establish actionable dilution. As the facts of that case demonstrate, such mental association will not necessarily
reduce the capacity of the famous mark to identify the goods of its owner, the statutory requirement for dilution under the FTDA. For even though Utah drivers may be reminded of the circus when they see a license plate referring to the “greatest snow on earth,” it by no means follows that they will associate “the greatest show on earth” with skiing or snow sports, or associate it less strongly or exclusively with the circus. “Blurring” is not a necessary consequence of mental association. (Nor, for that matter, is “tarnishing.”)

The record in this case establishes that an army officer who saw the advertisement of the opening of a store named “Victor’s Secret” did make the mental association with “Victoria’s Secret,” but it also shows that he did not therefore form any different impression of the store that his wife and daughter had patronized. There is a complete absence of evidence of any lessening of the capacity of the Victoria’s Secret mark to identify and distinguish goods or services sold in Victoria’s Secret stores or advertised in its catalogs. The officer was offended by the ad, but it did not change his conception of Victoria’s Secret. His offense was directed entirely at petitioners, not at respondents. Moreover, the expert retained by respondents had nothing to say about the impact of petitioners’ name on the strength of respondents’ mark.

Noting that consumer surveys and other means of demonstrating actual dilution are expensive and often unreliable, respondents and their amici argue that evidence of an actual “lessening of the capacity of a famous mark to identify and distinguish goods or services” may be difficult to obtain. It may well be, however, that direct evidence of dilution such as consumer surveys will not be necessary if actual dilution can reliably be proved through circumstantial evidence—the obvious case is one where the junior and senior marks are identical. Whatever difficulties of proof may be entailed, they are not an acceptable reason for dispensing with proof of an essential element of a statutory violation. The evidence in the present record is not sufficient to support the summary judgment on the dilution count, and the judgment is therefore reversed.

Judgment for Petitioners.

Trade Secrets

A trade secret is a process, product, method of operation, or compilation of information that gives a businessperson an advantage over his or her competitors. Inventions and designs may also be considered trade secrets. A trade secret is protected by the common law from unlawful appropriation by competitors as long as it is kept secret and comprises elements not generally known in the trade.

Competitors may discover the “secret” by any lawful means, such as reverse engineering or by going on public tours of plants and observing the use of trade secrets. Discovery of the secret means there is no longer a trade secret to be protected.

To enjoin a competitor from continuing the use of a trade secret, or to recover damages caused by the use of the secret, a plaintiff must prove that:

1. a trade secret actually existed;
2. the defendant acquired it through unlawful means, such as breaking into the plaintiff’s business and stealing it or securing it through misuse of a confidential relationship with the plaintiff or one of the plaintiff’s present or former employees; and
3. the defendant used the trade secret without the plaintiff’s permission.

Patents

A patent protects a product, process, invention, machine, or plant produced by asexual reproduction. For this protection to be granted, certain criteria must be satisfied (Table 15-2). First, the object of the patent must be novel, or new. No one else must have previously made or published the plans for this object. The second criterion is that it be useful, unless it is a design patent. It must provide some utility to society. The final criterion is that it be nonobvious. The invention must not be one that the person of ordinary skill in the trade could have easily discovered. When a patent is issued, it gives its holder the exclusive right to produce, sell, and use the object of the patent for 20 years. The holder of the patent may license, or allow others to manufacture and sell, the patented object. In most
cases, patents are licensed in exchange for the payment of *royalties*, a sum of money paid for each use of the patented process.

The only restriction on the patent holder is that he or she may not use the patent for an illegal purpose. The two most common illegal purposes would be tying arrangements and cross-licensing. A **tying arrangement** occurs when the patent holder issues a license to use the patented object only if the licensee agrees also to buy some nonpatented product from the holder. **Cross-licensing** occurs when two patent holders license each other to use their patents only on the condition that neither licenses anyone else to use his or her patent without the other’s consent. Both of these activities are unlawful because they tend to reduce competition.

To obtain a patent, one generally contacts an attorney licensed to practice before the U.S. Patent Office. The attorney does a patent search to make sure that no other similar patent exists. If it does not, the attorney fills out a patent application and files it with the Patent Office. The Patent Office evaluates the application, and, if the object meets the criteria already described, a patent is issued.

Once the patent is issued, the holder may bring a patent-infringement suit in a federal court against anyone who uses, sells, or manufactures the patented invention without the permission of the patent holder. A successful action may result in an injunction prohibiting further use of the patented item by the infringer and also an award of damages. Sometimes, however, the result of the case is that the holder loses the patent. This loss would occur when the alleged infringer is able to prove that the Patent Office should not have issued the patent in the first place.

A common dilemma facing an inventor is whether to protect an invention through patent or trade-secret law. If the inventor successfully patents and defends the patent, the patent holder has a guarantee of an exclusive monopoly on the use of the invention for 20 years, a substantial period of time. The problem is that, once this period is over, the patented good goes into the public domain and everyone has access to it. There is also the risk that the patent may be successfully challenged and the protection lost prematurely.

Trade-secret law, in contrast, could protect the invention in perpetuity. The problem is that once someone discovers the secret lawfully, the protection is lost.

### Copyrights

**Copyrights** protect the expression of creative ideas. They do not protect the ideas themselves but only their fixed form of expression. Copyrights protect a diverse range of creative works, such as books, periodicals, musical compositions, plays, motion pictures, sound recordings, lectures, works of art, and computer programs. Titles and short phrases may not be copyrighted.

There are three criteria for a work to be copyrightable (Table 15-3). First, it must be fixed, which means set out in a tangible medium of expression. Next, it must also be original. Finally, it must be creative.

A copyright arises under common law when the idea is expressed in tangible form and carries appropriate notice, but if the work is freely distributed without notice of copyright, it falls into the public domain. A copyrighted work reproduced with the appropriate notice affixed is protected for the life of its creator plus 70 years, or, if the owner is a publisher, for 95 years after the date of publication or 120 years after creation, whichever occurs first.

Under the common law of copyright, any infringer may be enjoined from reproducing a copyrighted work. For the creator to be able to sue the infringer to recover damages arising from the infringement, however, the copyrighted work must be registered. One may register a work by filing a form with the Register of Copyright and providing two copies of the copyrighted materials to the

---

**Table 15-3**

<table>
<thead>
<tr>
<th>CRITERIA FOR A COPYRIGHT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed form</td>
</tr>
<tr>
<td>Original</td>
</tr>
<tr>
<td>Creative</td>
</tr>
</tbody>
</table>
Library of Congress. Whenever the work is reproduced, it should be accompanied by the appropriate notice of copyright. Printed works, for example, should be published with the word “copyright” and the symbol © or the abbreviation “copr.,” followed by the first date of publication and the name of the copyright owner. Once the work is registered, as long as it is always accompanied by the notice of copyright when reproduced, the holder of the copyright has the additional right to sue any infringer for damages caused by the infringer’s use of the copyrighted materials and to recover any profits made by the infringer on the copyrighted material.

FAIR USE DOCTRINE

A source of controversy involving copyrighted works is application of the fair use doctrine. This doctrine provides that a portion of a copyrighted work may be reproduced for purposes of “criticism, comment, news reporting, teaching (including multiple copies for classroom use), scholarships, and research.” When deciding whether the use is fair, the court looks not only at the purpose of the use, but also at the amount of the work that is used and whether the use has any impact on the commercial value of the copyrighted work. Case 15-3 provides an illustration of a case in which a defendant unsuccessfully attempted to use the fair use doctrine to avoid liability for copyright infringement.

**CASE 15-3**


United States Court of Appeals for the Sixth Circuit
Nos. 06-5013/5266, June 26, 2007

Panorama manufactured and sold karaoke compact discs (CD+Gs), issuing a new disc monthly in each of a variety of musical genres. Each monthly karaoke package contained the top 9 or 10 hits in that genre for the relevant month.

Plaintiff Zomba is in the business of exploiting musical compositions for commercial gain, holding and administering copyrights to a variety of musical compositions, including songs performed by performers such as 98 Degrees, Backstreet Boys, and Britney Spears. Zomba discovered that Panorama was using songs on which Zomba held the copyright. Zomba sent Panorama a cease-and-desist letter that included terms on which Zomba would be willing to grant a license: a $250 fixing fee for each Zomba-owned song on each package, plus royalties of $0.16 per song per CD+G sold for the first half of the term, and $0.19 per song per CD+G sold for the second half of the term.

Panorama contacted Zomba about the letter but did not negotiate a licensing agreement. On April 12, 2002, Zomba sent a follow-up cease-and-desist letter. Again, Panorama responded to the letter but failed either to license Zomba’s songs or to cease selling CD+Gs containing them.

On January 13, 2003, Zomba filed its complaint, asserting one count of copyright infringement for each Zomba-owned song Panorama had recorded and sold in its karaoke packages. On April 22, 2003, the parties entered into a consent order in which Panorama agreed “to be restrained from distributing, releasing or otherwise exploiting any karaoke package containing compositions owned or administered by” Zomba. Within a week, Panorama breached its agreement and resumed selling CD+Gs containing Zomba’s copyrighted songs. One year later, Zomba moved for sanctions for the violations. Both parties filed motions for summary judgment.

The district court granted Zomba’s motion for summary judgment on the issue of copyright infringement. The district court concluded that Panorama’s infringement was willful, and awarded Zomba $31,000 for each of the 26 infringements at issue, for a total of $806,000, $76,456.16 in attorney fees, and $1,058.91 in costs. Panorama appealed.

**Circuit Judge Karen Nelson Moore**

Plaintiff copyright owners whose copyrights actually have been infringed may elect between receiving as damages (1) their actual damages plus the infringer’s profits attributable to its infringement, or (2) statutory damages. In the standard copyright-infringement case, the district court
has discretion to award statutory damages of any amount between $750 and $50,000 for each copyright infringed. However, if the plaintiff proves that the infringement is willful, the statutory-damage ceiling rises to $150,000. Conversely, if the defendant establishes that infringement is innocent, the statutory-damage floor falls to $200.

III. Analysis
On appeal, Panorama... objects to the district court’s rejection of its fair-use defense.... Next, it disputes the district court’s statutory-damage calculation, arguing both that any infringement was not willful and that the $806,000 damage award is unconstitutionally high.... Finally, Panorama appeals the district court’s award of attorney fees to Zomba.

A. Copyright Infringement
The elements of a copyright-infringement claim are (1) ownership of the copyright by the plaintiff and (2) copying by the defendant. Panorama disputes neither element. Instead, it claims that the fair-use doctrine affirmative defense precludes liability.

Panorama’s core argument is that its copying should be considered “fair use” under the Copyright Act. ... § 107 of the Copyright Act provides that “the fair use of a copyrighted work... for purposes such as criticism, comment, news reporting, teaching (including multiple copies for classroom use), scholarship, or research, is not an infringement of copyright.” It further instructs district courts to consider the following factors in analyzing a claim of fair use:

1. the purpose and character of the use, including whether such use is of a commercial nature or is for nonprofit educational purposes;
2. the nature of the copyrighted work;
3. the amount and substantiality of the portion used in relation to the copyrighted work as a whole; and
4. the effect of the use upon the potential market for or value of the copyrighted work.

Because, as explained below, none of these factors supports Panorama’s position, we reject Panorama’s fair-use defense.

a. Purpose and Character of Use
The central purpose of this investigation [into purpose and character of use] is to see... whether the new work merely “supersed[e]s the objects” of the original creation, or instead adds something new, with a further purpose or different character, altering the first with new expression, meaning, or message; it asks, in other words, whether and to what extent the new work is “transformative.”... “The more transformative the new work, the less will be the significance of other factors, like commercialism, that may weigh against a finding of fair use.”... As an initial matter, Panorama’s use of the compositions is only minimally, if at all, transformative.

Unlike a parody, a facsimile recording of a copyrighted composition adds nothing new to the original and accordingly has virtually no transformative value.

Although Panorama offered a passing reference to karaoke’s value as “an interactive and educational experience,” it never argued that the primary purpose of karaoke is “teaching,” and for good reason, as this argument is wholly meritless.... “Karaoke is primarily thought of as a form of entertainment that allows anyone to grab a microphone, hop on stage, and live out their [sic] fantasies of performing as famous music stars.”

More importantly, though, the end-user’s utilization of the product is largely irrelevant; instead, the focus is on whether the alleged infringer’s use is transformative and/or commercial. In Princeton University Press, we considered a copyright suit against a college-town copy shop that copied portions of books and then sold these copies to students in “coursepacks.” We rejected the copy shop’s fair-use defense, concluding that the defendant’s copying was a commercial use, even though the students ultimately used the copies for educational purposes.

Quite similarly, Zomba does not challenge karaoke crooners’ renditions (atrocious or otherwise) of the relevant compositions, but rather Panorama’s decision to copy these songs onto CD+Gs and then distribute them without paying royalties. Like the copying at issue in Princeton University Press, Panorama’s manufacturing and selling the karaoke packages at issue “was performed on a profit-making basis by a commercial enterprise.” Accordingly, Panorama’s use is commercial in nature, a fact militating against its fair-use defense.

b. The Nature of the Copyrighted Work
The second of the § 107 factors “calls for recognition that some works are closer to the core of intended copyright protection than others,” and accordingly are entitled to stronger protection. Like the musical composition in Campbell (Roy Orbison’s “Oh, Pretty Woman”), the compositions of pop songs here at issue “fall within the core of the copyright’s protective purposes.” Accordingly, this factor militates against a finding of fair use.

c. The Amount and Substantiality of the Portion Used
“[T]he larger the volume... of what is taken, the greater the affront to the interests of the copyright owner, and the less likely that a taking will qualify as a fair use.” Here, Panorama acknowledges that it copied the entire compositions. It hired studio musicians to play the songs as closely as possible to the original performers, and distributed copies of their efforts. Additionally, it copied the lyrics, in both an auditory (on the tracks containing vocals) and a visual (on the graphics display) fashion. Because Panorama copied the relevant compositions in their entirety, this factor, too, cuts against Panorama’s fair-use defense.

d. Effect on the Potential Market
for the Copyrighted Work
The thrust of Panorama’s argument—that Zomba and Panorama operate in different markets—is factually inaccurate, as the record illustrates that Zomba has previously licensed (and continues to license) its musical compositions to purveyors of karaoke products. It follows, then, that market harm is a given, as Panorama’s unlicensed copying deprived Zomba of licensing revenues it otherwise would have received. Further, there can be no doubt that
Panorama’s practices, if they became widespread throughout the karaoke industry, would have a deleterious effect on the potential market for licenses to Zomba’s songs. Accordingly, Panorama cannot show that its copying passes the market-harm test, and this factor, like the other three, militates in favor of rejecting its fair-use defense.

B. Willfulness

Next, Panorama argues that even if it infringed Zomba’s copyrights, the district court erred by concluding that the infringement was willful and thus was subject to enhanced statutory damages.

. . . We disagree. For infringement to be “willful,” it must be done “with knowledge that [one’s] conduct constitutes copyright infringement.” Accordingly, “one who has been notified that his conduct constitutes copyright infringement, but who reasonably and in good faith believes the contrary, is not ‘willful’ for these purposes.” This belief must be both (1) reasonable and (2) held in good faith.

Panorama argues that it held a good-faith belief that the copying at issue was a fair use. . . . As in Princeton University Press, the issue is not so much whether Panorama held in good faith its belief that its copying was fair use (although we have serious misgivings on this matter), but whether Panorama reasonably believed that its conduct did not amount to copyright infringement. To decide this issue, we must determine “whether the copyright law supported the plaintiffs’ position so clearly that the defendants must be deemed as a matter of law to have exhibited a reckless disregard of the plaintiffs’ property rights.”

Here, we conclude that Panorama exhibited a reckless disregard for Zomba’s rights, and accordingly, that Panorama’s reliance on its fair-use defense was objectively unreasonable. The fact most crucial to this inquiry is that Panorama continued to sell karaoke packages containing copies of each of the relevant compositions after the district court entered its April 22, 2003, consent order forbidding Panorama to do so. In copyright cases, it is unreasonable to rely on a defense to infringement after a court rejects it on the merits. . . . By entering into the consent decree, Panorama agreed to cease infringing Zomba’s copyrights. Thus, it implicitly agreed to suspend its reliance on the fair-use defense at least temporarily, and this agreement was reduced to an order of the court. Because an order entered by a court of competent jurisdiction must be obeyed even if it is erroneously issued, Panorama lacked any legal justification for continuing to distribute copies of Zomba’s copyrighted works after April 22, 2003. . . . On this basis, we agree with the district court’s conclusion that Panorama’s infringements were willful and accordingly justified enhanced statutory damages.

C. Attorney Fees

In Fogerty v. Fantasy, Inc., the Supreme Court endorsed in dicta a series of factors “to guide courts’ discretion” in awarding attorney fees. The factors include “frivolousness, motivation, objective unreasonableness (both in the factual and in the legal components of the case) and the need in particular circumstances to advance considerations of compensation and deterrence.” . . . [G]iven the unreasonableness of Panorama’s positions and the need to deter such conduct, it is difficult to see how the imposition of attorney fees here could qualify as an abuse of discretion.

Affirmed in favor of Plaintiff, Zomba.

Under a broad conception of fair use, parody is also protected, but it is difficult to know when the author has taken so much of the original that the court will find infringement and not fair use. For example, in 2001, the estate of the author of Gone with the Wind sought an injunction to block the publication of The Wind Done Gone. The author of the second text said it was a parody of the former book and a portrayal of life in the Old South from a black point of view. The estate of the author of Gone with the Wind, however, claimed that the second book was an illegal sequel that infringed on the older work, citing the book’s direct taking of characters, character traits, scenes, settings, physical descriptions, and plot from the copyrighted novel, as well as its appropriation of direct quotes from the novel.5

The district court initially granted the injunction, but on appeal, the higher court overturned the district court’s decision, claiming that the injunction was an unlawful prior restraint of speech under the First Amendment. The court looked at the record and did not believe that the plaintiffs had made a strong enough case that (1) there was a substantial likelihood that the plaintiffs would prevail on the merits, (2) the plaintiffs would suffer irreparable harm if the injunction were not granted, (3) the threatened injury to the plaintiff outweighed that to the defendant, and (4) the granting of the injunction would be in the public interest, which are the necessary prerequisites for the granting of a preliminary injunction.6

The Wind Done Gone went on sale on June 28, 2001, with the following words encircled on its cover: “An Unauthorized Parody.” The estate of the author of

6 Id.
Copyrights in the Digital Age

The Copyright Act of 1976 was created well before the digital age. When that Act was passed, the drafters did not even consider the potential implications of the Internet for copyright protection. However, as use of the Internet became widespread, copyrighted material immediately began to appear all over the Internet; copyrighted materials such as written works and pictures were transferred online and copied numerous times in violation of the spirit of copyright law. However, no laws existed to directly regulate such acts. Today, copyrighted material such as videos, movies, songs, and music videos are all frequently uploaded or transferred online, and our copyright laws have evolved to address these activities.

One of the first problems legislators had when addressing copyrighted material and the Internet was how to define whether a “copy” of something was created. Legislators determined that once material was downloaded into a computer’s memory or RAM, the material was officially “copied.”

Software and the Copyright Act of 1976. The first digitally related amendment to the Copyright Act of 1976 was for software. In 1980, the Computer Software Copyright Act was passed by Congress. This amendment was made in response to computer technology. The Act declared that computer software was material that could now be protected with a copyright. Subsequently, courts have determined that other parts of computer software that can be copyrighted are the language that humans can read and coded language, as well as the general framework or organization of computer software and programs.

The No Electronic Theft Act of 1997. In 1997, President Clinton signed into law a law that would impose criminal penalties on individuals who intentionally distributed copies of copyrighted materials over the Internet without authorization from the copyright holder, regardless of whether such individuals received profits for these actions. Such an individual could be fined up to $250,000 and imprisoned for up to five years.

An interesting result of the No Electronic Theft (NET) Act was its effect on the application of fair use doctrine to materials copied on the Internet. This doctrine had formerly protected individuals who made copies for certain uses that were not for profit. The NET Act instead outlawed any distribution or copying of copyrighted material over the Internet regardless of profits or profit-making intent.

The Digital Millennium Copyright Act. In October, 1998, the Digital Millennium Copyright Act (DMCA) was passed by Congress and signed into law by President Clinton. The DMCA, similar to the NET Act, aimed to protect copyrights in the digital age. Specifically, the DMCA states that the act of evading anti-piracy technologies included in software, including DVDs and CDs, is a crime. However, such activities are permitted if one is involved with and working on behalf of a nonprofit library, educational institution, archive, or other such

---

Gone With the Wind eventually settled in 2002 with the author of The Wind Done Gone and her publishers. The appellate court accurately predicted that the plaintiffs would not find success on the merits. Had the plaintiffs succeeded, however, they would have been entitled to a permanent injunction and, most likely, damages in the amount of the profits made from the infringing work.

---

7 Peak Computer, Inc. v. MAI Systems Corp., 991 F.2d 511; 1993 U.S. App. LEXIS 7522 (9th Cir. 1993).
10 Among other sites, the text of the DMCA is available from UCLA at http://www.gseis.ucla.edu/iclp/dmca1.htm.
entity. The DMCA also forbids creation or sale of a device that can crack codes to allow one to copy any kind of software. Certain exceptions apply to this provision, too, one example being encryption research.

Internet service providers were given some protection from copyright-infringement claims, because these providers simply transmit information and do not produce or intentionally distribute it. Colleges and universities are also protected if they act as service providers. However, service providers are required to take down or cease transmission of information if the information is reported to be an infringement of a copyright. Also, any Web site continually casting music over the Internet must have licensing agreements with the record companies or other copyright holder.

Finally, the DMCA demanded that the Register of Copyrights help Congress determine how long-distance education via the Internet can be appropriately conducted to avoid copyright infringement.

File-Sharing Networks and Technologies. A major issue in the courts arose over file-sharing technologies. Basically, a type of software was created that enabled individuals to make the size of a music file extremely small and thus, able to be easily transmitted to someone else’s computer. In other words, music files could be simply and rapidly distributed to many different people.

As a result of such technology, file-sharing Web sites popped up that facilitated this peer-to-peer networking. Peer-to-peer networking is made possible when many personal computers are connected to a network hosted online, and all of the files in those personal computers can be shared with others without the files actually being hosted on the Internet Web site.

Web hosts such as Napster began to facilitate peer-to-peer networks, which were violating music copyrights on a grand scale. Basically, such Web sites were facilitating the act of transferring copyrighted material from one individual to another without any permission from the copyright holder.

Eventually, in 2005, the Supreme Court determined that certain file-sharing Web hosts had the intent to violate copyright law, and therefore hosts of file-sharing and networking sites could be liable for the distribution of copyrighted material, even though the hosts were only indirectly liable for the actions of their users.

It was only a matter of time, as technology improved, before not just music files, but also movie files started to be copied and distributed without permission. The following case illustrates the legal system’s response to technology designed to enable people to copy movies.

**CASE 15-4**

RealNetworks, Inc. v. DVD Control Copy Association, Inc., et al.
United States District Court for the Northern District of California
641 F. Supp. 2d 913 (2009)

RealNetworks is a media company that produces and sells software called RealDVD. The software enables people to make copies of DVDs they have purchased. In 2009, the company sued the DVD Control Copy Association of America and seven movie studios in pursuit of a legal declaration that its DVD copying software did not breach the DMCA. RealNetworks claimed that its software was only intended for people to make “backups” of DVDs that they had already purchased themselves.

The association and the movie studios disagreed, claiming that although the DMCA did permit RealNetworks’ initial access to the copyrighted material, it did not protect the company’s granting access to the material to additional individuals without any consent from the copyright owners. Furthermore, the software enables individuals to save copyrighted content to a computer hard drive or a portable drive, which deactivates any protection in the technology of the actual DVD.
The court agreed with the association and determined that the software did in fact violate the DMCA, for the reasons given in its opinion, and granted the association and studios a preliminary injunction that banned RealNetworks not only from selling the software, but also from licensing it to any other company. This decision effectively altered the digital technology and copyright laws for the future.

Global Dimensions of Intellectual Property Law

The primary international protection for intellectual property is offered through multilateral conventions and treaties. The major treaty on intellectual property is the Trade Related Aspects of International Property Rights (TRIPS), which is administered through the World Trade Organization (WTO). The WTO is administrators a multitude of trade treaties. On a regular basis, the member states convene to renegotiate the treaties. In the Uruguay Round of negotiation (1986–1994), intellectual property rights became a major issue for developed countries such as the United States and the European Union. TRIPS was the agreed-upon solution.

TRIPS is the most comprehensive intellectual property treaty to date. Previous agreements have included the Berne Convention of 1886, the Universal Copyright Convention, the Paris Convention of 1883, and the Patent Cooperation Treaty. These treaties covered various aspects of intellectual property, but they did not have universal membership, and not all parties had signed all versions of the various conventions. TRIPS must be signed and adhered to by all WTO members, numbered at 151 as of July 2007. There are also 30 observer countries that must begin negotiations to join the WTO within 5 years of becoming observers.

TRIPS begins by ensuring equal protection through its national treatment policy (domestic and foreign products must be treated the same) and its most-favored-nation policy (every member nation must be treated the same). TRIPS expands the copyright protection in the Berne Convention to include computer programs and rental rights, and continues to protect against unauthorized copying of written and recorded creations. TRIPS defines trademark and protects trademarks for both goods and services. TRIPS also has a protection category of geographical indications, to protect names such as “Champagne,” and “Tequila,” which refer to origin of the product and indicate special characteristics.
Under TRIPS, industrial designs must be protected for at least 10 years, and patents must be protected for at least 20 years. There are several exceptions to the patent requirements, allowing a country to deny a patent to prevent the commercial exploitation of something dangerous to public order or morality. Countries also have the right not to patent different processes, such as surgical methods. Furthermore, countries are also permitted to issue compulsory licenses to force production of a patented product while protecting the patent holder’s rights.

The protection for integrated circuit layout designs has not yet come into force. Trade secrets and other undisclosed information are protected as long as a reasonable attempt was made to keep the information secret.

TRIPS allows governments the right to curb anticompetitive licensing contracts under certain circumstances. The governments must enforce the intellectual property rights with their national laws. TRIPS provides standards for intellectual property laws and punishments.

TRIPS entered into force on January 1, 1995. Member countries, based on their level of development, had different amounts of time to comply with TRIPS. Developed countries had a year to comply, whereas less-developed countries had 6 years to comply, and least-developed countries had 11 years to comply. Some of those deadlines have been extended. China has changed its intellectual property laws to come into compliance with TRIPS, although enforcement is still lacking. In summary, TRIPS provides strong protection of intellectual property rights through its near-universal membership and the WTO’s ability to enforce treaties.

**SUMMARY**

The primary forms of protected intellectual property are trademarks, copyrights, patents, and trade secrets. Unlike most property, which is protected by state law, the first three forms of intellectual property are protected by federal statutes. These statutes set forth the criteria for establishment of a valid trademark, copyright, or patent, and permit the holders of intellectual property rights to sue for infringement or misuse of their protected property.

Intellectual property is protected internationally primarily through treaties such as TRIPS, which is enforced by the WTO.

**REVIEW QUESTIONS**

15-1 How does trademark infringement differ from trademark dilution?

15-2 Explain the different types of marks that are protected under the Lanham Act.

15-3 What factors would lead a person to choose patent protection over trade-secret protection, and vice versa?

15-4 Explain the four factors that are relevant to a determination of whether the fair use doctrine is available as a defense.

15-5 Explain the relationship between a tying arrangement and cross-licensing.

15-6 How is trade dress different from a trademark?
REVIEW PROBLEMS

15-7 Matt creates a small doughnut shop called DoGos. He uses the term DoGo surrounded by three concentric blue circles on all packaging. He starts selling his specialty DoGo doughnuts in local grocery stores, and soon develops a strong customer base, although he never sells the product outside of the state of Ohio. After five years of increasing business, he notices a sudden dropoff in sales. He soon discovers that a competitor is producing a similar product, but at a lower price, packaged in almost identical packaging, but with the name DoGoos inside the three concentric blue circles. Matt finds out who the producer of DoGoos is and sends him a request that he change his product name and packaging. Simon, the producer of DoGoos, refuses, saying that because Matt has no trademark, his signature packaging has no protection. Explain why Simon either is or is not correct.

15-8 Grover creates a machine that enables a manufacturer to make screws with 50 percent less waste than the industry norm. He patents his process and then decides to license the patent to Markham Manufacturing for a small royalty fee and a promise that Markham will buy a key ingredient needed to produce the screws from Grover. Is there anything wrong with this contract?

15-9 Kristy and Cameron, two college students, cannot find summer jobs, so they decide to make money by printing and selling T-shirts that have printed on them the words “Just done it!!!” over an image of an upside-down Nike “swoosh.” Kristy’s dad warns her that she might be doing something illegal. Is he correct? Why or why not?

15-10 Thrifty Inn decides to open a motel along an interstate that will provide cheap lodging. It calls the motel Sleep McCheap. McDonald’s seeks to enjoin Thrifty Inns from using the name, claiming that it violates the McDonald’s trademark as well as the McStop trademark that McDonald’s has for its one-stop business that provides cheap food, cheap lodging, and cheap gas. Will the injunction be granted? Why or why not?

15-11 Amerec Corporation developed a secret, unpatented process for producing methanol and built a special plant where it was going to use this process. The Christophers were hired by a competitor of Amerec to take aerial photographs of the construction. Amerec sued the photographers for misappropriation of trade secrets. What defenses might the Christophers raise? Would these be successful?

15-12 Professor Kendall wants students to read three articles from a recently published journal. The professor, who is concerned about the students’ expenditures for books, photocopies the articles and places them on reserve. The publisher of the journal sues the professor for copyright infringement. What defense will the professor raise? Would this defense be successful?

CASE PROBLEMS

15-13 Jerry Seinfeld’s wife, Jessica Seinfeld, was sued for copyright infringement and plagiarism over her cookbook, Deceptively Delicious, by Missy Chase Lapine. Lapine is the author of The Sneaky Chef, a cookbook with a concept similar to Seinfeld’s. Both cookbooks are based on sneaking healthy ingredients into food prepared for children so that children will inadvertently eat foods they otherwise would be opposed to. The goal of both cookbooks is for children to eat more healthfully. Lapine wrote her cookbook in 2007; Seinfeld’s came out in 2008. Seinfeld argued that many cookbooks have a goal not only to help individuals eat healthier, but to get children to eat healthier.

Lapine later added a count to her complaint, stating that Jerry Seinfeld launched a verbal attack on her by calling her a “wacko” during a guest appearance on David Letterman’s TV show. How do you think the judge ruled with respect to the plaintiff’s claims of copyright infringement? Do you think the idea of sneaking healthy foods into children’s meals is so obscure that Seinfeld was indeed guilty of plagiarism and copyright infringement? Missy Chase Lapine v. Jessica Seinfeld et al., 2010 U.S. App. LEXIS 8778 (2d Cir., Apr. 28, 2010).

15-14 In 2009, Capitol Records sued Jammie Thomas-Rasset for damages after she was found liable for copyright violations when she illegally downloaded 24 songs off the Internet. Apparently, in addition to downloading the songs, Thomas-Rasset was involved in a peer-to-peer network and was additionally allowing Capitol’s songs to be downloaded from her computer to other individuals’ computers. In other words, Thomas-Rasset was distributing copyrighted material without permission from the holder of the copyrights. Ultimately, Capitol Records was suing for monetary damages. An award of $2 million (in response only to the 24 songs) was the expected decision of the court. However, Thomas-Rasset argued that $2 million was an excessive award.

**15-15** Grokster, Ltd., distributed free software that could be used to download files from the Internet. Frequently, this software was used to illegally download copyrighted material. MGM Studios sued Grokster, alleging that Grokster had marketed its software for the purpose of sharing copyrighted files. There was also evidence that Grokster made no attempt to prevent or discourage copyrighted material from being transferred. Grokster made no money from the file transfers themselves; rather, its income came from advertising sold on its website. Grokster moved for summary judgment on the basis that its software could be legitimately used to transfer noncopyrighted works. The U.S. District Court ruled for Grokster on its motion for summary judgment. The Court of Appeals upheld the ruling. The Supreme Court vacated the motion for summary judgment and remanded for further proceedings. What do you think the Court’s reasoning behind this decision was? *MGM Studios v. Grokster*, 545 U.S. 913 (2005).

**15-16** Dippin’ Dots Inc. markets and sells a brightly colored, flash-frozen ice cream it calls “dippin’ dots,” consisting of free-flowing small beads (or dots) of ice cream. Dippin’ Dots owns the patent to the flash-freezing process it uses to make its ice cream. Frosty Bites Distribution is a competitor to Dippin’ Dots that sells brightly colored flash-frozen ice cream, called Frosty Bites, that are mostly popcorn-shaped, as well as small and spherical in shape. Dippin’ Dots brought suit against Frosty Bites, alleging trade-dress infringement. Dippin’ Dots claimed that Frosty Bites are substantially similar in appearance to Dippin’ Dots. What elements must Dippin’ Dots prove to win its case? Why do you believe that Dippin’ Dots was or was not successful? *Dippin’ Dots, Inc. v. Frosty Bites Dist., LLC*, 2004 U.S. App. LEXIS 9217 (11th Cir. 2004).

**15-17** Plaintiff Perfect 10 is a corporation that ran a subscription Web site featuring nude pictures of “natural” adults. Perfect 10 brought a copyright-infringement action against Google, Inc., and Amazon, Inc., on the basis of their display of thumbnail images on search pages. An image search on Google provides pages of thumbnail pictures—reduced-size, lower-resolution images than on the original Web page. Moreover, Google’s results will display the pictures on any other sites that are illegally displaying Perfect 10’s copyrighted images. Perfect 10 argued that this copying, distribution, and display of its images infringed upon its copyright. The defendants argued that their use of the images fell within the fair use doctrine because the images were not full size or full resolution. The plaintiff moved for an injunction to prevent the display of its images on Google’s search engine, based on its copyright claims. How do you think the court ruled? Why? *Perfect 10 v. Google, Inc.*, 416 F. Supp. 2d 828 (C.D. Cal. 2006).

**15-18** In 2008, UMG Recordings sued Veoh Networks because Veoh not only provided Web sites, but also invested in Web sites that allowed certain copyrighted materials to be distributed from the sites. Although Veoh Networks did not participate in managing or running the Web sites, the plaintiffs argued that Veoh was a large investor and as such had control over the Web sites and the content and actions of the Web sites. Veoh attempted to dismiss the claims that it was responsible for the possible copyright infringement by the Web sites it invested in. Do you think that, as an investor, Veoh had inherent control over the Web sites and thus responsibility for their content? How do you think the court decided? *UMG Recordings, Inc. v. Veoh Networks, Inc.*, 2009 U.S. Dist. LEXIS 14955 (C.D. Cal. 2009).

**THINKING CRITICALLY ABOUT RELEVANT LEGAL ISSUES**

**A Question under TRIPS**

When TRIPS came into effect, many member states had to change their intellectual property laws. Additionally, any states joining the WTO had to comply with TRIPS, which prompted many other countries to change their intellectual property laws. Most developing countries were given a longer time period to come into compliance with TRIPS than was required for developed countries, but for many developing countries that time period has recently ended. One of these countries is India.

India’s previous patent laws covered a manufacturing method, rather than the finished product, so Indian companies were taking patented products, making them a different way, and selling them as generics. This legal treatment was a major problem for pharmaceutical companies. India sold huge numbers of generic pharmaceuticals in Africa, primarily HIV/AIDS medications, denying the pharmaceutical companies their royalties.

It is very important for patents for HIV/AIDS medication to be upheld. Although it might at first seem unfair to charge more than a generic company would for a medication, it is crucial to realize that the generic company did not have to invest in the research and development of the drug. Although the drug may not cost as much as the name-brand price to produce, the
research and development, clinical trials, and salaries of everyone involved in the process of creating new medication must be accounted for in the price of the medication. What is really unfair is allowing a generic company to take advantage of the hard work done by the original company.

Perhaps more importantly, patents provide incentive for pharmaceutical companies to continue to create new and better drugs. With the expansion of HIV/AIDS and the tolerance that patients build up to drugs, it is necessary for pharmaceutical companies to come up with new treatments. Without the incentive from patents, innovation would slow, a result more detrimental to the treatment of HIV/AIDS than paying the true cost for medications.

Enforcing patents on HIV/AIDS drugs fairly reimburses the pharmaceutical companies for their work in research and development and helps patients by ensuring innovations in the form of new medications.

1. What are the issues and conclusion of this essay?
2. What ethical norms drive the author’s reasoning?
3. Ask and answer the critical thinking question that you believe reveals the main problem with the author’s reasoning.
4. Write an essay about this issue with a different conclusion.

Clue: What alternate definitions of the primary ethical norm might change the conclusion?

ASSIGNMENT ON THE INTERNET

To demonstrate your knowledge of the various types of marks, search the Web and find two examples of each of the following types of marks: product mark, collective mark, service mark, and certification mark. Provide the citation for the Web page, copy the mark, and explain how you know it fits under that category of marks.

WWW ON THE INTERNET

www.copyright.gov The U.S. Copyright Office gives information about copyrights, as well as directions on how to copyright your own work.
www.uspto.gov This is the Web site of the U.S. Patent and Trademark Office.
www.wipo.int This is the home page of the World Intellectual Property Organization.
www.intelprolaw.com The Intellectual Property Law Server provides useful information on patent, trademark, and copyright intellectual property. The many links at this site contain laws, articles, and cases of interest.
www.icann.org This site is the home page for the Internet Corporation for Assigned Names and Numbers, where you can find information about domain name ownership.

FOR FUTURE READING


Agency law has become more prominent in our complex postindustrial society. In an earlier period, when business owners (principals) did most or all of their business on a one-to-one basis with their customers, agents and third parties played a very small role in the business environment. As business entities became larger and conducted far-flung transactions within the United States and worldwide, businesspeople felt a need to hire domestic and foreign agents to represent their interests to potential customers.

This chapter examines: (1) the definition and creation of an agency relationship, as well as employment relationships; (2) the rights and duties of agents and principals toward each other and toward third parties; (3) the law of contracts and torts as they affect agency relationships; and (4) the global dimensions of agency law.

**CRITICAL THINKING ABOUT THE LAW**

Agency law is based on a trusting relationship between two parties or individuals. Critical thinking skills, such as identifying ethical norms and missing information, are especially important when thinking about agency relationships.

1. Agency relationships are frequently used in modern society. Businesses increasingly rely on agents to conduct their business with customers. What ethical norms would businesses expect their agents to hold and act on in carrying out their responsibilities?

   *Clue:* Look at the list of ethical norms and ask yourself: Which would be most important to a business?

2. As you will soon learn, agency relationships can be formed by informal oral agreements or by formal written contracts. Judges are often faced with the task of determining whether an agency relationship exists when there is an informal oral agreement (and sometimes, even when there is a formal written contract), or whether an agency relationship exists after an agent has performed a task. What kinds of information would be especially important to a judge in deciding whether an agency relationship had been established?

   *Clue:* What would tend to happen if a business formed a relationship with an employee to carry out a task?
Definition and Types of Agency Relationships

DEFINITION OF AGENCY

Agency is defined as a fiduciary relationship (one of trust and confidence) between two persons in which they mutually agree that one person (the agent) will act on behalf of the other (the principal) and be subject to the latter’s control and consent. For example, a corporate officer who enters into contracts that legally bind the corporation is representing the corporation as an agent.

Provided they are able to understand the instructions of a principal, most people have the capacity to act as agents. For example, a minor can be employed by a principal to act as an agent in making an offer of employment to a third person. The minor’s lack of capacity to enter a contract is immaterial here, because the contract is between the principal and the third party. (The minor’s lack of contractual capacity, however, means that any agreement between the minor and the principal may be voided by the minor before he or she reaches majority age or shortly thereafter.)

TYPES OF AGENCY RELATIONSHIPS

Agency law is concerned with three types of relationships: principal–agent, employer–employee, and employer–independent contractor. These relationships are summarized in Table 16-1.

Principal–Agent. The principal–agent relationship (Exhibit 16-1) is one in which the principal (usually an employer) hires an agent (employee) and gives the agent either expressed (express) or actual authority to act on the principal’s behalf. Express authority arises from specific statements made by the principal (employer) to the agent (employee). Actual authority includes expressed authority and implied authority—that authority customarily given to an agent in an industry, trade, or profession. The principal–agent relationship is the most basic type of agency relationship. It is, in fact, the foundation of the next two types of agency relationships we are about to discuss: that between employer and employee and that between principal (employer) and independent contractor.

Employer–Employee. The employer–employee relationship evolved out of the traditional master–servant relationship, in which a master employed a servant to perform services and the servant’s conduct was subject to the master’s physical control. Under the doctrine of respondeat superior, the master was responsible for servants’ acts that were within the scope of their employment. In the postindustrialized version of this arrangement, the

<table>
<thead>
<tr>
<th>Principal–agent</th>
<th>Agent is hired by the principal to act on the principal’s behalf subject to the latter’s control and consent.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employer–employee</td>
<td>Employer controls the employee’s physical conduct and determines the details of performance.</td>
</tr>
<tr>
<td>Employer–independent</td>
<td>Employer does not control the details of performance or conduct of the independent contractor.</td>
</tr>
</tbody>
</table>

Clue: Do any of the definitions of justice give special guidance here?

3. Consider the definitions of justice in Chapter 1. How might the fact that the agent has already performed the task affect the judge’s decision?
employer–employee relationship, the employee is subject to the control of the employer and, in accordance with expressed or implied authority, may enter into contractual relationships on behalf of the employer. In general, any agent who works for pay is considered an employee, and any employee, unless specifically limited, who deals with a third party is given agent status. The employer–employee relationship is particularly important because it is the only agency relationship that is subject to worker’s compensation, Social Security, and unemployment compensation laws (as well as numerous other state and federal laws). It is also important to distinguish the employer–employee relationship from an employer–independent contractor relationship, which normally is not subject to these statutes; this is an important distinction in the legal environment of business.

Employer–Independent Contractor. Independent contractors are hired by the principal (employer) to do a specific job, but are not controlled with respect to their physical conduct or the details of their work performance. In this type of agency relationship, the employer is normally not required to make payments into worker’s compensation pools or to withhold Social Security amounts, and is not usually liable for torts committed by the independent contractor. (Torts, you will recall, are wrongful acts, other than breaches of contract, for which damages may be obtained.) For example, the employer of a taxi driver who is an independent contractor and owns his or her own cab is not liable, in most instances, for damages when the driver injures another person in an accident.

When called on to distinguish between an employee and an independent contractor, courts scrutinize the degree of control the employer has over the agent. Courts also consider factors such as (1) whether the hired persons had a distinct occupation or profession, (2) whether they supplied their own tools and equipment, (3) whether they were employed only for a specific time period, (4) whether they were paid hourly or on completion of a job, and (5) what degree of skill was required to do the job.

To escape paying unemployment insurance taxes, as well as medical benefits, many employers in recent years have classified their workers as independent contractors or part-time workers. A common strategy in the highly competitive business environment of the 1990s was to “downsize” by cutting back on the number of employees in a corporation through early retirement plans and layoffs and then to “restructure” by rehiring these people as “consultants” (independent contractors) to accomplish the same work they did as employees. This is essentially a cost-cutting measure. The “consultants” draw a per diem or lump sum instead of a salary for the job they are hired to perform, and the company saves on health care, unemployment compensation, and Social Security benefits. In turn, the independent contractors are free to work for others besides their old employer, perhaps while receiving a pension from the employer. The case that follows indicates the close scrutiny courts are giving to employers’ classification of workers as independent contractors.
Finance

In finance you have examined agency relationships and, particularly, costs associated with such relationships. For example, if both parties to a relationship are utility maximizers, there is reason to believe that the agent will not act in the best interest of the principal. The principal can limit divergences from its interest by establishing appropriate incentives for the agent and by monitoring costs of agents. In addition, in some situations it pays the agent to expend resources (bonding costs) to make sure that the principal is not harmed.

The sum of agency costs includes:

1. monitoring expenditures by the principal;
2. bonding expenditures by the agent; and
3. residual loss.


### CASE 16-1

**Alberty-Vélez v. Corporación de Puerto Rico**

U.S. Court of Appeals, First Circuit

361 F.3d 1 (2004)

In 1993, Victoria Lisa Alberty-Vélez (Alberty) began to co-host a new television show, *Desde Mi Pueblo*, on WIPR, a television station in Puerto Rico. The show profiled Puerto Rican cities and towns. Instead of signing a single contract, Alberty signed a new contract for each episode. Each contract obligated her to work a certain number of days. She was not obligated to do other work for WIPR, and WIPR was not obligated to contract with her for other work. During the filming, Alberty was responsible for providing her own clothing, shoes, accessories, hairstylist, and other services and materials. She was paid a lump sum, ranging from $400 to $550, for each episode. WIPR did not withhold income or Social Security taxes and did not provide health insurance, life insurance, a retirement plan, paid sick leave, maternity leave, or vacation pay. Alberty became pregnant, and after November 1994, WIPR stopped contracting with her. She filed suit in a federal district court against WIPR’s owner, Corporación de Puerto Rico para la Difusión, alleging in part discrimination on the basis of her pregnancy in violation of a federal statute. The court issued a judgment in the defendant’s favor. Alberty appealed to the U.S. Court of Appeals for the First Circuit.

**Justice Howard**

We will apply the common law test to determine whether Alberty was WIPR’s employee or an independent contractor.

Under the common law test, a court must consider the hiring party’s right to control the manner and means by which the product is accomplished. Among other factors relevant to this inquiry are the skills required; the source of the instrumentalities and tools; the location of the work; the duration of the relationship between the parties; whether the hiring party has the right to assign additional projects to the hired party; the extent of the hired party’s discretion over when and how long to work; the method of payment; whether the work is part of the regular business of the hiring party; whether the hiring party is in business; the provision of employee benefits; and the tax treatment of the hired party.

Several factors favor classifying Alberty as an independent contractor. First, a television actress is a skilled position requiring talent and training not available on-the-job. In this regard, Alberty possesses a master’s degree in public communications and journalism; is trained in dance, singing, and modeling; taught within the drama department at the University of Puerto Rico; and acted in several theater and television productions prior to her affiliation with *Desde Mi Pueblo*.

Second, Alberty provided the tools and instrumentalities necessary for her to perform. Specifically, she provided, or obtained sponsors to provide, the costumes, jewelry, and other image-related supplies and services necessary for her appearance.

Third, WIPR could not assign Alberty work in addition to filming *Desde Mi Pueblo*.

Fourth, the method of payment favors independent-contractor status. Alberty received a lump sum fee for each
episode. Her compensation was based on completing the filming, not the time consumed. If she did not film an episode, she did not get paid.

Fifth, the work of hiring television cohosts was part of WIPR’s business.

Sixth, Alberty’s tax treatment suggests independent-contractor status.

Despite these factors favoring independent-contractor status, Alberty argues that she was WIPR’s employee because WIPR controlled the manner of her work by directing her during filming, dictated the location of her work by selecting the filming sites, and determined the hours of her work. While “control” over the manner, location, and hours of work is often critical to the independent contractor–employee analysis, it must be considered in light of the work performed and the industry at issue. Considering the tasks that an actor performs, we do not believe that the sort of control identified by Alberty necessarily indicates employee status.

Alberty’s work on Desde Mi Pueblo required her to film at the featured sites, at the required times, and to follow the instructions of the director. WIPR could only achieve its goal of producing its program by having Alberty follow these directions. Just as an orchestra musician is subject to the control of the conductor during concerts and rehearsals, an actor is subject to the control of the director during filming.

While no one factor is dispositive [determines the outcome], it is clear, based on the parties’ entire relationship, that a reasonable fact finder could only conclude that Alberty was an independent contractor. Accordingly, we conclude that Alberty was an independent contractor as a matter of law and therefore cannot maintain this action against WIPR.

Affirmed in favor of Defendant, Corporación de Puerto Rico (WIPR).

CRITICAL THINKING ABOUT THE LAW

When courts establish legal tests, they describe conditions that must be met for the test to be passed. In Case 16-1, the plaintiff hoped she could meet the standards of the common-law test attached to an agency relationship.

To meet this test, a large range of facts had to be present. If the facts all fell into place in a particular way, the plaintiff would prevail.

1. Identify specific facts from Case 16-1 that might permit the plaintiff to prevail.

   **Clue:** Go to the location in the decision where the court goes step-by-step through the test, and pick out a few instances in which one part of the test was met because of a particular set of circumstances.

2. What “facts,” had they existed, would have allowed the plaintiff to win this case?

   **Clue:** Read the court’s statement of the necessary conditions for establishing agency. Then imagine some “facts” that would satisfy those conditions.

“Temps”: Employees or Independent Contractors?

In 1990, the Internal Revenue Service found that Microsoft Corporation had hundreds of workers who were actually employees of the company, as opposed to independent contractors, based on the control that Microsoft exercised over them. Instead of contesting the IRS ruling, which required the company to pay back payroll taxes, Microsoft required most of its former independent contractors to become associated with employment agencies and work for Microsoft as “temps.” If they didn’t, they were laid off. Those workers who didn’t sign up with an agency sued Microsoft, claiming that they were employees of the company and were entitled to participate in the stock option plan. Microsoft argued that each of the workers had signed an independent contractor agreement and, thus, they were not eligible for benefits. At the Ninth Circuit Court of Appeals level, the court held that the “temps” were “common-law employees” under agency law. Furthermore, the court stated that being employees of a temporary employment agency did not prevent the workers from being common-law employees of Microsoft at the same time.

Source: Vizcaino v. Microsoft, 173 F.3d 713 (9th Cir. 1999).
Creation of an Agency Relationship

Agency relationships can be created by informal oral agreements or formal written contracts. Under the statute of frauds (see Chapter 10), some states require that all agency contracts be in writing.

Most such relationships grow out of the consent of two parties, the principal indicating in some way that the agent should act on its behalf and the agent agreeing to do so. An agency relationship may be formed through (1) expressed agency, (2) implied authority, (3) ratification of the agent’s previous acts by the principal, or (4) apparent agency (Table 16-2).

### EXPRESSED AGENCY OR AGENCY BY AGREEMENT

An agency relationship formed through oral or written agreement between the principal and agent is known as an **expressed agency** or **agency by agreement**. Under the statute of frauds, agency agreements that will last longer than one year must be in writing. An **exclusive agency contract** is a type of agreement whereby the principal agrees that it will not employ any other agent for a period of time or until a particular job is completed. If the principal fails to live up to this agreement, the agent may file a breach-of-contract suit to recover monetary damages plus court costs and attorney’s fees.

A legal document used to establish an agency relationship is called a **power of attorney**. It gives the agent the authority to sign legal documents on behalf of the principal. Many states allow powers of attorney for both business and health care purposes. In the latter kind of power of attorney, the principal designates in writing an individual (agent) who will act for the principal in the event of a serious illness that renders the principal mentally incompetent to make decisions concerning his or her own medical care. The agent is usually given the authority to make such decisions in consultation with physicians. The power of attorney for business purposes may be a general document that gives the agent broad powers to act on the principal’s behalf, or it may be a more limited document that authorizes the agent to act only in matters enumerated in the agreement. Many people now incorporate by reference powers of attorney for both health and business purposes into their wills or trusts.

### AGENCY BY IMPLIED AUTHORITY

When a principal and an agent create an agency relationship, they often do not set out every detail of the agent’s authority in the written or oral agreement. In **agency by implied authority**, customs, circumstances, and the facts of a

<table>
<thead>
<tr>
<th>Agency Relationships</th>
<th>Method of Creation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expressed agency or agency by agreement</td>
<td>Formed by detailed written or oral agreement. A power-of-attorney document is often used to establish this relationship.</td>
</tr>
<tr>
<td>Agency by implied authority</td>
<td>Formed in situations in which custom and circumstances determine the agent’s authority to do business for the principal.</td>
</tr>
<tr>
<td>Agency through ratification</td>
<td>Formed when an unauthorized act of an agent is accepted by the principal.</td>
</tr>
<tr>
<td>Agency by estoppel or apparent authority</td>
<td>Formed when a principal leads a third party to believe that a certain person is acting as agent for the principal. The principal is thereafter estopped from denying the agency relationship.</td>
</tr>
</tbody>
</table>
situation determine the authority of the agent to do business on behalf of the principal.

Unless the agency contract says otherwise, courts have generally allowed agents to:

1. Receive payments of money due the principal
2. Enter into contracts for incidentals
3. Employ or discharge employees
4. Buy equipment and supplies

In the following case, the court indicates the extent to which implied authority will be granted to an agent.

**CASE 16-2**

**Penthouse International v. Barnes**  
**United States Court of Appeals**  
**792 F.2d 943 (9th Cir. 1986)**

Priscilla Barnes was a hostess at a club in Hollywood, California, when she was approached by a freelance photographer (Dunas) who sold nude photographs to *Penthouse* magazine. Dunas was an independent contractor. He asked Barnes to pose nude. She agreed but did not want her actual name used. Dunas agreed to her terms, and Barnes signed a “Release, Authorization and Agreement Form” that gave Penthouse the right to “republish photographic pictures or portraits.” Dunas added the term AKA (also known as) on the contract to indicate that the photographs would not be published under her actual name but under a pseudonym. Penthouse did so in 1976.

Later, Barnes became a well-known television broadcaster for a station in Los Angeles. When Penthouse informed her, in 1983, that it wished to republish her nude photograph, she threatened to sue, claiming that Dunas had implied agency to write the term AKA and that Penthouse was thus bound by his actions and representations. Penthouse requested a declaratory judgment from the federal district court allowing it to republish a nude photo of the defendant. The district court found for Barnes and issued an injunction against Penthouse. Penthouse appealed.

**Judge Boochever**

Under California law, questions regarding the existence of agency are questions of fact that we review for clear error. California Civil Code Section 2316 defines actual authority as “such as a principal intentionally confers upon the agent, or intentionally, or by want of ordinary care, allows the agent to believe himself to possess.” At issue is whether Dunas contracted to act on behalf of Penthouse.

Penthouse instructed photographers “to get a signed model release and not to alter the release in any way, without our permission.” However, Penthouse carried Dunas’s name on its masthead, gave him blank Penthouse contracts, may have given him business cards, and had him present contracts to models. Thus, although the record conflicts as to whether Dunas was an actual agent of Penthouse, on review, we cannot find that the district court clearly erred in finding Dunas to be a Penthouse agent.

Having found that the district court did not err in characterizing Dunas as an agent, we next turn to whether Dunas was acting within the scope of his authority by modifying the contract. Barnes does not contend nor is there evidence that Dunas possessed express actual authority to modify the contract. Dunas, however, had implied actual authority. Implied actual authority requires that (1) Dunas believe he was authorized to modify the contract based on Penthouse conduct known to him or (2) such a belief was reasonable.

Circumstantial evidence exists that Dunas placed “AKA” on other contracts with no objection from Penthouse. In June 1974, a year and a half before Barnes posed, contracts prepared by Dunas had “AKA” on them. Further, Penthouse internal memoranda reflect an understanding among Penthouse employees that “AKA” added to a contract meant that Penthouse was to associate a fictitious name with a woman’s photograph. The evidence thus indicates that Dunas reasonably believed he was authorized to add “AKA” and modify the contract to require that only a fictitious name be used.

*Affirmed* in favor of Defendant, Barnes.
CRITICAL THINKING ABOUT THE LAW

One of the primary purposes of a judge’s opinion is to explain the court’s reasoning in a particular case. A judge’s opinion is not arbitrary, in the sense that a judge must give due consideration to relevant facts and rules of law for any legal issue. From a judge’s opinion, we are, therefore, able to know not only a judge’s conclusion but also why the judge ruled for one party over another. These opinions provide the court’s rationale in a particular case, which may later be used as precedent for subsequent cases that contain similar fact patterns. In Case 16-2, the judge provided several reasons to support the conclusion. The next two questions relate to the judge’s reasoning in Case 16-2.

1. What reasons did the judge provide for ruling in favor of the defendant?
   Clue: To ensure that you have found a reason, ask yourself whether what you have listed answers the question: “Why did the court rule for the defendant?”
2. What aspects of the court’s reasoning were particularly strong or weak? (Remember that just because reasons are given does not mean that these reasons are necessarily strong.)
   Clue: Reverse the roles in this case and assume that you are the plaintiff’s lawyer. With which parts of the judge’s opinion would you still disagree based on the court’s reasoning? Would there be parts of the judge’s reasoning with which, even though you were the opposing party, you would agree?

AGENCY THROUGH RATIFICATION BY PRINCIPAL

Agency by ratification occurs when a person misrepresents himself or herself as an agent and the principal accepts (ratifies) the unauthorized act. If the principal accepts the results of the agent’s act, then the principal is bound, just as if he or she had authorized the individual to act as an agent. Two conditions are necessary for the ratification to be effective: (1) the principal must have full knowledge of the agent’s action and (2) the existence of the principal must be clear to the third party at the time of the agent’s unauthorized act. For example, Max Black tells his friend Mary Ann Jones, a realtor, that if she ever finds anyone who is ready, willing, and able to sell a certain kind of computer franchise store, he will buy it. Jones finds such a store, cannot reach Black, and has never been his agent, but she enters into the agreement with the franchisor anyway and signs the contract “Mary Ann Jones, agent for Max Black.” Jones is not Black’s agent. If Black, however, decides to honor the contract, he will have ratified an agency relationship, and Jones will most likely be due a commission.

AGENCY BY ESTOPPEL OR APPARENT AUTHORITY

If a third person is led by a principal to believe that a certain individual is the principal’s agent, then there appears to be authority for the agent to act and the principal is estopped from denying that the individual is an agent. It is the writing, words, or acts, or some combination thereof, of the principal that create the agency by estoppel, or apparent authority for the agent to act; the third party relies on the principal’s conduct.
(3) a duty of cooperation, and (4) a duty to provide safe working conditions. These duties are either part of a written contract or implied by law.

**Duty of Compensation.** In the absence of a written agreement, it is implied that a principal will compensate the agent for services rendered, either when services are contracted for or when they are completed. If the parties cannot agree on the amount, courts will usually indicate that the compensation should be calculated on the basis of what is reasonable or customary. For example, lawyers and real estate brokers are sometimes paid on a contingency fee (commission) basis.

**Duty of Reimbursement and Indemnification.** An indemnity is an obligation on the part of an individual (principal) to make good (or reimburse) another person (agent) against any losses incurred when the latter is acting on behalf of the former. All necessary expenses can be recouped by the agent, but the agent is not entitled to expenses arising out of tortious conduct (e.g., negligence) or unlawful activities (e.g., bribes paid to suppliers).

**Duty of Cooperation.** The principal must do nothing to interfere with the reasonable conduct of an agent as agreed upon in an express or implied contract. For example, if a franchisor (principal) agrees with a franchisee (agent) that the latter has an exclusive right to sell a specific item within a geographic territory, the franchisor cannot legally compete with the franchisee by setting up another franchisee within that territory. If the franchisor does establish a competitive franchisee, the first franchisee can sue for breach of contract, asking either for lost profit, court costs, and attorney’s fees or for specific performance.

**Duty to Provide Safe Working Conditions.** The principal has a duty to its agent to provide safe working conditions. Federal legislation such as the Occupational Safety and Health Act (discussed in Chapter 18) set standards designed to create a safe working environment for employees. Employers who repeatedly violate those standards may be fined or imprisoned or both.

### AGENT’S DUTIES TO PRINCIPAL

Just as a principal has legal duties to an agent, the agent has legal obligations toward the principal: loyalty, obedience, accounting, and performance.

**Duty of Loyalty.** Courts have often indicated that the agent’s most important obligation is fiduciary. The fiduciary obligation includes loyalty to the principal—that is, acting on behalf of one principal only to avoid conflicts of interest, communicating all material information to the principal, and refraining from acting in a manner that is adverse to the principal’s interest.

---

**CASE 16-3**

**Cousins v. Realty Ventures, Inc.**

Court of Appeals of Louisiana, Fifth Circuit

844 So. 2d 860 (2003)

Don Cousins acted as the representative/agent for Eagle Ventures, Inc., to find a real estate investment for the corporation to purchase. To do so, Cousins engaged the services of Leo Hodgins, a real estate agent/broker and owner of Realty Ventures, Inc. (RVI).

In March of 1991, Leo Hodgins learned that 3330 Lake Villa Drive, an 8,000-square-foot office building in Metairie, Louisiana, owned by Westinghouse Credit Corporation, was being sold for $125,000. In June 1991, Leo Hodgins first brought 3330 Lake Villa Drive to Cousins’s attention.
Cousins asked Hodgins to submit an offer to Westinghouse on behalf of Eagle Ventures, Inc., for $90,000. Mr. Hodgins submitted the offer to Westinghouse. Westinghouse was unable to sell the property at the time because it was having difficulties with Tonti Management, which was managing some of its local commercial holdings.

In October 1991, Leo Hodgins resubmitted Eagle Ventures’ June 1991 offer. Hodgins learned that Westinghouse was ready to sell 3330 Lake Villa, but only as part of a package deal with its neighboring property, 4141 Veterans Boulevard.

In April 1992, Mr. Hodgins and his brother, Paul, created a partnership, known as 4141 Vets Limited Partnership, to purchase the property. On May 7, 1992, Westinghouse sold 3330 Lake Villa to 4141 Vets Limited Partnership for $65,000 and sold 4141 Veterans to the same partnership for $355,000. Hodgins then offered to sell 3330 Lake Villa to Eagle Ventures for $175,000.

The plaintiff, Don Cousins, filed the instant suit against defendants, Realty Ventures, Inc. and others. The plaintiff’s suit alleged that the defendants breached their fiduciary duties to him. The jury returned a verdict in favor of the plaintiff and awarded damages in the amount of $1,750,000. The defendants filed this appeal.

Justice Edwards

The precise duties of a real estate broker must be determined by an examination of the nature of the task the real estate agent undertakes to perform and the agreements he makes with the involved parties. In the instant case, Leo Hodgins accepted Mr. Cousins’[s] request to find commercial real estate for Eagle Ventures to purchase by turning his attention to 3330 Lake Villa. The common law sets forth the types of duties expected of a real estate agent. For example, a real estate agent may be found liable where he or she does not timely communicate an offer and that failure to communicate results in damages to the client. Similarly, a real estate broker has been found to have a duty to communicate to his principal all offers received and may be liable in damages for failure to do so. Moreover, a [R]ealtor has a duty to relay accurate information about property, a duty which extends to both vendor and purchaser, and may be held liable if such duty is breached.

Plaintiffs argued at trial that Leo Hodgins committed a breach of his fiduciary duty to them in several respects, [including] failing to communicate Westinghouse’s response to their offer. Defendants argue [that] they owed no further duty to plaintiffs after the June purchase offer for 3330 Lake Villa was submitted to Westinghouse. Once Westinghouse responded that it could not sell the property due to the property management agreement, Leo Hodgins relayed this information to Don Cousins. Plaintiffs contend that the agent/client relationship persisted far beyond that point based on Leo Hodgins’[s] resubmission of Eagle Ventures’ offer in October. They argue that the information regarding the package sale of 3330 Lake Villa and 4141 Veterans Boulevard constituted a counteroffer by Westinghouse that should have been communicated to Mr. Cousins.

In our opinion, as late as February or March of 1992, Mr. Cousins was still communicating with Leo Hodgins regarding the status of his offer and Leo Hodgins was still discussing Eagle Ventures’ offer with Westinghouse as late as January 1992. We believe Mr. Cousins acted consistently with his belief that Leo Hodgins was acting as his agent with Westinghouse at that time, while Leo Hodgins did nothing to dispel that belief. During some of that time, Leo Hodgins was armed with the information that 3330 Lake Villa was only for sale as a package with 4141 Veterans Boulevard and was covertly planning to acquire the property himself. Hodgins never told Don Cousins or anyone else associated with Eagle Ventures about Westinghouse’s decision to sell the properties together prior to March 1992. Leo Hodgins’[s] failure to communicate the package sale to plaintiffs the moment he learned of it constituted a breach of his fiduciary duties to them. Leo Hodgins’[s] duty was to give plaintiffs the information that Westinghouse rejected their offer for a single property sale and allow them to decide whether they wished to purchase both properties.

Affirmed in favor of the Plaintiff, Cousins.

Duty of Obedience. The agent has the duty to follow all reasonable and lawful instructions of the principal. If the manufacturer of a drug to alleviate the symptoms of the common cold tells its advertising department, salespeople, and distributors to tout the product as a cure for the common cold, these agents have no duty to follow the instructions because they are in violation of Section 5 of the Federal Trade Commission Act (see Chapter 26).

Duty of Accounting. Whenever the principal requests an accounting of money or property, it is the duty of the agent to hand over the requested material. When courts have been asked to determine how the duty of accounting is met, their answers have varied from case to case, but the keeping of accurate books that can be viewed by the principal is the minimum activity expected.

Duty of Performance. In all agency relationships, courts have indicated that agents must use reasonable care and skill in performing their work. This is generally taken to mean that agents must live up to the standards of performance expected of people in their occupation.
A bank acts as an agent for its customer when collecting an item presented for payment. Suppose that the item is an international check to be paid in currency subject to a variable rate of exchange. Does the bank have a duty to account for the difference between the amount paid to the customer and the amount collected on the check? That was a question in the following case.

**CASE 16-4**

**Gossels v. Fleet National Bank**  
Appeals Court of Massachusetts  
876 N.E.2d 872 (2007)

Peter Gossels received a check from the German government for 85,071.19 euros, drawn on Dresdner Bank of Germany. The check was a payment in reparation for the seizure by the Third Reich of property belonging to Gossels’s family. On October 15, 1999, he took the check to a branch of Fleet National Bank in Boston and presented it to the international teller.

The teller failed to inform Gossels that Fleet paid international checks at a “retail exchange rate” several percentage points lower than the interbank “spot rate” for foreign currency.

As Gossels started to endorse the check, the international teller also incorrectly instructed Gossels not to endorse the check.

Fleet, as collecting bank, sent the check to Fleet’s foreign correspondent bank in Germany, Deutsche Bank, which sent it to Dresdner Bank. After a delay to obtain Gossels’s endorsement, Dresdner Bank debited the funds from the appropriate account and sent 85,071.19 euros to Deutsche Bank, which credited 84,971.19 euros to Fleet’s account at Deutsche Bank (100 euros having been deducted as a collection fee).

On December 15, 1999, Gossels received notice from Fleet that it had credited his account with check proceeds in the amount of $81,754.77, which was based on the December 15, 1999, retail exchange rate offered by Fleet for 84,971.19 euros. The same number of euros would have been worth $88,616.45 based on the October 15, 1999, retail exchange rate offered by Fleet or $92,023.80 based on the October 15, 1999, spot rate offered by Dresdner Bank.

When Gossels learned of the different rates, he filed suit in a Massachusetts state court against Fleet. The court entered a judgment for Gossels on the ground of negligent misrepresentation. Both parties appealed to a state intermediate appellate court.

**Justice Gelinas**

Under [Section 4-201(a) of the Uniform Commercial Code.] Fleet became Gossels’s agent when he passed the check to Fleet, and Fleet accepted the check, for collection.

As Gossels’s agent and fiduciary, Fleet was obliged to disclose fully all facts material to the transaction. The principal has a right to be informed of all material facts known to the agent in reference to the transaction in which he is acting for his principal, and good faith requires a disclosure of such facts by the agent. Whenever facts known to the agent but not to the principal may affect the desires and conduct of the principal, the agent must communicate that information to the principal particularly if the agent is engaging in any arrangement adverse to the principal’s interest.

Fleet was required, as a fiduciary, to advise Gossels that it would pay his international check at a retail exchange rate that was several percentage points lower than the spot rate it received for foreign currency. Nowhere in the transaction did Fleet reveal that it would pay Gossels, its principal, a retail rate of exchange substantially less than the spot rate it obtained for the item, which former rate was set out daily on a “secret” rate sheet that bank employees were advised not to disclose to the public, and that it would profit by effectively keeping the difference.

By failing to disclose the rate, and by withholding the amount without giving Gossels an adequate explanation, Fleet further committed a breach of its fiduciary duty to give a complete accounting of the disposition of the funds. An agent or fiduciary is under a duty to keep and render accounts and, when called upon for an accounting, has the burden of proving that he properly disposed of funds which he is shown to have received for his principal.

If there is no prior agreement with regard to the profit, the agent must not only render an account of it, but must pay the funds over to the principal. Fleet was bound to account for the amounts it kept in the rate arbitrage [the profits it earned on the transaction], and to pay it over to Gossels.

The [trial] judge’s finding that Fleet is liable to Gossels for negligent misrepresentation has not been shown to be erroneous. Fleet is also liable to Gossels for breach of fiduciary duty. The judgment is vacated and we remand the case to the trial court for entry of a single judgment in favor of Gossels on the aforementioned claims.

*Affirmed for Gossels.*
Principal’s and Agent’s Liability to Third Parties

Principals are normally responsible for the acts of their agents if those acts come within the scope of the agents’ employment. Principals, then, can be held liable when their agents enter contracts, commit torts within the scope of their employment, or commit crimes while acting on behalf of their principal (Table 16-3).

CONTRACTUAL LIABILITY

The purpose of a principal–agency relationship is to enable the principal to expand business through the use of agents who can negotiate agreements with third parties that the principal would find it difficult or impossible to contact. To do their job, therefore, agents must be authorized to enter into contracts. A principal’s liability for an agent’s contracts depends in large part on whether the principal is disclosed or undisclosed to the third party at the time the agreement is executed. In the following case, we have an agent for a disclosed principal. Usually an agent (Taxman) does not have liability for nonperformance of a fully disclosed principal (Arctic).

CASE 16-5

McBride v. Taxman Corp.
Court of Illinois, First District
765 N.E.2d 51 (2002)

Walgreens Company entered into a lease with Taxman Corporation (defendant) to operate a drugstore in Kedzie Plaza, a shopping center in Chicago, Illinois, owned by Kedzie Plaza Associates; Taxman was the center’s property manager. The lease required the “landlord” to promptly remove snow and ice from the center’s sidewalks. Taxman also signed, on behalf of Kedzie Associates, an agreement with Arctic Snow and Ice Control, Inc., to remove ice and snow from the sidewalks surrounding the Walgreens store. On January 27, 1996, Grace McBride, a Walgreens employee, slipped and fell on snow and ice outside the entrance to the store. McBride filed a suit in an Illinois state court against Taxman and others alleging, among other things, that Taxman had negligently failed to remove the accumulation of ice and snow. Taxman filed a motion for summary judgment in its favor, which the court granted. McBride appealed.

Justice Cerda

On October 10, 1995, Taxman signed, on behalf of the owner, Arctic’s one-page “Snow Removal Proposal & Contract” (although dated August 7, 1995), for the term November 16, 1995, through April 16, 1996, for the shopping center where this Walgreens store was located. Also on October 10, 1995, Arctic and Taxman signed a multi-page document dated October 3, 1995, that was apparently drafted by Taxman. The document was not given a title but contained several pages of terms concerning snow removal “per contract(s) attached.”

Plaintiff argues that the contract between Taxman and Arctic created a duty of Taxman to remove ice and snow for the benefit of the plaintiff.

The Arctic proposal and contract was signed “Kedzie Associates by the Taxman.” The Taxman-drafted portion of the contract contained a line above the signature of Taxman’s director of property management stating “The Taxman Corporation, agent for per contracts attached.” The latter document specifically stated that the contract was not an obligation of Taxman and that all liabilities were those of the owner and not Taxman. We conclude that Taxman was the management company for the property owner and entered into the two contracts for snow and ice removal only as the owner’s agent.

Taxman did not assume a contractual obligation to remove snow or ice; it merely retained Arctic as a contractor on behalf of the owner.

Affirmed in favor of Taxman.
TABLE 16-3
DUTIES OF PRINCIPALS AND AGENTS

<table>
<thead>
<tr>
<th>Principal's Duties to Agents</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Duty of cooperation</td>
<td>Must cooperate with and assist the agent</td>
</tr>
<tr>
<td>in the performance of the agent's duties and the accomplishment</td>
<td>of the agency.</td>
</tr>
<tr>
<td>Duty to provide safe working conditions</td>
<td>Must provide safe working conditions,</td>
</tr>
<tr>
<td>and warn agents of dangerous conditions, and repair and</td>
<td>remedy unsafe conditions.</td>
</tr>
<tr>
<td>Duties of reimbursement and indemnification</td>
<td>Must reimburse an agent for all expenses</td>
</tr>
<tr>
<td>and indemnification</td>
<td>paid that were authorized by the principal,</td>
</tr>
<tr>
<td>and necessary to discharge the agent's duties.</td>
<td>within the scope of the agency,</td>
</tr>
<tr>
<td>Duty of compensation</td>
<td>and necessary to discharge the agent's</td>
</tr>
<tr>
<td></td>
<td>duties.</td>
</tr>
<tr>
<td></td>
<td>Must indemnify the agent for any losses</td>
</tr>
<tr>
<td></td>
<td>suffered because of the principal's acts.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Agent's Duties to Principal</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Duty of performance</td>
<td>Performance of the lawful duties</td>
</tr>
<tr>
<td></td>
<td>expressed in the agency contract</td>
</tr>
<tr>
<td>Duty of notification</td>
<td>with reasonable care, skill, and</td>
</tr>
<tr>
<td></td>
<td>diligence.</td>
</tr>
<tr>
<td>Duty of loyalty</td>
<td>Duty not to act adversely to the</td>
</tr>
<tr>
<td></td>
<td>interests of the principal. The</td>
</tr>
<tr>
<td></td>
<td>most common breaches of loyalty are</td>
</tr>
<tr>
<td>1. Self-dealing Agent</td>
<td>Agent cannot deal with the principal</td>
</tr>
<tr>
<td></td>
<td>unless his or her position is disclosed</td>
</tr>
<tr>
<td>2. Usurping an opportunity</td>
<td>and the principal agrees to deal with</td>
</tr>
<tr>
<td></td>
<td>the agent.</td>
</tr>
<tr>
<td>3. Competing with the principal</td>
<td>Agent cannot usurp (take) an opportunity</td>
</tr>
<tr>
<td></td>
<td>belonging to the principal as his or her</td>
</tr>
<tr>
<td></td>
<td>own.</td>
</tr>
<tr>
<td>Duty of obedience</td>
<td>Must obey the lawful instructions of the</td>
</tr>
<tr>
<td></td>
<td>principal during the performance of the</td>
</tr>
</tbody>
</table>
| Duty of accountability                                           | transactions undertaken on the principal's behalf. A principal may demand an accounting from the agent at any time.

**E-COMMERCE: INTELLIGENT AGENTS**

When discussing agency law in this chapter and contract law in Chapters 10 and 11, we have discussed relationships between human beings and entities represented by individual corporations, partnerships, or franchisors. Usually, the agent acted within the scope of her or his expressed or implied authority. Today, electronic agents (e-agents) such as computer programs are used in e-commerce to perform such tasks as searching the Web for the best price on a service or good.

As discussed in Chapter 11, “click-on” agreements often are part of e-commerce. The terms of such an agreement must be recognized by an intelligent agent. Failing to observe such terms by the agent (A) may bind a principal (P), especially in a lengthy franchise agreement. Also, it may be important that certain click-on agreements exempt third parties (T) from liability. To avoid such problems, click-on agreements are now being developed for online stores that are more easily understood by e-agents.

The Uniform Electronic Transaction Act (UETA) (previously discussed in Chapter 11) allows e-agents to bind principals. When an individual or business entity places an order over the Internet, the principal or company that takes the order from an e-agent cannot disclaim the order.
LIABILITY OF DISCLOSED, PARTIALLY DISCLOSED PRINCIPALS, AND UNDISCLOSED PRINCIPALS

A disclosed principal is one whose identity is known by the third party at the time he or she enters into the agreement; the third party is aware that the agent is acting on behalf of this principal. A partially disclosed principal is one whose identity is not known to the third party at the time of the agreement; the third party does know, however, that the agent represents a principal. In both these cases, the agent has actual authority and, therefore, the principal is liable.

For example, if Jones (agent) enters into an agreement with Thomas (third party) to buy a new car on behalf of Smith, Inc. (principal), Smith will be liable for the contract. Disclosure of a principal is usually shown in the agent’s signature on the contract (e.g., Smith, Inc., by Jones, Agent).

LIABILITY OF UNDISCLOSED PRINCIPAL

When the third party is aware of neither the identity of the principal nor the agency relationship, the agent may be liable to the third party if the principal does not perform the terms of the contract. Undisclosed principal—agent relationships are lawful and are often used by wealthy people to conceal their involvement in a negotiation. For example, Jones, a famous tycoon, hires Smith to go to an auction to bid on a castle. Jones wishes to remain undisclosed because he fears the other bidders will “bid up” the price if they know he is bidding. In this case, both Jones and Smith are liable to the seller whose castle is being auctioned.

TORT LIABILITY

Under the doctrine of respondeat superior, a principal (employer) may be liable for the intentional or negligent torts of his or her agent (employee) if such acts are committed within the scope of the agent’s employment. If the unauthorized acts are committed outside the scope of employment, liability shifts to the agent. Thus, the crucial issue for the courts is whether the employee/agent was acting within the scope of employment when the tort took place.

Two criteria used by the courts to decide this issue are: (1) Was the agent or employee acting in the principal’s interest? (2) Was the agent or employee authorized to be in the particular place where he or she was at the time of commission of the tort? For example, Smith, an employee of Brennan Pizza Company, is authorized to deliver pizza in a vehicle owned by the company but not to make any stops in between delivering the pizza and returning the company vehicle to Brennan Pizza. Smith stops off at a local tavern after delivering the last pizza. Smith comes out of the tavern and hits a third party, Jones, who is walking across the street in a legal manner. If Jones sues the company and Smith, the court must decide these questions: Should the company be held liable? Should the agent, Smith, be held liable? Or should they be held liable jointly and severally? In most states, the agent would be liable given this factual situation because she was not authorized to be where she was at the time of the accident. When company rules against the tortious activity are in place, courts generally rule against the agent. Were the company and Smith found to be jointly and severally liable, the agent would have had to indemnify the principal for what the company has to pay. Practically speaking, though, an agent like Smith usually does not have the money to pay either damages or indemnities. Under the “deep pocket” concept, Brennan Pizza Company alone would pay damages because it has the money to do so.

TORT LIABILITY AND NEGLIGENCE

In a series of cases, tort negligence in hiring and supervision has arisen. A school district’s failure to do background checks before hiring teachers or bus drivers, when
the potential employee’s past offensive conduct toward a child could have been discovered (through computer checks), constitutes the tort of negligent hiring.

The tort of negligent supervision comes about when an employee is left in a position that may be harmful to others after notice is given to an employer. For example, after notice is given of a faculty or staff member’s inappropriate conduct toward students, the college or university may be held liable for failure to take timely action against that employee.

CRIMINAL LIABILITY

Principals are generally not liable for criminal acts (e.g., murder, rape, price-fixing, extortion) of their agents because it is difficult to show the intent of the principal that is required for liability for such crimes. This general rule, however, has two major exceptions: (1) when a principal participates directly in the agent’s crime and (2) when the principal has reason to know that a violation of law by employees or agents is taking place (see United States v. Park in Chapter 7).

For an example of the first exception, assume that a refinery threatens to terminate Jones (employee) unless he agrees to set the prices of gasoline in a certain location and communicate those prices to all company-owned and independent dealers that use the refinery’s gasoline. If Jones does what he is told and is caught, both the refinery and Jones will be prosecuted under the Sherman Act for price-fixing (see Chapter 25). Jones’s defense that he was just an employee following his employer’s orders when he fixed prices will not be accepted. In contrast, if Jones refuses to do what his employer is demanding and is discharged, he can sue the refinery on the basis of the tort of wrongful discharge (see Chapter 20).

Termination of the Principal–Agent Relationship

The principal–agent relationship may be terminated by agreement or by operation of law.

TERMINATION BY AGREEMENT

Either of the parties may decide to terminate the principal–agent relationship. When such a relationship is terminated, all third parties who dealt with the agent should be given actual notice by the principal. Constructive notice may be given to others through advertisement in newspapers published in areas where the agent operated on behalf of the principal.

Some agency relationships are terminated by a lapse of time. For example, Jones agrees with Smith that Smith will serve as his agent for business purposes until May 20, 2007. On that day, Smith’s actual or apparent authority lapses. Once again, the principal should notify all relevant third parties at the termination.

TERMINATION BY OPERATION OF LAW

When the principal–agent relationship is terminated by law, there is no requirement to give notification to relevant third parties. The five most common methods of termination by operation of law are: (1) death of one of the parties, even if the other party is unaware of that death; (2) insanity of one of the parties; (3) bankruptcy of the principal; (4) impossibility of performance, which may come about through the destruction or loss of subject matter or a change in the law; and (5) an outbreak of war, particularly when the agent’s country is at war with the principal’s country.
Ms. M was born in 1918. After retiring, Ms. M returned to Fairfield, South Carolina, where she lived on her family farm with her brother, a dentist, until his death in the early 1980s. Ms. M never married. Dr. Gaddy was Ms. M's physician and a close family friend. The appellants are Ms. M's third cousins.

In 1988, Ms. M then executed a durable general power of attorney designating Dr. Gaddy as her attorney-in-fact. Concerns about Ms. M's progressively worsening mental condition prompted Dr. Gaddy to file the 1988 durable power of attorney in November 1995. Thereafter, Dr. Gaddy began to act as Ms. M's attorney-in-fact and assumed control of her finances, farm, and health care. His responsibilities included paying her bills, tilling her garden, repairing fences, and hiring caregivers.

In March 1996, Dr. Gaddy discovered that Ms. M had fallen in her home and fractured a vertebra. Ms. M was hospitalized for six weeks. During the hospitalization, Dr. Gaddy fumigated and cleaned her home, which had become flea-infested and unclean to the point where rat droppings were found in the house. Finding that Ms. M was not mentally competent to care for herself, he arranged for full-time caretakers to attend to her after she recovered from the injuries she sustained in her fall. He made improvements in her home, including plumbing repairs adapting a bathroom to make it safer for caretakers to bathe Ms. M, who was incapable of doing so unassisted. During Ms. M's hospitalization, neither of the appellants visited her in the hospital or sought to assist her in any manner.

Dr. Gaddy had Ms. M examined and evaluated by Dr. James E. Carnes, a neurologist, in December 1996. After examining Ms. M, Dr. Carnes found that she suffered from dementia and confirmed that she was unable to handle her own affairs. As Ms. M's Alzheimer's disease progressed and her faculties deteriorated, Dr. Gaddy managed her financial affairs, oversaw maintenance of her properties, and ensured that she received constant care, including food, clothing, bathing, and housekeeping.

Ms. M's long-standing distant relationship with some members of her family, including appellants, changed in March of 1999. On March 12, 1999, the appellants visited Ms. M, and with the help of a disgruntled caretaker, took her to an appointment with Columbia attorney Douglas N. Truslow to “get rid of Dr. Gaddy.” On the drive to Truslow's office, Heller had to remind Ms. M several times of their destination and purpose. At Truslow's office, Ms. M signed a document revoking the 1988 will and the 1988 durable power of attorney. She also signed a new durable power of attorney (1999 durable power of attorney) naming the appellants as her attorneys-in-fact. The appellants failed to disclose Ms. M's dementia to Truslow and to David Byrd, a witness to the execution of the March 12 document. Based on the revocation of the 1988 power of attorney and recently executed power of attorney, the appellants prohibited Dr. Gaddy from contacting Ms. M and threatened Dr. Gaddy with arrest if he tried to visit Ms. M.

On March 16, 1999, three days after Ms. M purportedly revoked the 1988 durable power of attorney and executed the 1999 durable power of attorney, Dr. Gaddy brought a legal action as her attorney-in-fact pursuant to the 1988 durable power of attorney. He alleged, among other things, that the purported revocation of the 1988 durable power of attorney and the execution of the 1999 durable power of attorney were invalid because “on March 12, 1999, the date on which Ms. M purportedly signed the 1999 power of attorney and the revocation, she was not mentally competent” due to “senile dementia of the Alzheimer's type.” Medical testimony was presented from five physicians who had examined Ms. M. They concluded that Ms. M (1) was “unable to handle her financial affairs” and (2) would not “ever have moments of lucidity” to “understand legal documents.”

The trial judge concluded that Ms. M lacked contractual capacity “from March 12, 1999 and continuously thereafter.” As a result, he invalidated the 1999 revocation of the 1988 durable power of attorney and the 1999 durable power of attorney, and declared valid the 1988 durable power of attorney. Finally, he awarded Dr. Gaddy litigation expenses to be paid from Ms. M's assets.

Justice Kittredge

Since 1986, the South Carolina Legislature has expressly authorized and sanctioned the use and efficacy of durable powers of attorneys.

Upon the execution of a durable power of attorney, the attorney-in-fact retains authority to act on the principal's behalf notwithstanding the subsequent physical disability or mental incompetence of the principal. To honor this unmistakable legislative intent, it is incumbent on courts to uphold a durable power of attorney unless the principal retains contractual capacity to revoke the then existing durable power of attorney or to execute a new power of attorney.

“In order to execute or revoke a valid power of attorney, the principal must possess contractual capacity.” Contractual capacity is generally defined as a person's ability to understand in a meaningful way, at the time the contract is executed, the nature, scope, and effect of the contract. Where, as here, the mental condition of the principal is of a chronic nature, evidence of the principal's prior or subsequent condition is admissible as bearing upon his or her condition at the time the contract is executed.
Global Dimensions of Agency Law

As global business by multinational, midsize, and even small corporations has expanded, many U.S. businesses have hired foreign agents to represent them abroad. With the lowering of tariff barriers through such treaties as the North American Free Trade Agreement and the World Trade Organization, foreign agents will become ever more essential to the movement of goods and services across national boundaries. Thus, it behooves managers in businesses of all sizes to become knowledgeable about the exporting companies, distributors, and sales agents they contract with and the rules that govern those agents in their own countries. We covered the general aspects of these treaties and the international legal environment of business in Chapter 9. Here we encapsulate some of the major differences between agency law and practice in the United States and in two importing trading partners of U.S. business: Japan and the European Union (EU).

JAPAN

In Japan, agents must disclose whom they are representing, and third parties often require proof that agents are acting on behalf of a particular principal. Unlike in the United States, an agent in Japan must have expressed authority to act, and principals are held liable for acts of agents within their limited range.

EUROPEAN UNION

European Union principals are bound to act in good faith toward their agents. If there is no written contract, compensation is based on customary practice in the location where the agent is acting. Agents are also expected to act in good faith.
All items in negotiations must be communicated to the principal, and the agent is bound to follow the principal’s instructions quite literally. Most agency agreements are assumed to be for an indefinite time; thus, notice of one, two, and three months, respectively, is required to terminate a relationship of one, two, and three years’ duration.

**U.S. AGENTS ABROAD**

From just these two examples, you can see how agency law elsewhere can differ significantly from agency law in the United States. Managers should carefully review a host country’s laws on agency before carrying on business in that country.

There are special complications for managers when the law of the host country conflicts with the Foreign Corrupt Practices Act (FCPA) of 1977, as amended in 1988. Although the FCPA allows remuneration to lower-level foreign agents and officials to expedite the handling of goods that U.S. businesses are seeking to sell in another country, it strictly forbids payments to political officials beyond a certain level. Because companies are liable for both civil and criminal sanctions for violating the FCPA, managers must keep a close watch over the actions of hired foreign agents, as well as over the actions of their own employees abroad.

**COMPARATIVE LAW CORNER**

Many businesspeople doing business in Japan have particular difficulty with the authority level given agents representing Japanese multinationals. As noted previously, agents must have expressed authority to represent Japanese companies, so such agents will likely have proof of some expressed (oral or written) authority. U.S. companies, in contrast, expect implied or apparent authority to be sufficient for agents. It would seem that U.S. company managers should be careful in reviewing Japanese law as well as U.S. law. Please note carefully the FCPA of 1977, as amended in 1988. See the preceding section on “U.S. Agents Abroad,” as well as details on the FCPA in Chapter 26.

**SUMMARY**

An agency relationship is a fiduciary relationship in which the agent acts on behalf of, and is subject to the control of, the principal. There are three types of such relationships: principal–agent, employer–employee, and employer–independent contractor. The four methods of creating an agency relationship are: (1) through expressed agency (agency by agreement), (2) by implied authority, (3) through ratification by the principal, and (4) by estoppel or apparent authority.

The duties of the principal to the agent are compensation for services rendered, reimbursement for expenses and indemnification for losses, cooperation, and provision of safe working conditions. Those of the agent toward the principal are loyalty, obedience to reasonable and lawful instructions, an accurate accounting, and skillful and careful performance.

Principals are liable to third parties for contracts made by their agents on their behalf, torts committed by the agent within the scope of the agent’s employment, and crimes committed by the agent at the principal’s direction.

Agency relationships may be terminated by mutual consent or by operation of law.

Managers doing international business need to be aware of the sometimes significant differences between agency law in the United States and agency law in other countries.
**REVIEW QUESTIONS**

16-1 Explain the doctrine of respondeat superior.
16-2 Define apparent and actual authority.
16-3 Describe the agent’s duties to the principal.
16-4 Distinguish an agent from an independent contractor.
16-5 Is a principal responsible for all contracts entered into by an agent? Explain.
16-6 Why must a principal notify a third party of the termination of an agency relationship? Explain.

**REVIEW PROBLEMS**

16-7 Profit Corporation authorized Anderson, an employee, to find a buyer for used equipment that Profit intended to sell. Anderson believed that he had authority to contract for the sale of the equipment, but in fact he did not. Anderson found a prospective buyer, Caveat Corporation, and contracted with Caveat on behalf of Profit for the sale of the equipment to Caveat. In this contract, Anderson warranted that the equipment was fit for Caveat’s particular needs. A responsible officer of Profit read the contract and directed that the equipment be shipped to Caveat. The equipment did not meet the special needs of Caveat, and Caveat refused to pay for it. Profit sued Caveat for the contract price. Who will win this case and why?

16-8 Mrs. Terry sees a cashmere sweater she likes in Peters Department Store but notices that it is slightly soiled. Alice, the sales clerk, agrees to mark it down from $55 to $40, which she has no authority to do. Mrs. Terry consents, asks that the sweater be delivered, and promises to pay cash on delivery. The manager of Peters sees the item being wrapped, corrects the bill, and sends it out to Mrs. Terry. On seeing her sweater accompanied by a bill for $55, Mrs. Terry calls and is told by Peters that Alice had no authority to knock down the price and that she should either pay the bill or return the sweater. Is Mrs. Terry entitled to the bargain? Why or why not?

16-9 Owner orally authorized Agent to sell his house. Agent completed a sale of the house to Buyer. When Buyer attempted to enforce the contract against Owner, Buyer was told that the contract was not enforceable because Owner’s agency relationship with Agent was not in writing. Must Owner have given Agent written authorization?

16-10 Owner listed his house with Penelope, a real estate broker, granting Penelope an exclusive right to sell Owner’s house. Penelope entered into negotiations with Buyer, who seemed interested in purchasing the property. Buyer found the price agreeable, but he insisted on including in the sales contract a clause giving him the right to cancel the contract if he could not get a loan to finance his purchase. At the closing, Buyer exercised his right to cancel, giving as his reason inability to procure a loan. Penelope turned to Owner and claimed that she was entitled to her commission even though the sale did not go through. Must Owner pay Penelope a commission?

16-11 Julius and Olga Sylvester owned an unimproved piece of land near King of Prussia, Pennsylvania. They were approached by Beck, a real estate broker, who asked if they were willing to sell their land, stating that an oil company was interested in buying, renting, or leasing the property. The Sylvesters said that they were only interested in selling, and they authorized Beck to sell the property for $16,000. Several weeks later, Beck phoned the Sylvesters and offered to buy the property for himself for $14,000. Olga asked, “What happened to the oil company?” and Beck responded, “They are not interested. You want too much money for it.” The Sylvesters sold the property to Beck. A month later, Beck sold the property to Epstein for $25,000. When the Sylvesters learned that Beck had realized a huge profit in a quick resale of the property, they sued Beck, claiming that he owed them the $9,000 profit. Does Beck owe the Sylvesters the money?

16-12 Peter authorized Arnon, a grain broker, to buy at the market 20,000 bushels of wheat for Peter. At the time, Arnon had in storage 5,000 bushels belonging to Johnson, who had authorized Arnon to sell for him. Arnon also had 15,000 bushels that she owned. Arnon transferred these 20,000 bushels to Peter’s name and charged Peter the current market price. Shortly thereafter, and before Peter had used or sold the wheat, the market price declined sharply. Peter refused to pay for the wheat and tried to cancel the contract. Can he cancel? Explain.
16-13  Greif Brothers Corporation, a steel drum manufacturer, owned and operated a manufacturing plant in Youngstown, Ohio. In 1987, Lowell Wilson, the plant superintendent, hired Youngstown Security Patrol, Inc. (YSP), a security company, to guard Greif’s property and “deter thieves and vandals.” Some YSP security guards, as Wilson knew, carried firearms. Eric Bator, a YSP security guard, was not certified as an armed guard but nevertheless took his gun in a briefcase to work. While working at the Greif plant on August 12, 1991, Bator fired his gun at Derrell Pusey, in the belief that Pusey was an intruder. The bullet struck and killed Pusey. Pusey’s mother filed suit in an Ohio state court against Greif and others, alleging in part that her son’s death was the result of YSP’s negligence, for which Greif was responsible. Greif filed a motion for directed verdict. Who won? Explain. *Pusey v. Bator*, 94 Ohio St. 3d 275, 762 N.E.2d 968 (2002).

16-14  Ford Motor Credit Company is a subsidiary of Ford Motor Company, with its own offices, officers, and directors. Ford Credit buys contracts and leases of automobiles entered into by dealers and consumers. Ford Credit also provides inventory financing for dealers’ purchases of Ford and non-Ford vehicles and makes loans to Ford and non-Ford dealers. Ford Credit is not subject to any agreement with Ford Motor “restricting or conditioning” its ability to finance the dealers’ inventories or the consumers’ purchases or leases of vehicles. A number of plaintiffs filed a product liability suit in a Missouri state court against Ford Motor. The plaintiffs asserted that Ford Credit, which had an office in the jurisdiction, acted as Ford’s “agent for the transaction of its usual and customary business” there. Is Ford Credit an agent of Ford Motor? Explain. *State ex rel. Ford Motor Co. v. Bacon*, 63 S.W.3d 641 (Mo. 2002).

16-15  Sam and Theresa Daigle decided to build a home in Cameron Parish, Louisiana. To obtain financing, they contacted Trinity United Mortgage Company. At a meeting with Joe Diez on Trinity’s behalf, on July 18, 2001, the Daigles signed a temporary loan agreement with Union Planters Bank. Diez assured them that they did not need to make payments on this loan until their house was built and that permanent financing had been secured. Because the Daigles did not make payments on the Union loan, Trinity declined to make the permanent loan. Meanwhile, Diez left Trinity’s employ. On November 1, the Daigles moved into their new house. They tried to contact Diez at Trinity but were told that he was unavailable and would get back to them. Three weeks later, Diez came to the Daigles’ home and had them sign documents that they believed were to secure a permanent loan but that were actually an application with Diez’s new employer. Union filed a suit in a Louisiana state court against the Daigles for failing to pay on its loan. The Daigles paid Union, obtained permanent financing through another source, and filed a suit against Trinity to recover the cost. Who should have told the Daigles that Diez was no longer Trinity’s agent? Could Trinity be liable to the Daigles on this basis? Explain. *Daigle v. Trinity United Mortgage, LLC*, 890 So. 2d 583 (La. Ct. App. 2004).

16-16  Juanita Miller filed a complaint in an Indiana state court against Red Arrow Ventures, Ltd., Thomas Hayes, and Claudia Langman, alleging that they had breached their promise to make payments on a promissory note issued to Miller. The defendants denied this allegation and asserted a counterclaim against Miller. After a trial, the judge announced that, although he would be ruling against the defendants, he had not yet determined what amount of damages would be awarded to Miller. Over the next three days, the parties’ attorneys talked and agreed that the defendants would pay Miller $21,000. The attorneys exchanged correspondence acknowledging this settlement. When the defendants balked at paying this amount, the trial judge issued an order to enforce the settlement agreement. The defendants appealed to a state intermediate appellate court, arguing that they had not consented to the settlement agreement. What is the rule regarding the authority of an agent to agree to a settlement? How should the court apply the rule in this case? Why? *Red Arrow Ventures, Ltd. v. Miller*, 692 N.E.2d 939 (Ind. Ct. App. 1998).

**THINKING CRITICALLY ABOUT RELEVANT LEGAL ISSUES**

The only agency relationships that the courts should recognize are those created by agreement. Agency relationships are like contracts. There must be a meeting of the minds in order for a contract to be valid, and this standard ought also to apply to agency relationships.

Agency relationships created by implied authority, ratification, or estoppel all originate with either an
ambiguous agreement or a false statement. In the first instance, the ambiguity surrounding the agreement prevents both parties from knowing if there has been a meeting of the minds. This situation may be likened to two people who speak different languages negotiating a contract. Each will never know if the other is willing to grant his or her desires.

The second scenario violates a notion that civilized human beings hold very dear: that we should tell the truth. By allowing agency relationships that began with one party’s telling a lie, we encourage dishonesty. People are motivated to lie about their agency relationships out of hope that the other party will accept the lie. It’s the same as telling all of your friends that you are engaged to someone in order to pressure that person into accepting your proposal for marriage.

Finally, by allowing such relationships the opportunity to become legally valid, we are merely opening the door for more lawsuits. Our courts’ dockets are already full; we should work to reduce the court workload, not to increase it. To create a better society, we must treat agency relationships like other contracts.

The author of this passage relies heavily on analogies in his reasoning. Locate these analogies and evaluate how reasonable they are. (Remember, the way to evaluate an analogy is to state ways in which the two things being compared are similar, and then to state ways in which they are different.)

1. What is the author’s conclusion, and with what reasons does he support it?
2. Is there any additional information that would aid you in your task of evaluating this argument?
3. State an argument that is the opposite of the one set out by the author here.

ASSIGNMENT ON THE INTERNET

Using one of the two Web sites that follow, or another Web site of your choosing, find a recent case involving principal–agent law. Read the case and determine the issue being decided, the court’s holding or conclusion, and the reasons cited for the holding. Next, identify the ideas discussed in this chapter that were used in the court’s reasoning. Do you agree with the court’s reasoning? Why?

WWW ON THE INTERNET

www2.chass.ncsu.edu/garson/pa765/agent.htm This site provides a brief discussion of the principal–agent theory in business management. This site also contains suggested readings for further research.

www.law.cornell.edu/topics/agency.html The Legal Information Institute’s site on agency contains a brief overview and links to recent court cases involving agency law.

FOR FUTURE READING


The world of business is now much more complex than ever before. Businesses vary greatly in size and organizational form. In Chapters 17 and 18 we outline the differences, and the advantages and disadvantages of each form. See Table 17-1 for factors influencing a manager’s choices of organizational form.

This chapter outlines some of the common forms of business associations, including simple proprietorships, partnerships, and specialized associations.

**TABLE 17-1 COMPARISON OF ALTERNATIVE FORMS OF BUSINESS ORGANIZATION**

<table>
<thead>
<tr>
<th>Organizational Form</th>
<th>Tax Ramifications</th>
<th>Control Considerations</th>
<th>Liability</th>
<th>Ease and Expense of Formation</th>
<th>Transferability of Ownership Interests</th>
<th>Lifetime</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole proprietorship</td>
<td>Profits taxed directly to proprietor as ordinary income and losses deducted by proprietor.</td>
<td>Sole proprietor has total control.</td>
<td>Sole proprietor has unlimited personal liability.</td>
<td>No formalities or expenses required other than those specific to the business to be operated.</td>
<td>Nontransferable.</td>
<td>Limited to life of proprietor</td>
</tr>
<tr>
<td>General partnership</td>
<td>A federal income tax return must be filed for information only. Profits taxed to partners as ordinary income and losses deducted by partners. Profits and losses shared equally unless changed by partnership agreement.</td>
<td>Each partner is entitled to equal control. Can be changed by partnership agreement.</td>
<td>Each partner has unlimited personal liability for debts of the partnership.</td>
<td>No formalities or expenses required other than those specific to the business to be operated. Written agreement advisable.</td>
<td>Nontransferable.</td>
<td>Limited to life of partners</td>
</tr>
<tr>
<td>Limited partnership (limited liability partnership)</td>
<td>Same as general partnership.</td>
<td>Same as for general partners. Limited partners cannot take part in management.</td>
<td>Same as for general partners. Liability of limited partner is limited to his or her capital contribution.</td>
<td>Added expense and time required to draw up and file written partnership agreement. Failure to comply with formalities will result in loss of limited partnership.</td>
<td>Nontransferable.</td>
<td>Limited to life of general partners</td>
</tr>
<tr>
<td>--------------------------------------------------</td>
<td>-----------------------------</td>
<td>-----------------------------------------------------------------</td>
<td>-----------------------------------------------------------------</td>
<td>-----------------------------------------------------------------</td>
<td>-----------------------------</td>
<td>-----------------------------------------------------------------</td>
</tr>
<tr>
<td>Public corporation</td>
<td>Profits taxed as income to corporation and again as income to owners when distributed as dividends.</td>
<td>Separation of ownership and control. No control over daily management decisions.</td>
<td>Liability limited to loss of capital contribution.</td>
<td>Expense and time required to comply with statutory formalities. Must receive charter from state; usually required to register and pay fees to operate in states other than state of incorporation.</td>
<td>Generally unlimited, except by shareholder agreement.</td>
<td>Unlimited</td>
</tr>
<tr>
<td>Subchapter S corporation</td>
<td>Taxed as a partnership.</td>
<td>Separation of ownership and control. No control over daily management decisions.</td>
<td>Liability limited to loss of capital contribution.</td>
<td>Same as for public corporation; must follow IRS rules carefully or lose Subchapter S status.</td>
<td>Ownership interests limited to no more than 35 shareholders; all must be individuals, estates, or certain types of trusts, and no shareholder may be a nonresident alien. Shares may not be issued or transferred to more than 35 shareholders.</td>
<td>Unlimited</td>
</tr>
<tr>
<td>Limited liability company</td>
<td>Taxed as a partnership.</td>
<td>Control over daily management decisions.</td>
<td>Liability limited to loss of capital contribution.</td>
<td>Same as for public corporation; must follow IRS rules carefully or lose limited liability status.</td>
<td>Ownership interests limited to no more than 35 shareholders; all must be individuals, estates, or certain types of trusts, and no shareholder may be a nonresident alien. Shares may not be issued or transferred to more than 35 shareholders.</td>
<td>Unlimited</td>
</tr>
</tbody>
</table>

Additionally, global dimensions of some of these business associations will be examined here. Chapter 18 is an in-depth treatment of corporations and the various corporate forms.
CRITICAL THINKING ABOUT THE LAW

We point out in this chapter that the organizational form of a business will determine the amount of regulation that business experiences. Furthermore, business owners will have different rights and responsibilities according to the organizational form. Although you will learn about the major organizational forms later in this chapter, you can prepare to use your critical thinking skills while you consider business associations by asking yourself the following questions.

1. This question is not a formal critical thinking question, but it lays the groundwork for critical thinking about forms of business organization. Think about the businesses with which you interact every day. For example, where do you buy groceries? Who cuts your hair? Where did you buy this book? Why should the community even care whether these businesses are owned by a single person or by hundreds of shareholders?

   **Clue:** Ask yourself what the community expects from businesses and how these different forms of ownership would affect the extent to which those expectations are fulfilled.

2. Joan wants to open a business that specializes in selling fine wines. She believes that, as long as she follows the law of selling alcohol only to individuals 21 years of age or older, the government should not impose any other regulation on her business activity. What ethical norm seems to dominate Joan’s thinking?

   **Clue:** Think about the list of ethical norms in Chapter 1. Which norm seems most consistent with little or no governmental regulation? Which ethical norm seems to conflict with the idea of little governmental regulation?

3. One of the factors that might influence business owners to choose one organizational form over another is the liability associated with that organizational form. For example, in a sole proprietorship, the owner is liable for all losses, whereas owners in a corporation have limited liability. Vanessa has a chance to be either a sole proprietor or a shareholder in a corporation. She chooses to become a sole proprietor, even though she considers this option to be riskier. Which ethical norms might be guiding her decision to become a sole proprietor?

   **Clue:** Look closely at the list of ethical norms. Which norms seem consistent with Vanessa’s choice? Can you identify any other ethical norms that may be influencing her decision?

Factors Influencing a Business Manager’s Choice of Organizational Form

There is no ideal form for a business venture. Each of the forms we discuss in this chapter has advantages and disadvantages. The entrepreneur, with the counsel of an attorney and an accountant or tax expert, should carefully weigh the advantages and disadvantages of different organizational forms for the type of business the entrepreneur wishes to engage in. The principal factors influencing the choice of organizational form are: (1) tax ramifications, (2) control considerations, (3) potential liability of the owner(s), (4) ease and expense of formation and operations, (5) transferability of ownership interests, and (6) the projected life of the organization. Table 17-1 gives an overview of how these six factors differ for each organizational form.

Some Common Forms of Business Organization in the United States

Some common forms of business organization in the United States are the sole proprietorship, the partnership, the corporation, and the specialized businesses (Table 17-2). We examine each of these organizational forms in this chapter and Chapter 18.
### TABLE 17-2 ALTERNATIVE FORMS OF BUSINESS ORGANIZATION

<table>
<thead>
<tr>
<th>Form of Business Organization</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole proprietorship</td>
<td>Person going into business on his or her own; responsible for all profits and losses.</td>
</tr>
<tr>
<td>Partnership (general)</td>
<td>Voluntary association of two or more persons to carry on a business as co-owners for profit. A limited liability partnership is a voluntary association, as is a general partnership, but one or more partners contribute capital only, and those partners play no role in management. Their liability is limited to the amount of capital they contribute.</td>
</tr>
<tr>
<td>Corporation</td>
<td>A legal entity created by state law that raises capital by issuing stocks and bonds to investors, who become shareholders and owners of the corporation. Corporations can be classified as public or private and are further distinguished as multinational, professional, closely held, Subchapter S, or nonprofit.</td>
</tr>
</tbody>
</table>

### SOLE PROPRIETORSHIPS

When a single proprietor seeks to go into business for himself or herself (alone), the person must examine the following: tax ramifications, control considerations, liability, ease and expense of formation, transferability of ownership, and the projected lifetime of the business. Each of these is outlined in Table 17-1.

The **sole proprietorship** is the easiest and least expensive way to create a business organization. After obtaining any licenses that are required by state and local law, an individual is in business. This is a distinct advantage over the other forms to be discussed in this chapter and Chapter 18.

A sole proprietor generally pays only personal income taxes (inclusive of Social Security and Medicare taxes) on profits. Sole proprietor’s profits are reported on his or her personal income tax form. An individual can also set up retirement accounts for the owner and any employees.

A sole proprietor may be held personally liable for the debt of the business. Often other forms of business organizations are used to avoid this risk. The ease of transferring ownership of a single proprietorship is a potential advantage. Less documentation is needed than for transfer of other business forms and interests.

Some advantages (pros) and disadvantages (cons) of sole proprietorships over other forms of business organization are summarized here and in Table 17-1.

<table>
<thead>
<tr>
<th>Advantages (Pros)</th>
<th>Disadvantages (Cons)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Only one individual is involved—ease of formation.</td>
<td>(1) Personal liability for almost all assets, both personal and business.</td>
</tr>
<tr>
<td>(2) Total control belongs to one individual.</td>
<td>(2) Individual pays all taxes on profits made by business. Ownership cannot be</td>
</tr>
<tr>
<td>The individual may dissolve the sole (single) proprietorship at any time.</td>
<td>transferred.</td>
</tr>
<tr>
<td>(3) Sole proprietorships are subject to less government regulation at all levels.</td>
<td>(3) As a single proprietorship grows, it must gain maturity as to regulation, and</td>
</tr>
<tr>
<td></td>
<td>management thereof, to be successful. Often, individuals lack the sophistication</td>
</tr>
<tr>
<td></td>
<td>to make the next step and take the business to the next level.</td>
</tr>
</tbody>
</table>

### GENERAL PARTNERSHIPS

When two or more people wish to be involved in the ownership of a business, either a limited or a general partnership may be formed. Under the Uniform Partnership Act (UPA), the law that governs partnerships in most states, a **partnership** is defined as a voluntary association of two or more persons formed to carry on a business as co-owners for profit. As in a sole proprietorship, the profits of a partnership are taxed only as income to the partners. More recently, the Revised Uniform Partnership Act (RUPA) has been adopted in more than 35 states (others continue to follow the UPA). The RUPA states that a partnership
need not dissolve just because a partner leaves (in contrast to the UPA), clarifies the fiduciary duties of partners, and establishes a formula for valuing a partnership interest during a buyout. It also provides greater protection for the limited liability partner (to be discussed later in this chapter).

In a general partnership, all profits are usually divided equally among the partners, and all partners have unlimited personal liability for partnership debts. Also, management responsibilities may be, but are not always, divided equally. For example, if James and Carol decide to operate a florist shop as co-owners in a general partnership, each of them makes an initial contribution in the form of cash, realty, business supplies, or services. They take an equal role in the management of the business, with each expected to contribute services. They split the profits equally (assuming that no other proportion has been specified in a written partnership agreement). At the end of the first year, they file a partnership return with the Internal Revenue Service (IRS) that shows the partnership’s profit or loss. If the partnership makes a profit, James and Carol each pay income tax on half the profits; if the partnership incurs a loss, each deducts one-half of that loss from his or her ordinary income. The partnership itself pays no taxes. If the business fails, both James and Carol can be sued by creditors and forced to pay the partnership’s debts out of their personal resources.

Creating a Partnership. In many partnerships, there is initially no written partnership agreement; the partners informally split the capital contribution and work between them. In the absence of a written agreement, the UPA controls. For example, the UPA requires partners to share profits equally. Now, James and Carol from our preceding example may not have intended an equal distribution of profits when they went into business, and such a distribution may be unfair because Carol does 90 percent of the work and the less-energetic James does a mere 10 percent. However, if they have no written agreement, James can legally claim 50 percent of the profits. To avoid conflicts over management responsibilities, borrowing power, profit sharing, and other common bones of contention in a partnership, the partners should set out the rights and responsibilities of each partner in a written partnership agreement at the outset. Exhibit 17-1 lists some of the items that should be included in such an agreement.

Most of the RUPA consists of rules that will apply unless the partnership agreement states differently. This will force all partnerships to be thoughtfully and carefully created. All parties engaged in an existing partnership or creating a new one should be careful to see if the RUPA has been adopted in the state where the partnership agreement is formed. If so, the RUPA will determine when a partnership exists based on three factors: (1) whether there exists a sharing of

---

**EXHIBIT 17-1**

**ITEMS INCLUDED IN PARTNERSHIP AGREEMENTS**

- Name and address of partnership
- Name and address of partners
- Purpose of partnership
- Duration of partnership
- Amount and type of investment of each partner (e.g., cash, realty, services)
- Loans to partnership
- How profits and losses are to be shared
- Management and voting power of each partner
- Method of settling disputes that should arise
- Cross-insurance of partners
- Duties of each partner
- How books are to be set up and maintained
- Banking arrangements—who has authority to deposit and withdraw
- Who has authority to borrow money in the name of the partnership
- Who does the hiring and firing of employees
profits and losses, (2) a joint ownership of the business, (3) an equal opportunity to participate in the management of the business. This test of partnership existence is illustrated by the following case.

**CASE 17-1**

In re KeyTronics
Supreme Court of Nebraska
744 N.W.2d 475 (2008)

In 1999, King was doing business under the name of “Washco” as a sole proprietorship engaged in selling, installing, and servicing carwash systems and accessories. King offered to his customers the “QuikPay” system, a cashless vending system for carwashes that used a memory-chip key that interacted with a controller at the carwash. A cash value can be placed on the key, or the carwash usage recorded on the key can be billed monthly. Washco purchased QuikPay systems for resale from Datakey Electronics, Inc. (Datakey), but the arrangement was becoming unprofitable for Datakey, partly because the keys for QuikPay could only be obtained from an attendant. According to Glen Jennings, president of Datakey, because most carwashes are unattended, this reliance on the presence of the carwash owner or employee was limiting the market for the product.

As QuikPay’s largest distributor, King was aware that QuikPay’s limitations made the product unattractive to many of his customers. King contacted Willson, an electronics technician and computer programmer, to see if Willson could develop a combined “key dispenser” and “revalue station” for the QuikPay system that would make the system self-service. King also asked Willson if he would design and install an interface between the QuikPay system and the carwash of one of King’s customers; designing such an interface was beyond King’s technical expertise. Willson individually designed and installed at least four specific customer interfaces that allowed King to sell the QuikPay system to those customers, but Willson was never paid for his work.

According to King, there was an oral agreement among himself, Willson, and Scott Gardeen (an employee of Datakey who was an original designer of QuikPay) to form a corporation whenever Willson developed the key dispenser-revalue station. The three parties met in the spring of 2002 to discuss a venture in which they would develop the key dispenser-revalue station. The meeting ended with Willson indicating that if a final, marketable key dispenser-revalue station were developed, Datakey would be interested in a business relationship with Secure Data Systems.

Willson estimated that he had put at least 2,000 hours into QuikPay sales and maintenance and development of the key dispenser-revalue station. When Willson was asked why he invested his time and expertise into QuikPay without any remuneration, he explained, “That was my contribution to the company. I mean that was my piece.” Willson contacted a law firm to draft papers to formalize the partnership. These papers were never drafted. According to Willson, when he told King he was looking into creating a written agreement for their relationship, King “assured [him] that he was having his attorneys look at it.” King and Willson had another meeting around the end of December and agreed to end their relationship and any joint QuikPay or key dispenser-revalue station activities. Approximately two weeks after this meeting, King called Willson and offered to compensate him for the time he had spent in maintaining or repairing QuikPay. Willson refused.

Willson brought an action for winding up and an accounting, alleging formation of a partnership. King denied that they had formed a partnership. The trial court found that King and Willson had “pooled resources, money and labor,” but found that no partnership existed because there was no “specific agreement.” Alternatively, the trial court found that because King did not commit his preexisting business to any specifically formed partnership, the scope of the partnership did not encompass any activity garnering profits. Willson appealed the trial court’s order.

**Justice McCormack**

This case is governed by the revised Uniform Partnership Act. Section (202(a)) of the Act defines that a partnership is formed by “the association of two or more persons to carry on as co-owners a business for profit” and explains that this is true “whether or not the persons intend to form a partnership.” . . .

Obviously, the relationship between King and Willson is “of two or more persons.” In addition, whether the business of QuikPay maintenance, or even the development of the never-produced key dispenser-revalue station, qualifies as a business “for profit” is not in issue. It is not essential that the business for which the association was formed ever actually be carried on, let alone that it earn a profit. Without Willson’s technical assistance, King would have
been unable to continue QuikPay’s viability after Datakey abandoned the product. That King could have dealt with certain issues by hiring contractors or employees is irrelevant. He chose not to do so—presumably because the promise of the key dispenser-revalue station made a partnership relationship more worthwhile—and saved himself the expense of paying for this labor.

We also find that despite King’s protestations to the contrary, the evidence shows that King and Willson shared control over QuikPay business. We note that control is “elusive because of the many gradations of control and because partners often delegate decision-making power.” Still, Willson testified that he and King consulted with each other over what appropriate pricing would be as they picked up Datakey’s equipment and customers.

Willson also testified that he had an agreement with King to share profits, although King denies this. Of the five indicia of co-ownership, profit sharing is possibly the most important, and the presence of profit sharing is singled out in [Section 202(c)(3)] as creating a rebuttable presumption of a partnership. However, what is essential to a partnership is not that profits actually be distributed, but, instead, that there be an interest in the profits. Willson’s testimony that they agreed to share in the profits of the business is, in light of all the evidence, simply more credible than King’s statement that compensation “was never discussed.” And even King vaguely admits that they had an understanding to share profits of the key dispenser-revalue station, if that were developed. It seems reasonable to assume that this same understanding would apply to Willson as his participation and the scope of the venture expanded to encompass all QuikPay business.

We do not find any evidence that King and Willson had an agreement for loss sharing. But we find this of little import, since purported partners, expecting profits, often do not have any explicit understanding regarding loss sharing. Likewise, although King and Willson admittedly do not own any joint property, in an informal relationship, the parties may intend co-ownership of property but fail to attend to the formalities of title. Moreover, in this case, it is unclear that there is much QuikPay “property” at all.

We conclude that both parties, as well as subjective, indicia are sufficient to prove co-ownership of the business of selling, maintaining, and developing QuikPay. Having already concluded that there was an association for the same, we conclude that Willson proved that he and King had formed a partnership for the business of selling, maintaining, and developing QuikPay.

Reversed and Remanded for Willson and QuikPay.

Relationship between Partners. The RUPA states that each partner has a fiduciary relationship to the partnership and must act in good faith for the benefit of the partnership. In most general partnerships, each partner has one vote in decisions pertaining to the management of the business, though in some instances—such as a decision to merge with another partnership—a unanimous vote may be required. The fiduciary relationship (duty of loyalty) and a duty of good faith and fair dealings by partners are established by the RUPA, as demonstrated in the following case.

Enea v. Superior Court of Monterey County
Court of Appeals of California, Sixth Appellate District
34 Cal. Rptr. 3d 513 (2005)

In 1980, Defendants William Daniels and Claudia Daniels, and other family members, formed a general partnership known as 3-D. The partnership’s sole asset was a building that had been converted from a residence into offices. A portion of the property had been rented since 1981, on a month-to-month basis, by the law practice of William Daniels (the firm’s sole member). From time to time, the property was rented on similar arrangements to others, including defendant Claudia Daniels. The partnership agreement has as its principal purpose the ownership, leasing, and sale of the only partnership asset—the building. The partnership agreement contained no provision that the property would be leased for fair market value. The defendants asserted that there was no evidence of any agreement to maximize rental profits.

In 1993, plaintiff Benny Enea, a client of William Daniels, purchased a one-third interest in the partnership from William’s brother, John P. Daniels. In 2001, however, the plaintiff questioned William Daniels about the rents being paid for the property, and in 2003 the plaintiff was “disassociated” from the partnership.

On August 6, 2003, the plaintiff brought an action for damages, alleging that the defendants had occupied the partnership property while paying significantly less than fair rental value, in breach of their fiduciary duty to the plaintiff. The trial court granted the defendants’ motion for summary judgment, and the plaintiff appealed.
Justice Rushing

For present purposes it must be assumed that defendants in fact leased the property to themselves, or associated entities, at below-market rents. . . . Therefore the sole question presented is whether defendants were categorically entitled to lease partnership property to themselves, or associated entities (or for that matter, to anyone) at less than it could yield in the open market. Remarkably, we have found no case squarely addressing this precise question. We are satisfied, however, that the answer is a resounding “No.”

The defining characteristic of a partnership is the combination of two or more persons to jointly conduct business. It is hornbook law that in forming such an arrangement the partners obligate themselves to share risks and benefits and to carry out the enterprise with the highest good faith toward one another—in short, with the loyalty and care of a fiduciary. “Partnership is a fiduciary relationship, and partners are held to the standards and duties of a trustee in their dealings with each other.”

“[I]n all proceedings connected with the conduct of the partnership every partner is bound to act in the highest good faith to his copartner and may not obtain any advantage over him in the partnership affairs by the slightest misrepresentation, concealment, threat or adverse pressure of any kind.” Or to put the point more succinctly, “Partnership is a fiduciary relationship, and partners may not take advantages for themselves at the expense of the partnership.”

Here the facts as assumed by the parties and the trial court plainly depict defendants taking advantages for themselves from partnership property at the expense of the partnership. The advantage consisted of occupying partnership property at below-market rates, i.e., less than they would be required to pay to an independent landlord for equivalent premises. The cost to the partnership was the additional rent thereby rendered unavailable for collection from an independent tenant willing to pay the property’s value.

Defendants . . . persuaded the trial court that they had no duty to collect market rents in the absence of a contract expressly requiring them to do so. This argument turns partnership law on its head. Nowhere does the law declare that partners owe each other only those duties they explicitly assume by contract. On the contrary, the fiduciary duties at issue here are imposed by law, and their breach sounds in tort.

The trial court’s order is set aside and the motion for summary judgment by the defendant is denied.

CRITICAL THINKING ABOUT THE LAW

The decision in this case clearly describes the purpose and expectations associated with a partnership. For the defendants to have succeeded in this case, partnership duties would have to consist only of those laid out in explicit contract form. The act of forming a partnership in and of itself, however, includes by law certain expectations.

1. What facts would have to have existed for the defendants to be granted summary judgment?
   Clue: What does the court say at the start of its final paragraph?

2. The defendants are assuming that the duties of the partners to the business association are something about which the parties to the agreement must negotiate. What does the court mean in this regard when it says the duties are “imposed by law”?
   Clue: Once a partnership agreement is signed, does the very fact of its existence as a partnership mean that certain duties exist?

Read Exhibit 17-1 carefully, for it will give you a good idea of the issues that should be resolved before people enter into a business partnership. The relationship between partners will go much more smoothly if the parties agree beforehand on how much each will invest, the management duties each will undertake, methods of dispute resolution, banking arrangements and borrowing policies for the business, and how the books will be kept. See Exhibit 17-2 Model Partnership Agreement, which is a model form for a general partnership agreement. It does not contain 911 variables that might be wise to include for specific kinds of partnerships, but it is a useful starting point for drafting such an agreement. See Exhibit 17-3 for a summary of duties and rights between and among partners.
**Terminating a Partnership.** A partnership, unlike a corporation, does not have perpetual existence. It can “die” when partners leave the partnership, the partnership is merged with another business or goes bankrupt, or the partnership agreement expires. On its “deathbed,” a partnership goes through a process called *dissolution and winding-up. Dissolution* prevents any new business from taking place after

---

**EXHIBIT 17-2**

**MODEL GENERAL PARTNERSHIP AGREEMENT FORM**

This agreement, made and entered into as of the [Date], by and among Kubasek-Brennan-Browne (referred to as “Partners”).

**WITNESSETH:**

Whereas, the Parties hereto desire to form a General Partnership (hereinafter referred to as the “Partnership”), for the term and upon the conditions hereinafter set forth.

Now, therefore, in consideration of the mutual covenants hereinafter contained, it is agreed by and among the Parties hereto as follows:

**Article I**

**BASIC STRUCTURE**

**Form.** The Parties hereby form a General Partnership pursuant to the Laws of the State of Newgarth.

**Name.** The business of the Partnership shall be conducted under the name of Kubasek-Brennan-Browne.

**Place of Business.** The principal office and place of business of the Partnership shall be located at 2130 Foot Street, Justin, Newgarth, or such other place as the Partners may from time to time designate.

**Term.** The Partnership shall commence on [Date], and shall continue for [Number] years, unless earlier terminated in the following manner:

(a) By the completion of the purpose intended, or
(b) Pursuant to this Agreement, or
(c) By applicable Newgarth law, or
(d) By death, insanity, bankruptcy, retirement, withdrawal, resignation, expulsion, or disability of all of the then Partners.

**Article II**

**MANAGEMENT**

**Managing Partners.** The Managing Partner(s) shall be all partners.

**Voting.** All Managing Partner(s) shall have the right to vote as to the management and conduct of the business of the Partnership according to their then Percentage Share of [Capital/Income]. Except otherwise herein set forth a majority of such [Capital/Income] shall control.

**Percentage Share of Profits.** Distribution to the Partners of net operating profits of the Partnership shall be made quarterly in the percentage agreed upon (40%, 40%, 20%).

**Article III**

**DISSOLUTION**

**Dissolutions.** In the event that the Partnership shall hereafter be dissolved for any reason whatsoever, a full and general account of its assets, liabilities and transactions shall at once be taken. Such assets may be sold and turned into cash as soon as possible and all debts and other amounts due the partnership collected. The proceeds thereof shall thereupon be applied as follows:
(a) To discharge the debts and liabilities of the Partnership and the expenses of liquidation.
(b) To pay each Partner or his legal representative any unpaid salary, drawing account, interest or profits to which he shall then be entitled and in addition, to repay to any Partner his capital contributions in excess of his original capital contribution.
(c) To divide the surplus, if any, among the Partners or their representatives as follows:
   (1) First (to the extent of each Partner’s then capital account) in proportion to their then capital accounts;
   (2) Then according to each Partner’s then Percentage Share of Capital/Income.

Right to Demand Property. Each partner shall have the right to demand and receive property in kind for his distribution.

Article IV
MISCELLANEOUS

Accounting Year, Books, Statements. The Partnership’s fiscal year shall commence on January 1st of each year and shall end on December 31st of each year. Full and accurate books of account shall be kept at such place as the Managing Partner(s) may from time to time designate, showing the condition of the business and finances of the Partnership; and each Partner shall have access to such books of account and shall be entitled to examine them at any time during ordinary business hours.

Arbitration. Any controversy or claim arising out of or relating to this Agreement shall only be settled by arbitration in accordance with the rules of the American Arbitration Association’s chosen Arbitrator, and shall be enforceable in any court having competent jurisdiction.

Witness Partners

J. Foster Kubasek-Brennan-Browne

Duties among Partners

• Fiduciary Duties—include duty of loyalty, good faith, fairness, duty not to appropriate partnership opportunities, not to compete in some instances, not to have conflicts of interest, and not to reveal confidential information of the partnership.
• Duty of Obedience—duty to act in accord with partnership agreement.
• Duty of Care—duty to manage the affairs of the partnership without gross negligence, reckless, or intentional misconduct.

Rights among Partners

• Partnership Property—the right to possess and use for partnership purposes.
• Transferability of Interest in Partnership Property—the right to share of profits and losses of the partnership.
• Management of Property—partners have equal rights unless otherwise agreed on pursuant to the partnership agreement.
• Information—each partner has the right to information necessary to carry out rights of the partnership.

partners have initiated termination proceedings. Winding-up involves completing all unfinished transactions, paying off debts, dividing any remaining profits, and distributing assets. When winding-up is complete, the partnership’s legal existence is terminated.

winding-up The process of completing all unfinished transactions, paying off outstanding debts, distributing assets, and dividing remaining profits after a partnership has been terminated or dissolved.
LIMITED PARTNERSHIPS AND LIMITED LIABILITY LIMITED PARTNERSHIPS

Limited partnerships have at least one general partner and one limited partner and are easily identifiable because they must include the word **limited** (or an abbreviation of that word). Strictly following the statutory scheme for the formation of a limited partnership, general and limited partnerships function similarly (see Exhibit 17-4). The primary law governing limited partnerships is

---

**LIMITED PARTNERSHIPS AND LIMITED LIABILITY LIMITED PARTNERSHIPS**

<table>
<thead>
<tr>
<th>Factors</th>
<th>General Partnerships</th>
<th>Limited Partnerships</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Creation</td>
<td>By contractual agreement between two or more persons to carry on a business as co-owners for profit.</td>
<td>Same, but most include one or more general partners and one or more limited partners on certificate filed with state.</td>
</tr>
<tr>
<td>(2) Profits and losses</td>
<td>By agreement; or, in absence of agreement, are shared equally.</td>
<td>Profits are shared equally, as required by certificate, and losses are shared up to the amount of each limited partner’s capital contribution.</td>
</tr>
<tr>
<td>(3) Liability</td>
<td>Unlimited personal liability.</td>
<td>Limited liability for general partners; for others, limited to amount of capital contribution.</td>
</tr>
<tr>
<td>(4) Capital contribution</td>
<td>Usually no minimum or mandatory amount, unless set by partnership agreement.</td>
<td>Usually set by agreement.</td>
</tr>
<tr>
<td>(5) Management</td>
<td>Specified in the partnership agreement; or, in the absence of an agreement, each has an equal role.</td>
<td>General partners only. If limited partners have some voting right, they will generally be subject to liability. Sometimes limited partners act as agents.</td>
</tr>
</tbody>
</table>
the Revised Uniform Limited Partnership Act (RULPA), which has been adopted by 48 states. The question of how much management activity a limited partner can engage in before losing the special status granted by statute is still unsettled.

**Limited Liability Limited Partnership.** A limited liability limited partnership (LLLP) differs and is distinguished from a limited partnership in that liability is the same for a general partner(s) as for a limited partner(s). The liability of each is limited to the amount of capital contributed. Some states provide by statute for LLLPs. Others may allow a limited partnership to register with the state (usually the Secretary of State) as an LLLP.

A 2001 revision to the RULPA provides that an LLLP “means a limited partnership whose certificate of limited partnership states that the limited partnership is a limited liability limited partnership.” Under the 2001 revision, a limited partner cannot be held liable for the partnership debts even if he or she participates in the management and control of the limited partnership.

**Specialized Forms of Business Associations**

Table 17-3 summarizes some common but more specialized forms of business associations used in the United States. These include joint stock companies, syndicates, joint ventures, and franchises.

**JOINT STOCK COMPANY**

A **joint stock company** is a partnership agreement in which members agree to stock ownership in exchange for partnership liability. Although members own shares that are transferable (as in a corporation), the joint stock company is treated as a partnership because all goods are held in the name of the partners, who are held personally liable when sued successfully by a third party.

**SYNDICATE**

A **syndicate** is an investment group that makes a private agreement to come together for the purpose of financing a large commercial project (e.g., a hotel or a sports team) that the individual members (partnerships or corporations) could not finance alone. The advantage of a syndicate is that it can raise large amounts of capital quickly. The disadvantage is that if the project fails, the syndicate members may be held liable for a breach of the agreement by a third party.

**JOINT VENTURE**

When individuals, partnerships, or corporations make a private agreement to finance, produce, and sell goods, securities, or commodities for a limited purpose and/or a limited time, they have formed a **joint venture**. Joint ventures

**TABLE 17-3 SPECIALIZED FORMS OF BUSINESS ASSOCIATIONS**

<table>
<thead>
<tr>
<th>Form</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Joint stock company</td>
<td>A partnership agreement in which individuals agree to take stock ownership while retaining partnership liability.</td>
</tr>
<tr>
<td>Syndicate</td>
<td>An investment group created primarily for the purpose of financing a purchase, usually a single transaction.</td>
</tr>
<tr>
<td>Joint venture</td>
<td>A partnership, individual, or corporation that pools labor and capital for a limited period of time.</td>
</tr>
<tr>
<td>Franchising</td>
<td>A method of marketing goods through a private agreement whereby the franchisor allows use of its trade name, trademark, or copyright in exchange for a percentage of the gross profits made by the franchisee. Federal and state laws govern franchising.</td>
</tr>
</tbody>
</table>
are a popular way for developing nations (e.g., China) to attract foreign capital. Typically, two companies (e.g., Chrysler and Bank of America) join with foreign companies (e.g., Chinese state auto companies) to finance, produce, and market goods to be sold in the foreign nation and possibly in other nations. In 2010, Chinese state-owned companies backed by Chinese capital entered into joint ventures with Latin American and African nations as well as private-sector entities.

**FRANCHISING**

A **franchising** relationship is based on a private commercial agreement between the **franchisor**, who owns a trade name or trademark, and the **franchisee**, who sells or distributes goods using the trade name or trademark. It is a method of marketing goods or services.

The franchisee usually pays a percentage of the gross sales to the franchisor in exchange for use of the trademark name, construction of the building, and numerous other services. Usually, the franchisee is a local entrepreneur whom the franchisor supplies with goods to be sold under conditions set out in the agreement. Failure to meet such conditions (e.g., not keeping a fast-food restaurant clean) may lead to termination of the franchise agreement.

**Laws Governing Franchising.** When franchising exists based on a contractual relationship, traditional common law applies for nongoods. Article 2 of the UCC applies when the franchisor and franchisee are involved in a sales agreement. In addition, there are federal and state laws that are designed to protect franchisees from terminating franchise agreements without good cause. Other federal and state laws are discussed later in this section.

**TERMS OF A FRANCHISE AGREEMENT**

Generally, a franchise agreement is a standard form contract prepared by the franchisor. Franchise agreements cover the following topics:

1. **Quality-control standards.** The franchisor's most important assets are its name and reputation. The quality-control standards set out in the franchise agreement—such as the franchisor's right to make periodic inspections of the franchisee's premises and operations—are intended to protect these assets. Failure to meet the proper standards can result in loss of the franchise.

2. **Training requirements.** Franchisees and their personnel usually are required to attend training programs either on site or at the franchisor's training facilities.

3. **Covenant not to compete.** Covenants not to compete prohibit franchisees from competing with the franchisor during a specific time and in a specified area after termination of the franchise. Unreasonable (overextensive) covenants not to compete are void.

4. **Arbitration clause.** Most franchise agreements contain an arbitration clause providing that any claim or controversy arising from the franchise agreement or an alleged breach thereof is subject to arbitration. The U.S. Supreme Court has held such clauses to be enforceable.

5. **Other terms.** Capital requirements include restrictions on the use of the franchisor's trade name, trademarks, and logo; standards of operation; duration of the franchise; recordkeeping requirements; sign requirements; hours of operation; prohibition on sale or assignment of the franchise; conditions for termination of the franchise; and other specific terms pertinent to the operation of the franchise and the protection of the parties' rights.
**FRANCHISE FEES**

Franchise fees payable by the franchisee are usually stipulated in the franchise agreement. The franchisor may require the franchisee to pay any or all of the following fees:

1. **Initial license fee.** A lump-sum payment for the privilege of being granted a franchise.
2. **Royalty fee.** A fee for the continued use of the franchisor’s trade name, property, and assistance that is often computed as a percentage of the franchisee’s gross sales.
3. **Assessment fee.** A fee for such things as advertising and promotional campaigns and administrative costs, billed either as a flat monthly or annual fee or as a percentage of gross sales.
4. **Lease fees.** Payment for any land or equipment leased from the franchisor, billed either as a flat monthly or annual fee or as a percentage of gross sales or other agreed-upon amount.
5. **Cost of supplies.** Payment for supplies purchased from the franchisor.

**Federal Laws.** The Franchise Rule promulgated by the Federal Trade Commission requires a franchisor to disclose all material facts to a franchisee before entering into a franchise agreement. (See Chapter 26 for a discussion of this rule.)

**State Laws.** State deceptive trade practices acts and the Uniform Franchise Law set out by the National Conference of Commissioners on Uniform State Laws seek to make all states’ franchise laws similar. (However, the latter must be adopted by a state’s legislature before it is applicable in that state.) Further, state franchise administrators developed a Uniform Franchise Offering Circular (UFOC). It requires a franchisor to make specific presale disclosures to any prospective franchisee. Information that must be disclosed includes the franchisor’s major business balance sheet and income statement for the franchisor for the preceding three years, material terms of the franchise agreement, restrictions on the franchisee’s territory, grounds for termination of the franchise, and other relevant information. The UFOC and state and federal law should be examined by counsel for all parties to a franchise agreement prior to execution to prevent action later on that leads to misunderstandings and costly litigation.

**Internet Franchising.** With the advent of Internet marketing, the issue now has arisen as to whether a franchisee violates a territorial-area clause included in its franchise agreement when it uses an Internet Web site to market products worldwide. Both courts and arbitration panels have had difficulty dealing with this cyberspace issue. The franchisor believes that the exclusive territorial clause it grants the franchisee in the franchise agreement is lost if the franchisee can market goods from its Web site. The franchisee sees its Web site as a cheap and convenient method of marketing.

**Global Dimensions of Business Associations**

It is inevitable that the worldwide trend toward market-oriented economies will raise the demand for the investment capital and manufactured goods and services of the industrialized world. This certainty, together with the forging of international and regional agreements to lower or eliminate tariffs and other barriers to trade in recent years (see Chapter 9), is spurring many partnerships, single proprietorships, and specialized business associations that were once strictly domestic businesses to become transnational, multinational, or international buyers and sellers of goods and services.
In deciding whether to take the plunge into international waters, managers of small, midsize, and large businesses need to ask the following questions:

- Is there a demand for the product in the targeted country or countries?
- Are there legal obstacles in the targeted country that should be carefully considered?
- Is managing an international business at a distance a realistic possibility for the firm?
- Will management be able to deal successfully with currency fluctuations?
- Is the risk of political interference by the target country’s government too great to make doing business in that country worthwhile?
- Is there a serious risk of nonperformance, nonpayment, or loss of property or freight in the country or region the firm is considering entering?

If the responses to the preceding questions indicate that the firm should go ahead, managers need to determine the optimal level of global involvement by answering the following questions:

- Should the firm directly export to another firm in the target country, or should it hire an export trading company to market its products?
- Should the firm license the use of its products under an international licensing agreement? For example, international franchising is a form of licensing in which franchisees in the targeted countries are allowed to use the franchisor’s name in exchange for a percentage of the gross profits. This specialized business form is the preferred way to go international among fast-food retailers such as McDonald’s, Wendy’s, and Pizza Hut. If the firm holds a patent, trademark, or copyright on its product, however, it must always be concerned about possible efforts by businesses or individuals in the target country to circumvent multilateral and bilateral international agreements.
- Should the firm go international by joint venture, merger, or acquisitions? These alternatives, which involve investment of large sums of capital, seem most appropriate for large multinational companies.

Outsourcing

The increase in outsourcing of manufacturing and service-sector jobs, despite political opposition (e.g., Democrats, unions, prisoners, and others), brought into focus a dilemma for private- and public-sector companies in developed nations worldwide. Treading the delicate balance between cost savings on goods and services and increased exports to fast-growing developing countries on the one hand, versus loss of jobs and “heat” from politicians on the other hand, present problems for many private-sector companies. Candidates in the 2004 and 2008 presidential elections offered contrasting views on this subject.

Also, doing a cost-benefit analysis with regard to outsourcing does not produce many hard numbers. For example, if some jobs are outsourced to India, how is that balanced against Indians buying more U.S. services, and U.S. citizens being able to buy cheaper goods manufactured in India? Most multinationals need to ask themselves many questions in regard to outsourcing, such as the types of employees and skill levels needed, the time required for employees training, and the effect of outsourcing on the process of delivering the services or manufacturing the good. Legal questions also exist at the federal, state, and international levels.

---


At the state level, some 35 states have introduced anti-outsourcing bills, though none of the bills have passed in a form that would curtail outsourcing. Indiana and Maryland passed a nonbinding preference act for hiring in-state companies for state contracts as opposed to performance by a contractor from a site located outside the United States. Both the Chamber of Commerce and unions lobbied in opposition to each other at the state legislative level. The business lobby indicated that anti-outsourcing legislation would interfere with work done on everything from roads to state employee pension plans, where in the latter case Indiana subcontractors had produced the software running the system. Another example was in Maryland, where foreign nationals were employed in its overseas study program at the University of Maryland. Compromises were made in both legislatures (Indiana and Maryland).\(^c\)


**SUMMARY**

The sole proprietorship, the partnership, and the corporation are the three major forms of business organizations in the United States. (See Chapter 18 for a discussion of corporations.)

Factors influencing the choice of one of these three types of business associations include tax ramifications, control considerations, liability of owners, and (less significantly) ease and expense of ownership, transferability of properties, and the projected life of the business. The sole proprietorship allows the owner to have total control of management, assets, and profits; the owner also has unlimited personal liability. General partners usually exercise equal control over management and profits; they, too, incur unlimited personal liability. Limited partners forgo management control in return for limited liability. In both sole proprietorships and partnerships, profits are taxed as personal income to the owners.

Specialized forms of business associations are joint stock companies, syndicates, joint ventures, and franchising.

Business organizations of all forms should ask some basic questions before they enter global markets. Once they have decided to go ahead, they need to decide the optimal level of involvement and marketing methods.

**REVIEW QUESTIONS**

17-1 Identify the primary differences between a limited partnership and a general partnership.

17-2 Identify the factors that an entrepreneur should consider when selecting an organizational form for a business.

17-3 Describe the circumstances under which a partnership would offer greater tax advantages than a single proprietorship.

17-4 What is a single tax advantage of a limited liability company?

17-5 Explain the difference between an LP and an LLP.

17-6 Why is a joint venture often considered to be a partnership?
CASE PROBLEMS

17-13 Charlie Waugh owned and operated an auto parts junkyard in Georgia. Charlie’s son, Mack, started working in the business part-time as a child and full-time when he left school at the age of sixteen. Mack oversaw the business’s finances, depositing the profits in a bank. Charlie gave Mack a one-half interest in the business, telling him that if “something happened” to Charlie, the entire business would be his. In 1994, Charlie and his wife, Alene, transferred to Mack the land on which the junkyard was located. Two years later, however, Alene and her daughters, Gail and Jewel, falsely convinced Charlie, whose mental competence had deteriorate, that Mack had cheated him. Mack was ordered off the land. Shortly thereafter, Charlie died. Mack filed a suit in a Georgia state court against the rest of the family, asserting, in part, that he and Charlie had been partners and that he was entitled to Charlie’s share of the business. Was the relationship...

17-14 James Ferguson operates “11-E Auto Sales” in Jonesborough, Tennessee as a sole proprietorship. In 1999, Consumer Finance Co. issued a policy to “Jim Ferguson, Jim 11-E Auto Sales” covering “Owned Autos Only.” Auto was defined to include “a land motor vehicle” which was not further explained in the policy. Coverage extended to damage caused by the owner or driver of an underinsured motor vehicle. In 2000, Ferguson bought and titled in his own name a 1976 Harley-Davidson motorcycle, intending to repair and sell the cycle through his dealership. In October 2001, while riding the motorcycle, Ferguson was struck by an auto driven by John Jenkins. Ferguson filed a suit in a Tennessee state court against Jenkins, who was underinsured with respect to Ferguson’s medical bills, and Consumers. The insurer argued, among other things, that because the motorcycle was bought and titled in Ferguson’s own name, and he was riding it at the time of the accident, it was his personal vehicle and thus was not covered under the dealership’s policy. What is the relationship between a sole proprietor and a sole proprietorship? How might this status affect the court’s decision in this case? *Ferguson v. Jenkins*, 204 S.W.3d 779 (Tenn. App. 2006).

17-15 Charles Chaney and Lawrence Burdett were equal partners in a partnership in Georgia known as BMW Partners. Their agreement was silent as to the effect of a partner’s death on the firm. The partnership’s sole asset was real property, which the firm leased in 1987 to a corporation that the partners co-owned. Under the lease, the corporation was to pay the partnership $8,000 per month, but after a few years, the corporation began paying $9,000 per month. Chaney died on April 15, 1998. Burdett wanted to continue the partnership business and offered to buy Chaney’s estate’s interest in it. Meanwhile, claiming that the real property’s fair rental value was $4,500 (not $9,000) and that the corporation had overpaid the rent by $80,000, Burdett adjusted the rental payments to recoup this amount. Bonnie Chaney, Charles’s widow and his estate’s legal representative, filed a suit in a Georgia state court against Burdett, alleging in part that he had breached his fiduciary duty by adjusting the amount of the rent. Did Burdett’s fiduciary duty expire on Chaney’s death? Explain. *Chaney v. Burdett*, 274 Ga. 805, 560 S.E.2d 21 (2002).

17-16 In August 1998, Jea Yu contacted Cameron Eppler, president of Design 88, Ltd., to discuss developing a Web site that would cater to investors and provide services to its members for a fee. Yu and Patrick Connelly invited Eppler and Ha Tran, another member of Design 88, to a meeting to discuss the site. The parties agreed that Design 88 would perform certain Web design, implementation, and maintenance functions for 10 percent of the profits from the site, which would be called “The Underground Trader.” They signed a “Master Partnership Agreement,” which was later amended to include Power Uptik productions, LLC (PUP). The parties often referred to themselves as partners. From Design 88’s offices in Virginia, Design88 designed and hosted the site, solicited members through Internet and national print campaigns. When relations among the parties soured, PUP withdrew. Design 88 filed a suit against PUP and the others. Did a partnership exist among these parties? Explain. *Design 88 Ltd., v. Power Uptik Productions, LLC*, 135 E Supp.2d 873 (W.D.Va. 2001).

17-17 On August 23, 1995, Climaco Guzman entered into a commercial janitorial services franchise agreement with Jan-Pro Cleaning Systems, Inc., in Rhode Island for a franchise fee of $3,285. In the agreement, Jan-Pro promised to furnish Guzman with “one (1) or more customer account(s) . . . amounting to $8,000.00 gross volume per year. . . . No portion of the franchise fee is refundable except and to the extent that the Franchisor, within 120 business days following the date of execution of the Franchise Agreement, fails to provide accounts.” By February 19, Guzman had not received any accounts and demanded a full refund. Jan-Pro promised “accounts grossing $12,000 per year in income.” Despite its assurances, Jan-Pro did not have the ability to furnish accounts that met the stated requirements. In September, Guzman filed a suit in a Rhode Island state court against Jan-Pro, alleging in part fraudulent misrepresentation. Should the court rule in Guzman’s favor? Why or why not? *Guzman v. Jan-Pro Cleaning Systems, Inc.*, 839 A.2d 504 (R.I. 2003).

**THINKING CRITICALLY ABOUT RELEVANT LEGAL ISSUES**

Ed Johnson is a real estate manager and investor. Nearly 20 years ago, Ed embarked on a partnership with Jack Jones to improve and operate an office building in New Haven, Connecticut. The building and land are owned by James Jason. James gave Ed and Jack a 20-year lease; at the end of 20 years, the lease would terminate and
the property would revert to James. Pursuant to their partnership agreement, Ed and Jack each provided 50 percent of the capital for improvements to the office space and received 50 percent of allocable net profits.

Though he no longer needed Jack’s capital for the project, Ed suspected that Jack would be interested in participating in the mall development. However, it was not clear whether James made the offer to renew the lease solely to Ed or to the partnership. Because Jack had not been invited to dinner and his name had never been mentioned, Ed believed that the offer was made solely to him.

1. Does Ed have an ethical responsibility to inform Jack of the opportunity to renew the lease? Why not? Explain.

2. Does it matter that the renewal offer for the long-term lease was initially raised in a dinner conversation between Ed and James? Explain.

3. Should Ed be free to sever relations with Jack with regard to the property? Consider that Ed has managed the property and no longer needs Jack’s capital. What competing values does his dilemma involve? Explain.

ASSIGNMENT ON THE INTERNET

This chapter introduces the common forms of business organization in the United States. Business structures outside the United States, however, are often very different. Use the Internet to determine some of the major differences in business organization between the United States and the European Union. You can begin your search by visiting the Eurolegal Services Web site at www.eurolegal.org/webresources/eustartup.htm.

If you were looking to start a business in the European Union, what would you do differently than if you intended to start the business in the United States? The following Web sites may also assist you in your search.

ON THE INTERNET

www.irs.gov/faqs/faq-kw127.html The IRS provides information about LLCs at this site.

www.mycorporation.com/index.htm This is the site of a private firm that assists small companies and businesses to become incorporated.

www.llc-reporter.com/28.htm This site provides an analysis of the Uniform Limited Liability Company Act.

FOR FUTURE READING


The Corporation

The partnership is the most common form of business organization in the United States. The dominant business organizational form, however, is the corporation, a legal entity created by state law that raises capital by issuing stock to investors, who own the corporation. Although the corporation may have many owners, it is legally treated as a single person. Before we go into the laws governing the creation, financing, and operation of corporations, we'll explain how corporations are classified (see Table 18-1).

corporation An entity formed and authorized by state law to act as a single legal person and to raise capital by issuing stock to investors who are the owners of the corporation.

stock The capital that a corporation raises through the sale of shares that entitle the shareholders to certain rights of ownership.

CRITICAL THINKING ABOUT THE LAW

When we say that the corporation is treated legally as if it were a single person, we are making a statement that affects the nature of our democracy. A citizen is allowed to have freedom of speech and to participate fully in the political life of our country. Should we extend the same liberties to corporations?

Certainly, corporations are greatly affected by political actions. Therefore, would it not follow that they should be offered the opportunity to participate in the political life of the nation in the same manner as individual citizens?

But when they are allowed to fully participate, are they just like any other voter and political voice? Do they have characteristics that differentiate them from those of regular human citizens?

Suppose that Drill Baby Drill Oil Company, a Saudi Arabian-owned oil company incorporated in Delaware, wishes to spend $1 billion to elect the Republican candidate for president. Furthermore, suppose that this corporation has assets that exceed the gross national product of all but 12 nations.

1. As it spent money for political purposes to influence elections, would Drill Baby Drill, which is required by law to pursue profits, be likely to use its money to elect politicians who had the long-run health of the nation uppermost in their minds?
All corporations are broadly classified as either public or private. They are further differentiated as closely held, publicly held, multinational, Subchapter S, professional, or limited liability corporations. Not-for-profit (nonprofit) corporations also exist under state laws, and qualify under federal and state tax laws.

**Closely held Corporation**
A corporation whose stock is not traded on the national securities exchanges but is privately held by a small group of people.
PUBLICLY HELD CORPORATION

Those corporations whose stock is traded on the national securities exchanges are known as publicly held corporations. Although technically governed by the same rules as closely held corporations (except for securities law, which is discussed in Chapter 24), their operations are much different from those of closely held corporations. Publicly held corporations have numerous shareholders who are simply investors. Real control rests in the hands of the officers and managers, who may own some stock, though generally not a majority or controlling amount.

When the term corporation is used in this book, a publicly held corporation is meant, unless otherwise specified. Although some regulations apply only to publicly held corporations, in most instances the same laws apply to both public and private corporations. The impact of such laws differs, though, depending on whether the affected corporation is public or private. The reason for our focus on public rather than private corporations is the same as our reason for emphasizing corporations rather than partnerships: impact on society. Public corporations are wealthier than any other form of business organization and, therefore, the impact of regulation on these corporations has the greatest effect on society.

MULTINATIONAL OR TRANSNATIONAL CORPORATION

This relatively new type of publicly held corporation now dominates the world economy. It is called a multinational, or transnational, corporation because it does not restrict its production to a single nation and generally maintains worldwide distribution sites. Its stock is usually traded on the securities exchanges of several nations, and its managers are often citizens of different countries. Through their tremendous wealth, power, and reach, multinationals have great influence on societies all over the world.

SUBCHAPTER S CORPORATION

This type of closely held corporation is best described as a hybrid of the corporation and the partnership. The Subchapter S corporation is organized and operates as a regular business corporation, but for tax purposes it is treated like a partnership. To qualify for Subchapter S treatment under the Internal Revenue Code (IRC), a domestic corporation must (1) have no more than 35 shareholders, all of whom are individuals, estates, or certain types of trusts, and none of whom is a nonresident alien; (2) have only one class of stock outstanding; and (3) not be a member of an affiliated group of corporations. All shareholders must consent to the election of Subchapter S status.

Subchapter C corporations pay taxes on income generated by a business, and shareholders pay tax on the same income when it is distributed as dividends. Any corporation not meeting the requirements for an S corporation is automatically classified as a C corporation.

PROFESSIONAL CORPORATION

The professional corporation is a fairly new form of business organization intended for doctors, lawyers, dentists, accountants, and other professionals who were once unable to incorporate legally. Most states now have passed statutes permitting specified professionals to incorporate so that they can take the tax advantages of deductions for health and pension plans that are allowable under the corporate form. In most states, the professional corporation differs from other corporations in that the owners are not accorded limited liability for professional acts. (It is generally considered contrary to public policy to grant professionals limited liability for their negligence.)
NONPROFIT CORPORATION

This type of corporation is formed for purposes other than making a profit. Some examples of nonprofit (not-for-profit) corporations include hospitals, educational institutions, charities, and religious groups. Most are private in nature, but not necessarily so. Nonprofit corporations are used by groups as a way to carry out transactions and own property without individuals (who belong to a group) being held liable. Often, in legal papers, they are referred to as eleemosynary institutions (private corporations created for charitable and benevolent purposes).

Creation of Corporations

Corporations are creatures of state, not federal, law. Each of the 50 states, as well as the District of Columbia, Puerto Rico, and Guam, has a general incorporation statute that stipulates the articles of incorporation to be used in that state. These articles, generally standardized forms, identify the name of the corporation, its registered address and resident agent, the general purpose of the business, the classes of stock to be issued by the corporation and their face value, and the names and mailing addresses of the incorporators. The articles, accompanied by the required fees, are filed with the secretary of state of the state of incorporation, who then issues a certificate of incorporation. Upon issuance of the certificate, the corporation holds its first board meeting, at which a board of directors is elected, bylaws are enacted, and corporate stock is issued. The bylaws are the governing regulations of the corporation and often are the basis for litigation when directors act on behalf of the shareholders of the corporation.

The Delaware Supreme Court is considered the most influential of all courts in the nation with regard to corporate governance and the chief arbiter of conflicts between corporations and between shareholders and a single corporation. More than 50 percent of Fortune 100 companies are registered in Delaware. Anyone who merges, sues, or manages a Delaware corporation is subject to Delaware law as interpreted by its courts. This is why, fairly recently, there has been significant controversy surrounding the appointment and reappointment of Delaware state supreme court justices and the politicizing of appointments made by the commission that recommends candidates to the governor.

Two primary concerns of state corporate laws are the financing of the corporation and its operation. These two areas are necessarily entwined, but they are separated here for discussion purposes. Laws governing these two areas of corporate activity are primarily state regulations, though most states are guided by a modified version of the Revised Model Business Corporations Act (RMBCA).

Financing of Corporations

Financing refers to the acquisition of funds or capital for the operation or expansion of a corporation. Corporations generally engage in two types of financing: debt and equity. Debt financing may be described as the taking out of loans; equity financing is accomplished by the sale of ownership interests in the corporation.

DEBT FINANCING

A corporation can issue three primary types of debt instruments: notes, bonds, and debentures. Notes are short-term loans. Bonds are usually long-term loans secured by a lien or mortgage on corporate assets. Debentures are usually unsecured long-term corporate loans.

In all forms of debt financing, corporations incur a liability to the holder of the debt security. Periodic interest payments are generally required. Interest payments

*notes Short-term loans.
*bonds Long-term loans secured by a lien or mortgage on corporate assets.
*debentures Unsecured long-term corporate loans.*
on debt securities are tax deductible, whereas dividend payments made to owners under equity financing are not. This difference in the tax treatment of the two types of financing is one reason for corporations’ heavy reliance on debt financing. Even though debt financing offers distinct tax advantages to both the corporation and the investors, there is always the risk that a corporation that relies too much on debt financing will be deemed too thinly capitalized by the Internal Revenue Service (IRS), which will then treat any loans made by shareholders as capital contributions.

**EQUITY FINANCING**

All business corporations must raise operating capital through the sale of stock, or equity securities. *Shareholders*—persons who purchase shares of stock—generally acquire rights to control the corporation through voting; to receive income through dividends; and, upon dissolution of the corporation, to share in the net assets in direct proportion to the number of shares they own.

The number of shares of stock must be authorized in the corporation’s articles of incorporation. All shares authorized by the articles need not be issued or sold to shareholders immediately, but no shares may be issued that are not authorized. Under the RMBCA, the articles of incorporation must authorize (1) one or more classes of stock that entitle their owners to unlimited voting rights and (2) one or more classes of stock (these may be the same classes as those with voting rights) that entitle their owners to receive the net assets of the corporation upon dissolution. This provision of the RMBCA ensures that there will be a class of shareholders with the power to elect directors and make other important decisions and a class of shareholders who will share in the residuary (remaining assets) of the corporation on its termination.

**Classes of Stock.** Most states allow corporations to authorize and issue different classes of stock, with different rights attaching to the different classes. The limitations and preferences of each class must be stated in the articles of incorporation. The two primary classes of stock are (1) common and (2) preferred.

Traditionally, **common stock** has carried with it the right to vote, the right to participate in income through dividends, and the right to participate in the net assets on liquidation. Common stock has no preferential rights (described in the next paragraphs) and, therefore, common stockholders bear the greatest risk of loss. If a corporation has only one class of stock, it is ordinarily assumed to be common stock.

Owners of **preferred stock** are given special preferences relating to either the payment of dividends or the distribution of assets. Most preferred stock is preferred as to dividends, meaning that in every year in which the corporation pays a dividend, the preferred shareholders are paid before the common shareholders at a rate stipulated in the articles of incorporation.

If the stock is **cumulative preferred**, the preferred shareholders do not lose their rights to a dividend during a year in which no dividends are paid. Rather, their rights to each year’s unpaid dividends accumulate. Thus, during the next year in which dividends are paid, the preferred shareholders receive all past dividends that have accumulated plus the present year’s dividend before any dividends are paid to the common shareholders.

If the stock is **participating preferred**, the preferred shareholders first receive their dividends at the preferred rate. The common shareholders receive dividends at the same rate. The remaining income is shared, on a pro rata basis, by the common and preferred stockholders.

If the stock is **liquidation preferred**, upon liquidation of the corporation, preferred shareholders receive either the par value of their stock or a specified monetary amount before the common shareholders share pro rata in the remainder of the assets. Liquidation preferences may also be participating.

---

**common stock** A class of stock that entitles its owner to vote for the corporation’s board of directors, receive dividends, and participate in the net assets upon liquidation of the corporation.

**preferred stock** A class of stock that entitles its owner to special preferences relating either to dividends or to the distribution of assets.
Finally, preferred stock may be *convertible*. At the holder's request, such stock may be exchanged for common stock at a stated ratio.

Preferred stock frequently has limited voting rights. It is also generally redeemable, meaning that the corporation has the right to exchange each preferred share for a prespecified monetary amount.

All these distinctions may become irrelevant as more states adopt the RMBCA. The RMBCA stipulates that the various classes of stock and the number of shares in each class that may be issued must be stated in the articles of incorporation, but it omits references to such classes of stock as “preferred” and “common.” If only one class of stock is designated in the articles of incorporation, it is presumed that the shares confer both the right to vote and the right to participate in corporate assets. If more than one class of stock is authorized, either the distinguishing designation and preferences, limitations, and rights of those classes must be listed or the board of directors must be authorized to designate such features at a later date.

This broad flexibility given to the directors to affect the capital structure of the corporation may be desirable from management's perspective. It does not, however, benefit the shareholders, because it may dilute their interests. It is also contrary to present trends in securities regulation (discussed in Chapter 24).

Under the RMBCA, corporations can also issue rights to purchase a stated number of shares at a stated price, usually for a stated period of time. Legal documents, called *stock warrants*, that certify these rights may be freely traded. Employees may receive such rights as compensation in the form of *stock options*.

---

**Stock Options and Government Regulation**

Stock options were used as a way of providing incentives or bonuses for a company's top employees in the late 1800s and early 1900s. As publicly traded companies grew, tax laws promulgated by Congress in the 1950s allowed employees to pay a capital gains tax rate of 25 percent. By 1952, one-third of all New York Stock Exchange companies were using executive stock options.

In the 1960s and 1970s, Congress enacted a number of restrictions on stock options. In 1973, the Chicago Board of Trade opened the first public market for stockholders to trade options on the shares of public companies. In the 1980s, Congress enacted new laws that made stock options important. It restored the capital gains treatment for option profits and slashed further the capital gains tax rate, which encouraged companies to offer large stock options to key executives instead of increasing salaries. In 1992, the top five executives at the 1,500 largest U.S. corporations cashed in approximately $2.4 billion of options. During the 1990s, many companies gradually extended options to large numbers of employees as bonuses.

By 2002, between 20 and 25 percent of public companies made options available to many of their full-time employees. This was particularly important in the growth of high-tech companies where founders could not afford large salaries, and these stock options were frequently given as a substitute. Many people working for high-tech companies became wealthy overnight.a

In 2006, the SEC and the Justice Department began investigating the question of backdating stock options. Over 100 companies were served warrants under the 1934 Exchange Act. The SEC argued that backdating of stock options is not, in and of itself, illegal if properly disclosed. Backdating increases stock options' potential value if the option grant is backdated to a time when the stock is at a lower market price. Many executives claimed that backdating was common in some industries as a way to obtain employment of talented people.

---

*a Federal Securities Law Reports, July 26, 2006; August 16, 2007.*
In August of 2007, the former CEO of Brocade Communication, Gregory Reyes, was convicted on 10 counts that included securities fraud, mail fraud, falsifying books, and making false statements to auditors. This case may be overturned by a U.S. Supreme Court decision. (Skilling v. U.S., 130 S. Ct. 2896 [2010]). This was the first U.S. Justice Department conviction based on backdating of stock options. It sent a message to executives about full disclosure under the 1934 Exchange Act. The government was able to prove that Reye knowingly manipulated an option grant date to defraud investors.


When employees are granted the rights to purchase shares at a stated price, however, these rights cannot be traded. A major issue was whether director, officer, and employee stock options would become expense items under a Financial Accounting Standards Board (FASB) proposal. In December 2004, the FASB unanimously adopted the expense item rule, which was scheduled to take effect in July of 2005. Further, the FASB told companies that if they expect to buy back shares of their own company stock in connection with a stock option plan, they must declare an estimate of how many shares they will buy back. Often, buyback programs were used to prevent stock options and the new shares resulting from the exercise of options from diluting stock prices and earnings per share. This decision of the FASB was appealed to the Securities and Exchange Commission (SEC) and may be overturned by Congress. The SEC approved the FASB rule; Congress has not acted as of this writing.

**CONSIDERATION**

Stocks and warrants are issued in return for consideration—that is, something of value. That consideration cannot be less than the stated value of the shares. If a corporation issues shares for less than the stated value, the shareholder remains liable to the corporation for the difference between the stated value and the amount of consideration actually paid.

Traditionally, the minimum amount for which a share could be issued was called the **par value**. In general, this amount was so low (often $1) that the likelihood of a buyer not paying at least that much for the stock was slim. The total par value of all stock initially issued by a corporation was known as **stated capital**. Some states allowed the issuance of no-par stock, which is stock that does not have a stated par value, but when a corporation issued no-par stock, the board of directors still had to designate a stated value for the stock. The sum of the stated values was the stated capital of the corporation.

The RMBCA has done away with the terms **par**, **no par**, and **stated capital**. Now, before issuing any shares, the board of directors must determine that the amount of consideration received or about to be received is adequate. When the corporation receives the consideration for which the board of directors authorized the issuance of the shares, the shares are deemed fully paid.

Under the RMBCA and most current state laws, the consideration paid for the stock may be in the form of money, property, or past services. The RMBCA also allows for payment by promissory notes and agreements to provide future services.

In some states, problems can arise over the valuation of nonmonetary consideration. Most states use the good-faith rule, which presumes that the valuation of the property or services given as consideration for the stock was fair as long as it was honestly made—in other words, there was no fraud or bad faith.
on the part of the directors in making their valuation, and they exercised the
degree of care that ordinarily prudent persons in their position would exercise.

**Operation of Corporations**

The question of how the corporation is financed can be answered relatively easily. As the previous section explained, the corporation is financed by debt and equity security holders. The answer to the question of who manages the corporation is not quite so simple. Even legal experts disagree to some extent over who actually manages the corporation, as well as who should manage it.

Three groups theoretically have a voice in the management of the corporation: the shareholders, the board of directors, and the corporate officers and managers. Formal responsibility for management of the corporation is vested in its board of directors, who are elected by the shareholders. These directors determine policy matters and appoint the officers who carry out those policies and manage the everyday affairs of the corporation. Exhibit 18-1 illustrates the division of responsibility in this corporate hierarchy of shareholders, board of directors, and officers and managers.

**THE ROLE OF THE SHAREHOLDERS**

The shareholders are the owners of the corporation, yet they have no direct control over its operation. They are not agents of the corporation and cannot act on its behalf. Their control of the corporation is limited to exercising their right to vote at shareholders’ meetings and, through that voting, to select the board of directors who will set corporate policy.

Most corporations are obliged to hold an annual shareholders’ meeting at a time specified in the corporate bylaws. In addition, special shareholders’ meetings may be called by the board of directors, the holders of more than 5 percent of the shares entitled to cast a vote at such meetings, or anyone else authorized to do so under the corporate bylaws.

Shareholders vote at the shareholders’ meetings either in person or by a **proxy**, which is a written delegation of authority to cast one’s votes. Most shareholders vote by proxy, and it is this process of proxy election that has led many

---

**EXHIBIT 18-1**

THE CORPORATE HIERARCHY

- **Shareholders**
  - Elect directors
  - Vote on extraordinary matters

- **Board of Directors - Executive Committees**
  - Set corporate policy; hire, oversee, and terminate officers and managers; approve changes in fundamental structure of the business; and declare dividends
  - May be delegated board functions, such as setting executive compensation

- **Officers and Managers**
  - Manage daily corporate affairs

**proxy** A document by which shareholders or a publicly held company can transfer their rights to vote at a shareholders’ meeting to a second party.
people to question whether shareholders really have any say in operating the corporation.

The proxy election is usually run by a proxy committee of corporate executives, who, under the Security and Exchange Commission’s Proxy Rules, must use a ballot form to solicit proxies. The form must state that the shares held by the shareholder will be voted in accordance with the way the shareholder marks the ballot. The shareholder has the option to indicate on the ballot that he or she wishes to allow the proxy committee to vote the shares in any way it sees fit. The proxy committee also sends all shareholders a statement of resolutions on which the shareholders are to vote, as well as a biographical sketch of each of the candidates for the board of directors.

This process sounds efficient, even benign. Because shareholders of major corporations, however, are scattered across the country and could not realistically attend a shareholders’ meeting, the proxy process gives management effective control over the election. By placing on the ballot only the names of those candidates management wishes to see elected to the board of directors, management, in essence, selects the board. Although a shareholder can write in the name of another candidate, the cost of communicating with other shareholders makes the prospects for a write-in candidate quite slim.

Any shareholder may also engage in proxy solicitation. The costs of doing so, however, are almost prohibitive. In a fight between a shareholder and the corporate proxy committee for proxies, the corporate committee has access to corporate funds; corporate office materials such as paper, duplicating machinery, and postage accounts; shareholder contact information; corporate clerical personnel; and also the corporate legal staff. The shareholders have only their personal funds.

In recent years, the proxy forms sent out by proxy committees of major corporations have sometimes contained resolutions submitted by politically active shareholders who understand how the corporate machinery operates. Most of these resolutions have sought to change the corporation’s social policies; for example, resolutions seeking to prohibit the corporation from investing in countries that practice apartheid and from withholding information from shareholders regarding the environmental impact of the corporation’s activities have been popular in the past decade or so. The public-interest proxy resolution shown in Exhibit 18-2 was proposed by a shareholder of General Motors in the proxy statement for the 1985 annual meeting. Its objective was to force General Motors to be politically neutral.

**Resolves:** That the stockholders of General Motors, assembled in annual meeting in person and by proxy, hereby recommended that the Corporation affirm the political non-partisanship of the Corporation. To this end, the following practices are to be avoided.

- **a.** The handing of contribution cards of a single political party to an employee by a supervisor.
- **b.** Requesting an employee to send a political contribution to an individual in the corporation for subsequent delivery as part of a group of contributions to a political party or fund-raising committee.
- **c.** Requesting an employee to issue personal checks blank to payee for subsequent forwarding to a political party, committee, or candidate.
- **d.** Using supervisory meetings to announce that contribution cards of one party are available and that anyone desiring cards of a different party will be supplied one on request to his supervisor.
- **e.** Placing a preponderance of contribution cards of one party at mail station locations.
When these types of resolutions appear on proxy forms, the management of the corporation usually suggests that shareholders vote against them. Management also generally includes a strong argument against such resolutions on the proxy statement on which the proposal appears. Thus, even if a shareholder does get a resolution on the ballot, the chances of it passing are slim, though there are more frequent and more vigorous fights over policy resolutions than over the election of directors.

Recognizing that shareholder voting occurs primarily by proxy and, thus, that the shareholders’ meeting really serves no purpose but to fulfill the demands of the law, Delaware decided to abolish the requirement that corporations hold an annual shareholders’ meeting. Other states may soon follow Delaware’s example.

**THE ROLE OF THE BOARD OF DIRECTORS**

Most incorporation laws state that the corporation shall be managed by the board of directors. Although such a rule may reflect the behavior of the directors of a closely held corporation who are also its officers, it does not describe the behavior of the directors of publicly held corporations; nor does it describe the behavior that most people expect from directors of publicly held corporations.

Recognizing that most directors are not going to become involved in daily corporate affairs, the RMBCA in its statement on the role of the board of directors says merely that the corporation shall be managed “under the direction of” the board. This provision does seem to make it clear, however, that the directors are expected to function at least as overseers and policy makers. In this role, the board of directors generally must authorize or approve: (1) the payment of dividends, changes in financing, and other capital changes; (2) the selection, supervision, and removal of officers and other executive personnel; (3) the determination of executive compensation and pension plans; (4) the adoption, amendment, or repeal of the corporate bylaws; and (5) the establishment of policy regarding products, services, and labor relations. Unfortunately, most corporate boards abdicate their policymaking function and merely rubber-stamp decisions already made by the officers and managers of the corporation. Rarely does a board challenge an action taken by its corporate officers (Exhibit 18-3).

The board, like the shareholders, must function as a group. Unlike shareholders, however, directors are not allowed to vote by proxy. Instead, they are supposed to vote in person at a formal directors’ meeting. The rationale for this traditional restriction is that corporations derive benefits from the consultation, discussion, and collective judgment of their boards. Today, however, the laws in most states have been relaxed enough so that board members may act informally, without a meeting, when all the directors consent to such action in writing.

**THE ROLE OF THE OFFICERS AND MANAGERS**

The officers and managers are responsible for the actual management of corporate affairs. Unlike directors and shareholders, officers are agents of the corporation. Technically, they are appointed and supervised by the board of directors, but because the officers of the company control the proxy election, it is usually the directors who serve at the pleasure of the corporate officers.

Traditional statutes provided that a corporation must have certain officers, such as a president, a vice president, and a treasurer. The RMBCA, however, makes no such stipulations.
Following the exposure of high salaries, and other financial problems, involving companies and individuals inclusive of Enron, WorldCom, Adelphia, and Richard Grasso (formerly of the New York Stock Exchange), the compensation of officers of corporations has been spotlighted.

The decisions for compensation to be paid to a CEO, and other officers of a publicly held corporation, is usually made by the compensation committee of the board of directors. The board of directors is often made up of present and past CEOs, of corporations, nominated informally by the CEO of the company itself and voted on by the full board. Reforms on compensation, how committees are formed, and what members of the board are eligible have taken place.

Boards, representing shareholders, pay large sums to CEOs and other officers of a corporation for several reasons as noted below.

- Some argue that CEOs should be paid based on stock market performance of the company. There are up and down years in the market, but generally qualified CEOs are needed for direction.
- Some argue that if CEOs own stock, they have the same interest as shareholders.
- Others doubt this analysis, arguing that compensation committees of board of directors seek to keep compensation packages similar to those in other corporations in the same sector.
- Compensation committees seek to increase compensation packages in order to keep CEOs from going to other companies, and often tie such packages to stock performance.
- Under rules adopted by the SEC in January, 2011, companies whose stock market value exceeds $75 million must give shareholders a chance at least once every three years to voice their approval or disapproval of how senior management is paid. The vote, if called for, is mandatory, but the result is advisory.

---

EXHIBIT 18-3
CEO PAY: THE BENEFITS AND COSTS TO SHAREHOLDERS

---

FIDUCIARY OBLIGATIONS OF DIRECTORS, OFFICERS, AND MANAGERS

As previously noted, the shareholders do not have any direct control over the corporation’s operations. Whenever the property of one party is placed in the control of another, however, a fiduciary relationship exists between the two. Thus, certain obligations, called fiduciary duties, are placed on property holders to ensure that they will treat the property as carefully as if it were their own. Because the shareholders own the corporation (property) but its care is entrusted to the directors, officers, and managers, a fiduciary relationship exists between the shareholders and the officers, managers, and directors. The standards of conduct—and, thus, the fiduciary duties—imposed by the RMBCA on officers and directors of corporations are almost identical. Both are required to exercise their duties (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner he or she reasonably believes to be in the best interests of the corporation.

There is a potential breach of this duty to act in the best interests of the corporation when a corporate officer or director takes personal advantage of an opportunity that, in all fairness, should have belonged to the corporation. The following case illustrates the corporate opportunity doctrine.

---

1 RMBCA §§ 8.30, 8.42.
Case 18-1

Beam v. Stewart
Court of Chancery of Delaware, New Castle

M
onica A. Beam, a shareholder of Martha Stewart Living Omnimedia, Inc., (MSO) brought a derivative action against the defendants, all current directors and a former director of MSO, and against MSO as a nominal defendant. MSO is a Delaware corporation that operates in the publishing, television, merchandising, and Internet industries marketing products bearing the “Martha Stewart” brand name. Defendant Martha Stewart (Stewart) is a director of the company and its founder, chairman, chief executive officer, and by far, its majority shareholder, controlling roughly 94.4 percent of the shareholder vote. Stewart, a former stockbroker, has in the past 20 years become a household icon, known for her advice and expertise on virtually all aspects of cooking, decorating, entertaining, and household affairs generally.

The market for MSO products is uniquely tied to the personal image and reputation of its founder, Stewart. MSO retains “an exclusive, worldwide, perpetual royalty-free license to use [Stewart’s] name, likeness, image, voice and signature for its products and services.” In its initial public offering prospectus, MSO recognized that impairment of Stewart’s services to the company, including the tarnishing of her public reputation, would have a material adverse effect on its business. In fact, under the terms of her employment agreement, Stewart may be terminated for gross misconduct or felony conviction that results in harm to MSO’s business or reputation, but is permitted discretion over the management of her personal, financial, and legal affairs to the extent that Stewart’s management of her own life does not compromise her ability to serve the company.

Stewart’s alleged misadventures with ImClone arose in part out of a longstanding personal friendship with Samuel D. Waksal (Waksal). Waksal is the former chief executive officer of ImClone as well as a former suitor of Stewart’s daughter. Waksal and Stewart have provided one another with reciprocal investment advice and assistance, and they share a stockbroker, Peter E. Bacanovic (Bacanovic) of Merrill Lynch. The speculative value of ImClone stock was tied quite directly to the likely success of its application for FDA approval to market the cancer-treatment drug Erbitux. On December 26, Waksal received information that the FDA was rejecting the application to market Erbitux. The following day, December 27, he tried to sell his own shares and tipped off his father and daughter to do the same. Stewart also sold her shares on December 27 (see Case 1-1). After the close of trading on December 28, ImClone publicly announced the rejection of its application to market Erbitux. The following day, the trading price closed slightly more than 20 percent lower than the closing price on the date that Stewart had sold her shares. By mid-2002, these events had attracted the interest of the New York Times and other news agencies, federal prosecutors, and a committee of the U.S. House of Representatives. Stewart’s publicized attempts to quell any suspicion were ineffective at best because they were undermined by additional information as it came to light and by the other parties’ accounts of the events. Ultimately, Stewart’s prompt efforts to turn away unwanted media and investigative attention failed. Stewart eventually had to discontinue her regular guest appearances on CBS’s The Early Show because of questioning during the show about her sale of ImClone shares. After barely two months of such adverse publicity, MSO’s stock price had declined by slightly more than 65 percent. In January 2002, Stewart and the Martha Stewart Family Partnership sold 3 million shares of Class A stock to ValueAct, an investor group.

The complaint alleges that the director defendants breached their fiduciary duties by failing to ensure that Stewart would not conduct her personal, financial, and legal affairs in a manner that would harm the company, its intellectual property, or its business. It also alleges that Stewart breached her fiduciary duty of loyalty, usurping a corporate opportunity by selling large blocks of MSO stock.

Chancellor Chandler

The “duty to monitor” has been litigated in other circumstances, generally where directors were alleged to have been negligent in monitoring the activities of the corporation, activities that led to corporate liability. That the Company is “closely identified” with Stewart is conceded, but it does not necessarily follow that the Board is required to monitor, much less control, the way Stewart handles her personal financial and legal affairs.

Regardless of Stewart’s importance to MSO, she is not the corporation. And it is unreasonable to impose a duty upon the Board to monitor Stewart’s personal affairs because such a requirement is neither legitimate nor feasible. Monitoring Stewart by, for example, hiring a private detective to monitor her behavior is more likely to generate liability to Stewart under some tort theory than to protect the Company from a decline in its stock price as a result of harm to Stewart’s public image.

[A] corporate officer or director may not take a business opportunity for his own if: (1) the corporation is financially able to exploit the opportunity; (2) the opportunity is within the corporation’s line of business; (3) the corporation has an interest or expectancy in the opportunity; and (4) by taking the opportunity for his own, the corporate fiduciary will thereby be placed in a position [imipal] to his duties to the corporation.

In this analysis, no single factor is dispositive. Instead the Court must balance all factors as they apply to a particular case. For purposes of the present motion, I assume
that the sales of stock to ValueAct could be considered to be a “business opportunity.” I now address each of the four factors articulated in Broz.

The amended complaint asserts that MSO was able to exploit this opportunity because the Company’s certificate of incorporation had sufficient authorized, yet unissued, shares of Class A common stock to cover the sale to ValueAct. Defendants do not deny that the Company could have sold previously unissued shares to ValueAct. I therefore conclude that the first factor has been met.

An opportunity is within a corporation’s line of business if it is an activity as to which [the corporation] has fundamental knowledge, practical experience and ability to pursue.

MSO is a consumer products company, not an investment company. Simply stated, selling stock is not the same line of business as selling advice to homemakers.

A corporation has an interest or expectancy in an opportunity if there is “some tie between that property and the nature of the corporate business.” . . . Here, plaintiff does not allege any facts that would imply that MSO was in need of additional capital, seeking additional capital, or even remotely interested in finding new investors.

The corporate opportunity doctrine is implicated only in cases where the fiduciary’s seizure of an opportunity results in a conflict between the fiduciary’s duties to the corporation and the self-interest of the director as actualized by the exploitation of the opportunity. Given that I have concluded that MSO had no interest or expectancy in the issuance of new stock to ValueAct, I fail to see, based on the allegations before me, how Stewart’s . . . sales placed [her] in a position inimical to their duties to the Company. Were I to decide otherwise, directors of every Delaware corporation would be faced with the ever-present specter of suit for breach of their duty of loyalty if they sold stock in the company on whose Board they sit.

Additionally, Delaware courts have recognized a policy that allows officers and directors of corporations to buy and sell shares of that corporation at will so long as they act in good faith.

On balancing the four factors, I conclude that plaintiff has failed to plead facts sufficient to state a claim that Stewart . . . usurped a corporate opportunity for [herself] in violation of [her] fiduciary duty of loyalty to MSO. [This count] is dismissed in its entirety for failure to state a claim upon which relief can be granted.

For Defendants.

LINKING LAW AND BUSINESS

Financial Accounting

As a consequence of the disadvantages involved with debt financing, users of financial statements use ratios to assess the risk. Using one ratio or even several ratios, however, is not the basis for effective analysis of financial statements. It is imperative that ratios be used concurrently with one another and with other information, including historical facts, because the usefulness of ratios depends on the likelihood that history will repeat itself. One example of a ratio that evaluates the risk involved in debt financing is the times-interest-earned ratio. This ratio is computed by dividing a firm’s earnings before interest and taxes (EBIT) by the interest expense. The times-interest-earned ratio is used for the purpose of determining how many times an organization can pay interest expenses using available earnings for interest payments. The higher the ratio, the more likely it is that the firm will be able to make its interest payments. A firm’s inability to make interest payments can lead to bankruptcy; therefore, a higher ratio indicates that there is less risk for the firm.

into a transaction with the corporation. This problem, known as a conflict of interest, is specifically addressed by the RMBCA. The act provides that a transaction will not be voided because of a conflict of interest when any one of the following is true: (1) The material facts of the transaction and the director’s interest were disclosed or known to the board of directors or a committee thereof, and the board authorized, approved, or ratified the transaction; (2) the material facts of the transaction and the director’s interest were known or disclosed to the shareholders entitled to vote, and they approved, authorized, or ratified the transaction; or (3) the transaction was fair to the corporation. Use of the broad language, “the transaction was fair,” seems to give the utmost flexibility to directors. In many states that have not adopted the RMBCA, directors can protect themselves from conflict-of-interest charges through full disclosure and ratification by the board of directors.

We have said that officers and directors are required to exercise their duties in a manner they reasonably believe to be in the best interests of the corporation. Under the business judgment rule, the courts generally avoid second-guessing corporate executives and let stand any business decisions made in good faith that are uninfluenced by personal considerations.

In determining whether a director’s conduct fulfills the duty of care, the courts are aided by the RMBCA, which states that a director is entitled to rely on information and reports provided or prepared by (1) officers or employees of the corporation whom the director reasonably believes are reliable and competent, (2) legal counsel or accountants in regard to matters that the director believes are within that professional’s competence, or (3) a committee of directors of which the director is not a part, if he or she reasonably believes that the committee merits confidence. The use courts make of the business judgment rule is illustrated in the following case. Note carefully the court’s emphasis on the financial expertise required when discussing the question of a valuation study.

CASE 18-2

Smith v. Van Gorkom
Delaware Supreme Court
488 A.2d 858 (1985)

In order to take advantage of a favorable tax situation, defendant Van Gorkom, chief executive of Trans Union Corporation (Trans Union or the Company), solicited a merger offer from Pritzker, an outside investor. Van Gorkom acted on his own and arbitrarily arrived at a buyout price of $55 per share. Without any investigation, the full Trans Union board accepted the offer informally. The offer was proposed two more times before its formal acceptance by the board. Plaintiff Smith and other shareholders brought suit, claiming that the board had failed to give due consideration to the offer. The trial court held that the shareholder vote approving the merger should not be set aside because the stockholders had been “fairly informed” by the board of directors before they voted on it.

The court also found that, because the board had considered the offer three times before formally accepting it, the board had acted in an informed manner and was, therefore, entitled to the protection of the business judgment rule. The plaintiffs appealed.

Justice Horsey

On Friday, September 19, Van Gorkom called a special meeting of the Trans Union Board for noon the following day. . . . Van Gorkom began the Special Meeting of the Board with a twenty-minute oral presentation. Copies of the proposed Merger Agreement were delivered too late for study before or during the meeting. He reviewed the Company’s ITC and depreciation problems and the efforts theretofore made to solve them. He discussed his initial meeting with Pritzker and his motivation in arranging that meeting. Van Gorkom did not disclose to the Board,
however, the methodology by which he alone had arrived at the $55 figure, or the fact that he first proposed the $55 price in his negotiations with Pritzker.

Van Gorkom outlined the terms of the Pritzker offer as follows: Pritzker would pay $55 in cash for all outstanding shares of Trans Union stock, upon completion of which Trans Union would be merged into new T Company, a subsidiary wholly-owned by Pritzker and formed to implement the merger; for a period of 90 days, Trans Union could receive, but could not actively solicit, competing offers; the offer had to be acted on by the next evening, Sunday, September 21; Trans Union could only furnish to competing bidders published information, and not proprietary information; the offer was subject to Pritzker obtaining the necessary financing by October 10, 1980; if the financing contingency were met or waived by Pritzker, Trans Union was required to sell to Pritzker one million newly-issued shares of Trans Union at $38 per share.

The Board meeting of September 20 lasted about two hours. . . . The directors approved the proposed Merger Agreement.

On February 10, the stockholders of Trans Union approved the Pritzker merger proposal. Of the outstanding shares, 69.9% were voted in favor of the merger, 7.25% were voted against the merger, and 22.85% were not voted.

The determination of whether a business judgment is an informed one turns on whether the directors have informed themselves “prior to making a business decision of all material information reasonably available to them.”

In the specific context of a proposed merger of domestic corporations, a director has a duty under 8 [Delaware Code §] 251(b), along with his fellow directors, to act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the stockholders. Certainly in the merger context, a director may not abdicate that duty by leaving to the shareholders alone the decision to approve or disapprove the agreement.

On the record before us, we must conclude that the Board of Directors did not reach an informed business judgment on September 20, 1980 in voting to “sell” the company for $55 per share pursuant to the Pritzker cash-out merger proposal. Our reasons, in summary, are as follows:

The directors (1) did not adequately inform themselves as to Van Gorkom’s role in forcing the “sale” of the Company and in establishing the per share purchase price; (2) were uninformed as to the intrinsic value of the Company; and (3) given these circumstances, at a minimum, were grossly negligent in approving the “sale” of the Company upon two hours’ consideration, without prior notice, and without the exigency of a crisis or emergency.

Without any documents before them concerning the proposed transaction, the members of the Board were required to rely entirely upon Van Gorkom’s 20-minute oral presentation of the proposal. No written summary of the terms of the merger was presented; the directors were given no documentation to support the adequacy of [the] $55 price per share for sale of the Company; and the Board had before it nothing more than Van Gorkom’s statement of his understanding of the substance of an agreement, which he admittedly had never read, nor which any member of the Board had ever seen.

There was no call by the Board, either on September 20 or thereafter, for any valuation study or documentation of the $55 price per share as a measure of the fair value of the Company in a cash-out context. It is undisputed that the major asset of Trans Union was its cash flow. Yet, at no time did the Board call for a valuation study taking into account that highly significant element of the Company’s assets.

The record also establishes that the Board accepted without scrutiny Van Gorkom’s representation as to the fairness of the $55 price per share for sale of the Company—a subject that the Board had never previously considered. The Board thereby failed to discover that Van Gorkom had suggested the $55 price to Pritzker and, most crucially, that Van Gorkom had arrived at the $55 figure based on calculations designed solely to determine the feasibility of a leveraged buy-out. No questions were raised either as to the tax implications of a cash-out merger or how the price for the one million share option granted Pritzker was calculated.

We do not say that the Board of Directors was not entitled to give some credence to Van Gorkom’s representation that $55 was an adequate or fair price. . . . The issue is whether the directors informed themselves as to all information that was reasonably available to them. Had they done so, they would have learned of the source and derivative of the $55 price and could not reasonably have relied thereupon in good faith.

The defendants ultimately relied on the stockholder vote of February 10 for exoneration. The defendants contend that the stockholders’ “overwhelming” vote approving the Pritzker Merger Agreement had the legal effect of curing any failure of the Board to reach an informed business judgment in its approval of the merger.

The burden must fall on defendants who claim ratification based on shareholder vote to establish that the shareholder approval resulted from a fully informed electorate. On the record before us, it is clear that the Board failed to meet that burden.

To summarize: we hold that the directors of Trans Union breached their fiduciary duty to their stockholders (1) by their failure to inform themselves of all information reasonably available to them and relevant to their decision to recommend the Pritzker merger; and (2) by their failure to disclose all material information such as a reasonable stockholder would consider important in deciding whether to approve the Pritzker offer.

We hold, therefore, that the Trial Court committed reversible error in applying the business judgment rule in favor of the director defendants in this case.

Reversed in favor of Plaintiff, Smith.
The standards we use to make judgments are often ambiguous. For example, in judging someone's character, we might consider whether that person is fair, honest, and reasonable. To the extent that standards such as “fair” and “honest” and “reasonable” do not have universal meanings, they are ambiguous.

As you are well aware by this time, courts are not exempt from this tendency to use ambiguous standards in judging. The facts of a case are important in determining how ambiguous standards will be applied.

An important critical thinking skill is the ability to recognize ambiguous language in a court’s opinion, for without this recognition, you are not prepared to make an informed decision about whether the court’s application of standards was merited by the facts of the case. The questions that follow are intended to help you improve this critical thinking skill.

1. To demonstrate your ability to recognize ambiguous language, identify at least two examples of such language in the court’s opinion in Case 18-2.

   **Clue:** Remember that adjectives are often ambiguous.

2. The court applies this ambiguous language in a manner unfavorable to the defendant. What reasons does the court provide for doing so?

   **Clue:** If the defendant had met the standards by which he was being judged, the decision would have been favorable to him. Another way of phrasing this question is: Why didn’t the court find that he met these standards?

---

**COMMENT:** In *Cinerama Inc. v. Technicolor Inc.*, 663 A.2d 1156 (1995), the Supreme Court of Delaware distinguished the *Van Gorkom* case and held that the defendant (Technicolor) board of directors did not violate its duty of loyalty when, as interested directors, they participated in a unanimous vote to repeal the company’s supermajority provisions. The court stated that an “entire fairness analysis is required” when considering how a board of directors discharges its fiduciary duties. The Delaware Supreme Court affirmed the chancery court’s decision in favor of the defendants despite the fact that the interested directors had played a major part in negotiating the merger of their company without disclosing their material conflicts of interest to shareholders such as the plaintiff, Cinerama.

In *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000), the issue was whether stockholders may impose personal liability on the directors of a Delaware corporation for lack of due care and for waste of corporate assets. The legal standards referring to corporate governance and compliance with statutory and case were found not to have been violated. The appeals court affirmed the dismissal of the action of the lower court (chancery court). The appeals court stated that the lucrative buyout of the former president of Disney (Ovitz) did not constitute waste by the board. In the absence of fraud, disagreements were not grounds for imposing personal liability based on breach of fiduciary duty with regard to the board.

In January 2003, E. Norman Veasey, chief justice of the Delaware Supreme Court, indicated in a roundtable discussion on executive compensation at the University of Delaware that corporate directors could be held personally liable if they fail to act in good faith and thus breach their fiduciary duty to shareholders.

Experts in the area of corporate governance seemed to interpret such comments as meaning that the independence of a board’s compensation committee from the CEO will be looked at by the court carefully in terms of good faith, as outlined in this chapter. The large number of companies incorporated in Delaware make such comments particularly important.

---

On March 2, 2004, the chairman and chief executive of Walt Disney Company (Michael Eisner) lost his position as chairman after an estimated 43 percent of voting shareholders declined to support his reelection. Other nominees to the board received fewer dissenting votes. Roy Disney, nephew of the founder, led the dissenting shareholders. Despite the no-confidence vote, Eisner still had the directors’ support as CEO. In October of 2004, Eisner announced his resignation effective in 2005. In a related matter, the Court of Chancery of Delaware denied Roy Disney’s request to remove the confidentiality tag from certain documents of the company. Roy Disney was seeking the removal of Eisner as CEO (857 A.2d 444 (Del. 2004)). Eisner subsequently resigned at a later date.

**Limited Liability Companies**

The limited liability company (LLC) is a hybrid form of business organization. It allows entrepreneurs and small business owners to enjoy the same limited personal liability that shareholders in a corporation have while retaining the status of partners in a partnership. The LLC is federally taxed, not as a corporation but as a partnership, so taxes are paid personally by members of the LLC. Limited liability corporation members share in the profits from the business and exercise management control without these actions affecting their profit share or limited liability status. The LLC differs from the Subchapter S corporation in that other corporations, partnerships, and foreign investors can be LLC members, and there is no limit on the number of members.

**THE UNIFORM LIMITED LIABILITY ACT**

The National Conference of Commissioners on Uniform State Law (comprised of lawyers, academics, and judges) issued the Uniform Limited Liability Company Act (ULLCA). This act covers the formation, operation, and termination of LLCs. Each state through its legislature must determine whether the ULLCA will become state law. Forty-eight states have adopted all or part of this Uniform Act as a state statute.

**LLC CHARACTERISTICS**

The LLC is a separate legal person (or entity) under state law. It can sue or be sued, enforce contracts, and be found civilly and criminally liable for violations of law (ULLCA Section 201).

The owners of the LLC are called members. They are not personally liable to third parties for the debts, obligations, and liabilities of the LLC beyond an individual’s capital contribution—that is, they are under a limited liability (ULLCA Section 303[9]). A member is personally liable for the debts of an LLC only if he or she agrees to become so in writing or if it is so stated in the articles of incorporation. An example of personal liability is set out in the case that follows.

**CASE 18-3**

**Creative Resource Management Inc. v. Soskin**

Court of Appeals of Tennessee


Nashville Pro Hockey, LLC, was a limited liability company organized under the laws of Tennessee. The LLC owned and operated the Nashville Nighthawks, a minor-league professional hockey team. On September 4, 1996, Nashville Pro Hockey, LLC, contracted with Creative Resource Management, Inc. (CRM), the plaintiff, whereby CRM, for fees
and other consideration, would provide employee leasing services to Nashville Pro Hockey, LLC. The contract was signed by Barry Soskin, the president of Nashville Pro Hockey, LLC. A paragraph in the contract provided: “By affixing my hand and seal to this agreement, I personally guarantee any and all payments payable as represented and outlined in this agreement.”

Nashville Pro Hockey, LLC, failed, owing CRM $29,626. CRM sued Nashville Pro Hockey, LLC, and Barry Soskin to recover the unpaid compensation. Soskin defended, alleging that his signature on the contract was in his representative capacity only and not in his individual capacity as a guarantor. The trial court ruled and granted summary judgment to Soskin. CRM appealed.

Justice Cain
The well-settled precedent in Tennessee suggests that a corporate officer's signature preceded by a corporation’s capacity is evidence that the signer was acting as an agent of the corporation rather than individually.

This rule, however, must yield where the language of the contract compels a different conclusion. The language of the contract involved in the case at bar distinguishes this case from the general rule. This case concerns a contract, which contains personal guarantee language in the body of the contract.

The words “I personally guarantee any and all payments payable as represented and outlined in this agreement” reflect indisputably a guarantee by someone. Soskin insists that he signed only as a representative of the limited liability company. CRM insists that his signature imposes personal liability upon him. The stark fact is that the words “I personally guarantee” are meaningless if applied to Nashville Pro Hockey, LLC and not to Barry Soskin individually. Since the words “I personally guarantee” cannot refer to Nashville Pro Hockey, LLC, and retain any meaning at all in the text of this agreement, they must of necessity reflect the personal guarantee of Barry Soskin.

Reversed in favor of Plaintiff, CRM.

CRITICAL THINKING ABOUT THE LAW
Ethical norms act as the lenses through which we view particular situations. Individuals who give greater weight to one ethical norm could easily view the same set of facts as another person but see those facts in a different light. These different lenses do not necessarily suggest that one person has the correct view and the other does not. Instead, these lenses simply influence an individual’s perception of certain events, which could lead to disagreement between individuals who are wearing ethical lenses of varying colors. Disagreements on the basis of contrasting ethical lenses are easily seen in the relationship between plaintiffs and defendants. These opposing sides often disagree about what should be the outcome of a case, even when they agree about most of the facts. In Case 18-3, Soskin and CRM viewed the same set of facts; they agreed that there was a contract, signed by Barry Soskin, and the clause in dispute stated “I personally guarantee.” Soskin and CRM, however, vehemently disagreed about who should be liable—the individual or the LLC. The next two questions ask you to view the facts of Case 18-3 while trying on a couple of different ethical lenses.

1. Make a list of the facts in Case 18-3.
   Clue: Reread the introductory section. Be sure to consider the relevant rules of law in this case.

2. Assume that you are defendant Soskin in Case 18-3. What ethical norm would be most important to you when viewing the facts of the case as you make your argument? To enhance your understanding of the ways in which ethical norms influence your perception of given facts, now pretend that you are a business manager for CRM. With which primary ethical norm are you most likely to view this case?
   Clue: Focus on the way in which each party would interpret the defendant's capacity in signing the agreement.

CREATING A LIMITED LIABILITY COMPANY
The following steps are important in creating an LLC:

- Choose a state where the LLC will be doing most of its business.
- Select a name. It is important to make sure the state's statute governing the LLC is met and the name is not already being used. The words limited liability company or the abbreviation LLC or other language approved by ULLCA Section 105(a) should be used, as adopted by the state statute.
Reserve the name by filing the application with the secretary of state, following a determination of whether the proposed company name is federally trademarked by another company.

- Under the ULLCA, an LLC may be formed by one or more persons by delivering articles of organization to the secretary of state. The LLC comes into existence at the time of filing by the secretary (ULLCA Section 202).

**DURATION OF THE LLC**

Unless an LLC has specified otherwise in its articles of organization, its duration is unlimited or at will, meaning that it has no specific term.

**FINANCING OF THE LLC**

Members’ contributions to the LLC may be in the form of money; real, personal, tangible, and intangible property (e.g., often a patent); or contracts for services, promissory notes, or other agreements to contribute (ULCC Section 401).

**CONTROL CONSIDERATIONS**

Members of an LLC should have an operating agreement that outlines responsibilities, voting rights, and how the LLC is to be managed, at minimum. Often, outside management companies are hired. Experienced counsel and accountants should be involved in the drafting of such an agreement.

**TAX RAMIFICATIONS**

As noted previously, the LLC does not pay taxes. Income and losses are passed through to members to be reported on individual tax returns. Accountants and tax lawyers should be hired to set up this “flow-through” treatment on tax returns.

Some advantages and disadvantages of LLCs over other forms of business organizations are summarized here and in Table 17-1 of the previous chapter.

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Members are not personally liable for the LLC’s debts and obligations. Loss is limited to personal investment of capital.</td>
<td>1. State statutes are not uniform.</td>
</tr>
<tr>
<td>2. The LLC has continuity beyond the death of a member or members.</td>
<td>2. A foreign LLC (an LLC in a state not originally chartered within the state) may not be treated the same.</td>
</tr>
<tr>
<td>3. The LLC can include foreign investors, with some limitations.</td>
<td>3. In a member-managed LLC, all decisions are made by a majority, which often causes delay in decision making or derivative lawsuits filed by dissenting members.</td>
</tr>
<tr>
<td>4. The LLC can be taxed as a partnership (two or more members) or a corporation.</td>
<td></td>
</tr>
</tbody>
</table>

**Global Dimension of Corporations:**

**A “Big Fat Greek” Bailout II**

You would do well to go back and review the facts of the bailout of Greece set out in Chapter 9 before examining this material.

Following the threat of bankruptcy to Greece and later Spain and Portugal in 2010, the question became who held the debt (approximately $2.6 trillion) issued by these nations. It appeared that no one knew the full story, and because
of this mystery the private- and public-sector banks and other institutions of Europe and the United States stopped lending money to one another. Interbank loans came to a halt. There was a call for transparency from governments and other institutions around the world—including China, which holds a large amount of U.S. debts. Approximately 2.2 trillion euros of debt were issued by Spanish, Portuguese, and Greek institutions as of June, 2010. The exposure of foreign banks and other institutions was largest in France, Germany, Britain, the Netherlands, Italy, and Belgium; U.S.-based institutions had the smallest exposure. Estimates were vague because little was publicly known as to which banks held what exact amounts. Government regulators of the European Union (EU) had only incomplete information, as did those of individual countries. In Europe, bank secrecy has traditionally been part of many countries’ business culture.

The European Central Bank (ECB) joined with the International Monetary Fund (IMF) to offer $1 trillion in loan guarantees to Europe’s banks. The ECB began buying government bonds for the first time ever to prevent a debt sell-off of Greek, Spanish, and other sovereign debt. Through June of 2010, this “bailout,” along with severe austerity measures, helped calm the waters to a degree. Nonetheless, major indexes in Europe and the United States fell. The euro fell dramatically, and the U.S. dollar became a safe haven. Investors remained skeptical that Greek institutions and others in Europe could repay their debts. As the euro fell, there was no indication that transparency had either arrived or would come soon enough. Would the “bailout” be sufficient? Would it help as the growth of European economies faltered? Some skeptics also wondered whether the United States would fall back into a second recession, after seemingly recovering (at least somewhat) from the one in 2008.

SUMMARY

The classification of corporations includes: (1) closely and publicly held, (2) domestic and foreign, (3) multinational, (4) Subchapters S and C, (5) professional, and (6) nonprofit. The policy implications of, and the role of multinational corporations in, actions taken by national and supranational entities were briefly discussed.

The nature of corporations was examined with regard to their creation, financing, and operation. This chapter also reviewed the nature, advantages, and disadvantages of limited liability companies. Finally, the global dimensions of both private- and public-sector corporations were related to the context of a European economic crisis.

REVIEW QUESTIONS

18-1 Explain the difference between notes, bonds, and debentures.
18-2 Describe the various types of corporations discussed in this chapter.
18-3 Identify the factors that an entrepreneur should consider in selecting an organizational form for a business.
18-4 Describe the circumstances under which a partnership would offer greater tax advantages than a corporation.
18-5 Explain why it is somewhat misleading to assert that the corporate form provides limited liability for its owners, whereas the partnership form saddles its owners with unlimited liability.
18-6 What is a single tax advantage of a limited liability company?
CHAPTER 18 • Law and Business Associations—II

REVIEW PROBLEMS

18-7 A truck owned by Thoni Trucking Company was involved in an accident that caused severe injuries to the Fosters (the plaintiffs). After learning of the accident, the owner (the defendant) of all but two shares of the stock in Thoni Trucking and the rest of the board of directors, which consisted of the majority owner's wife and his father, transferred substantial corporate assets to themselves as salary and dividends. The remaining assets and business operations were transferred to another company that the defendant owned. In the midst of these activities, the defendant kept sending misleading information to the plaintiffs, first telling them to seek recovery from the defendant corporation, then advising them that the corporation had no assets. Would the defendant's actions allow him to reduce his liability?

18-8 Jumping Jills, Inc., was a corporation that provided trampolines for the use of the public. Defendant Jones owned 80 percent of the stock of Jumping Jills, Inc.; his wife owned 10 percent; and his stepson owned the remaining 10 percent. Jones also owned a drive-in theater located next to the trampoline business. The finances of the two businesses were kept completely separate, and the family finances were kept separate from those of both businesses. The public had no notice that the ownership of the two businesses was similar. Jumping Jills employed two persons. It had been in business for only three months when young Banks was injured on one of its trampolines. Jumping Jills' insurance company went bankrupt and, thus, could not compensate Banks for his injuries. The corporation itself had no assets, so Banks sought to recover from the major shareholder, Jones. Would Banks be successful?

18-9 Alder, Svingos, and Shaw owned an equal number of shares in a corporation that was organized to run a restaurant. They entered into a shareholders' agreement that provided, among other things, that all corporate changes, including changes in the corporate structure, would have to be approved by a unanimous vote of the shareholders. When Alder and Shaw tried to sell the business, Svingos alleged that this sale would violate the shareholders' agreement. Shaw and Alder argued that the pertinent provision was void because it should have been contained in the articles of incorporation, not in the shareholders' agreement. Was the shareholders' agreement enforceable in this case?

18-10 AstroStar, Inc., has a board of directors consisting of three members (Eckhart, Dolan, and Macero) and has approximately 500 shareholders. At a regular board meeting, the board selects Galiard as president of the corporation by a two-to-one vote, with Eckhart dissenting. The minutes of the meeting do not register Eckhart's dissenting vote. Later, an audit discovers that Galiard is a former convict and has embezzled $500,000 from the corporation that is not covered by insurance. Can the corporation hold directors Eckhart, Dolan, and Macero personally liable? Discuss.

18-11 Kline was both president and one of two directors of Fayes, Inc. The business, the ladies' ready-to-wear department of a department store, was supervised by a general manager and operated under a five-year written lease. In March, the renewal lease was sent to Kline, as president. He held the lease for eight months and then had it redrawn as a personal lease in his own name. The corporation itself had no assets, so Banks sought to recover from the major shareholder, Jones. Would Banks be successful?

CASE PROBLEMS

18-12 In February 1998, Robert Phansalkar, a Wall Street executive, joined a small merchant banking firm, Anderson Weinroth & Company (AWC). During his tenure, AWC sold Phansalkar more than 600,000 shares of its client, Millennium Cell, as part of an initial public offering. Phansalkar also represented AWC on the board of directors of several client companies, including Osicom Technologies, a public company, and Zip Global Network, a privately held company based in India. Both Osicom and Zip granted Phansalkar stock options. As required, Osicom described the stock options in a filing with the Securities and Exchange Commission, but privately held Zip was not required to make a public filing. In June 2000, Phansalkar left AWC to become president of Osicom. In September 2000, AWC filed a lawsuit against Phansalkar, claiming that he had failed to disclose the stock options he received while he was AWC's representative on the Osicom and Zip boards. A month later, Phansalkar filed a counterclaim, arguing that
A WC had illegally converted his Millennium shares, worth $4.4 million, so that they would become AWC property. Did Phansalkar have a legal or ethical obligation to disclose his stock option grants to AWC? If so, on what basis? Phansalkar v. Anderson Weinroth & Co., 344 F.3d 184 (2d Cir. 2003).

18-13 WMI Corporation was initially financed primarily by loans from Wells Fargo. Early on, the company got into deep financial difficulties, and needed to obtain additional loans to continue operations. To secure the needed additional loans, all members of the board of directors personally guaranteed the additional loans; no compensation was given for these loan guarantees.

Three years later, the company needed additional financing, which required loan guarantees from the shareholders. One shareholder, Baldwin, refused to give a guarantee, so the directors went ahead and secured the loan based on loan guarantees from all the directors and shareholders except Baldwin. As compensation for their guarantees, the directors issued themselves additional shares of stock. They used a formula of a 5 percent grant of shares for each $100,000 of corporate debt guaranteed—a formula that they came up with on their own, without using any outside consultants, because they feared that the stock would actually have a negative value. A couple of years later, the firm’s financial situation had improved slightly, but it still needed additional loans that required personal guarantees. Again, Baldwin refused, and the board secured the loans without his guarantees. They again issued themselves additional shares of stock as compensation for the guarantees, using the original formula for determining how much stock to issue, which further diluted Baldwin’s equity interest in WMI from 5.04 percent to 3.25 percent.

Baldwin sued, claiming that both issuances of compensatory shares constituted a breach by the directors of their fiduciary duties as directors. The district court found that the directors’ actions in the first instance were justified because emergency action was needed immediately to preserve the corporation, but not in the second situation. Both sides appealed. Do you think the directors violated their duty to Baldwin? How do you think application of the business judgment rule would affect the outcome in the court of appeals? Baldwin v. Daber et al., 585 F.3d 18; 2009 U.S. App. LEXIS 22880 (2009).

18-14 A Westbury Properties, Inc., and others (collectively, the Westbury Group) owned, managed, and developed real property. Jerry Stoker and The Stoker Group, Inc. (the Stokers), also developed real property. The Westbury Group entered into agreements with the Stokers concerning a large tract of property in Houston County, Georgia. The parties formed LLCs, including Bellemeade, LLC (the LLC Group), to develop various parcels of the tract for residential purposes. The operating agreements provided that “no Member shall be accountable to the [LLC] or to any other Member with respect to [any other] business or activity even if the business or activity competes with the [LLC’s] business.” The Westbury Group entered into agreements with other parties to develop additional parcels within the tract in competition with the LLC Group. The Stokers filed a suit in a Georgia state court against the Westbury Group, alleging, among other things, breach of fiduciary duty. What duties do the members of an LLC owe to each other? Under what principle might the terms of an operating agreement alter these duties? In whose favor should the court rule? Discuss. Stoker v. Bellemeade, LLC, 272 Ga. App. 817, 615 S.E.2d 1 (2005).

18-15 Harry Hoaas and Larry Griffiths were shareholders in Grand Casino, Inc. which owned and operated a casino in Watertown, South Dakota. Griffiths owned 51 percent of the stock and Hoaas 49 percent. Hoaas managed the casino, which Griffiths typically visited once a week. At the end of 1997, an accounting showed that the cash on hand was less than the amount posted in the casino’s books. In October 1999, Griffiths did a complete audit. Hoaas was unable to account for $135,500 in missing cash. Griffiths then kept all of the casino’s most recent profits, including Hoaas’s $9,447.20 share, and, without telling Hoaas, sold the casino for $100,000 and kept all of the proceeds. Hoaas filed a suit in a South Dakota state court against Griffiths, asserting, among other things, a breach of fiduciary duty. Griffiths countered with evidence of Hoaas’s misappropriation of corporate cash. What duties did these parties owe each other? Did either Griffiths or Hoaas, or both of them, breach those duties? Explain. 314 N.W.2d 61 (2006).

THINKING CRITICALLY ABOUT RELEVANT LEGAL ISSUES

Corporations should be outlawed. They have harmed our society in far more ways than they have helped it. After all, we have corporations to thank for all of the sweatshops, old-boy networks, and underpaid workers. And let’s not forget about the pollution. It’s always those big chemical corporations and industrial plants
that are filling the air we breathe and the water we drink with pollutants. It's a miracle that our life expectancy is greater than 50 years!

Just look at what corporations today do. They put poisonous products on the market and then use million-dollar marketing schemes to trick the public into buying them. Take cigarettes, for example. For decades, the big tobacco corporations have been lying to the public and paying off our government officials. They've invested millions in covering up the fact that cigarettes kill. Hundreds of thousands of innocent Americans have died because of the lengths to which these corporations have gone just to make money.

Additionally, corporations don’t know how to treat their workers. A recent survey showed that workers at corporations were five times as unhappy as were sole proprietors. Another study demonstrated that 87 percent of on-the-job accidents happened to people who worked at corporations. If we’d just get rid of these corporations, Americans would be much safer at work.

We don’t have these kinds of problems with partnerships or sole proprietorships. When’s the last time you heard of a small “mom and pop” store that severely polluted the environment or killed people with its products?

Furthermore, the capitalist ideas that our economy is built upon do not support corporations. Capitalism is based upon the idea that all competing businesses will be “mom and pop” stores. Even the founder of capitalism stated that he didn’t trust businessmen and that in order for his ideas to work, the businesses would have to be small.

Our founding fathers would probably roll over in their graves if they knew that our country is being run by these large corporations. It’s time that we return to the ideas on which our economy is based. All businesses should be either sole proprietorships or partnerships. The time has come for corporations to join the ranks of the dinosaurs.

1. What reasons does the author give for his conclusion?
2. What important information is omitted from the author’s reasoning?
3. Please create some arguments in opposition to the ones the author sets out in the essay.

ASSIGNMENT ON THE INTERNET

This chapter describes the common corporate forms of business organization in the United States. Business structures outside the United States, however, are often very different. Use the Internet to determine some of the major differences in corporate business organization between the United States and the European Union. You can begin your search by visiting the Eurolegal Services Web site at www.eurolegal.org/webresources/eustartup.htm.

If you were looking to start a business in the European Union, what would you do differently than if you were to start the business in the United States? The following Web sites may also assist you in your search.

- www.irs.gov/faqs/faq-kw127.html The IRS provides information about LLCs at this site.
- www.mycorporation.com/index.htm This is the site of a private firm that assists small companies and businesses to become incorporated.
- www.llc-reporter.com/28.htm This site provides an analysis of the ULLCA.
- www.eurolegal.org/webresources/eustartup.htm This site contains information about starting a corporation in the European Union.
- www.hg.org/corp.html This site provides links to useful information on corporate law and recent court cases that decide issues of corporate law.
- www.lexfori.net/france/incorp_france.html This site provides information about starting a corporation in France and the various structures corporations can take in that country.
FOR FUTURE READING


Part Three focuses on the public laws that regulate the legal environment of business. Because most public laws governing the legal environment are administered and created by administrative agencies, this part opens with a chapter introducing administrative agencies. After this foundational chapter, we examine laws affecting employees in the workplace, laws governing employee benefits, labor–management relationships, and employment discrimination. The focus then shifts to laws governing the physical environment, securities, antitrust, and consumer protection, as well as debtor–creditor relationships.
The first two federal administrative agencies—the Interstate Commerce Commission (ICC) (no longer in existence) and the Federal Trade Commission (FTC)—were created by Congress in the late nineteenth century and early twentieth century during an era of reform. Congress felt that the anticompetitive conduct of railroads and other corporations could best be controlled by separate administrative agencies with defined statutory mandates. In another era of reform following the stock market crash of 1929 and the beginning of the Great Depression, Congress saw a need for additional agencies to assist a free-market economy and to act in the public interest—hence, the creation of such agencies as the Securities and Exchange Commission (SEC), the National Labor Relations Board (NLRB), and the Federal Communications Commission (FCC). From time to time since then, new administrative agencies have been established, until today there are some 76 federal administrative agencies now functioning and affecting nearly every aspect of life in the United States.¹ With the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act² (Dodd-Frank) in 2010 the usage of federal regulatory agencies to implement federal statutes passed by Congress continued. Additional agencies have been added by Dodd-Frank (see chapter 24).

For example, the clothes we wear are subject to regulation by the Consumer Product Safety Commission (CPSC); the cars we drive are subject to regulation by the National Highway Safety Transportation Board (NHSTB) and the Environmental Protection Agency (EPA); and the television we watch and the out-of-state telephone calls we make are subject to regulation by the FCC.

² Public L. 111-203 became effective when President Obama signed the bill on August 2, 2010. As of this writing, this citation will be used throughout the text when the Dodd-Frank act is referred to.
Because government agencies have such a powerful effect on business, businesspeople need to understand the laws (regulations) these agencies are empowered to create and the rules of procedure they use to make such laws. The impact of administrative agency regulations on business and society is a primary focus of this text. Although we emphasize the role of federal administrative agencies, each of the 50 states, the District of Columbia, and Puerto Rico, as well as counties, cities, and some towns, have administrative agencies that also regulate business and societal conduct. In this chapter, we define administrative law and administrative agencies and discuss the reasons for their growth, how they were created, and their functions. We also explore the federal administrative agencies’ relationship to the executive, legislative, and judicial branches of government, as well as the institutions and laws that limit the power of administrative agencies. We end this chapter with a brief consideration of the global dimensions of administrative agencies.

Introduction to Administrative Law and Administrative Agencies

ADMINISTRATIVE LAW

For the purposes of this text, administrative law is defined broadly as any rule (statute or regulation) that affects, directly or indirectly, an administrative agency. These rules may be procedural or substantive, and they may come from the legislative, executive, or judicial branch of government or from the agencies themselves. Such rules may be promulgated at the federal, state, or local levels. A procedural rule generally has an impact on the internal processes by which the agencies function or prescribes methods of enforcing rights. For example, under administrative law Any rule (statute or regulation) that directly or indirectly affects an administrative agency.

procedural rule A rule that governs the internal processes of an administrative agency.

CRITICAL THINKING ABOUT THE LAW

As a future business leader, you will certainly encounter many governmental regulations. Congress created administrative agencies, in part, because it could not hope to address the enormous variety and number of concerns that are now covered by administrative agencies. Although you will not learn about every administrative agency in this chapter, you can jump-start your thinking about administrative agencies by answering these critical thinking questions.

1. Your roommate states that people do not have to follow the regulations passed by administrative agencies because these regulations are not laws. She argues that only Congress can make laws. Which critical thinking question could be applied to settle this disagreement?

   Clue: Do you and your roommate agree on the meaning of the words she is using?

2. Some individuals may argue that the creation of regulations by administrative agencies promotes unfair restrictions on business. What ethical norm seems to be behind this thought?

   Clue: If you want fewer restrictions from the government, what ethical norm is influencing your thought? What ethical norm seems to conflict with the wish for fewer governmental regulations?

3. Congress assumes that the administrative agencies will effectively address problems in their respective areas. For example, the EPA ensures compliance with environmental laws. If Matt makes the assumption that environmental problems are so complex and widespread that the EPA could not hope to make a difference, what conclusion do you think Matt would draw regarding administrative agencies?

   Clue: Think about a contrary assumption. If Matt assumed that the administrative agencies were effective, would he be more likely to support the regulations passed by the various agencies?
In the Administrative Procedure Act (APA), a federal administrative agency must give adequate notice to all parties involved in an agency hearing. A **substantive rule** defines rights of parties. An example is an act of Congress that forbids the FTC from applying the antitrust laws to all the Coca-Cola bottlers in the United States. In this instance, the rights and regulations of both the FTC and the Coca-Cola bottlers were defined by Congress.

**ADMINISTRATIVE AGENCIES**

An **administrative agency** is any body that is created by the legislative branch (e.g., Congress, a state legislature, or a city council) to carry out specific duties. Some agencies are not situated wholly in the legislative, executive, or judicial branch of government. Instead, they may have legislative power to make rules for an entire industry, judicial power to adjudicate (decide) individual cases, and executive power to investigate corporate misconduct. Examples of such independent federal administrative agencies are the EPA, the FCC, and the FTC; at the state level, examples are public utilities commissions and building authorities; at the city level, examples are city planning commissions and tax appeals boards.

**Types.** Administrative agencies are generally classified as independent or executive (see Table 19-1). **Independent administrative agencies**, such as the FTC and the SEC, are usually headed by a board of commissioners, who are appointed for a specific term of years by the president with the advice and consent of the Senate. A commissioner can be removed before serving out a full term only for causes defined by Congress, not at the whim of the president—which is why these agencies are called independent.

**Executive administrative agencies** are generally located within departments of the executive branch of government. For example, the Occupational Safety and Health Administration (OSHA) is located in the Department of Labor, and the National Transportation Safety Board (NTSB) in the Department of Transportation. Heads and members of these boards have no fixed term of office. They serve at the pleasure of the president, meaning they can be removed from their positions by the chief executive at any time.

**Reasons for Growth.** Administrative agencies have proliferated rapidly since the late 1890s for the following reasons:

1. **Flexibility.** Unlike the court proceedings studied in Chapter 3, administrative agency hearings are not governed by strict rules of evidence. For example, hearsay rules are waived in most cases.

2. **Need for expertise.** The staff of each of the agencies has technical expertise in a relatively narrow area, gained from concentrating on that area over the years. It would be impossible, for example, for 435 members of the House of Representatives and 100 senators to regulate the television, radio, and satellite communication systems of the United States on a daily basis. Only the FCC staff has that expertise.

3. **Prevention of overcrowding in courts.** If administrative agencies did not exist, our highly complex, often litigious, society would have to seek redress of grievances through the federal and state court systems. As explained in Chapter 4, both corporations and individuals are already seeking alternatives to the overburdened court system.

4. **Expeditious solutions to national problems.** After the 1929 stock market crash and the ensuing Depression, Congress sought to give investors confidence in the securities markets by creating the SEC in 1934. The SEC was intended to be a “watchdog” agency that would ensure full disclosure.
TABLE 19-1  SELECTED ADMINISTRATIVE AGENCIES

<table>
<thead>
<tr>
<th>Independent Agencies</th>
<th>Executive Agencies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commodity Futures Trading Commission (CFTC)</td>
<td>Federal Deposit Insurance Corporation (FDIC)</td>
</tr>
<tr>
<td>Consumer Product Safety Commission (CPSC)</td>
<td>General Services Administration (GSA)</td>
</tr>
<tr>
<td>Equal Employment Opportunity Commission (EEOC)</td>
<td>International Development Corporation Agency (IDCA)</td>
</tr>
<tr>
<td>Federal Communications Commission (FCC)</td>
<td>National Aeronautics and Space Administration (NASA)</td>
</tr>
<tr>
<td>Federal Trade Commission (FTC)</td>
<td>National Science Foundation (NSF)</td>
</tr>
<tr>
<td>National Labor Relations Board (NLRB)</td>
<td>Occupational Safety and Health Administration (OSHA)</td>
</tr>
<tr>
<td>National Transportation Safety Board (NTSB)</td>
<td>Office of Personnel Management (OPM)</td>
</tr>
<tr>
<td>Nuclear Regulatory Commission (NRC)</td>
<td>Small Business Administration (SBA)</td>
</tr>
<tr>
<td>Securities and Exchange Commission (SEC)</td>
<td>Veterans Administration (VA)</td>
</tr>
<tr>
<td></td>
<td>Department of Homeland Security</td>
</tr>
</tbody>
</table>

of material information to the investing public and prevent a repetition of the fraudulent practices that marked the freewheeling 1920s. When the public became concerned about the deterioration of the nation’s water, land, and air, Congress created the EPA to implement air, water, and waste regulations.

All these reasons and more are why administrative agencies exist. These reasons, however, are frequently challenged by proponents of deregulation—or no regulation—of industry. The debate between advocates of returning to a period in our history when market forces were the sole regulators of business conduct and champions of administrative agency regulation is highlighted throughout Part III of this text. We also now have advocates of reregulation in areas such as the power sector. With prices rising for electricity, for both homes and businesses, calls for reregulation are often heard. Administrative agencies are becoming more important again. This is especially true in 2010, because the current administration’s philosophy includes a belief that federal regulation is necessary to solve national problems.

Creation of Administrative Agencies

Congress creates federal administrative agencies through statutes called enabling legislation. In general, an enabling statute delegates to the agency congressional legislative power for the purpose of serving the “public interest, convenience, and necessity.” Armed with this mandate, the administrative agency can issue rules that control individual and business behavior. In many instances, such rules carry criminal as well as civil penalties. In Chapter 24, you will see how the SEC, using its mandate under the 1933 and 1934 Securities Acts, can both fine and criminally prosecute individuals involved in insider trading. The enabling statute also delegates executive power to the agency to investigate potential violations of rules or statutes. Chapter 24 sets out the wide-ranging investigative powers of the SEC staff. Finally, the enabling statutes delegate judicial power to the agency to settle or adjudicate any disputes it may have with businesses or individuals. For example, the SEC, using its congressional mandate under the 1933 and 1934 Securities Acts, has prescribed rules governing the issuance of, and trading in, securities by businesses as well as by brokers and underwriters. Administrative law judges assigned to the SEC adjudicate cases in which individuals or corporations may have violated the rules.

enabling legislation
Legislation that grants lawful power to an administrative agency to issue rules, investigate potential violations of rules or statutes, and adjudicate disputes.

legislative power
The power delegated by Congress to an administrative agency to make rules that must be adhered to by individuals and businesses regulated by the agency; these rules have the force of law.

desenexutive power
The power delegated by Congress to an administrative agency to investigate whether the rules enacted by the agency have been properly followed by businesses and individuals.

judicial power
The power delegated by Congress to an administrative agency to adjudicate cases through an administrative proceeding; includes the power to issue a complaint, hold a hearing by an administrative law judge, and issue either an initial decision or a recommended decision to the head(s) of an agency.
Because the framers of the U.S. Constitution carefully separated the legislative (Article I), executive (Article II), and judicial powers of government into three distinct branches, some people complain that allowing administrative agencies (Article III) to exercise all three powers violates the spirit of the Constitution. Critics go so far as to state that these agencies constitute a “fourth branch of government.” In 1995, the House of Representatives and the Senate overwhelmingly passed a bill that required all administrative agencies (both executive and independent) to do a cost-benefit analysis of any proposed regulation that would cost the economy more than $25 million. All agencies also have to identify possible alternatives to the proposed regulation that would require no government action, as well as varying actions customized for different regions of the country, and “the use of market-based mechanisms.” The Office of Management and Budget (OMB) reviews all proposed rules judged to be “major.” Because OMB (located in the executive branch) recommends annual budgets to Congress for each administrative agency, it has influence over all rulemaking.

Functions of Administrative Agencies

Administrative agencies perform the following functions: (1) rulemaking; (2) adjudication of individual cases brought before administrative law judges by agency staff; and (3) administrative activities, which include (a) informal advising of individual businesses and consumers, (b) preparation of reports and performance of studies of industries and consumer activities, and (c) issuance of guidelines for the business community and others as to what activities are legal in the eyes of agency staff.

RULEMAKING

We said that administrative agencies are authorized to perform the legislative function of making rules or regulations by virtue of their enabling statutes. For example, the enabling statute of the OSHA gave the secretary of labor authority to set “mandatory safety and health standards applicable to businesses affecting interstate commerce.” The secretary was also given the power to “prescribe such rules and regulations that he may deem necessary to carry out the responsibilities under this act.” In some cases, the procedures for implementing the rulemaking function are spelled out in the enabling act. If they are not, agencies follow the three major rulemaking models—formal, informal, and hybrid—outlined in the Administrative Procedure Act (APA) of 1946.

Formal Rulemaking. Section 555(c) of the APA requires formal rulemaking when an enabling statute or other legislation states that all regulations or rules must be enacted by an agency as part of a formal hearing process that includes a complete transcript. This procedure provides for (1) an agency notice of proposed rulemaking to the public in the Federal Register; (2) a public hearing at which witnesses give testimony on the pros and cons of the proposed rule, each witness is cross-examined, and the rules of evidence are applied; and (3) the making and publication of formal findings by the agency. On the basis of these findings, an agency may or may not promulgate a regulation. Because of the expense and time involved in creating a formal transcript and record, most enabling statutes do not require agencies to go through a formal rulemaking procedure when promulgating regulations.

Informal Rulemaking. As provided by Section 553 of the APA, informal rulemaking applies in all situations in which the agency’s enabling legislation or other congressional directives do not require another form. The APA requires that the agency (1) give prior notice of the proposed rule by publishing it in the Federal Register; (2) provide an opportunity for all interested parties to submit written
Step 1
Agency drafts rules in consultation with interested parties.

Step 2
Proposed rules are published in the *Federal Register*.

Step 3
Interested parties can file written comments on the written draft usually within a 30-day period from publication in the *Federal Register*.

Step 4
Final draft of a rule is published in the *Federal Register* 30 days before it takes effect. A statement of its purpose and cost-benefit analysis must accompany its publication.

Step 5
Agency receives feedback from interested parties during the 30-day period and makes a decision on whether the final draft should be rewritten. If not, it becomes law.

Informal rulemaking is the model most often used by administrative agencies because it is efficient in terms of time and cost. No formal public hearing is required, and no formal record need be established, as in formal rulemaking. Parties opposed to a particular rule arrived at through informal rulemaking, however, often seek to persuade the appellate courts that the agency in question did not take important factors into account when the rule was being made.

**Hybrid Rulemaking.** Interested parties often complained that informal rulemaking gave them little opportunity to be heard other than in writing. Both Congress and the executive branch wanted administrative agencies to do a cost-benefit analysis of proposed regulations. Out of this input, from the public and two branches of government, came hybrid rulemaking, which combines some of the aspects of formal and informal rulemaking. This model requires the agency to give notice of a proposed regulation, set a period for public comments, hold a public hearing, and have a cost-benefit analysis done by an independent executive agency.

**Exempted Rulemaking.** Section 553 of the APA allows the agencies to decide whether there will be public participation in rulemaking proceedings relating to “military or foreign affairs” and “agency management or personnel,” as well as in proceedings relating to “public property, loans, grants, benefits, or contracts” of an agency. Public notice and comment are also not required when the agency is making interpretive rules or general statements of policy.

It is generally conceded that proceedings dealing with military and foreign affairs often require speed and secrecy, both of which are incompatible with public notice and hearings.

**Judicial Review of Rulemaking.** After a regulation is promulgated by an administrative agency and is published in the *Federal Register*, it generally becomes
On October 20, 1999, a group of 19 private organizations (the petitioners) filed a rulemaking petition asking the EPA to regulate “greenhouse gas emissions from new motor vehicles under § 202 of the Clean Air Act.” The petitioners maintained that greenhouse gas emissions have significantly accelerated climate change; and that “carbon dioxide remains the most important contributor to [man-made] forcing of climate change.”

Fifteen months after the petition was filed, the EPA requested public comment on “all the issues raised in [the] petition,” adding a “particular” request for comments on “any scientific, technical, legal, economic or other aspect of these issues that may be relevant to EPA’s consideration of this petition,” including whether there was global warming due to carbon emissions. The EPA received more than 50,000 comments over the next five months.

On September 8, 2003, the EPA entered an order denying the rulemaking petition because (1) the Clean Air Act does not authorize the EPA to issue mandatory regulations to address global climate change; and (2) even if the agency had the authority to set greenhouse gas emission standards, it would be unwise to do so at this time. Massachusetts, other states, and private organizations filed suit challenging the EPA denial as arbitrary and capricious, violative of the APA, and ultra vires because of statutory mandates for EPA action. The court of appeals dismissed the appeal from the agency denial and the Supreme Court granted certiorari.

Justice Stevens

In concluding that it lacked statutory authority over greenhouse gases, EPA observed that Congress “was well aware of the global climate change issue when it last comprehensively amended the [Clean Air Act] in 1990,” yet it declined to adopt a proposed amendment establishing binding emissions limitations. Congress instead chose to authorize further investigation into climate change. In essence, EPA concluded that climate change was so important that unless Congress spoke with exacting specificity, it could not have meant the agency to address it.

According to the climate scientist Michael MacCracken, “qualified scientific experts involved in climate change research” have reached a “strong consensus” that global warming threatens (among other things) a precipitate rise in sea levels by the end of the century.

While it may be true that regulating motor-vehicle emissions will not by itself reverse global warming, it by no means follows that we lack jurisdiction to decide whether EPA has a duty to take steps to slow or reduce it. Because of the enormity of the potential consequences associated with man-made climate change, the fact that the effectiveness of a remedy might be delayed during the (relatively short) time it takes for a new motor-vehicle fleet to replace an older one is essentially irrelevant.

We find such action is “... arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.”

The first question is whether § 202(a)(1) of the Clean Air Act authorizes EPA to regulate greenhouse gas emissions from new motor vehicles in the event that it forms a “judgment” that such emissions contribute to climate change.

The Clean Air Act’s sweeping definition of “air pollutant” includes “any air pollution agent or combination of such agents, including any physical, chemical ... substance or matter which is emitted into or otherwise enters the
ADJUDICATION

In carrying out its adjudicative function in individual cases, as opposed to rule-making for whole industries, an administrative agency usually pursues a four-step process. After receiving a complaint alleging violation of an administrative law, the agency notifies the party against whom the complaint is made and conducts an investigation into the merits of the complaint. If the agency staff finds the complaint has merit, the agency next negotiates with the party to see if it can get the party to voluntarily stop the violation. If negotiation is unsuccessful, the third step is to file a complaint with an administrative law judge (ALJ). Step 4 consists of a hearing and decision by the ALJ. The party may appeal the ALJ’s decision to the full commission or agency head and ultimately to a federal court of appeals and the U.S. Supreme Court.

Dissenting Opinion

Chief Justice ROBERTS, with whom Justice SCALIA, Justice THOMAS, and Justice ALITO join, dissenting.

Global warming may be a “crisis,” even “the most pressing environmental problem of our time.” Indeed, it may ultimately affect nearly everyone on the planet in some potentially adverse way, and it may be that governments have done too little to address it. It is not a problem, however, that has escaped the attention of policymakers in the Executive and Legislative Branches of our Government, who continue to consider regulatory, legislative, and treaty-based means of addressing global climate change.

Apparent dissatisfied with the pace of progress on this issue in the elected branches, petitioners have come to the courts claiming broad-ranging injury, and attempting to tie that injury to the Government’s alleged failure to comply with a rather narrow statutory provision. I would reject these challenges as non-justiciable. Such a conclusion involves no judgment on whether global warming exists, what causes it, or the extent of the problem. Nor does it render petitioners without recourse. This Court’s standing jurisprudence simply recognizes that redress of grievances of the sort at issue here “is the function of Congress and the Chief Executive,” not the federal courts. I would vacate the judgment below and remand for dismissal of the petitions for review.
All these steps are guided by the APA, which sets out minimum procedural standards for administrative agency adjudication. Enabling statutes that create agencies often add other procedural requirements. Finally, case law arising out of appeals of agency decisions to the U.S. circuit courts of appeal and the U.S. Supreme Court provides further guidelines for agencies in carrying out their adjudicative function.

In the following detailed description of the four-step adjudicative process for federal administrative agencies, we use the FTC as a representative agency. You will find it easier to follow our discussion if you look first at the organizational outline of the FTC provided in Exhibit 19-2 and the summary of adjudication and judicial review of agency decision making given in Exhibit 19-3.

**Investigation and Complaint.** The FTC, which includes the Bureau of Competition and the Bureau of Consumer Protection, is obliged to conduct an investigation whenever it receives a complaint from other government agencies, competitors, or consumers. For example, upon receiving a complaint about a mouthwash product that is advertised as killing germs and protecting people from sore throat, the commission examines the product to see if the statement has any scientific validity. Should the commission’s staff find that the advertising is “deceptive” or “unfair” within the meaning of Section 5 of the Federal Trade Commission Act, it will seek to stop the advertising campaign in one of two ways:

1. **Voluntary compliance.** The staff will ask the corporation to voluntarily stop the advertising campaign. Usually, no penalty is assessed if the company agrees to do this.

---

**EXHIBIT 19-2**

**FEDERAL TRADE COMMISSION**

[Diagram of FTC organization structure]

2. Consent order: If voluntary compliance is not obtained, the staff notifies the mouthwash company that it has 10 days to enter into a consent order, or the staff will issue a formal complaint. Most cases are closed at this stage because, under a consent order, the company does not have to admit that it was deceptive or unfair in its advertising; it only has to promise that it will not do such unlawful advertising again and agree to the remedy that the commission imposes. The latter may be some form of corrective advertising that tells the public that the mouthwash does not kill germs. A consent order helps the commission staff to obtain a binding cease-and-desist order with limited effort and time. It also benefits the company, because by agreeing to a consent order, the company avoids both an admission of guilt and the cost of litigation and shareholder and consumer lawsuits that might ensue if the next steps in the adjudication process—a formal complaint and a hearing by an ALJ—resulted in an adverse decision for the company.

Formal Complaint and Hearing. If the case is not settled by voluntary compliance or a consent order, the commission’s staff, usually through the FTC’s Office of the General Counsel (see Exhibit 19-2), will issue a formal complaint listing the charges against the mouthwash company and will request that certain penalties be assessed by the ALJ. Administrative law judges (ALJs), who number approximately 1,150, are selected on the basis of a merit examination and are assigned to specific administrative agencies. They usually come from within the federal administrative bureaucracy and are given life tenure. Administrative law judges (ALJs) are selected on the basis of a merit examination and are assigned to specific administrative agencies.
law judges are noted for their independence, even though they may be assigned to a particular independent or executive agency for a number of years.3

A hearing before an ALJ may take several months or years. It resembles a judicial proceeding in that it includes notice to the parties; discovery; the presentation of evidence by both the staff of the commission and the accused party (the respondent); direct examination and cross-examination of the witnesses; and presentation of motions and arguments to the ALJ. There is, however, no jury at these hearings, and they are more informal than court proceedings. For instance, an ALJ will often intervene to ask questions and to take note of evidence that neither of the parties has introduced. At times, in fact, the ALJ becomes a severe questioner of both parties, especially in hearings involving disability and welfare claims. Thus, adjudicative proceedings are less adversarial and more investigative, or inquisitorial, than court proceedings.

**Initial or Recommended Decision.** After the hearing is completed, both the commission staff and the respondent submit proposed findings of facts and conclusions of law. Under the APA, the ALJ must then prepare an initial or recommended decision. An initial decision becomes the final agency action unless an appeal is taken to the full commission by either the staff or the respondent. In contrast, a recommended decision is not final; it has to be acted on by the full commission or by the head of the agency. Agency heads and commissions are not required to defer to the ALJ’s factual findings. It should be remembered that commissioners and agency heads are political appointees of the president and may have political or policy reasons for overruling an ALJ’s decision. Should either the staff or the respondent appeal a full commission’s decision to a federal circuit court of appeals, the court is likely to give deference to the ALJ’s factual findings, because the ALJ is the person who actually heard the witnesses testify and read the submitted exhibits.

**Appeal to the Full Commission.** If the losing party (the agency staff or the respondent) does not agree with the ALJ’s decision, it may appeal to the full commission, in the case of the FTC, or to the head of an executive department (or agency), in the case of an executive agency. In the mouthwash case used as an example, a majority of the commission members must rule in favor of one of the parties on the basis of a *preponderance of the evidence* standard (51 percent or more). The APA requires that the commission state factual, legal, and policy bases for its decision. This requirement makes the agency responsible for its decision both to the public and to the courts that may later review it.

**Judicial Review of Adjudicative Proceedings.** If the party that loses at the full-commission or agency-head level in an adjudicative proceeding wishes to appeal, it must file a motion for appeal with the federal circuit court of appeals that has jurisdiction in the case. Briefs are filed by both parties, and the court hears oral argument. The court also reviews the whole record, including the ALJ’s findings, in the case. It does not review the commission’s factual findings as long as they are supported by substantial evidence in the record. (The substantial evidence rule requires that the court find that a reasonable person, after reviewing the record, would make the same findings the agency did.) Rather, it reviews the commission’s legal findings to ensure that (1) it acted in a constitutionally approved way, (2) it acted within the scope of its jurisdiction as outlined by the enabling statute, and (3) it followed proper statutory procedures and did not act in an arbitrary or capricious manner.4 The following case considers the application of the arbitrary and capricious standard.

---


The Federal Communication Commission’s (FCC’s) policing of “indecent” speech stems from 18 U.S.C. Section 1464, which provides that “[w]hoever utters any obscene, indecent, or profane language by means of radio communication shall be fined or imprisoned not more than two years, or both.” The FCC first exercised its statutory authority to sanction indecent (but nonobscene) speech in 1975, when it found Pacifica Foundation’s radio broadcast of comedian George Carlin’s “Filthy Words” monologue indecent.

Under the FCC’s definition, indecent speech is language that describes, in terms patently offensive as measured by contemporary community standards for the broadcast medium, sexual or excretory activities and organs.


On a complaint about the broadcast by individuals associated with the Parents Television Council, the FCC held that any use of any variant of “the F-Word” inherently has sexual connotation and therefore falls within the scope of the indecency definition. The Commission found the fact that use of the word was fleeting and isolated irrelevant and overruled all prior decisions in which fleeting use of an expletive was held not indecent.

On February 21, 2006, the Commission found Fox Television Stations, Inc.’s broadcast of the 2002 Billboard Music Awards and Fox’s broadcast of the 2003 Billboard Music Awards indecent and profane. During the 2002 broadcast, Cher stated: “People have been telling me I’m on the way out every year, right? So f*** ’em.”

Fox filed a petition for review of the FCC’s order in the U.S. Court of Appeals for the Second Circuit.

Justice Pooler

Agencies are of course free to revise their rules and policies. Such a change, however, must provide a reasoned analysis for departing from prior precedent. When an agency reverses its course, a court must satisfy itself that the agency knows it is changing course, has given sound reasons for the change, and has shown that the rule is consistent with the law that gives the agency its authority to act. In addition, the agency must consider reasonably obvious alternatives and, if it rejects those alternatives, it must give reasons for the rejection. The agency must explain why the original reasons for adopting the rule or policy are no longer dispositive [a deciding factor].

The primary reason for the crackdown on fleeting expletives advanced by the FCC is the so-called “first blow” theory. Indecent material on the airwaves enters into the privacy of the home uninvited and without warning. To say that one may avoid further offense by turning off the [television or] radio when he hears indecent language is like saying that the remedy for an assault is to run away after the first blow.

We cannot accept this argument as a reasoned basis justifying the Commission’s new rule. First, the Commission provides no reasonable explanation for why it has changed its perception that a fleeting expletive was not a harmful “first blow” for the nearly thirty years between [the decisions in Pacifica’s case] and Golden Globes. More problematic, however, is that the “first blow” theory bears no rational connection to the Commission’s actual policy regarding fleeting expletives.

A re-broadcast of precisely the same offending clips from the two Billboard Music Award programs for the purpose of providing background information on this case would not result in any action by the FCC.

The Order makes passing reference to other reasons that purportedly support its change in policy, none of which we find sufficient. For instance, the Commission states that even non-literal uses of expletives fall within its indecency definition because it is “difficult (if not impossible) to distinguish whether a word is being used as an expletive or as a literal description of sexual or excretory functions.” This defies any commonsense understanding of these words, which, as the general public well knows are often used in everyday conversation without any “sexual or excretory” meaning. Even the top leaders of our government have used variants of these expletives in a manner that no reasonable person would believe referenced “sexual or excretory organs or activities.” [The court proceeded to recount examples of when President Bush and Vice President Cheney used the questionable words in public.]

Accordingly, we find that the FCC’s new policy regarding “fleeting expletives” fails to provide a reasoned analysis justifying its departure from the agency’s established practice. For this reasons, Fox’s petition for review is granted.

Verified for Fox Television.
ADMINISTRATIVE ACTIVITIES

In addition to rulemaking and adjudication, executive and independent agencies perform a variety of tasks that are less well known but equally important to the average individual or business. The most significant of these are the following:

1. Advising businesses and individuals concerning what an agency considers legal or not legal. The antitrust merger guidelines we discuss in Chapter 25 are an example of an attempt by the Justice Department and the FTC to advise all interested parties about what conduct will be considered violations of Section 7 of the Clayton Act. More generally, lawyers representing interested parties meet daily with agency officials to receive informal comments or advice.

2. Conducting studies of industry and markets. Agencies such as the FTC, OSHA, and the FDA carry out studies to determine the level of economic concentration in an industry, dangerous products in the workplace, and the harmful effects of legal drugs.

3. Providing information to the general public on myriad matters through answering telephone calls, distributing pamphlets, and holding seminars.

4. Licensing of businesses in certain areas, such as radio and television stations (FCC).

5. Managing property. The General Services Administration (GSA) is the largest landlord in the country. It buys, sells, and leases all property used by the U.S. government.

Limitations on Administrative Agencies’ Powers

STATUTORY LIMITATIONS

Certain federal statutes, summarized in Table 19-2, limit the power of administrative agencies and their officials. We have already discussed the APA. You should carefully review the brief descriptions of the other statutes listed in the table. It is important that you know, both as a future business manager and as an individual citizen, their major provisions. For instance, under the Federal Register Act of 1933, the Federal Privacy Act of 1974, and the Freedom of Information Act of 1966 as amended in 1974 and 1976, the decision-making processes of administrative agencies are open to the public. This legislation prevents secret, arbitrary, or capricious activity by the “fourth branch of government.” Also, as you have seen, judicial review of administrative agencies’ rulemaking and adjudication functions serves a similar purpose. Note also that private citizens have a means of relief against improper acts by employees of federal administrative agencies through the Federal Tort Claims Act of 1946, which forces agencies to waive sovereign immunity for their tortious actions and those of their employees. Tortious actions under this act include assault, battery, abuse of prosecution, false arrest, and trespass. For example, if an inspector from the EPA illegally enters a business property after being told to leave, the inspector, as well as the agency, may be held liable.

We said earlier that agencies were exempted from holding open hearings in certain circumstances, chiefly when proceedings concern military matters or foreign affairs. Some agencies have tried to stretch the exemption to cover proceedings in other “sensitive” matters.

INSTITUTIONAL LIMITATIONS

Executive Branch. The power of administrative agencies is limited by the executive branch through (1) the power of the president to appoint the heads of
TABLE 19-2  FEDERAL STATUTES LIMITING ADMINISTRATIVE AGENCIES’ AUTHORITY

<table>
<thead>
<tr>
<th>Statute</th>
<th>Summary of Provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Register of Act of 1993</td>
<td>Created the Federal Register system, which mandates the publication of all notices of federal agency meetings, proposed regulations, and final regulations in the Federal Register. The Federal Register system includes the Government Manual, which lists information, updated yearly, about each administrative agency, and the Code of Federal Regulations (CFR), which codifies regulations promulgated by agencies of the federal government.</td>
</tr>
<tr>
<td>Freedom of Information Act of 1966 (FOIA)</td>
<td>Requires each agency to publish in the Federal Register places where the public can get information from the agency, procedural and substantive rules and regulations, and policy statements. Also, the FOIA requires each agency to make available for copying on request such items as staff manuals, staff instruction orders, and adjudicated opinions, as well as interpretations of policy statements. Nine exceptions exist that enable an agency to deny an FOIA request by the public, a business, or other groups.</td>
</tr>
<tr>
<td>Government in Sunshine Act of 1976 (Sunshine Act)</td>
<td>Requires each agency headed by a collegiate body to hold every portion of a business meeting open to public attendance. A collegiate body exists if the agency is headed by two or more individuals, the majority of whom are appointed by the president and confirmed by the Senate.</td>
</tr>
<tr>
<td>Federal Privacy Act of 1974 (FPA)</td>
<td>Prevents an agency from disclosing any record in a system of records, by any means of communication, to any person or agency without the written authority of the individual. Eleven exceptions to the statute allow information to be released by the agency without the consent of individuals. Some exceptions are (1) to meet an FOIA request, (2) for use by the Selective Service System, (3) for use by another federal agency in civil or criminal law enforcement, (4) for use by a committee of the Congress, or (5) to meet a court order. Also, under the FPA, an individual may obtain information and correct errors in his or her record.</td>
</tr>
<tr>
<td>Administrative Procedure Act (APA)</td>
<td>The APA requires that certain uniform procedures be followed by all federal administrative agencies when performing their rulemaking and adjudicative functions.</td>
</tr>
<tr>
<td>Federal Tort Claims Act of 1946 (FTCA)</td>
<td>Requires the federal government to waive sovereign immunity and to assume liability for the tortious acts of its employees if nondiscretionary functions are being carried out by the employee.</td>
</tr>
<tr>
<td>Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA)</td>
<td>Requires analysis, which measures the cost that a proposed rule would impose on a business (particularly a small business). Congress may review a proposed regulation for 60 days. The SBREFA helps enforce the Regulatory Flexibility Act to make sure federal agencies seek to reduce the impact of new regulations on small businesses.</td>
</tr>
<tr>
<td>Congressional Review Act of 1996</td>
<td>This law, in effect, gives Congress a “veto power” over every single regulation agencies pass. Under this statute, a regulation cannot take effect until at least 60 working days have passed since the regulation was promulgated. If, during the 60-day period, a majority of the members of Congress pass a resolution of disapproval of the rule, and either the president signs it or Congress overrules his veto of it, the regulation is nullified.</td>
</tr>
</tbody>
</table>

The president not only appoints the head of each administrative agency, but also designates some lower-level heads of departments and divisions that do not come under the federal civil service system. Naturally, presidential appointees tend to have the same philosophical bent as the chief executive and are often of the same party. In this way, the president gains some influence over both independent and executive agencies.

Presidents exercise even greater influence over executive agencies through the budget process and executive orders. In 1981, for instance, President Reagan...
signed Executive Order 12291, which requires executive agencies to perform a cost-benefit analysis before promulgating a major federal regulation. A major federal regulation is one that will cost businesses $100 million or more to comply with. To take another example, this one concerning the budget process, Executive Order 12498, signed in 1985 (also by President Reagan), extended the OMB’s powers so that it now has authority over “pre-rulemaking action” by executive agencies. This executive order requires civilian government agencies to submit a Draft Regulatory Program listing all pre-rulemaking and other significant actions they intend to take in a fiscal year. These Draft Regulatory Programs become part of the administration’s Regulatory Program. Once that program is published by the OMB, no agency may deviate from the plan without approval from the OMB unless forced to do so by the courts.

Note that these executive orders affect executive administrative agencies. However, independent administrative agencies have been requested to comply voluntarily with these orders, and some have done so. A bill passed by the House of Representatives and the Senate in 1995, and discussed in this chapter under “Creation of Administrative Agencies,” applies to both executive and independent administrative agencies.

**Legislative Branch.** Congress limits the authority of administrative agencies through its (1) oversight power, (2) investigative power, (3) power to terminate an agency, and (4) power to advise on and consent to presidential nominations for heads of administrative agencies.

When Congress creates an agency, it delegates to that agency its own legislative power over a narrow area of commerce, say, human rights. Each year, through one of its oversight committees, it determines whether the agency has been carrying out its mandated function. Suppose, for example, that the House Energy and Commerce Committee’s Subcommittee on Consumer Finance and Telecommunications finds that the SEC is not enforcing laws against insider trading and fraud. The full committee will investigate and, if it finds dereliction, will order the SEC to enforce the laws as it is charged to do.

The greatest legislative limitation on agency power, however, lies in Congress’s right to approve or disapprove an agency budget submitted by the executive branch (the OMB). If Congress disagrees with the agency’s actions, it can slash the budget or refuse to budget the agency at all. The latter action, of course, will shut down the agency. In contrast, if Congress believes that the executive branch is shortchanging an agency for some reason, it can raise that agency’s budget above the amount proposed by the OMB.

**Judicial Branch.** The courts can curb administrative agencies’ rulemaking and adjudicative excesses by reversing or modifying such actions, as explained earlier in this chapter. You might want to go back to that portion of the chapter at this point and reread the standards used by the courts in reviewing these agency functions.

**State and Local Administrative Agencies**

Each of the 50 states, the District of Columbia, and territories such as Puerto Rico and Guam have created state and local administrative agencies to carry out tasks assigned to them by their legislative bodies. Most have utilities commissions (or the equivalent) that regulate local and in-state telephone rates, and are similar to the Federal Communications Commission, which regulates telephone rates for calls between states (interstate calls). Agencies that regulate state-chartered banks, worker’s compensation, state universities, and state
Vonage Holdings Corporation markets and sells Vonage DigitalVoice, a service that permits voice communication via a high-speed (broadband) Internet connection. Vonage’s service uses a technology called Voice over Internet Protocol (VoIP), which allows customers to place and receive voice transmissions routed over the Internet.

Traditional telephone companies use circuit-switched technology. Voice communication using the Internet has been called Internet protocol (IP) telephony, and rather than using circuit switching, it utilizes “packet switching,” a process of breaking down data into packets of digital bits and transmitting them over the Internet.

Vonage has approximately 500 customers with billing addresses in Minnesota. The Minnesota Department of Commerce (MDOC) investigated Vonage’s services and on July 15, 2003, filed a complaint with the Minnesota Public Utilities Commission (MPUC). The complaint alleged that Vonage failed to obtain a proper certificate of authority required to provide telephone service in Minnesota.

Vonage then moved to dismiss the MDOC complaint. The MPUC concluded that Vonage was required to comply with Minnesota statutes and rules regarding the offering of telephone service. Vonage then filed a complaint seeking an injunction.

Justice Davis

The issue before the Court is whether Vonage may be regulated under Minnesota law that requires telephone companies to obtain certification authorizing them to provide telephone service. Vonage asserts that the Communications Act of 1934, as amended by the Communications Act of 1996, preempts the state authority upon which the MPUC’s order relies. Vonage asserts that its services are “information services,” which are not subject to regulation, rather than “telecommunications services,” which may be regulated.

The Supremacy Clause of Article VI of the Constitution empowers Congress to preempt state law. Preemption occurs when (1) Congress enacts a federal statute that expresses its clear intent to preempt state law; (2) there is a conflict between federal and state law; (3) compliance with both federal and state law is in effect physically impossible; (4) federal law contains an implicit barrier to state regulation; (5) comprehensive congressional legislation occupies the entire field of regulation; or (6) state law is an obstacle to the accomplishment and execution of the full objectives of Congress. Moreover, a federal agency acting within the scope of its congressionally delegated authority may preempt state regulation.

Examining the statutory language of the Communications Act, the Court concludes that the VoIP service provided by Vonage constitutes an information service because it offers the “capability for generating, acquiring, storing, transforming, processing, retrieving, utilizing, or making available information via telecommunications.” Vonage’s services are closely tied to the provision of telecommunications services as defined by Congress, the courts and the Federal Communications Commission (FCC), but this Court finds that Vonage uses telecommunications services, rather than provides them.

The Court acknowledges the attractiveness of the MPUC’s simplistic “quacks like a duck” argument, essentially holding that because Vonage’s customers make phone calls, Vonage’s services must be telecommunications services. However, this simplifies the issue to the detriment of an accurate understanding of this complex question. The Court must follow the statutory intent expressed by Congress, and interpreted by the FCC. Short of explicit statutory language, the Court can find no stronger guidance for determining that Vonage’s service is an information service.

Where federal policy is to encourage certain conduct, state law discouraging that conduct must be preempted.

For Plaintiff, Injunction Granted.
Global Dimensions of Administrative Agencies

Like the United States, other nations have created administrative agencies to carry out important governmental functions. In some cases, they have more unfettered authority than their U.S. counterparts. Japan's Ministry of International Trade and Industry, Ministry of Finance, and Ministry of Foreign Affairs, for example, are often thought to be more powerful than elected Japanese politicians. Educated Japanese compete to work for these powerful agencies, which deeply influence trade, foreign affairs, and domestic issues.

The U.S. Trade Representative's Office, the Commerce Department's International Division, and the State Department share power over trade matters and regularly meet with and influence their administrative agency counterparts in Japan and Europe, particularly in the European Union. Recently, the SEC entered into a memoranda of agreement with Switzerland and other European countries, as well as with several Caribbean nations, to obtain disclosure of numbered bank accounts suspected of being used to harbor illegal profits from insider trading and other fraudulent activities in the United States (these topics are discussed in Chapter 24).

SUMMARY

Administrative law is defined broadly as any rule (statute or regulation) that directly or indirectly affects an administrative agency. The APA provides procedural guidelines for federal agencies; these guidelines are often copied, in whole or in part, by state and local administrative agencies.

The major functions of administrative agencies are rulemaking, adjudication, and the carrying out of numerous administrative activities. The executive, judicial, and legislative branches of government limit the power of federal agencies in numerous ways. In addition, several federal statutes limit the authority of administrative agencies.

Federal administrative agencies meet with their counterparts in other nations and enter into international agreements that aid the enforcement powers of U.S. agencies.

REVIEW QUESTIONS

19-1 Why did Congress create administrative agencies?
19-2 What are the two major functions of administrative agencies?
19-3 Explain the distinction between executive administrative agencies and independent administrative agencies.
19-4 Describe how the courts check the power of administrative agencies.
19-5 Describe how the executive branch of government checks the power of administrative agencies.
19-6 Describe how the legislative branch of government checks the power of administrative agencies.
REVIEW PROBLEMS

19-7 The OSHA promulgated a rule limiting employees’ exposure to cotton dust during the manufacture of cotton products because serious diseases were traced to exposure to such dust. The cotton industry argued that the standard was beyond the scope of OSHA’s authority, in that it failed to reflect a reasonable relationship between the costs of compliance for the industry and the benefits to people working in the cotton industry. OSHA and the secretary of labor argued that they did not need to perform a cost-benefit analysis to justify the standard, but rather needed to show only that the standard reduced the risk of illness to an extent that was technologically and economically feasible. Who won this case and why?

19-8 Under the Clean Air Act, the EPA can regulate gasoline additions if they “endanger the public welfare.” Scientific evidence showed that lead emissions from gasoline constituted 90 percent of all the lead in the air and that this lead could be absorbed into the body. The EPA promulgated regulations requiring a step-by-step reduction of the lead content of gasoline. Gasoline manufacturers challenged the EPA’s rulemaking procedure, claiming that it was arbitrary and capricious because the evidence supporting the agency’s decision was unsound. They claimed that air was only one of several sources of the lead absorbed by the body. The EPA argued that the evidence it had marshaled was sufficient to justify the regulations. Who won this case and why?

19-9 The FCC promulgated rules prohibiting cable television from broadcasting feature films more than 3 years old but less than 10 years old in addition to certain other programs. Home Box Office (HBO) argued that these rules were arbitrary and capricious and that they discriminated against cable companies. The FCC countered that the regulations were necessary to prevent siphoning-off of movies by cable companies from (free) network television. Who won this case and why?

19-10 In 1969, the secretary of transportation approved a plan to extend an interstate highway through Overton Park in Memphis, Tennessee. A group of environmentalists petitioned the courts, seeking to enjoin the Department of Transportation (DOT) from financing the project. They argued that under the Federal Aid Highway Act, federal funds could not be used for highway construction through a public park if a “feasible and prudent alternative” existed. DOT personnel produced affidavits indicating that the secretary had considered other alternatives and argued that, unless there was substantial evidence to the contrary, the secretary’s decision should be upheld by the reviewing court. Who won this case and why?

19-11 The FTC instituted proceedings against the Soft Drink Bottling Company, alleging violations of laws prohibiting unfair methods of competition. The complaint against Soft Drink Bottling challenged the validity of exclusive bottling agreements between the company and franchised bottlers, who had to agree not to sell the company’s products outside a designated territory. Soft Drink Bottling asked the FTC to include the 513 bottlers in the case. The FTC refused to do so on the ground that inclusion of so many bottlers would make the case unmanageable—although it said that any bottlers who wished to could intervene in the case. Soft Drink Bottling decided to appeal the decision to a federal court. Did the court entertain the action?

19-12 One of the hottest business issues today is the outrageously lavish pay of many chief executive officers (CEOs) vis-à-vis corporate profits. In 1990, for example, United Airlines’ CEO got $18.3 million—1,200 times what a new flight attendant makes—even though United’s profits had fallen by 71 percent that year! The ICC would like to regulate CEO pay. Does it have the authority to do so? Explain.

CASE PROBLEMS

19-13 The Public Citizen Health Research Group brought the OSHA to court when the group argued that chromium regulations established by the OSHA were too hard for some companies to maintain. First, chromium is a metal and can be most dangerous in its Cr(VI) form. In many types of work, there is exposure to this form of chromium as dust or fumes. Long term, the exposure can lead to lung cancer. Other problems related to exposure include asthma and nasal or skin irritation. Therefore, the OSHA determined that exposures to Cr(VI) must not surpass 5 μg/m³ permissible exposure limit (PEL). Subsequently, there was a proposal to reduce the PEL to 1 μg/m³. However, representatives from the affected industries argued that this
low level was not feasible for certain industries. Feasibility standards are set in a way so that an industry will not be harmed when trying to comply with the standards. The OSHA determined that costs to comply with the standards must be less than 1 percent of the company’s revenues and 10 percent of profits. Yet, in regard to the proposed PEL of 1 μg/m³, the OSHA could not determine that the standard was feasible for five industries: welding, aerospace painting, and pigment, catalyst, and dye production. Moreover, industry representatives disagreed with and criticized the studies that the OSHA used to determine relative exposure times and the resulting development of lung cancer. Therefore, the Public Citizen Health Research Group argued that the new PEL proposals by the OSHA should not be approved. How did the court decide in this case? Should the OSHA be forced to provide feasibility proof for the five industries listed above and more cancer studies? Public Citizen Health Research Group v. OSHA, No. 06-1818 (3d Cir. Feb. 23, 2009).

19-14 Because of Superfund—technically, the Comprehensive Environmental Response, Compensation and Liability Act—the EPA may have excessive permission to enforce rules upon companies forced to clean up possibly contaminated areas. Specifically, the EPA settles with a company on how and when the company will clean up a specific area. If the company resists the cleanup requirements or the cleanup in general for any reason, the EPA can then impose costs and fines on the company that will amount to triple what the company would otherwise have paid for the cleanup settlement. Ultimately, this rule keeps companies from evading cleanups in general and spending years fighting the EPA’s orders. However, this rule also forces companies to settle with the EPA regardless of their arguments and reasons for not doing the mandated cleanup, or the companies will face exorbitant costs. Therefore, General Electric brought the EPA to court, asking that this rule be eliminated because it is unfair to companies. How did the court decide? Do you agree with the EPA that the companies ought to clean up contaminated areas as soon as possible and fight about costs later? General Electric Co. v. Jackson, Administrator, US EPA and the EPA. 595 F Supp. 2d 8 (D.D.C. 2009).

19-15 As part of a crackdown, the EPA was directed to devise a test for all automobiles to determine if they were in compliance with the stringent new emissions standard. The EPA, already stretched thin by many pre-existing projects, enacted the CAP 2000 regulation, which requires all automobile manufacturers to devise their own tests for their automobiles. The EPA hopes this will do three things: cut down on the cost of producing its own test, force automobile manufacturers to share in the cost of producing cleaner cars, and result in an even more effective test for emissions. Ethyl Corporation produces gasoline additives, but because these tests will now be devised behind closed doors at automobile companies, it will have a more difficult time producing additives that will pass emission standards. Ethyl sued the EPA, challenging the CAP regulation. What arguments should Ethyl advance to persuade the court to strike down the EPA regulations? Ethyl Corp. v. EPA, 306 F.3d 1144 (D.C. Cir. 2002).

19-16 OSHA is part of the U.S. Department of Labor. OSHA issued a “directive” under which each employer in selected industries was to be inspected unless it adopted a “Comprehensive Compliance Program”—a safety and health program designed to meet standards that in some respects exceeded those otherwise required by law. The Chamber of Commerce of the United States objected to the directive and filed a petition for review with the U.S. Court of Appeals for the District of Columbia Circuit. The Chamber claimed, in part, that OSHA did not use proper rulemaking procedures in issuing the directive. OSHA argued that it was not required to follow those procedures because the directive itself was a “rule of procedure.” OSHA claimed that the rule did not alter the rights or interests of parties, “although it may alter the manner in which the parties present themselves or their viewpoints to the agency.” What are the steps of the most commonly used rulemaking procedure? Which steps are missing in this case? Chamber of Commerce of the United States v. U.S. Department of Labor; 74 F.3d 206 (D.C. Cir. 1999).

19-17 In 2007, the U.S. Supreme Court decided that under the Clean Air Act, the EPA had the right to regulate industry emissions of heat-trapping gases. Subsequently, challengers including individuals doubtful of the existence of global warming and representatives from certain industries brought the EPA to court, arguing against the EPA’s claim that human health and well-being are imperiled by greenhouse gases. Specifically, the opponents challenged EPA studies that indicate the danger to human health. Ultimately, many of EPA’s rules and regulations rely on that finding. One opponent of the EPA—Sullivan, the Alaska Attorney General—said that Alaska had “important interests that will be impaired by the endangerment finding.” Specifically, he argued that his state could not handle the encumbrance of some of the EPA’s regulations regarding greenhouse gases. This case was a 2010 consolidation of 16 separate cases challenging the EPA. What main issues does this case come down to? How did the court decide? Coalition for Responsible
In order for our administrative agencies to be more effective, we ought to require them to use formal rulemaking. To continue to allow agencies to use the informal rulemaking process is to undermine the democratic principles that we hold so dear.

Representative democracy is based on the notion that our elected officials will represent the views of the people. When the ideas and opinions of the people are not expressed, or are expressed but then ignored, the ideal of representative democracy is not realized. In such instances, our form of government is more like an autocracy because the government is able to rule at its whim free of responsibility to the citizens.

Formal rulemaking requires a full public hearing in which the testimony is printed in an official transcript. It also requires the publication of formal findings. These features ensure that the agency will listen to the opinions of the people. Additionally, the printed records of testimony and factual findings guarantee the people an opportunity to make sure that the agency’s reasoning in each decision is sound.

Informal rulemaking does not provide this guarantee that the agency’s officials will be responsive to the public’s desires. Informal rulemaking requires only the publication of the proposed rule in the Federal Register. Afterward, interested parties are able to submit written arguments for or against the rule. How can we be sure, however, that the agency will adequately consider this written testimony? If the head of the agency disagrees with what you write, he may tell you that your letter “must have gotten lost in the mail.” Clearly, it is too easy for agency officials to ignore the public in the process of informal rulemaking.

Many people argue that we should continue to allow informal rulemaking because it is more convenient for the agencies than formal rulemaking. Well, I suppose it would also be more convenient for the heads of the agencies to make the decision or rule by themselves.

1. What primary ethical value is least important to the author of this essay? Explain.

2. What are some problems with the evidence the author gives to support her arguments? Explain.

3. Give some arguments that are the opposite of those made by the author in this essay. Explain your choices.

ASSIGNMENT ON THE INTERNET

This chapter introduced administrative law and several administrative agencies. There are, however, many agencies not discussed that play a significant role in creating regulations. Use the Internet to discover three federal administrative agencies not discussed in this chapter. Explain the purpose of each agency and state at least two recent rules or regulations it has issued. The Web sites listed in the following section may be of use in locating the many federal administrative agencies.
www.whitehouse.gov/government/independent-agencies.html This site, maintained by the White House, contains links to federal agencies and commissions.
www.gsa.gov/Portal/gsa/ep/home.do?tabId=0 This site provides information about most administrative agencies.
www.abanet.org/adminlaw/process.html Here is the site to go to if you have ideas about how to improve the way administrative agencies cooperate.
www.law.cornell.edu/topics/administrative.html The Legal Information Institute’s site on administrative agencies includes recent administrative law judicial decisions.
www.constitution.org/ad_state/y5063e03.htm This site contains a discussion of the constitutional issues related to administrative activities.
www.oalj.dol.gov This is the site of the Office of Administrative Law Judges.

FOR FUTURE READING

The Employment Relationship

- WAGE AND HOUR LAWS
- UNEMPLOYMENT COMPENSATION
- CONSOLIDATED OMNIBUS BUDGET RECONCILIATION ACT OF 1985
- WORKER’S COMPENSATION LAWS
- THE FAMILY AND MEDICAL LEAVE ACT OF 1993
- THE OCCUPATIONAL SAFETY AND HEALTH ACT OF 1970
- EMPLOYEE PRIVACY RIGHTS
- GLOBAL DIMENSIONS OF THE EMPLOYMENT RELATIONSHIP

One way to think about the employment relationship is that it is a contractual relationship between the employer and the employee: The employer agrees to pay the employee a certain amount of money in exchange for the employee’s agreement to render specific services. Early in our history, the employer and employee were free to determine all the conditions of their employment relationship. Today, however, both the federal and state governments specify many of the conditions under which that relationship exists.

This chapter explains many of the conditions that the government imposes. The first five sections focus on the laws that affect employee wages and benefits: wage and hour laws; unemployment compensation legislation; the Consolidated Omnibus Budget Reconciliation Act of 1985; state worker’s compensation laws; and the Family and Medical Leave Act. The sixth and seventh sections shift the focus to protection of worker safety and health and privacy rights. The final section discusses the international dimensions of the employment relationship.

CRITICAL THINKING ABOUT THE LAW

Employers are required by law to provide specific employment conditions for their employees. For example, minimum wage and hours laws help to ensure that the worker will not be required to work an extraordinary number of hours for little pay.

Why do we have laws to protect workers? One reason for these laws is the belief that employees cannot protect themselves in the workplace. Because they have very little power over the employer, we have traditionally offered protection for employees to prevent their exploitation. After you read the following case example and answer the questions, you will have sharpened your critical thinking about employee benefits.
Mike works full time at a large factory. As he is preparing to go home after his shift, he sees his boss yelling angrily at the television in the executive office. The news station has just reported congressional passage of a new law that requires employers to provide paid leave for the birth of a child; both mothers and fathers will receive the paid leave. Mike’s boss thinks the new law is an outrageous restriction on employers. Mike, however, welcomes the new law because his wife is pregnant; he will be happy to stay home with his wife when she has the baby.

1. Mike’s opinion and his employer’s opinion about the new law obviously conflict. Their respective ethical preferences are one important cause of their disagreement. What ethical norm seems to be dominating the employer’s thought?
   **Clue:** Why is the employer upset? Review your list of ethical norms; try to match one of the norms to the reason why the employer is angry.

2. Mike’s boss makes the following argument: “It is ridiculous that the government would make me pay my employees to sit at home! They are my employees. I should get to decide if employees should be allowed to leave for the birth of a child.” Do you see any problems with this argument?
   **Clue:** How does the employer’s argument conflict with the reason for offering employee benefits?

3. Before you make a judgment about the worth of the new law, is there any additional information that would help your thinking?
   **Clue:** What information seems to be missing? Several crucial pieces of information about the paid leave are not offered in the news report.

---

**Wage and Hour Laws**

Employers no longer have complete freedom to pay workers any wages they choose or to require them to work any number of hours. Several federal laws impose minimum wage and hour requirements. For example, the Davis–Bacon Act\(^1\) requires that contractors and subcontractors working on government projects pay the “prevailing wage.” The most pervasive law regulating wages and hours, however, is the Fair Labor Standards Act (FLSA),\(^2\) which covers all employers engaged in interstate commerce or the production of goods for interstate commerce.

One of the most significant aspects of the FLSA is its requirement that a minimum wage of a specified amount be paid to all employees in covered industries. This specified amount is periodically raised by Congress to compensate for increases in the cost of living caused by inflation. The most recent bill to increase the minimum wage was signed into law on May 25, 2007. Under this law, the minimum wage increased to $5.85 on July 24, 2007, to $6.55 on July 24, 2008, and to $7.25 on July 24, 2009. The last increase in the minimum wage prior to this law had been on September 1, 1997, when the minimum wage rose to $5.15 per hour.

The FLSA also requires that employees who work more than 40 hours in a week be paid no less than one and one-half times their regular wage for all the hours beyond the standard 40-hour workweek. Four categories of employees, however, are excluded from this provision of the law: executives, administrative employees, professional employees, and outside salespersons. To prevent employers from taking advantage of these exemptions, however, the act generally requires that these employees earn at least a minimum amount of income and spend a certain amount of time engaged in specified activities before they can fall into each of those exempted categories.

---

A seemingly unending list of well-known companies appear to have attempted to avoid paying overtime, often by miscategorizing nonmanagerial employees as managers. For example, in 2002, Starbucks and UPS collectively agreed to pay $36 million in damages to settle claims by groups of workers who had been misclassified as “managers.” CVS agreed to pay an undisclosed sum to settle claims of pharmacists that they were not salaried, exempt employees, and PETCO agreed to pay its managers and assistant managers in California up to $25 million to settle their claims that they were not exempt from being paid overtime pay. In 2007, Computer Sciences Corporation paid a $24 million settlement to its technical support workers, who claimed they had not received proper overtime wages. The technical support workers represented about 40 percent of the total staff at the company. In 2007, Wal-Mart, the world’s largest employer, turned itself in to the Department of Labor for unpaid overtime; Wal-Mart agreed to pay $33 million in back wages and unpaid overtime.

According to the Department of Labor (DOL), the number of wage and hour class action suits now exceeds the number of employment discrimination cases under all federal discrimination statutes combined. During 2006, the DOL alone collected $172 million in back wages and overtime for employees, which is a 3.6 percent increase from 2005. Perhaps in an attempt to quell some of this litigation, the Bush administration made substantial changes to the DOL overtime regulations. In August 2004, the new DOL rules went into effect, redefining eligibility requirements for overtime protection. Under these new rules, workers earning less than $23,660 a year are guaranteed overtime protection, which is estimated to affect 1.3 million workers. Other changes to the rules, however, remove overtime protection from an estimated 4–6 million workers. One such change redefines “executive” to include those workers whose job is primarily manual or routine labor but who also perform supervision. The new definition of executive removes overtime protection from 1.4 million supervisors. Other key definitions, such as those of “professional” or “administrative,” were changed, resulting in a net loss of workers with overtime protection. As fewer employees are guaranteed overtime protection, the number of overtime-related lawsuits may drop.

To ensure that employers comply with the FLSA, the law imposes record-keeping requirements on employers. For each nonexempt employee, the employer must maintain the following records: (1) employee’s full name and Social Security number; (2) address, including zip code; (3) birth date, if under 18; (4) sex and occupation; (5) time and day of week when employee’s workweek begins; (6) hours worked each day; (7) total hours worked each workweek; (8) basis on which employee’s wages are paid (e.g., “$6 an hour,” “$220 a week,” “piece work”); (9) regular hourly pay rate; (10) total daily or weekly straight-time earnings; (11) total overtime earning for the workweek; (12) all additions to or deductions from the employee’s wages; (13) total wages paid each pay period; and (14) date of payment and the pay period covered by each payment.

Ireland and the Minimum Wage

Ireland, like the United States and most industrialized countries, has a national minimum wage. However, Ireland’s approach to the minimum wage is very different from the approach in the United States. Ireland has different stages of minimum wage. In 2007 in the United States, the national minimum wage was $5.85 per hour, with a few exceptions for tipped workers such as waiters and waitresses. The national minimum wage in Ireland in 2007 for an experienced adult worker was €8.65 per working hour. In Ireland, you must be an experienced adult worker to receive the national minimum wage.

So, who qualifies as an experienced adult worker in Ireland? Anyone who is not under the age of 18, in their first 2 years of working after turning 18, or undergoing training covered under the specific statute is considered an experienced adult worker. A worker under the age of 18 must be paid at least €6.06 per working hour. A worker in his or her first year of employment after turning 18 must be paid at least €6.92 per working hour, and a worker in his or her second year of employment after turning 18 must be paid at least €7.79 per working hour. Ireland’s minimum wage law assumes that a worker learns more and becomes more valuable with experience, and therefore rewards more experienced workers with a higher rate of pay than inexperienced workers.

Although many businesses in the United States might like a minimum wage law similar to Ireland’s, the size difference between the two countries makes such a step very improbable. The more complex a law is, the more complex the enforcement tends to be. Ireland has about 2 million workers, compared with more than 150 million workers in the United States. Ireland’s small size allows efficient application and administration of its more complex minimum wage law.

Eventually, to ensure that employees become aware of their rights, the employer must post in a conspicuous place a poster similar to the one in Exhibit 20-1.

Unemployment Compensation

Having a minimum wage provides a great deal of security for employees when they are working, but what happens to those who lose their jobs? In 1935, Congress passed the Federal Unemployment Tax Act,9 which created a state system that provides unemployment compensation to qualified employees who lose their jobs. Under this act, employers pay taxes to the states. These tax dollars are deposited into the federal government’s Unemployment Insurance Fund. Each state has an account from which to access the money in the fund. States then set up their own system of allocating these funds, determining such matters as how the amount of compensation is determined and how long it can be collected. Eligibility requirements must also be set, with most states requiring, at minimum, that an applicant not have been fired for just cause or did not voluntarily quit. Some states’ eligibility requirements are more generous than others. For example, although states generally require that employees did not voluntarily quit, some will still allow an employee to receive unemployment if he or she quit because of a compelling reason, as in the 2000 case of Beachem v. Unemployment Compensation Board of Review.10 In that case, Mr. Beachem was a single parent of a son who began having emotional and behavioral problems. The son was living with Beachem’s mother in Alabama at the time, and Beachem quit his job to move to Alabama to care for the boy after exhausting all possible child care options. He found a job in Alabama but was laid off after a month, too soon to collect unemployment compensation in that state, so he filed for benefits in

---

EMPLYEE RIGHTS
UNDER THE FAIR LABOR STANDARDS ACT
THE UNITED STATES DEPARTMENT OF LABOR WAGE AND HOUR DIVISION

FEDERAL MINIMUM WAGE
$7.25 PER HOUR
BEGINNING JULY 24, 2009

OVERTIME PAY
At least 1½ times your regular rate of pay for all hours worked over 40 in a workweek.

CHILD LABOR
An employee must be at least 16 years old to work in most non-farm jobs and at least 18 to work in non-farm jobs declared hazardous by the Secretary of Labor.

Youths 14 and 16 years old may work outside school hours in various non-manufacturing, non-mining, non-hazardous jobs under the following conditions:

No more than
- 3 hours on a school day or 18 hours in a school week;
- 8 hours on a non-school day or 40 hours in a non-school week.

Also, work may not begin before 7 a.m. or end after 7 p.m., except from June 1 through Labor Day, when evening hours are extended to 9 p.m. Different rules apply in agricultural employment.

TIP CREDIT
Employers of “tipped employees” must pay a cash wage of at least $2.13 per hour if they claim a tip credit against their minimum wage obligation. If an employee’s tips combined with the employer’s cash wage of at least $2.13 per hour do not equal the minimum hourly wage, the employer must make up the difference. Certain other conditions must also be met.

ENFORCEMENT
The Department of Labor may recover back wages either administratively or through court action, for the employees that have been underpaid in violation of the law. Violations may result in civil or criminal action.

Employers may be assessed civil money penalties of up to $1,100 for each willful or repeated violation of the minimum wage or overtime pay provisions of the law and up to $11,000 for each employee who is the subject of a violation of the Act’s child labor provisions. In addition, a civil money penalty of up to $50,000 may be assessed for each child labor violation that causes the death or serious injury of any minor employee, and such assessments may be doubled, up to $100,000, when the violations are determined to be willful or repeated. The law also prohibits discriminating against or discharging workers who file a complaint or participate in any proceeding under the Act.

ADDITIONAL INFORMATION
- Certain occupations and establishments are exempt from the minimum wage and/or overtime pay provisions.
- Special provisions apply to workers in American Samoa and the Commonwealth of the Northern Mariana Islands.
- Some state laws provide greater employee protections; employers must comply with both.
- The law requires employers to display this poster where employees can readily see it.
- Employees under 20 years of age may be paid $4.25 per hour during their first 90 consecutive calendar days of employment with an employer.
- Certain full-time students, student learners, apprentices, and workers with disabilities may be paid less than the minimum wage under special certificates issued by the Department of Labor.

For additional information:
1-866-4-USWAGE
(1-866-487-9243) TTY: 1-877-889-5627
WWW.WAGEHOUR.DOL.GOV

U.S. Department of Labor | Wage and Hour Division

WHID Publication 108B (Revised July 2009)

EXHIBIT 20-1
YOUR RIGHTS UNDER THE FAIR LABOR STANDARDS ACT POSTER
Pennsylvania. The court found that “a cause of necessitous and compelling nature exists where there are circumstances that force one to terminate his employment that are real and substantial and would compel a reasonable person under those circumstances to act in the same manner,” and allowed him to receive benefits.

Another example of an interesting exception to typical eligibility requirements is demonstrated in the following case from the Supreme Court of Minnesota.

**CASE 20-1**

**Cassandra Jenkins v. American Express Financial Corp.**

Supreme Court of Minnesota

721 N.W.2d 286 (2006)

Cassandra Jenkins worked as an insurance specialist for American Express Financial Corporation. After being convicted of assaulting a nurse in 2004, she was sentenced to 30 days in jail, with work-release privileges scheduled to begin on April 18, 2004. Prior to serving her sentence, Jenkins notified her supervisor, Joel Hansen, of her conviction, sentence, and work-release privileges. Hansen said that Jenkins could continue her employment while on work release. When Jenkins reported to the workhouse on April 18, 2004, she discovered that her employer had not verified her employment. She attempted to contact Hansen multiple times, but he never verified her employment and then terminated her employment for absenteeism on April 26. Jenkins filed for unemployment benefits but was denied because the department adjudicator determined that Jenkins had been discharged by her employer for misconduct. Jenkins appealed, but the unemployment law judge (ULJ) upheld the denial of unemployment benefits. Jenkins appealed to the court of appeals, which affirmed the department’s decision. Jenkins appealed to the Minnesota Supreme Court.

**Justice Meyer**

Whether an employee has engaged in conduct that disqualifies him from unemployment benefits is a mixed question of fact and law. Specifically, the determination of whether an employee was properly disqualified from receipt of unemployment compensation benefits is a question of law on which we are free to exercise our independent judgment.

An otherwise eligible employee will be disqualified from the receipt of unemployment benefits for a variety of reasons, including a discharge for employment misconduct. Employment misconduct is defined as “any intentional, negligent, or indifferent conduct, on the job or off the job (1) that evinces a serious violation of the standards of behavior the employer has the right to reasonably expect of the employee, or (2) that demonstrates a substantial lack of concern for the employment.”

Absence from work under circumstances within the control of the employee, including incarceration following a conviction for a crime, has been determined to be misconduct sufficient to deny benefits. Importantly, though, we declined to adopt a rule that absenteeism resulting from incarceration was misconduct as a matter of law. Instead, we directed the agency to base its determinations “upon the facts in each particular case, leaving the commissioner . . . with the responsibility of finding the facts as to ‘good cause’ and ‘fault’ within the intent and purpose of the act.”

We turn to the facts of this case to determine whether the employee engaged in misconduct. The first statutory definition of misconduct is conduct “that evinces a serious violation of the standards of behavior the employer has the right to reasonably expect of the employee.” This definition is an objective determination: was the employer’s expectation for the employee reasonable under the circumstances? The court of appeals applied this definition and determined that because the absenteeism resulted from Jenkins’ criminal conviction it was misconduct because American Express was not obligated to verify Jenkins’ employment. The employer in this case does not argue that Jenkins’ off-the-job behavior violated its standard of behavior for its employees. Rather, the employer contends that it was the simple fact of Jenkins’ failure to report to work that violated the employer’s reasonable expectation.

But the facts here lead us to conclude that it was unreasonable for the employer to expect Jenkins to report to work by April 26: the employer allowed Jenkins to continue working between the time of her conviction in March and the time she reported to the workhouse in April; the employer knew in advance of April 18 that Jenkins would be able to participate in a work-release program if the employer verified her employment; the employer told Jenkins that employees in the past had been allowed to participate in work-release programs; the employer told Jenkins that she

11 Id.
would be able to continue working while she served her sentence; Jenkins and others provided the employer with the name and phone number of the person to contact to verify Jenkins’ employment; and the employer failed to verify Jenkins’ employment despite good faith efforts on the part of Jenkins and others to obtain the verification.

Jenkins’ case is distinguishable from cases in which absenteeism due to incarceration was found to be misconduct: Grushus v. Minnesota Mining and Mfg. Co.; Smith v. American Indian Chemical Dependency Diversion Project; and Smith v. Industrial Claim Appeals Office of the State of Colorado. In all three of those cases, the claimant simply failed to show up at work because he had been incarcerated. In both of the Smith cases, the claimant did not contact his employer until after he had missed work because he had been incarcerated. The Grushus case also involved deception to the employer as to the reasons for the claimant’s inability to return to work.

For the above reasons, we conclude that the first statutory definition of misconduct relied on by the court of appeals is not satisfied.

The second statutory definition of misconduct is whether the employee “demonstrate[d] a substantial lack of concern for [her] employment.” Committing a crime that results in a period of incarceration may be evidence that an employee lacked concern for her employment. In this case, however, there is substantial evidence that Jenkins’ inability to report to work was not caused by a substantial lack of concern for her employment. The record establishes that Jenkins made diligent efforts to report to work. She informed her employer of her conviction and the availability of work release to allow her to continue her employment; she obtained a verbal assurance from the employer that the employer would cooperate with the work-release program; as soon as she became aware that she would not be able to report to work because her employment had not been verified, she made every effort to contact the employer; and she provided her employer with the necessary information to permit her release from the workhouse. The evidence as a whole amply demonstrates that she engaged in significant efforts to report for work and continue her employment. Her conduct does not demonstrate a substantial lack of concern for her employment.

We hold that under the facts presented, Jenkins’ absence from work was not misconduct that disqualified her from receiving unemployment benefits.

Reversed in favor of the Appellant, Cassandra Jenkins.

Consolidated Omnibus Budget Reconciliation Act of 1985

The Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) ensures that employees who lose their jobs or have their hours reduced to a level at which they are no longer eligible to receive medical, dental, or optical benefits can continue receiving benefits for themselves and their dependents under the employer’s policy. By paying the premiums for the policy, plus up to a 2 percent administration fee, employees can maintain the coverage for up to 18 months, or 29 months for a disabled worker. Employees have 60 days after their coverage would ordinarily terminate to decide whether to maintain the coverage.

This obligation does not arise if the employee was fired for gross misconduct or if the employer decides to eliminate the benefit for all current employees. Employers who refuse to comply with the law may be required to pay up to 10 percent of the annual cost of the group plan or $500,000, whichever is less.

Worker’s Compensation Laws

Unlike many other laws affecting the employment relationship, worker’s compensation legislation is purely state law. Our coverage of this topic must, therefore, be rather generalized. Prudent businesspeople will familiarize themselves with the worker’s compensation statutes of the states within which their companies operate.

**Coverage**

**Worker’s compensation laws** provide financial compensation to employees or their dependents when the covered employee of a covered employer is injured on the job. For administrative convenience, most states exclude certain types of businesses and small firms from coverage. A few states also allow employers to “opt out” of the system. These states may likewise give the employee the opportunity to reject coverage.
Worker’s compensation is said to be “no fault” because recovery does not depend on showing that the injury was caused by an error of the employer. Think of worker’s compensation as analogous to insurance: The employer pays premiums based on the frequency of accidents in the employer’s business, and the employees receive insurance-like benefits if injured.

To recover worker’s compensation benefits, the injured party must demonstrate that she or he is an employee as opposed to being an independent contractor. This distinction, discussed in Chapter 16, is based on the degree of control the employer can exert over the worker: The greater the degree of control, the more likely it is that the party will be considered an employee. Factors showing employer control include the employer’s dictating how the job is to be done, providing the tools to do the job, and setting the worker’s schedule. In contrast, in employer–independent contractor relationships, the employer generally specifies the task to be accomplished but has no control over how the task is done. A broker hired by a firm to sell a piece of property is an example of an independent contractor.

The employee must also establish that the injury occurred on the job, meaning it must have taken place during the time and within the scope of the claimant’s employment. Once an employee is on company property, the courts generally find that the employee was on the job, a finding based on the application of the so-called premises rule.

More difficult, however, is the situation of the employee who is injured on the way to or from work. If the employee works fixed hours at a fixed location, injuries on the way to or from work are generally noncompensable; but some states establish exceptions to this rule. For example, the special-hazards exception applies when a necessary means of access to the employer’s premises presents a special risk, even if the hazardous area is beyond the control of the employer. For example, if an employee must make a left-hand turn across a busy thoroughfare to enter the company parking lot, this situation has been held to be a risk of employment; therefore, employees involved in accidents while making the left-hand turn into their employer’s parking lot have been allowed compensation under this exception.

Another exception is when an employee is requested to run an errand for the employer on the way to or from work. Compensation is usually allowed for injuries sustained during the course of running the errand.

Sometimes, as a consequence of the job, an employee is forced to temporarily stay away from home. What if the employee is injured while away from home? In some states, reasonable injuries suffered while away from work are covered. In a New York case, a typist was required to travel to Canada to transcribe depositions. While showering in her hotel, she fell and injured herself. She filed a successful worker’s compensation claim.

The elements necessary for recovery under worker’s compensation laws are summarized in Exhibit 20-2.

RECOVERABLE BENEFITS

The amounts and types of benefits recoverable under worker’s compensation are specified by each state’s relevant statute. Most statutes cover medical, hospital, and rehabilitation expenses. Some statutes also cover “other treatment” or “appliances” necessary to treat workers for work-connected injuries.

EXHIBIT 20-2
ELEMENTS REQUIRED FOR A SUCCESSFUL WORKER’S COMPENSATION CLAIM

1. Claimant is an employee, as opposed to an independent contractor.
2. Both claimant and employer are covered by the state worker’s compensation statute.
3. The injury occurred while the claimant was on the job and acting within the scope of the claimant’s employment.
Compensation under state statutes also generally includes payment for lost wages. When employees become disabled as a result of their injury, most states have a schedule that determines the amount of compensation for the disability, as well as compensation schedules for loss of body parts. Thus, an employee who lost a toe in an industrial accident, even though not disabled as a result, would be entitled to some compensation for the loss.

**THE CLAIMS PROCESS**

Most worker's compensation claims are handled by a state agency responsible for administering the compensation fund and adjudicating claims. In general, an employee who is injured fills out a claim form and files it with the responsible administrative agency. A representative of the agency then verifies the claim with the employer. If the employer does not contest the claim—and most do not—an employee of the bureau (usually called a “claims examiner”) investigates the claim and determines the proper payment.

If either the amount or the validity of the claim is contested, there is an informal hearing before a regional office of the agency. Most states provide for an appeals process within the agency. A dissatisfied party who has exhausted the administrative appeals process may appeal to the state trial court of general jurisdiction.

**BENEFITS OF THE WORKER’S COMPENSATION SYSTEM**

Worker’s compensation systems are often touted as benefiting workers. In many ways, they do. Before we had worker’s compensation statutes, an employee who was injured on the job could successfully gain compensation from his or her employer only if able to prove that the injury was caused by the employer’s negligence. Such proof was often difficult to produce.

Recovery was further restricted by the availability of powerful defenses. If the employee’s own negligence contributed to the injury, the employee could not recover because of the defense of contributory negligence. Under the fellow servant rule, an employee could not recover if the act of another employee caused or contributed to the injury. In some cases, the courts would say that if the claimant employee engaged in work knowing that it presented a particular safety risk, that employee had assumed the risk of injury and, therefore, the employer was not liable.

Overall, then, worker’s compensation helps employees because it has removed from them the burden of having to prove employer negligence and has made all the defenses just mentioned irrelevant to compensation claims. Today, employees can obtain compensation in situations in which formerly they could not have recovered. The system also helps employees because they do not need to hire an attorney to recover. Many injured workers have never used attorneys and would not know how to seek legal help. They might also fear retaliation from their employers for bringing suit.

Certain aspects of worker’s compensation, however, hurt employees and help employers. In most states, employees who are covered by worker’s compensation statutes do not have the right to bring personal injury lawsuits against their employers. Because the payment schedule adopted under any state law is a political compromise heavily influenced by business lobbies, the amount of compensation given is minimal—generally far less than the amount a party could recover through a successful lawsuit against the employer.

Some people argue that claimants are not completely compensated under most payment schedules and that worker’s compensation laws compel employees to give up the chance of a large (or full) recovery in exchange for certain, but minimal, recovery. Because employers simply make regular payments to the
worker’s compensation fund, the costs of occupational injuries are a routine part of their operating expenses. Companies do not have to worry about incurring substantial unanticipated losses; at most, they may find their premiums increased if the number of claims filed against them goes up.

Some people argue further that, by reducing potential costs for workplace injuries in this manner, worker’s compensation has made employers less careful about employee safety than they would be if they had to fear huge damage awards.

The Family and Medical Leave Act of 1993

On August 5, 1993, the Family and Medical Leave Act (FMLA) went into effect. This law was designed to guarantee that workers facing an unexpected medical catastrophe or the birth or adoption of a child would be able to take needed time off from work. The act was hailed by its supporters as a “breakthrough” in U.S. law, and it was denigrated by its opponents as an unwieldy encumbrance upon business. So far, the jury is still out on the effectiveness of this act.

MAJOR PROVISIONS

The FMLA is a highly complex piece of legislation, containing 6 titles divided into 26 sections. The regulations, designed to guide the implementation of the act, are eight times longer than the statute itself! No wonder many employers were still not in full compliance with the act a year after it became effective.

The act covers all public employers and private employers of 50 or more employees. Covered employers must formulate a family leave policy and revise employee handbooks accordingly. The policy must provide all eligible employees with up to 12 weeks of leave during any 12-month period for any of the following family-related occurrences:

- The birth of a child
- The adoption of a child
- The placement of a foster child in the employee’s care
- The care of a seriously ill spouse, parent, or child
- A serious health condition that renders the employee unable to perform any of the essential functions of his or her job

To exercise the rights under the FMLA, an employee whose need for a leave is foreseeable must advise the employer of that need at least 30 days prior to the anticipated date on which the leave should begin, or as soon as practicable. A typical foreseeable leave would be one for the birth of a child.

If the leave is unforeseeable, notice must be given as soon as practicable. “As soon as practicable” is defined as within one or two business days from when the need for the leave becomes known.

The act does not provide a clear definition of exactly what type of notice is necessary. At minimum, the employee must inform the employer of why the employee needs the leave, and, if possible, the length of time needed. The request need not specifically mention the FMLA.

Courts look at the facts of each case individually to determine whether notice was sufficient.

Upon termination of their leaves, employees must be restored to the same position or one that involves substantially equivalent skills, effort, responsibility, and authority. Also, although the leave itself can be unpaid, the employer must continue health insurance benefits during the leave period. The employer may also require an employee to substitute paid time off for unpaid leave. For
Rachel Schaar worked as a medical receptionist for Lehigh Valley Physicians Business Service (Lehigh Valley) from December 2002 until her termination on October 3, 2005. Two weeks before Schaar was fired, she was treated for low back pain, fever, nausea, and vomiting. Dr. Twaddle, who also worked for Lehigh Valley, diagnosed Schaar with a urinary tract infection, fever, and low back pain. Dr. Twaddle placed Schaar on a clear diet and prescribed an anti-inflammatory for her back. He also prescribed an antibiotic for the infection, to be taken once a day for at least three days. During his deposition, Dr. Twaddle testified that the antibiotic should have lowered Schaar’s fever and eliminated her symptoms after a day or two. However, Dr. Twaddle also testified that it was “possible, although very unlikely” that Schaar would not be fully recovered enough to work after three days.

Dr. Twaddle wrote a note to Schaar’s supervisor indicating that the illness would prevent Schaar from working Wednesday and Thursday. Schaar taped the note to the supervisor’s door and went home and spent the next two days in bed. Friday through Monday Schaar remained ill but had already scheduled vacation days. She returned to work on Tuesday and the supervisor said that she had failed to call in sick according to company policy. Originally, Schaar was told that she would not be fired as a result of this offense. However, six days later she was terminated for not calling in sick, as well as for alleged other employment indiscretions. Schaar filed suit claiming interference and discrimination in violation of the FMLA. Lehigh Valley moved for summary judgment on the ground that Schaar had failed to give adequate notice of a serious medical condition. The district court granted Lehigh Valley’s motion, holding that Schaar did not establish a serious health condition because she failed to present medical evidence that she was incapacitated for more than three days. Schaar appealed.

**CASE 20-2**

Rachel Schaar, Appellant v. Lehigh Valley Health Services, Inc.; Lehigh Valley Physicians Business Services, Inc.
United States Court of Appeals for the Third Circuit
598 F.3d 156 (2010)

The purpose of the FMLA is “to balance the demands of the workplace with the needs of families.” Accordingly, the FMLA “entitle[s] employees to take reasonable leave for medical reasons.” But they must do so “in a manner that accommodates the legitimate interest of employers.” An eligible employee is entitled “to a total of twelve workweeks of leave during any twelve month period” but only if the employee has a “serious health condition that makes the employee unable to perform the functions of the position of such employee.” Once an employee is entitled to leave, the FMLA prohibits an employer from interfering with it or retaliating against an employee for taking it.

The crucial question in this appeal is whether Schaar was entitled to take FMLA leave. To be eligible, Schaar had to be a covered employee working for a covered employer. She also had to suffer from a serious health condition and give her employer adequate notice of her need for FMLA leave. It is undisputed that Schaar was an eligible employee and that Lehigh Valley was a covered employer. Lehigh Valley disputes, however, that Schaar suffered from a “serious health condition” and that she gave adequate notice.

---

12 *Miller v. AT&T Corp.*, 250 F.3d 820 (4th Cir. 2001).
As relevant to this appeal, the FMLA defines serious health condition as “an illness, injury, impairment, or physical or mental condition that involves . . . continuing treatment by a health care provider.” A Department of Labor regulation further defines continuing treatment by a health care provider as a period of incapacity . . . of more than three consecutive calendar days . . . that also involves . . . [t]reatment by a health care provider on at least one occasion which results in a regimen of continuing treatment under the supervision of the health care provider.” Incapacity means the inability to work, attend school or perform other regular daily activities due to the serious health condition, treatment therefore, or recovery therefrom.

The only issue in dispute is whether Schaar presented evidence that she was incapacitated for more than three days. The District Court held Schaar had to establish more than three days of incapacitation through medical evidence. Because Schaar presented a doctor’s note that established incapacitation only for two days and relied on her own testimony about the remaining days, the District Court granted summary judgment for Lehigh Valley.

Although we have not addressed the question presented by this appeal, other courts have adopted three approaches: (1) the evidence of incapacity must come exclusively from a medical professional; (2) lay testimony, on its own, is sufficient; or (3) lay testimony can supplement medical professional testimony or other medical evidence.

Many district courts, including those in the Third Circuit, have held that a health care provider’s professional medical opinion is the only evidence that can establish incapacity. These decisions reason that a medical expert is required to establish that the employee was incapacitated because of the injury or illness. . . .

 Contrary to the aforementioned district courts, all of the circuit courts of appeals that address the question we now consider have held that lay testimony can create a genuine issue of material fact regarding incapacitation. . . . Some of our sister circuits have held that lay testimony alone is sufficient to establish incapacity, while others have held that lay testimony may be used to supplement medical evidence.

The Courts of Appeals for the Fifth and Ninth Circuits hold that lay testimony is sufficient, by itself, to establish incapacitation. The Fifth Circuit has held that expert medical testimony is not “necessary to demonstrate (the employee’s) incapacitation.” The Ninth Circuit has gone even farther, holding that lay testimony creates a genuine issue of material fact even when all medical evidence is to the contrary. . . .

Taking a more restrictive approach than the Fifth and Ninth Circuits, the Eighth Circuit has allowed lay testimony only to supplement incomplete medical evidence.

The regulation at issue in this case provides that the ambiguous statutory language “continuing treatment by a health care provider,” can be satisfied by showing at least three days of incapacitation. This regulation does not speak to whether medical testimony is required. In the very next regulation, however, the Department of Labor requires a “health care provider” to determine that an employee is “[u]nable to perform the functions of the position.” Because the incapacitation regulation does not require, or even mention, a health care provider determination, we find no support in the regulations to exclude categorically all lay testimony regarding the length of an employee’s incapacitation. . . .

Contrary to the Fifth and Ninth Circuits, however, we do not find lay testimony, by itself, sufficient to create a genuine issue of material fact. Some medical evidence is still necessary to show that the incapacitation was “due to” the serious health condition. This does not place an undue burden on employers because they must present some medical evidence anyway to establish the inability to perform the functions of the position. In contrast, allowing unsupported lay testimony would place too heavy a burden on employers to inquire into an employee’s eligibility for FMLA leave based solely on the employee’s self-diagnosed illness. For these reasons, we hold that an employee may satisfy her burden of proving three days of incapacitation through a combination of expert medical and lay testimony.

[View][ing] the facts of this appeal in the light most favorable to Schaar, Dr. Twaddle wrote that Schaar was incapacitated for two days because of her illness. When that expert medical opinion is combined with Schaar’s lay testimony that she was incapacitated for two additional days, it necessarily follows that a material issue of act exists as to whether Schaar suffered from a “serious health condition. Of course, we express no opinion as to whether Schaar’s lay testimony regarding her incapacitation is credible and we do not reach the question of the adequacy of her notice because the district court did not address it.

Judgment of trial court vacated and remanded for further proceedings.

CRITICAL THINKING ABOUT THE LAW

1. **What facts are especially crucial in finding on behalf of Schaar?**
   **Clue:** Look at all of the available testimony.

2. **What ethical norms does the FMLA protect?**
   **Clue:** Ask yourself what is gained by providing employees with the guarantees flowing from the FMLA.
REMEDIES FOR VIOLATIONS OF THE FMLA

If an employer fails to comply with the FMLA, the penalties can be substantial. The plaintiff may recover damages for unpaid wages or salary, lost benefits, denied compensation, and actual monetary losses up to an amount equivalent to the employee’s wages for 12 weeks, as well as attorney fees and court costs. If the plaintiff can prove bad faith on the part of the employer, double damages may be awarded. An employee may also be entitled to reinstatement or promotion.

When employees prevail in FMLA trials, they generally are awarded a monetary amount double their actual lost wages and certain incurred expenses, such as payments made for COBRA insurance coverage. One of the largest jury awards under FMLA thus far has been $2,227,241.48, awarded in March of 2008, to Nicholas Lore from Chase Manhattan Mortgage Corporation. Lore was a regional manager for Chase, earning $600,000 per year. He requested time off to respond to a serious medical condition, undiagnosed pain in his groin and knee that prevented him from sleeping more than a few hours, and was told the company needed to hire another manager to take over some of his duties. Several months later, no replacement had been found. He approached his supervisor again about taking time off for a leave to diagnose and treat the problem, and the next day was informed by the supervisor’s assistant that his resignation was accepted, even though he had simply sought a leave. The reason the jury verdict was so high was that Lore was such a highly paid employee.

While his jury verdict was just over $2 million, Lore’s ultimate award was over $6 million because of the FMLA’s provision of a doubling of the jury award, plus interest.

In 2008, the FMLA was amended to provide benefits for family members of military personnel, adding a twelve week “exigency leave” for the child, spouse or parent of National Guard and Reserves service members to respond to exigencies related to a call to active duty, and a twenty six week “military caregiver’s leave” for family members of service members of the armed forces, National Guard and Reserves seriously injured while on active duty.

In 2009, the Department of Defense Authorization Law expanded the military caregiver’s leave to include veterans with injuries such as post-traumatic stress syndrome that would not manifest itself until after the service member was no longer on active duty, as well as to service members with pre-existing medical conditions that were made worse by incidents that occurred during their service.

The Occupational Safety and Health Act of 1970

Employees worry about more than compensation. They also want to work in a safe environment. Although working can be hazardous to one’s health and safety, not all jobs are equally hazardous. The most dangerous industry is mining, followed by construction, agriculture, and transportation. The safest industries are the service industries. Fortunately, workplaces are getting safer. Exhibit 20-3 illustrates the declining rates of occupational injuries in the U.S. workplace.

The primary regulatory measure designed to provide a safer workplace is the Occupational Safety and Health Act (OSH Act) of 1970. The OSH Act requires every employer to “furnish to each of his employees . . . employment . . . free from recognized hazards that are likely to cause death or serious physical harm. . . .”

---

13 http://www.customwebexpress.com/bflaw/sub/Atlanta-Employment-Attorneys.jsp;jsessionid=4C8167966EC444BDF7DAE6B9C882F19B
To ensure that this objective will be met, Congress, under the OSH Act, authorized the creation of three agencies: the Occupational Safety and Health Administration (OSHA), the National Institute for Occupational Safety and Health (NIOSH), and the Occupational Safety and Health Review Commission (OSHRC).

**OCCUPATIONAL SAFETY AND HEALTH ADMINISTRATION**

The most important of these agencies is the **Occupational Safety and Health Administration (OSHA)**. It has both a standard-setting and an enforcement role. In addition, it undertakes educational programs among employers and employees. In the 36 years since OSHA’s establishment in 1971, workplace fatalities have been cut by 60 percent and occupational injury and illness rates by 40 percent, even though the American workforce has more than doubled.

**Standard Setting.** OSHA sets the standards for occupational health and safety in the United States. These standards are frequently opposed by labor and management but for different reasons. In general, labor organizations criticize them for insufficiently protecting employees’ health and safety, whereas employer groups claim they are unnecessarily stringent and too costly.

In establishing health standards, OSHA has used the following four-step process since 1981:

1. The agency asks whether the hazard presents a “significant risk” that warrants intervention.
2. If it does, OSHA decides whether regulatory action can reduce the risk.
3. If it can, the agency establishes a standard to reduce the risk “to the extent feasible,” taking into account both technological and economic feasibility.
4. OSHA then analyzes the cost-effectiveness of various implementation options to determine which will achieve its goals most efficiently.14

**Enforcement.** OSHA is charged with enforcing the OSH Act through unannounced inspections and the levying of fines against violators. The goals of OSHA inspections are to find and correct existing hazards and to encourage employers to eliminate hazards before inspection.

---

14 *Preventing Illness and Injury in the Workplace* (Washington, DC: Office of Technology Assessment, 1985), 16.
OSHA conducts several different types of inspections. In order of priority, these are: imminent danger inspections, when OSHA learns of a hazard that can be expected to cause physical harm or death; catastrophe and fatality investigations, whenever an accident hospitalizes five or more workers or causes a death; employee complaints, when an employee alleges a violation and requests an inspection; special inspection programs, including those aimed at certain hazards or industries; and, finally, programmed or random inspections. Follow-up inspections may also be conducted at any time.

OSHA’s budget strongly affects the number of inspectors the agency has and, hence, the number of inspections it can perform. The agency’s budget obviously fluctuates annually. For fiscal year 2009, its budget was roughly $515 million; the agency was estimated to have conducted 39,004 workplace inspections that year. During fiscal year 2008, OSHA’s budget was $486 million and the agency conducted 38,591 workplace inspections.

**Inspection Procedure.** The safety and health compliance officer conducting the inspection arrives at the plant, usually unannounced, presents his or her credentials, and asks to meet with the person in charge and a union representative to explain the purpose of the visit. The inspector then asks to see any relevant records. Since 1981, the policy of OSHA has been for the inspector in a safety inspection to calculate from these employer records the average lost-workday rate of injury. If it is lower than the average for the industry, the inspection is ended. If it is higher, the inspector walks through the workplace, taking notes, pictures, and exposure samples when relevant. An employer or an employee representative, or both, may accompany the inspector on this tour. After the inspection, the inspector discusses any apparent violations with the employer. Any citations are usually mailed to the employer at a later date.

As noted in Chapter 5, an employer has the constitutional right to refuse to allow an inspection if the inspector does not have a warrant. If the employer does refuse to allow an inspection, however, the OSHA representative generally just goes to court and obtains a warrant.

**Penalties.** When violations are found, compliance inspectors may issue citations for violations. These violations fall into three categories: willful or repeat, serious, and nonserious. The maximum fine for serious and nonserious violations is $7,000 per day of noncompliance, whereas the maximum for a willful or repeat violation is up to $70,000 per violation. If a willful violation results in the death of a worker, criminal penalties may be imposed. For a first conviction, a fine of up to $10,000 and 6 months in jail are possible. For subsequent convictions, the penalty may be up to $20,000 and 1 year in jail.

Penalties can mount when a firm has multiple violations. In 2006, the John J. Steuby Company was fined $788,000 for more than 50 violations. Twelve violations were “willful,” 37 were “serious,” 1 violation was “repeat,” and 3 were “nonserious.” In 2007, OSHA proposed $227,500 in fines for American Airlines for 1 “willful” violation, 28 “serious” violations, 2 “repeat” violations, and 1 “nonserious violation.” Also in 2007, after the investigation of an employee death, OSHA proposed a $2.78 million fine for the Cintas Corporation. The high fine was based on 42 citations designated as “willful,” 1 “repeat” violation, and 3 “serious” violations. In 2010, VT Halter Marine, Inc., a shipbuilder, was fined...

---

$1,322,000 following a November 2009 explosion and fire that killed two workers and seriously injured two others. The high fine resulted from the court's finding of 17 "willful" and 11 "serious" violations.

On October 30, 2009, OSHA fined BP $87 million, the largest fine in OSHA history, for its failure to correct hundreds of safety violations discovered after a 2005 explosion at its Texas City, Texas, oil refineries. The fine was four times as large as any previous OSHA sanction.

In addition to citing companies for safety violations, OSHA, through its voluntary participation program (VPP), recognizes companies that have created a particularly safe workplace by designating them as "Star" work sites. These sites, which have put into practice outstanding safety and health programs, are not targeted by OSHA for regularly scheduled programmed inspections. These sites, however, tend to have fewer employee illnesses and injuries.

The program began in 1982 and is highly selective. Approximately 2,161 workplaces now participate in the program. An illustration of a company receiving recognition as a "Star" site is Parsons Corporation, a California-based company with seven active OSHA VPP sites. The company employs 11,500 employees worldwide, including 3,500 contractors. Because of the size of the company, it is able to influence the health and safety of numerous employees worldwide.

**Public Education.** Since 1975, OSHA has provided free, confidential, on-site consultations with employers seeking to bring their businesses up to OSHA standards. Any unsafe or unhealthful working conditions discovered during consultations are not reported to the OSHA inspection staff, as long as the firm commits itself to correcting any serious job safety and health hazards found during the consultation. The steps of a typical consultation are found in Exhibit 20-4. OSHA also sponsors a Targeted Training Program, which provides short-term grants to employers, employees, and nonprofit organizations to address health and safety issues about which OSHA has particular concerns.

**State Plans.** Under the present OSH Act, a state may regulate its own workplaces if its program provides for the establishment and enforcement of standards that will be at least as effective as the federal standards. As of May 2010, 25 states plus Puerto Rico and the Virgin Islands had OSHA-approved programs.

---

**OCCUPATIONAL SAFETY AND HEALTH REVIEW COMMISSION**

The **Occupational Safety and Health Review Commission (OSHRC)** is an independent body before which an employer can contest the issuance of a citation by OSHA, the amount of the penalty, or the time within which abatement is expected. A hearing is conducted before an administrative law judge, whose ruling becomes OSHRC’s final order 30 days after it is issued, provided it

---

Walk-through

Together, the employer and consultant will examine conditions in the workplace. OSHA strongly encourages maximum employee participation in the walk-through. Talking with employees during the walk-through helps the consultant identify and judge the nature and extent of specific hazards.

The consultant studies the entire workplace or the specific operations designated by the employer and discusses the applicable OSHA standards. Consultants also will point out other safety or health risks that might not be cited under OSHA standards, but still pose safety or health risks to employees. They may suggest other measures to prevent future hazardous situations.

A comprehensive consultation also includes (1) appraisal of all mechanical and environmental hazards and physical work practices, (2) appraisal of the present job safety and health program or establishment of one, (3) a conference with management on findings, (4) a written report of recommendations and agreements, and (5) training and assistance with implementing recommendations.

Opening Conference

Upon arrival at the site, the consultant will first meet with the employer in an opening conference to briefly review the consultant’s role and the obligations of the employer.

Initiation

The consulting process is initiated by a confidential phone call or letter to OSHA. A consultant will discuss the employer's specific needs and set up a visit date.

Abatement and Follow-through

Following the closing conference, the consultant sends the employer a detailed written report explaining the findings and confirming any abatement periods agreed upon. Consultants may also contact the employer from time to time to check the firm's progress. Ultimately, OSHA requires hazard abatement so that each consultation visit achieves its objective—effective employee protection. If you fail to eliminate or control identified serious hazards (or an imminent danger) according to the plan and within the limits agreed upon or an agreed-upon extension, the situation must be referred from consultation to an OSHA enforcement office for appropriate action, although these situations almost never arise.

Closing Conference

The consultant then reviews detailed findings with the employer in a closing conference. Problems, possible solutions, and abatement periods to eliminate or control any serious hazards identified during the walk-through are discussed. In rare instances, the consultant may find an “imminent danger” situation during the walk-through. If so, immediate action must be taken to protect all employees. In certain other situations that would be judged a "serious violation" under OSHA criteria, the employer and the consultant are required to develop and agree to a reasonable plan and schedule to eliminate or control that hazard. The consultants will offer general approaches and options to the employer, and may also suggest other sources for technical help.

is not contested. Within the 30-day period, any party may request a review of the decision by OSHRC, which is automatically granted. A final order is issued after the review is completed. The final order may be appealed to a circuit court of appeals.
The National Institute for Occupational Safety and Health (NIOSH) was established under the OSH Act to identify occupational health and safety problems, to develop controls to prevent occupational accidents and diseases, and to disseminate its findings. This body functions primarily as a research facility that attempts to make its findings on hazards available to those who can use them. Although independent of OSHA, NIOSH provides OSHA with information on which the agency bases many of its “criteria documents” (recommendations for health and safety standards that contain supporting evidence and bibliographical references).

OSHA, NIOSH, and OSHRC work together to implement the OSH Act. By taking advantage of the assistance offered by these agencies and by meeting the standards that OSHA has established, businesspeople can make their workplaces safer and more healthful. It may even be in their interests to do so, for often the increased costs of providing a safer workplace are more than offset by the benefits employers derive from reduced absenteeism, fewer worker’s compensation claims, and less work time lost because of accident investigations.

Employee Privacy Rights

Although employees are rightly concerned about safety, they are also increasingly concerned about privacy on the job. Privacy issues arise in a broad array of contexts, including the hiring process, monitoring of employee performance on the job, and the use of new technology.

Electronic Monitoring and Communication

Increasing use of technology in the workplace has raised a number of new privacy issues. When, for example, can employers monitor employees’ telephone conversations, read their e-mail, or listen to their voice mail? The legal issues related to

Management

In your management class, you may have learned about several theories of motivation related to human needs. The most widely known and accepted theory is Maslow’s hierarchy of needs. This concept, developed by Abraham Maslow, includes five fundamental human needs: physiological; security, or safety; social; esteem; and self-actualization. As previously mentioned, the OSH Act of 1970 has promoted safer working environments via the aid of the three agencies established by Congress. Therefore, one of the five needs in Maslow’s hierarchy, specifically safety needs, has been endorsed by congressional legislation. Because the statutes under the OSH Act encourage employers to create safer workplaces and better satisfy safety needs, managers have a more probable means of motivating employees to perform to the best of their ability to accomplish a particular task. Thus, advocating safer workplaces could potentially result in motivated employees, which is an essential element in attaining organizational goals.

workplace privacy involve the common-law tort of invasion of privacy (discussed in Chapter 12) and the Omnibus Crime Control and Safe Streets Act of 1968, as amended by the Electronic Communications Privacy Act (ECPA) of 1986.

The Omnibus Crime Control Act prohibits employers from listening to the private telephone conversations of employees and disclosing the contents of those conversations. Employers are allowed to ban personal calls and monitor calls for compliance, but once they determine that a call is personal, they are not allowed to continue listening to the conversation. Violators may be subject to fines of up to $10,000.

The ECPA extended employees' privacy rights to electronic forms of communication, including e-mail and cellular telephones. The act prohibits the intentional interception of electronic communications or the intentional disclosure or use of the information obtained through such interception. The act, however, includes a "business-extension exemption" that allows employers to monitor employees' telephone conversations in the ordinary course of their employment, as long as the employer does not continue to listen to conversations once it recognizes that they are of a personal nature. Employers often need to do such monitoring to improve job performance and to offer some protection to employees from harassing calls from the public. A second exception arises when the employees consent to the monitoring of their conversations. The following case illustrates the application of this law.

**CASE 20-3**

**Fraser v. Nationwide Mutual Insurance Co.**

United States Court of Appeals for the Third Circuit

352 F.3d 107 (2003)

Plaintiff Fraser's employment at Nationwide was terminated after e-mails revealed that he had divulged company trade secrets. Nationwide believed that Fraser had become disloyal to the company and, consequently, the company searched its own main file server for e-mails showing disloyal conduct. Fraser then filed a lawsuit against Nationwide, claiming wrongful termination and a violation of the ECPA. The district court found in favor of the defendant, Nationwide, on summary judgment. The plaintiff appealed.

**Circuit Judge Ambro**

Nationwide argues . . . that it terminated Fraser because he was disloyal. It points out that Fraser drafted a letter to two competitors expressing . . . dissatisfaction with Nationwide and seeking to determine whether [the competitors] would be interested in acquiring the policy-holders of the agents. Fraser claims that the letters only were drafted to get Nationwide's attention and were not sent.

When Nationwide learned about these letters, it claims that it became concerned that Fraser might also be revealing company secrets to its competitors. It therefore searched its main file server—on which all of Fraser's e-mail was lodged—for any e-mail to or from Fraser that showed similar improper behavior. Nationwide's general counsel testified that the e-mail search confirmed Fraser's disloyalty. Therefore, on the basis of the two letters and the e-mail search, Nationwide terminated Fraser's agreement. It is this search of his e-mail that gives rise to Fraser's claim for damages under the Electronic Communications Privacy Act of 1986 (ECPA).

Fraser argues that, by accessing his e-mail on its central file server without his express permission, Nationwide violated Title I of the ECPA, which prohibits "intercepts" of electronic communications such as e-mail. The act also defines an "intercept" as "the aural or other acquisition of the contents of any wire, electronic, or oral communication through the use of any electronic, mechanical, or other device." Nationwide argues that it did not "intercept" Fraser's e-mail within the meaning of Title I because an "intercept" can only occur contemporaneously with transmission and it did not access Fraser's e-mail at the initial time of transmission.

Every circuit court to have considered the matter has held that an "intercept" under the ECPA must occur contemporaneously with transmission.

---

22 42 U.S.C. § 2210 et seq.

The key question in cases involving employer monitoring and interception of employee communications via e-mail, telephone, or voice mail is whether the employee had a reasonable expectation of privacy with respect to the communication in question. Therefore, many employment law specialists recommend that, to minimize the likelihood of being sued by employees for invasion of privacy and to keep good morale in the workplace, employers should have written employee privacy policies that are explained to employees and printed in employee handbooks. Privacy policies should cover matters from employer surveillance policies to control of and access to medical and personnel records, to drug testing, and to all issues unique to the electronic workplace. Exhibit 20-5 provides a sample of a good e-mail policy.

A related privacy concern in the workplace is the use of surveillance cameras. The courts fall back on the reasonable expectation of privacy. Closed-circuit cameras are increasingly being used to combat employee theft, to monitor employee performance, and to safeguard employees. Clearly visible cameras are generally not challenged. As one arbitrator said, “Since one of the supervisor’s jobs is to observe employees at work, such supervision cannot be said to interfere with an employee’s right to privacy, even if it is done by a camera.” This logic, however, did not hold in a recent case involving a very well-known employer. During the night shift at Wal-Mart, a visible surveillance camera recorded four employees eating candy and nuts from damaged incoming boxes (which was against store policy). When Wal-Mart fired them for theft, the four employees sued the corporation, and won $5 million each. The employees received the money in part because of “slander” and “emotional distress,” but also, more relevantly, because of Wal-Mart’s eavesdropping. So, sometimes employers can get into trouble for taking action based on what is seen on a surveillance camera—even if it is in plain sight.

Hidden cameras may generally be placed in areas where employees do not have a reasonable expectation of privacy, such as hallways. Installation of video cameras in bathrooms, however, may prompt claims of invasion of privacy. In cases in which a plant is unionized, the courts may consider the installation of a closed-circuit television monitoring system to be an issue that the firm must bargain over with the union, because it changes working conditions.

**DRUG TESTING**

In the interests of safety, and to increase productivity, employers have become increasingly interested in using drug testing for employees. Employer interest in drug testing was also encouraged by Congress in 1988, when it passed the...
ELECTRONIC MAIL POLICY

* E-mail is the property of the company and should be used solely for work-related purposes.

* Employees are prohibited from sending messages that are harassing, intimidating, offensive, or discriminatory.

* Each employee will be given a password to access e-mail. Your password is personal and should not be shared with anyone else. However, the company retains a copy of all passwords and has a right to access e-mail at any time for any reason without notice to the employee. The employee has NO expectation of privacy or confidentiality in the e-mail system.

* The employee must sign and return an Acknowledgment and Consent form indicating receipt and acceptance of our company’s policy.

ACKNOWLEDGMENT

I understand that the company’s electronic mail and voice mail systems (herein together referred to as “the company’s systems”) are company property and are to be used for company business. I understand that excessive use of the company’s systems for the conduct of personal business is strictly prohibited.

I understand that the company reserves the right to access, review, and disclose information obtained through the company’s systems at any time, with or without advance notice to me and with or without my consent. I also understand that I am required to notify my supervisor and the company’s Security Department if I become aware of any misuse of the company’s systems.

I confirm that I have read this employee acknowledgment and have had an opportunity to ask questions about it. I also agree to abide by the terms of the company’s policy in this regard a copy of which has been provided to me.

AGREED TO THIS ________________ DAY OF _____________, 19____.

______________________________________________
Witness ________________________ Employee Signature ____________________

Drug-Free Workplace Act, which required employers who receive federal aid or do business of $25,000 or more with the federal government to develop an antidrug policy for employees, provide drug-free awareness programs for them, make them aware of assistance programs for those with drug problems, and warn them of penalties for violating the company’s drug-free policies.

Employers, however, must be careful when establishing drug-testing policies, because employees may challenge such policies on the ground that they violate state or federal constitutional rights, common-law privacy rights, or state or local drug-testing laws. Because of the variation among states regarding drug
testing, an employer must examine both the statutory and case law in its state very closely before implementing a drug-testing policy. With that caution in mind, however, some broad generalizations can be made.

Drug testing generally arises in four different contexts, and standards may be different for each. The most common drug testing is preemployment testing, allowed by most states. Sometimes, a prospective employee will try to sue the employer for requiring preemployment drug testing, but as long as the drug tests do not violate discrimination laws, the tests are usually accepted. In one case, a man failed his preemployment drug test and sued the physicians because he thought they must have made a mistake. The drug test came up positive, and he claimed that he had never taken any drugs. He did not win his case, however, because the physicians were hired by the employer and not by the plaintiff; hence, they owed him no duty. Interestingly, however, in a case the following year in a different state, the state supreme court imposed liability on a drug-testing firm whose negligent testing as part of an employer's substance abuse testing program led to the plaintiff's termination.\(^\text{25}\) The employer could not be sued because it was allowed to reject a prospective employee on any grounds, as long as the employer is not violating discrimination laws.\(^\text{26}\)

Most states also recognize the legitimacy of drug testing as a part of a periodic physical examination, assuming that proper standards for drug testing are followed. The third context in which drug testing may be used is when the employer has a reasonable suspicion that an employee may be under the influence of drugs in the workplace. "Reasonable suspicion" generally requires the employer to have some evidence, such as an unexplainable drop in performance, to justify the tests. If the employer does have such sound evidence, the test is generally upheld. The most controversial area is that of random drug testing, on which the courts are split. Random drug testing is most likely to be upheld when an employee may pose a safety risk to others by doing a job while under the influence of drugs and when employees have been informed in advance in writing of the random drug-testing policy.

Private-sector employers have much greater freedom to test for drugs than do public-sector employers. Whereas private employers may be restricted only by state constitutions and state and local laws, federal entities are also restricted by the Constitution. The exception would, in the end, swallow the rule.

**OTHER TESTING**

In recent years, the number of companies that use some form of preemployment testing has increased significantly. The time and costs of preemployment testing are offset in the long run because businesses are able to reduce turnover rates and low productivity by carefully screening applicants before they are offered a job. In addition, preemployment testing often saves businesses money by paring down the applicant pool efficiently and with some assurance that applicants are treated consistently.

Businesses, however, must be careful to ensure that their tests do not violate discrimination laws or the Americans with Disabilities Act. Tests should measure only what is necessary for the performance of a job. For example, a typing test that screens out those applicants who cannot use their hands is acceptable if the position is for a typist. Tests, however, should seek to accommodate those with disabilities if their disability does not impair the performance of a job.

Of the many forms of preemployment testing, polygraph testing has stimulated the greatest amount of legal action. In 1988, Congress passed the Employee

---


\(^{26}\) *Duncan v. Afton, Inc.*, 1999 WL 1073434 (Wyo 1999).
Polygraph Protection Act. This law prevents employers from using lie-detector tests while screening job applicants. It also prohibits administering lie-detector tests randomly, but it does allow their use in specific instances in which there has been an economic injury to the employer's business. The act also provides an exception to allow private security companies and those selling controlled substances to use lie-detector testing of applicants and current employees. The Labor Department may seek fines of up to $10,000 against firms that violate the act.

Skills testing, such as a typing test or a professional exam, is widely used and generally legal so long as the tests examine skills necessary for the job. Much less used are aptitude tests that seek to evaluate applicants’ general abilities. Aptitude tests often leave the employer open to discrimination lawsuits if the tests are not carefully written to elicit specific information necessary to job performance.

Another common type of test is a medical test, used because the applicant must be in good health to assure safety and good job performance. For example, airline pilots must undergo regular medical examinations to assure their health and the safety of their passengers.

Public-sector employees are granted an additional level of protection from discriminatory testing. Federal employees are protected under the Uniform Guidelines on Employee Selection Procedures of 1978. These procedures are evaluated and enforced by the federal Equal Employment Opportunity Commission.

**Global Dimensions of the Employment Relationship**

Although some of the benefits described in this chapter may seem significant, laws in some other nations ensure much greater benefits for workers. One area in which other nations provide significantly greater benefits is parental leave. Workers in the United States are guaranteed up to 12 weeks of unpaid leave; most European countries require a guaranteed paid leave. For example, in France, Austria, and Finland, paid parental leave begins 6 weeks before childbirth; it extends to 10 weeks after birth in France, 8 weeks in Austria, and almost 1 year in Finland. French working mothers are then entitled to an additional (unpaid) job-protected leave until their children reach age 3. Altogether, more than 120 nations require paid maternity leave, with the Czech Republic providing 24 weeks of paid leave. One of the reasons such extensive benefits can be offered in those nations, however, is that the tax-funded social insurance/social security systems provide most of the money for these benefits.

Another area in which employees have fewer rights in the United States is that of vacation time. The United States, unlike most European nations, does not mandate any minimum amount of annual vacation time for employees. But in Ireland, for example, the Holiday Act of 1973 guarantees every worker, regardless of how long he or she has been with a company, three weeks of paid vacation time and nine additional days off for public holidays. Luxembourg also has tremendous holiday benefits: Irrespective of the employee’s age, he or she is given 25 days of holiday, 12 of which must be taken in succession. Additionally, Luxembourg workers are given time off for 10 public holidays.

To try to ensure that workers around the world receive the rights and benefits described in this chapter, the United Nations Commission on Human Rights developed the International Covenant on Economic, Social, and Cultural Rights. This covenant does not really bind any employers, but the Commission exerts influence by documenting and publicizing where the terms of the covenant are not followed.
SUMMARY

The employment relationship today is still a contract between employer and employee, but the national and state governments specify certain parameters of this relationship. Laws that affect wages and hours include the Davis–Bacon Act, the FLSA, and the Federal Unemployment Tax Act.

The Family and Medical Leave Act ensures that workers will be able to take necessary time off from work when they or members of their family suffer from a serious medical condition. COBRA ensures that if an employee loses his or her job, he or she will be able to purchase health insurance for up to 18 months. The Occupational Safety and Health Act tries to secure safe working conditions for employees, but if they are injured on the job, worker’s compensation laws provide benefits to compensate them for the injury or disability they received.

A final concern of workers and employers is the extent of worker privacy rights. Federal employees have more rights in this area than private employees, because the public employer has to comply with the Fourth Amendment; nevertheless, private employers must still be sure that they do not violate state and federal laws designed to protect worker privacy. The prudent employer today will have a written privacy policy that clearly sets out when employees should have a reasonable expectation of privacy and when they should not.

A comparison of other countries’ employee benefits with those in the United States shows that the United States offers less protection to employees with respect to family leave benefits and vacation.

REVIEW QUESTIONS

20-1 What benefits do employees receive under the FLSA?
20-2 Explain how worker’s compensation laws benefit both employers and employees but in different ways.
20-3 What requirements are imposed on an employer by the Family and Medical Leave Act?
20-4 What remedies can an employee seek if an employer violates the Family and Medical Leave Act?
20-5 Explain the relationship between OSHA and NIOSH.
20-6 Explain the principles you would want to keep in mind when drafting an employee privacy policy for a firm.

REVIEW PROBLEMS

20-7 In early December, Decco Manufacturing Corporation underwent a major downsizing and laid off 40 percent of its employees. Robert Banks was not laid off, but he thought that he probably would be laid off in the near future unless business got dramatically better. In fact, his supervisor told him that he would probably be laid off in early January. Robert decided that if he was going to get laid off anyway, he would rather have the time between jobs over the holidays, so he quit and filed for unemployment compensation. Should he be able to collect worker’s compensation?
20-8 Nellie Mandle worked as a machine operator. She had been told on numerous occasions that if her press ever jammed up, she was not to stick her hand in to unjam it; rather, she was to use a special safety fork with a long handle that would allow her to unjam the machine without inserting any part of her hand into the press. Her machine jammed, and she looked
around for the safety fork. Realizing that the worker on the previous shift must have removed the fork, she reached her hand inside the machine to unjam it. Before she could remove her hand, the machine cycled, catching her hand and injuring it severely. She filed a worker’s compensation claim, which her employer contested because she caused the injury by her disobedience of the safety rules. Evaluate the employer’s argument.

**20-9** Caroline Williams works for a firm that has a written policy prohibiting the use of company telephones for personal use. Employees have been told that the company randomly monitors telephone conversations to enforce this policy. Caroline uses a company telephone to call her doctor to find out the results of a blood test she had taken to determine whether she had contracted a sexually transmitted disease. Her employer intercepted the phone call and, once he heard her question, stayed on the line to find out the results of her test. Discuss why you believe the employer’s behavior is lawful or unlawful. If unlawful, what penalty should he receive?

**20-10** Michael Meuter was an employee in a hospital emergency room. He used an extension phone to call one of the workers in the pharmacy to order some drugs for the emergency room. After placing his request, he started to complain to the pharmacy worker about his supervisor, calling the supervisor a number of offensive names. Unknown to Michael, his supervisor was listening to the conversation. Was the supervisor’s listening to the conversation lawful?

**20-11** Ginny Morris applied for a job as an executive assistant to the president of a software firm. She received high evaluations from those on the hiring committee and was told that she looked like an excellent candidate for the job, but before a final decision could be made, she would have to take a drug test so that the firm could be confident that she did not use any illegal drugs and a lie-detector test to ensure that she would be someone who could be entrusted with trade secrets. Discuss whether you believe there are any problems with the firm’s requests.

**CASE PROBLEMS**

**20-12** Clarence Trosper worked for Armstrong Wood Products, Inc. For the first four years of his employment, Trosper operated sanding and sawing equipment inside the plant. Eventually, he was assigned to work outdoors, removing heavy boards by hand rapidly and continuously from a conveyor belt. After removing them from the belt, Trosper would sort the boards and then stack them according to grade. After being reassigned, Trosper began to experience an intense pain in the base of his hands near his thumbs. He reported the pain to his supervisor and received an injection. The pain worsened.

Trosper asked to be moved back inside the plant and the employer agreed. Several years passed during which Trosper experienced little to no pain. Then, in 2001, Trosper began working in a position that required him to lift 45- to 70-pound buckets to shoulder level in order to pour chemicals into a hopper. The pain returned. Trosper reported the pain to a supervisor and eventually went to see a doctor. Trosper was diagnosed with carpometacarpal osteoarthritis. The diagnosis ultimately led to surgery on both of Trosper’s hands. A doctor later determined that given the nature of the injury, it was likely that Trosper’s injuries were preexisting and had been aggravated by the type of work he was assigned. At trial, numerous doctors testified but disagreed about whether the injury was preexisting. The trial court awarded partial worker’s compensation benefits. The Special Worker’s Compensation Appeals Panel concluded that the injury was not caused or aggravated by the work performed for the defendant. Trosper filed a request for a full court review that was later heard by the Supreme Court of Tennessee. How do you believe the court ruled? What reasons do you think the court used to justify its decision? *Trosper v. Armstrong Wood Products, Inc.*, 273 S.W.3d 598 (Tenn. 2008).

**20-13** Julie Krenzke worked as a financial services manager for Lindsay Lexus from March 2002 until October 2004. Krenzke was very good at her job when she was present, but she was often absent due to miscellaneous vague health concerns. On September 29, 2004, Krenzke awoke to symptoms commonly associated with extreme stress and anxiety, including heart palpitations, nausea, shaking, clamminess, and dizziness. Krenzke did not go to work on September 29, 2004. Instead, she went to see Dr. Michael Greene, who placed her on a heart monitor and wrote her a prescription. At this visit, the doctor also faxed a note to Krenzke’s direct supervisor indicating that Krenzke could not work for two days. The supervisor granted leave for those two days.
When Krenzke returned to work, she met with the general manager at Lindsay Lexus to inform him that Dr. Greene had indicated that she needed to take a leave of absence from work. Her request for leave was denied. Krenzke proposed that she work part time. This subsequent proposal was also denied. Five days later, Dr. Green faxed a note to Lindsay Lexus indicating that Krenzke needed to take two weeks off work due to illness. That same day, Krenzke submitted a letter to the general manager indicating that she was leaving her job because the company had failed to grant her a leave of absence. After leaving, Krenzke visited Dr. Greene several times and was referred to a cardiologist and pulmonary specialist.

Krenzke filed this action alleging that Lindsay Lexus had violated her rights under the FMLA. The district court granted summary judgment in favor of Lindsay Lexus, holding that Krenzke did not provide adequate notice that she was entitled to leave under FMLA or that she was suffering from a serious health condition. Was Krenzke successful in her FMLA claim? Why or why not? Krenzke v. Alexandria Motor Cars, Inc., 289 Fed. Appx. 629 (4th Cir. 2008).

20-14 Sabrina Polkey worked for Transtecs Corporation, a military contractor that operated a mailroom at a naval base. Polkey noticed opened, undelivered mail in a trash can at the front desk at the end of the day. Polkey reported the incident to her supervisor, Carl Kirtley, who then asked all of the employees to consent to a polygraph test. The employee suspected of tampering with the mail took his test first, and his results came back suggesting deception when he denied tampering with the mail. Kirtley then encouraged the other employees to take the polygraph test to clear their names. Polkey and the other employees expressed doubts about the accuracy of the polygraph and declined to take the test. Polkey was fired a week later for officially accepting deliveries through the back door, in violation of regulations. Polkey brought action against Transtecs, alleging a violation of the Employee Polygraph Protection Act (EPPA). Transtecs argued that it fell under two exceptions of the EPPA: first, it was a military contractor, so it fell under the national defense exception; second, it fell under the ongoing investigation exception. The district court granted summary judgment for Polkey, and Transtecs appealed to the Eleventh Circuit. How do you think the appeals court ruled and why? Polkey v. Transtecs Corp., 404 F.3d 1264 (11th Cir. 2005).

20-15 Yatram Indergit worked for Rite Aid as a store manager from 1979 to 2007. Indergit’s duties at Rite Aid included disciplining employees, interviewing employees, training employees, scheduling employee hours, performing various office duties, running cash registers, stocking shelves, and so on. When Indergit’s employment was terminated in 2007, he filed suit against Rite Aid for, among other things, failure to pay overtime as required by the FLSA. The defendants contended that Indergit’s employment fell within the executive exemption to the overtime requirement. Indergit contended that the majority of his job responsibilities were the same as those performed by nonexempt employees. Moreover, Indergit argued that his job duties were primarily nonexempt, as shown by evidence that nonexempt employees previously performed his duties. Rite Aid moved for summary judgment, arguing that there was no genuine issue of material fact that could be heard by the trier of fact. Is there an issue of material fact? What evidence would be necessary to decide whether Indergit’s job responsibilities made him exempt from the overtime requirements? Indergit v. Rite Aid Corp., 2010 U.S. Dist. LEXIS 32322 (2010).

20-16 Robert Krieg worked for the Streets and Sanitation Department of Marion, Indiana. In 2002, the city entered into a collective bargaining agreement (CBA) that allowed random and unannounced drug tests for “safety-sensitive” employees. A “safety-sensitive” position was a position that required the employee to hold a commercial driver’s license (CDL). Krieg’s position required a valid CDL for any new hires, but he was grandfathered in and was not required to obtain a CDL. He still operated pieces of large machinery, such as snowplows and dump trucks, but not commercial vehicles.

On October 28, 2004, it was announced that every employee would have to submit to a drug test or face termination of employment. Krieg refused to take the drug test and called his attorney. He was subsequently fired and filed suit against the city, alleging that a forced drug test for non-CDL employees was an illegal search under the Fourth Amendment. The city argued that the union had agreed to the random, unannounced drug testing in its CBA, and also that Krieg was a “safety-sensitive” employee, which allowed the city to require the drug test; based on these contentsions, the city moved for summary judgment. The district court granted summary judgment to the city. On appeal, the city’s argument that the union had agreed to the drug tests for non-CDL employees was rejected, but the appeals court still affirmed that the city was legally allowed to require a drug test from Krieg. What was the court of appeals’ reasoning in allowing Krieg to be randomly tested for drugs? Krieg v. Seybold, 481 F.3d 512 (7th Cir. 2007).

20-17 Douglas Schultz, Anthony Phiniccy, Melissa Lopes, Steven Rowe, and Jared Baker worked as personal protection specialists (PPS agents) for Prince Faisal bin Turki bin Nasser Al-Saud (the Prince), a diplomat and member of the Saudi royal family who had a residence in Virginia. The plaintiffs worked through Capital International Security, Inc. (CIS),
which was engaged by the Prince to provide his personal security detail. The agents worked on an hourly basis, based on the Prince’s protection needs, and performed a variety of services, such as sorting mail and vehicle care, as well as their main duty of protecting the Prince and his family. CIS and the Prince provided all of the agents’ equipment and weapons, unless the agents owned and wished to use their own handguns. Toward the end of their employment, Sammy Hebri, the founder of CIS, instructed all of the agents to get private security licenses and personal liability insurance so that they could be classified as independent contractors. None of the agents obtained private security licenses or liability insurance.

Shultz, Phiniezy, Lopes, Rowe, and Baker filed an action against CIS and Hebri, claiming unpaid overtime. CIS and Hebri argued that the agents were independent contractors and therefore were not covered by the FLSA. The agents argued that they were employees because they lacked the control over their duties and hours that an independent contractor would have and therefore were entitled to overtime compensation. The district court found for Hebri and CIS. The agents appealed. How do you think the appeals court ruled, and why? *Schultz v. Capital International Security, Inc.*, 466 F.3d 298 (4th Cir. 2006).

**THINKING CRITICALLY ABOUT RELEVANT LEGAL ISSUES**

For years, courts, employers, and employees have struggled with the issue of employee drug testing. Employers want their employees to be drug free, whereas employees do not want to submit to an invasive and embarrassing procedure. Courts want to uphold employees’ right to privacy while allowing employers to run a safe, drug-free workplace. This issue may finally have a solution.

Recently, a new drug test has been developed that uses a swab of saliva rather than urine or blood. It is being implemented in several states already, including Georgia and Hawaii. This new test gives much faster results than urine and blood tests, and some experts believe that it might be more effective than urine or blood tests. The results of negative or nonnegative can be returned within 10 minutes, and employees who test negative can begin or return to work immediately. This faster process alleviates the stress and anxiety of employees who must be tested for drugs.

The major benefit of the new saliva test is that it is a noninvasive test. Employees do not have to suffer the embarrassment of having to “pee in a cup” or the painful experience of having blood drawn. Giving a swab of saliva is easy. This drug test protects employees from having to undergo an invasive or embarrassing test, while allowing employers to keep their workplaces drug free.

Allowing employers to drug-test their employees is very important to keeping the workplace safe and ethical. Employees who use drugs while on the job are a danger to themselves and to others and could be responsible for lawsuits against an employer. Also, employees who break the law by taking illegal drugs might engage in other illegal activity, which could also be damaging to the employer. Allowing drug testing is the best way for an employer to keep the workplace drug free. Random drug testing has been legally questionable because of the employees’ right to privacy. The saliva drug test eliminates the concerns with the right to privacy and is a major step in helping keep the workplace safe and drug free.

1. How would you express the issue and conclusion?
2. Are any of the terms the author uses to make her point ambiguous?
   **Clue:** How is the new drug test better than the old drug tests?
3. What missing information would help your evaluation of this argument?
4. Write a short essay that someone with a different opinion about this topic might write.
   **Clue:** How could different definitions of ambiguous words in this essay change the conclusion?

**ASSIGNMENT ON THE INTERNET**

Laws that govern employment relationships indicate the ethical norms a particular country or state wishes to advance. This can be seen no more clearly than in cases of family or medical leave. Visit the Web site for the Clearing House in International Development in Child, Youth, and Family Policies (www.childpolicyintl.org)
and compare the family and medical leave policies of the United States with those of other industrialized countries around the world. Write a paper in which you address the following questions: How does the United States compare on a world scale when it comes to employee benefits for family leave? What does this comparison say about the ethical norms of the United States in areas of employment relationships?

**ON THE INTERNET**

**www.benefitnews.com** This site provides news about employee benefits for employers, employees, and advisors. The site also offers an e-mail newsletter.

**www.dol.gov** At this site, the home page of the Department of Labor, you can find all the information you would need as an employer to make sure that you are in compliance with the FLSA.

**www.osha.gov** The Web page of OSHA provides information about worker health and safety, including how to file a complaint. It also provides the text of the Occupational Safety and Health Act of 1970, as well as OSHA standards, regulations, and directives.

**www.hr.ucdavis.edu/Pubs/All/Fmla_booklet** This site contains a document entitled “Family and Medical Leave . . . What Every Supervisor Should Know,” which provides a good overview of the FMLA and illustrates its implementation by a public employer.

**www2.ohchr.org/english/law/cescr.htm** At this page, you can find the International Covenant on Economic, Social, and Cultural Rights.

**www.privacyfoundation.org** To learn more about privacy issues related to employment, go to this site.

**www.dol.gov/esa/minwage/america.htm** This Web site provides an interactive map detailing the minimum wage laws in U.S. states and territories.

**www.law.cornell.edu/topics/Table_Labor.htm** This Web site, run by Cornell Law School, provides links to the employment and labor laws in each state. Use this site to look up the employment laws in your state.

**FOR FUTURE READING**


In the early 1800s, labor unions were very rare. Despite the mistreatment of workers during the Industrial Revolution, most attempts to organize workers during the nineteenth and early twentieth centuries were treated by the courts as criminal conspiracies. Finally, in the economic chaos of the Great Depression, Congress enacted laws giving employees the right to organize and to bargain collectively over wages and terms and conditions of employment.

Union strength has fluctuated in the years since unions were legalized. More than a third of U.S. workers were organized in the post–World War II period. By 1983, however, only 20.1 percent of workers were unionized, and, by 2006, the percentage had fallen to 12.0 percent, or 15.4 million workers. However, in 2007, union membership increased to 12.1 percent, the first time union “density” had increased in several years. In 2008, the rate was 12.4, and it fell slightly to 12.3 in 2009.1

Moreover, in 2008, the median weekly earnings of workers who were represented by unions was $908, compared with $710 per week for those not represented by unions.2 Not all occupations are equally organized. Exhibit 21-1 shows the percentages of workers organized by occupational group in 2009.

Although organized workers are still not in as powerful a position as their employers, they are distinctly better off than they were during most of our

---

2 Ibid.
nation’s existence. The primary basis for their improved status is the National Labor Relations Act (NLRA), which was passed in 1935 and is the focus of this chapter.

The first section outlines the structure and enforcement of the NLRA and the Landrum–Griffin Act. The next three sections discuss areas of labor–management relations governed by the NLRA: organizing, collective bargaining, and the collective activities of striking, picketing, and boycotting. This chapter concludes with a consideration of the international dimensions of labor law.

Before you read about our system of labor laws, examine Table 21-1, which summarizes the two conflicting views of the role of unions in economics and society. Whether one thinks labor laws should strengthen or restrain labor organizations depends largely on which of the two “faces” of unions one thinks is “prettier.”

### CRITICAL THINKING ABOUT THE LAW

Many people hold strong feelings about unions. Workers who belong to unions often view unions as positive forces that work to their benefit. In contrast, employers are often suspicious of the activity of unions. As you consider the aspects of labor law in this chapter, be aware of the role of biases in complex legal issues. The following critical thinking questions will help you consider the role of biases and ethical norms in labor legislation.

1. **In the language of ethical norms, what function do unions serve for workers?**
   
   **Clue:** Remember the list of ethical norms and reread the beginning paragraphs of this chapter. How do labor unions help workers? Can you match this answer to an ethical norm?

2. **What role do you think personal ethical norms should play in thinking about labor legislation?**
   
   **Clue:** Could paying attention to these ethical norms benefit workers or employers in any manner?

3. **Your coworkers have been excitedly talking for days about plans to unionize. You are unsure if you will join the union. One of your coworkers argues that joining the union will help you get a raise. What questions do you have for your coworker about missing information?**
   
   **Clue:** Think about any possible costs associated with getting a raise.
Structure of the Primary U.S. Labor Legislation and the Mechanisms for Its Enforcement

Three major pieces of legislation govern labor–management relations in the United States today: the Wagner Act of 1935, the Taft–Hartley Act of 1947, and the Landrum–Griffith Act of 1959 (the last is also cited as the Labor–Management Reporting and Disclosure Act or LMRDA). The Taft–Hartley Act amended the Wagner Act, and they are jointly referred to as the NLRA. In this section, we briefly describe the primary features of each of these acts and discuss the situations in which the business manager is most likely to need an understanding of these laws.

### THE WAGNER ACT OF 1935

The Wagner Act (also called the National Labor Relations Act or NLRA) was the first major piece of federal legislation adopted explicitly to encourage the formation of labor unions. Many supporters of this act recognized that a number of labor problems were caused by gross inequality of bargaining power between employers and employees. They hoped that the Wagner Act would bring about industrial peace and raise the standard of living of U.S. workers. The act was to accomplish those goals by facilitating the formation of labor unions as a powerful collective voice for employees and by providing for collective bargaining between employers and unions as a means of obtaining the peaceful settlement of labor disputes. The key section of the Wagner Act is Section 7. This section provides that:

> employees shall have the right to self-organization, to join, form or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in concerted activities for the purpose of collective bargaining or other mutual aid and protection.

**Wagner Act** Guarantees the rights of workers to organize and bargain collectively and forbids employers from engaging in specified unfair labor practices. Also called the National Labor Relations Act (NLRA).

**collective bargaining** Negotiations between an employer and a union over, primarily, wages, hours, and terms and conditions of employment.

---

**TABLE 21-1 THE TWO FACES OF UNIONS**

<table>
<thead>
<tr>
<th>Collective Face</th>
<th>Monopoly Face</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unions primarily provide a collective voice through which workers can express their job-related concerns.</td>
<td>Unions are institutions that primarily serve to raise wages above competitive levels.</td>
</tr>
<tr>
<td>Unions increase efficiency because unionized firms have lower employee turnover rates, so the employer spends less money and time training new employees.</td>
<td>Unions decrease efficiency by securing unmerited wage increases for their workers, thereby causing a misallocation of resources.</td>
</tr>
<tr>
<td>Because unions usually negotiate contracts that base wage increases primarily on seniority, older workers are more likely to help newer ones and a more cooperative workplace will exist, thereby increasing efficiency.</td>
<td>Unions decrease efficiency by causing strikes that result in lost production and obtaining special contract provisions that reduce productivity.</td>
</tr>
<tr>
<td>Unions decrease inequality of wage distribution within the firm because they will try to raise the wages of the below-average workers up to those of the average; for solidarity purposes, they have to try to make the wages of those in the bargaining unit more equal.</td>
<td>Unions increase the existing inequality of wage distribution by providing higher wages for unionized workers at the expense of nonunionized workers.</td>
</tr>
<tr>
<td>Unions are democratic institutions, representing the interests of workers in general in the political process.</td>
<td>Unions gain their power through coercion and the threat of physical violence, and use that power to lobby for legislation to restrict competition in their respective industries.</td>
</tr>
</tbody>
</table>

Employees’ Section 7 rights are protected through Section 8(a) of the act, which prohibits specific “employer unfair labor practices.” These practices are delineated in Table 21-2. Section 9 of the act sets forth the procedures, including the secret ballot election, by which the exclusive employee-bargaining-unit representative (union representative) is to be chosen.

The final important portion of the Wagner Act authorized an administrative agency, the National Labor Relations Board (NLRB), to interpret and enforce the act. It also provided for judicial review in designated federal courts of appeal.

**THE TAFT–HARTLEY ACT OF 1947**

The passage of the Wagner Act led to a growth in unionization and an increase in workers’ power. Given that they had had almost no power before, any power workers obtained was bound to look like a dramatic increase. Thus, the public’s perception of union power may have been greater than the actual power of unions. At any rate, this perception led to the passage of the *Taft–Hartley Act*, designed to curtail the powers unions appeared to have acquired under the Wagner Act.

Section 8(b) of the Taft–Hartley Act, titled “Union Unfair Labor Practices,” bars unions from engaging in specified unfair labor practices, makes collective bargaining agreements enforceable in U.S. district courts, and provides a civil damages remedy for parties injured by certain prohibited union activities.

**THE LANDRUM–GRIFFITH ACT OF 1959**

The final major piece of labor legislation is the *Landrum–Griffith Act*, which primarily governs the internal operations of labor unions. Passage of this act was prompted by congressional hearings that uncovered evidence of looting of union treasuries by some powerful union officials and of corrupt, undemocratic practices in some labor unions. The act requires certain financial disclosures by unions and establishes civil and criminal penalties for financial abuses by union officials.
officials. It also includes a section, known as “labor’s bill of rights,” that gives employees protection against their own unions. The rights established by the Landrum–Griffith Act are summarized in Table 21-4.

### THE NATIONAL LABOR RELATIONS BOARD

**Structure.** The National Labor Relations Board (NLRB), as stated earlier, is the administrative agency responsible for the interpretation and enforcement of the NLRA. Its structure is diagrammed in Exhibit 21-2. The NLRB’s three primary functions are

1. Monitoring the conduct of the employer and the union during an election to determine whether workers want to be represented by a union
2. Preventing and remediying unfair labor practices by employers or unions
3. Establishing rules and regulations interpreting the act

The NLRB is composed of five members, each appointed by the president with the advice and consent of the Senate. Members serve staggered five-year terms. The board meets in Washington, D.C. Three-member panels decide routine cases involving disputes between employees, union, and employer, but the entire board may hear significant cases.

The general counsel of the NLRB, also appointed by the president with the advice and consent of the Senate, oversees the investigation and prosecution of unfair practice charges before the board. If a board decision is subsequently challenged in court, it is the general counsel who represents the board before the appellate court.

There are too many cases for the board and general counsel to handle each one personally, so most cases are handled by 34 regional offices, located in major cities across the country. These regional offices are headed by a regional director, who is appointed and overseen by the general counsel. The regional director and his or her staff are directly responsible for investigating charges of unfair labor practices, which they prosecute before administrative law judges (ALJs). They are also responsible for conducting representation elections, in which employees of a firm decide whether they wish to be represented by a union.

**Jurisdiction.** Just as a civil court must have jurisdiction over the parties before it, the NLRB must have jurisdiction over the parties before it in both representation
and unfair labor practice cases. The basis for NLRB jurisdiction is found in the NLRA, under which Congress granted jurisdiction to the NLRB over any business “affecting commerce,” with certain specific exceptions. Any employer or employee not covered by the NLRA need not abide by its provisions. (Noncovered employees and employers, however, may be covered by state labor laws.) Employees specifically omitted from NLRA coverage are those who work in federal, state, and local government; employees in the transportation industry and those covered by the Railway Labor Act; independent contractors; agricultural workers; household domestics; and persons employed by a spouse or parent.

Also excluded from NLRB jurisdiction are supervisors, managerial employees, and confidential employees. Much litigation has arisen over disputed definitions of managerial employee and supervisor. One of the employee groups that is facing the greatest difficulty today over the issue of whether or not they are supervisors is nurses. Thus far, the NLRB and the courts have been carefully examining the duties of the nurses in each individual case, with the nurse’s eligibility depending on the circumstances. It was thought for a while that the NLRB had finally come up with a workable test for what constituted “independent judgment,” which characterizes an employee as a supervisor. The board had said that employees do not exercise “independent judgment” when they exercise “ordinary professional or technical judgment in directing less skilled employees to deliver services in accordance with employer-specified standards.” The U.S. Supreme Court, however, rejected that test in 2001, in a decision many commentators believe may make it more difficult for health care personnel and other professionals to organize.

Just because Congress has granted the NLRB the authority to act in a given case does not mean that the board will act. The board does not have unlimited funds. Consequently, the NLRB has established its own set of guidelines, which it uses to determine whether it will exercise jurisdiction over an employer. These guidelines are basically designed to determine whether a firm does a significant amount of business and, thus, has enough employees to justify the expenditure of NLRB resources. The guidelines are established industry by industry (e.g., a transit system must have a total annual business volume of at least $250,000).

---

Procedures in Representation Cases. An important function of the NLRB and the general counsel is to ensure that employees will be uncoerced in their choice of a bargaining representative or in choosing not to be represented by a union. Under NLRB procedures, set out in Exhibit 21-3, a petition for a representation election is initially filed with the regional director (1) by the union, when it can demonstrate that it has the support of more than 30 percent of the employees it seeks to represent (known as “majority support”); (2) by the employer, when two or more unions are claiming to be the exclusive representative of the employees or when one union claims to have majority support; or (3) by the employees themselves. The union demonstrates its support by submitting authorization cards. Each card is signed by an employee and states that the employee gives the union the authority to act as the employee’s exclusive bargaining representative.

Once the petition is filed, the regional director conducts an investigation to determine whether the employer is under the jurisdiction of the NLRB, whether the group of employees the union is seeking to represent is covered by the NLRA, whether the group of employees seeking representation is an appropriate bargaining unit, and whether there is sufficient support (30 percent) for the union. If these findings are affirmative, the director will see whether all parties will consent to an election. If not, the regional office holds a hearing to receive evidence on whether an election should be held and, if so, which employees are entitled to vote. The transcript of the hearing is given to the regional director, who decides whether a question of representation exists and an election should be held. An affirmative decision results in an election by secret ballot, conducted by a representative of the
regional office. In fiscal year 2009, the NLRB conducted 1,619 representation elections, and workers chose union representation in 63.8 percent of the elections.4

After the election, the losing party may file objections to the outcome of the election with the regional director, who either orders a new election or certifies the results. The decision may be appealed to the board.

Procedures in Unfair Labor Practice Cases. A second important function of the NLRB is to prevent and remedy unfair labor practices by both employers and employees. An unfair labor practice charge is initiated when an aggrieved employee, union, or employer files an unfair labor practice charge with the appropriate regional office. (A sample charge is pictured in Exhibit 21-4.) In

<table>
<thead>
<tr>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employer Against Whom Charge is Brought</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a Name of Employer</td>
<td>b Number of workers employed</td>
<td>c Address, street, city, state, zip code</td>
<td>d Employer Representative</td>
<td>e Telephone No.</td>
<td>f Type of Establishment: factory, mine, wholesaler, etc.</td>
</tr>
<tr>
<td>h The above-named employer has engaged in and is engaging in unfair labor practices within the meaning of section 8 (a) subsections (1) and first subsections of the National Labor Relations Act and these unfair labor practices are unfair practices affecting commerce within the meaning of the Act</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>i Basis of the Charge (set forth a clear and concise statement of the facts constituting the alleged unfair labor practices)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

fiscal year 2009, 22,943 unfair labor charges were filed with the NLRB.\(^5\) After regional office employees, called *field examiners*, investigate the charge, the regional director decides whether to issue a complaint. If a complaint is issued, an attorney from the regional office tries to resolve the complaint informally.

If informal negotiations are unsuccessful, the regional office attorney prosecutes the case before an ALJ. In fiscal year 2009, NLRB administrative law judges issued 190 decisions.\(^6\) The ALJ issues an order recommending a remedy or suggesting a dismissal, in either case stating the rationale and evidence for the decision. If no party objects to the decision within 20 days, it automatically becomes a final order of the NLRB. If an order is issued and any party fails to abide by it, the board must petition a U.S. court of appeals for an enforcement order. The procedure in unfair labor practice cases is diagrammed in Exhibit 21-5.

Appeal to the board is available at times. If the regional director refuses to issue a complaint, the charging party may appeal to the general counsel in

---

\(^5\) *Id.* at 1.

\(^6\) *Id.* at 2.
Washington, D.C. Such appeals are almost always denied. Alternatively, a party dissatisfied with the ALJ’s decision may file an appeal, called an exception to the recommended order, with the board in Washington, D.C. Briefs are then filed and, in rare instances, oral arguments are heard. The board then issues its final order. In fiscal year 2009, the board issued 195 decisions in unfair labor practice cases.7

No one is actually required to honor an NLRB order, because the board has no contempt-of-court powers. If its order is not followed, the NLRB brings an enforcement proceeding in a circuit court of appeals, asking the court to order the parties to abide by its order. A dissatisfied party may appeal to a circuit court of appeals.

Labor Organizing

In a 1936 novel, In Dubious Battle, John Steinbeck graphically described the extreme hardships faced by union organizers just after the passage of the Wagner Act. Derided as communist sympathizers, they were often run out of town by company representatives and sometimes even by the workers they were trying to help.

Many small-town law enforcement officers were indebted to business during this era. The most protection they were willing to offer organizers was to advise them to get out of town. Many labor organizers lost their lives or were severely injured in these early unionization battles, and victories were often not clear-cut. Gradually, the violence directed against labor organizers subsided as companies realized that the NLRA would not be repealed and the courts were going to enforce employees’ right to organize.

Today, dissatisfied employees can contact a national union representing other employees engaged in the same type of work. For example, employees of a shop that manufactures parts for auto engines would contact the United Auto Workers (UAW) union. The union then sends a representative to meet with interested employees and explain what unionization would do for them. If the employees want to pursue unionization, the organizer helps them run a campaign to convince a majority of the workers to accept the union as their exclusive representative. Table 21-5 lists some of the largest unions in the United States.

BOARD RULES

During the course of this organizing campaign, certain activities of both employers and employees are prohibited by the NLRA and by “board rules,” that is, rules of conduct developed over the years by the NLRB in a number of cases. The constraints on employers’ behavior under the NLRA are found primarily in Section 8(a)(1), which prohibits interference with employees’ exercise of their Section 7 rights. It is important to distinguish conduct that constitutes an unfair labor practice from violations of board rules, because a violation of board rules may result in the NLRB’s setting aside the results of an election and ordering a new one, whereas the commission of an unfair labor practice by the employer may cause the board to ignore the election results altogether and order the employer to bargain with the union without a new election. The latter remedy occurs only in cases in which the employer’s conduct was so egregious as to make it impossible to hold a fair election and the union had previously collected authorization cards signed by a majority of the employees.

Board rules are designed to guarantee a fair election. One very important rule, the 24-hour rule, prohibits both union representatives and employers from making speeches to “captive audiences” of employees within 24 hours of a representative election.

---

7 Id., at 11.
representation election. A captive audience exists when the employees have no choice but to listen to the speech.

Another important board rule requires employers to file with the regional director, within seven days after an election order is issued, a list of the names and addresses of all employees eligible to vote. This list, known as the *Excelsior list* (after the case that created it), is then made available to the union or union organizers by the regional director.

It is essential that employers be aware of these and other board rules, because a violation of the rules may result in the setting-aside of an election, even when the behavior does not constitute an unfair labor practice. All unfair labor practices, whether by employers or employees, are also considered violations of the board’s election rules.

### UNFAIR LABOR PRACTICES BY EMPLOYERS

In fiscal year 2009, the majority of claims of unfair labor practices by employers (8,723 claims) alleged that the employer refused to bargain. The second largest category of unfair labor practices alleged illegal discharge of workers or that the employer engaged in other illegal discrimination against employees (6,411 charges).

**Interference with Organizing.** Section 8(a)(1) of the NLRA prohibits employer interference with, restraint of, or coercion of employees in the exercise of their Section 7 rights. It is sometimes difficult for a businessperson to know when her or his speech or conduct rises to the level of coercion, restraint, or interference. To make the issue even more complicated, Section 8(c) expressly provides that the expression of a view, argument, or opinion is not evidence of an unfair labor practice as long as it does not contain any threats of reprisals or promises of benefits.