Preface

Our goal is to provide students with a textbook that is up to date and comprehensive in its coverage of legal and regulatory issues—and organized to permit instructors to tailor the materials to their particular approach. This book engages students by relating law to everyday events with which they are already familiar (or with which they are familiarizing themselves in other business courses) and by its clear, concise, and readable style. (An earlier business law text by authors Lieberman and Siedel was hailed "the best written text in a very crowded field.")

This textbook provides context and essential concepts across the entire range of legal issues with which managers and business executives must grapple. The text provides the vocabulary and legal acumen necessary for businesspeople to talk in an educated way to their customers, employees, suppliers, government officials—and to their own lawyers.

Traditional publishers often create confusion among customers in the text selection process by offering a huge array of publications. Once a text is selected, customers might still have to customize the text to meet their needs. For example, publishers usually offer books that include either case summaries or excerpted cases, but some instructors prefer to combine case summaries with a few excerpted cases so that students can experience reading original material. Likewise, the manner in which most conventional texts incorporate video is cumbersome because the videos are contained in a separate library, which makes access more complicating for instructors and students.

Chapter 1
Introduction to Law and Legal Systems

LEARNING OBJECTIVES

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

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

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

1.1 What Is Law?

Law is a word that means different things at different times. *Black's Law Dictionary* says that law is "a body of rules of action or conduct prescribed by controlling authority, and having binding legal force. That which must be obeyed and followed by citizens subject to sanctions or legal consequence is a law." [1]

Functions of the Law

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

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

Law and Politics

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

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

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

KEY TAKEAWAY

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

EXERCISES

1. Consider Burma (named Myanmar by its military rulers). What political rights do you have that the average Burmese citizen does not?

2. What is a nongovernment organization, and what does it have to do with government? Do you contribute to (or are you active in) a nongovernment organization? What kind of rights do they espouse, what kind of laws do they support, and what kind of laws do they oppose?

---

[1] *Black's Law Dictionary*, 6th ed., s.v. "law."

1.2 Schools of Legal Thought

LEARNING OBJECTIVES

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

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

Legal Positivism: Law as Sovereign Command

As legal philosopher John Austin concisely put it, "Law is the command of a sovereign." Law is only law, in other words, if it comes from a recognized authority and can be enforced by that authority, or **sovereign**—such as a king, a president, or a dictator—who has power within a defined area or

territory. Positivism is a philosophical movement that claims that science provides the only knowledge precise enough to be worthwhile. But what are we to make of the social phenomena of laws?

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

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

The positive-law school of legal thought would recognize the lawmaker's command as legitimate; questions about the law's morality or immorality would not be important. In contrast, the natural-law school of legal thought would refuse to recognize the legitimacy of laws that did not conform to natural, universal, or divine law. If a lawmaker issued a command that was in violation of natural law, a citizen

would be morally justified in demonstrating civil disobedience. For example, in refusing to give up her seat to a white person, Rosa Parks believed that she was refusing to obey an unjust law.

Natural Law

The natural-law school of thought emphasizes that law should be based on a universal moral order. Natural law was "discovered" by humans through the use of reason and by choosing between that which is good and that which is evil. Here is the definition of natural law according to the *Cambridge Dictionary of Philosophy*: "Natural law, also called the law of nature in moral and political philosophy, is an objective norm or set of objective norms governing human behavior, similar to the positive laws of a human ruler, but binding on all people alike and usually understood as involving a superhuman legislator." [1]

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

The Unanimous Declaration of the Thirteen United States of America

July 4, 1776

> *When in the Course of human events, it becomes necessary for one people to dissolve the political bands which have connected them with another, and to assume among the powers of the earth, the separate and equal station to which the Laws of Nature and of Nature's God entitle them, a decent respect to the opinions of mankind requires that they should declare the causes which impel them to the separation.*
>
> *We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty and the Pursuit*

CC BY NC SA

> *of Happiness. That to secure these rights, Governments are instituted among Men, deriving their just powers from the consent of the governed….*

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

Civil disobedience—in the tradition of Henry Thoreau, Mahatma Gandhi, or Martin Luther King Jr.—becomes a matter of morality over "unnatural" law. For example, in his "Letter from Birmingham Jail," Martin Luther King Jr. claims that obeying an unjust law is not moral and that deliberately disobeying an unjust law is in fact a moral act that expresses "the highest respect for law": "An individual who breaks a law that conscience tells him is unjust, and who willingly accepts the penalty of imprisonment in order to arouse the conscience of the community over its injustice, is in reality expressing the highest respect for law....One who breaks an unjust law must do so openly, lovingly, and with a willingness to accept the penalty." [2]

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

It is easier to know what the law "is" than what the law "should be." Equal employment laws, for example, have specific statutes, rules, and decisions about racial discrimination. There are always difficult issues of interpretation and decision, which is why courts will resolve differing views. But how can we know the more fundamental "ought" or "should" of human equality? For example, how do we *know* that "all men are created equal" (from the Declaration of Independence)? Setting aside for the moment questions about

the equality of women, or that of slaves, who were not counted as men with equal rights at the time of the declaration—can the statement be empirically proven, or is it simply a matter of a priori knowledge? (*A priori* means "existing in the mind prior to and independent of experience.") Or is the statement about equality a matter of faith or belief, not really provable either scientifically or rationally? The dialogue between natural-law theorists and more empirically oriented theories of "what law is" will raise similar questions. In this book, we will focus mostly on the law as it is, but not without also raising questions about what it could or should be.

Other Schools of Legal Thought

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

The legal realist school flourished in the 1920s and 1930s as a reaction to the historical school. Legal realists pointed out that because life and society are constantly changing, certain laws and doctrines have to be altered or modernized in order to remain current. The social context of law was more important to legal realists than the formal application of precedent to current or future legal disputes. Rather than suppose that judges inevitably acted objectively in applying an existing rule to a set of facts, legal realists observed that judges had their own beliefs, operated in a social context, and would give legal decisions based on their beliefs and their own social context.

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

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

KEY TAKEAWAY

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

EXERCISES

1. Vandana Shiva draws a picture of a stream in a forest. She says that in our society the stream is seen as unproductive if it is simply there, fulfilling the need for water of women's families and communities, until engineers come along and tinker with it, perhaps damming it and using it for generating hydropower. The

same is true of a forest, unless it is replaced with a monoculture plantation of a commercial species. A forest may very well be productive—protecting groundwater; creating oxygen; providing fruit, fuel, and craft materials for nearby inhabitants; and creating a habitat for animals that are also a valuable resource. She criticizes the view that if there is no monetary amount that can contribute to gross domestic product, neither the forest nor the river can be seen as a productive resource. Which school of legal thought does her criticism reflect?

2. Anatole France said, "The law, in its majesty, forbids rich and poor alike from sleeping under bridges." Which school of legal thought is represented by this quote?
3. Adolf Eichmann was a loyal member of the National Socialist Party in the Third Reich and worked hard under Hitler's government during World War II to round up Jewish people for incarceration—and eventual extermination—at labor camps like Auschwitz and Buchenwald. After an Israeli "extraction team" took him from Argentina to Israel, he was put on trial for "crimes against humanity." His defense was that he was "just following orders." Explain why Eichmann was not an adherent of the natural-law school of legal thought.

---

[1] *Cambridge Dictionary of Philosophy*, s.v. "natural law."

[2] Martin Luther King Jr., "Letter from Birmingham Jail."

1.3 Basic Concepts and Categories of US Positive Law

LEARNING OBJECTIVES

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

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

Law: The Moral Minimums in a Democratic Society

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

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

The Common Law: Property, Torts, and Contracts

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

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

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

Courts in one state may look to common-law decisions from the courts of other states where the reasoning in a similar case is persuasive. This will happen in "cases of first impression," a fact pattern or situation that the courts in one state have never seen before. But if the supreme court in a particular state has

already ruled on a certain kind of case, lower courts in that state will always follow the rule set forth by their highest court.

State Courts and the Domain of State Law

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

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

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

Civil versus Criminal Cases

Most of the cases we will look at in this textbook are civil cases. Criminal cases are certainly of interest to business, especially as companies may break criminal laws. A criminal case involves a governmental decision—whether state or federal—to prosecute someone (named as a defendant) for violating society's

laws. The law establishes a moral minimum and does so especially in the area of criminal laws; if you break a criminal law, you can lose your freedom (in jail) or your life (if you are convicted of a capital offense). In a civil action, you would not be sent to prison; in the worst case, you can lose property (usually money or other assets), such as when Ford Motor Company lost a personal injury case and the judge awarded $295 million to the plaintiffs or when Pennzoil won a $10.54 billion verdict against Texaco (see Chapter 7 "Introduction to Tort Law").

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

Table 1.1 Differences between Civil and Criminal Cases

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

Regarding plaintiffs and prosecutors, you can often tell a civil case from a criminal case by looking at the caption of a case going to trial. If the government appears first in the caption of the case (e.g., *U.S. v. Lieberman*, it is likely that the United States is prosecuting on behalf of the people. The same is true of cases prosecuted by state district attorneys (e.g., *State v. Seidel*). But this is not a foolproof formula. Governments will also bring civil actions to collect debts from or settle disputes with individuals, corporations, or other governments. Thus *U.S. v. Mayer* might be a collection action for unpaid taxes,

or *U.S. v. Canada* might be a boundary dispute in the International Court of Justice. Governments can be sued, as well; people occasionally sue their state or federal government, but they can only get a trial if the government waives its sovereign immunity and allows such suits. *Warner v. U.S.*, for example, could be a claim for a tax refund wrongfully withheld or for damage caused to the Warner residence by a sonic boom from a US Air Force jet flying overhead.

Substance versus Procedure

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

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

In contrast, procedural laws are the rules of courts and administrative agencies. They tell us how to proceed if there is a substantive-law problem. For example, if you drive fifty-three miles per hour in a forty mile-per-hour zone on Main Street on a Saturday night and get a ticket, you have broken a substantive rule of law (the posted speed limit). Just how and what gets decided in court is a matter of procedural law. Is the police officer's word final, or do you get your say before a judge? If so, who goes first, you or the officer? Do you have the right to be represented by legal counsel? Does the hearing or trial have to take place within a certain time period? A week? A month? How long can the state take to bring its

case? What kinds of evidence will be relevant? Radar? (Does it matter what kind of training the officer has had on the radar device? Whether the radar device had been tested adequately?) The officer's personal observation? (What kind of training has he had, how is he qualified to judge the speed of a car, and other questions arise.) What if you unwisely bragged to a friend at a party recently that you went a hundred miles an hour on Main Street five years ago at half past three on a Tuesday morning? (If the prosecutor knows of this and the "friend" is willing to testify, is it relevant to the charge of fifty-three in a forty-mile-per-hour zone?)

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

KEY TAKEAWAY

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

EXERCISES

1. Jenna gets a ticket for careless driving after the police come to investigate a car accident she had with you on Hanover Boulevard. Your car is badly damaged through no fault of your own. Is Jenna likely to face criminal charges, civil charges, or both?

2. Jenna's ticket says that she has thirty days in which to respond to the charges against her. The thirty days conforms to a state law that sets this time limit. Is the thirty-day limit procedural law or substantive law?

1.4 Sources of Law and Their Priority

LEARNING OBJECTIVES

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

Sources of Law

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

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

As you might expect, these laws sometimes conflict: a state law may conflict with a federal law, or a federal law might be contrary to an international obligation. One nation's law may provide one substantive rule, while another nation's law may provide a different, somewhat contrary rule to apply. Not

all laws, in other words, are created equal. To understand which laws have priority, it is essential to understand the relationships between the various kinds of law.

Constitutions

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

The nation's states also have constitutions. Along with providing for legislative, executive, and judicial functions, state constitutions prescribe various rights of citizens. These rights may be different from, and in addition to, rights granted by the US Constitution. Like statutes and judicial decisions, a constitution's specific provisions can provide people with a "cause of action" on which to base a lawsuit (see Section 1.4.3 "Causes of Action, Precedent, and " on "causes of action"). For example, California's constitution provides that the citizens of that state have a right of privacy. This has been used to assert claims against businesses that invade an employee's right of privacy. In the case of Virginia Rulon-Miller, her employer, International Business Machines (IBM), told her to stop dating a former colleague who went to work for a competitor. When she refused, IBM terminated her, and a jury fined the company for $300,000 in damages. As the California court noted, "While an employee sacrifices some privacy rights when he enters the workplace, the employee's privacy expectations must be balanced against the employer's interests....[T]he point here is that privacy, like the other unalienable rights listed first in our Constitution...is unquestionably a fundamental interest of our society." [1]

Statutes and Treaties in Congress

In Washington, DC, the federal legislature is known as Congress and has both a House of Representatives and a Senate. The House is composed of representatives elected every two years from various districts in each state. These districts are established by Congress according to population as determined every ten

years by the census, a process required by the Constitution. Each state has at least one district; the most populous state (California) has fifty-two districts. In the Senate, there are two senators from each state, regardless of the state's population. Thus Delaware has two senators and California has two senators, even though California has far more people. Effectively, less than 20 percent of the nation's population can send fifty senators to Washington.

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

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

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

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

Delegating Legislative Powers: Rules by Administrative Agencies

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

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

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

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

State Statutes and Agencies: Other Codified Law

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

On a more local level, counties and municipal corporations or townships may be authorized under a state's constitution to create or adopt ordinances. Examples of ordinances include local building codes, zoning laws, and misdemeanors or infractions such as skateboarding or jaywalking. Most of the more unusual laws that are in the news from time to time are local ordinances. For example, in Logan County, Colorado, it is illegal to kiss a sleeping woman; in Indianapolis, Indiana, and Eureka, Nebraska, it is a crime to kiss if you have a mustache. But reportedly, some states still have odd laws here and there.

Kentucky law proclaims that every person in the state must take a bath at least once a year, and failure to do so is illegal.

Judicial Decisions: The Common Law

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

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

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

Priority of Laws

The Constitution as Preemptive Force in US Law

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

Statutes and Cases

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

Treaties as Statutes: The "Last in Time" Rule

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

One example of treaty obligations overriding, or taking priority over, federal statutes was the tuna-dolphin dispute between the United States and Mexico. The Marine Mammal Protection Act amendments in 1988 spelled out certain protections for dolphins in the Eastern Tropical Pacific, and the United States

began refusing to allow the importation of tuna that were caught using "dolphin-unfriendly" methods (such as purse seining). This was challenged at a GATT dispute panel in Switzerland, and the United States lost. The discussion continued at the WTO under its dispute resolution process. In short, US environmental statutes can be ruled contrary to US treaty obligations.

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

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

Causes of Action, Precedent, and *Stare Decisis*

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

that the instruments were trumpets rather than trombones or that they were delivered too late to be of use to him—you could expect to recover some compensation for his breaching of your agreement with him.

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

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

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

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

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

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

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

Written judicial opinions are thus a good playing field for developing critical thinking skills by identifying the issue in a case and examining the reasons for the court's previous decision(s), or holding.
What *has* the court actually decided, and why? Remember that a court, especially the US Supreme Court, is not only deciding one particular case but also setting down guidelines (in its holdings) for federal and

state courts that encounter similar issues. Note that court cases often raise a variety of issues or questions to be resolved, and judges (and attorneys) will differ as to what the real issue in a case is. A holding is the court's complete answer to an issue that is critical to deciding the case and thus gives guidance to the meaning of the case as a precedent for future cases.

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

KEY TAKEAWAY

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

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

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

EXERCISES

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

---

[1] *Rulon-Miller v. International Business Machines Corp.*, 162 Cal. App.3d 241, 255 (1984).

1.5 Legal and Political Systems of the World

LEARNING OBJECTIVE

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

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

Comparing Common-Law Systems with Other Legal Systems

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

Civil-Law Systems

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

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

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

There are also legal systems that differ significantly from the common-law and civil-law systems. The communist and socialist legal systems that remain (e.g., in Cuba and North Korea) operate on very

different assumptions than those of either English common law or European civil law. Islamic and other religion-based systems of law bring different values and assumptions to social and commercial relations.

KEY TAKEAWAY

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

EXERCISE

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

1.6 A Sample Case

Preliminary Note to Students

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

> *(a) it shall be an unlawful employment practice for an employer—*
>
> *(1) to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or natural origin.*

At common law—where judges decide cases without reference to statutory guidance—employers were generally free to hire and fire on any basis they might choose, and employees were generally free to work for an employer or quit an employer on any basis they might choose (unless the

employer and the employee had a contract). This rule has been called "employment at will." State and federal statutes that prohibit discrimination on any basis (such as the prohibitions on discrimination because of race, color, religion, sex, or national origin in Title VII) are essentially legislative exceptions to the common-law employment-at-will rule.

In the 1970s, many female employees began to claim a certain kind of sex discrimination: sexual harassment. Some women were being asked to give sexual favors in exchange for continued employment or promotion (quid pro quo sexual harassment) or found themselves in a working environment that put their chances for continued employment or promotion at risk. This form of sexual discrimination came to be called "hostile working environment" sexual harassment. Notice that the statute itself says nothing about sexual harassment but speaks only in broad terms about discrimination "because of" sex (and four other factors). Having set the broad policy, Congress left it to employees, employers, and the courts to fashion more specific rules through the process of civil litigation.

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

Harris v. Forklift Systems

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

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

JUSTICE O'CONNOR delivered the opinion of the Court.

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

I

Teresa Harris worked as a manager at Forklift Systems, Inc., an equipment rental company, from April 1985 until October 1987. Charles Hardy was Forklift's president.
The Magistrate found that, throughout Harris' time at Forklift, Hardy often insulted her because of her gender and often made her the target of unwanted sexual innuendoes. Hardy told Harris on several occasions, in the presence of other employees, "You're a woman, what do you know" and "We need a man as the rental manager"; at least once, he told her she was "a dumbass woman." Again in front of others, he suggested that the two of them "go to the Holiday Inn to negotiate [Harris's] raise." Hardy occasionally asked Harris and other female employees to get coins from his front pants pocket. He threw objects on the ground in front of Harris and other women, and asked them to pick the objects up. He made sexual innuendoes about Harris' and other women's clothing.

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

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

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

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

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

II

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

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

But Title VII comes into play before the harassing conduct leads to a nervous breakdown. A discriminatorily abusive work environment, even one that does not seriously affect employees' psychological well-being, can and often will detract from employees' job performance, discourage employees from remaining on the job, or keep them from advancing in their careers. Moreover, even without regard to these tangible effects, the very fact that the discriminatory conduct was so severe or pervasive that it created a work environment abusive to employees because of their race, gender,

religion, or national origin offends Title VII's broad rule of workplace equality. The appalling conduct alleged in Meritor, and the reference in that case to environments "'so heavily polluted with discrimination as to destroy completely the emotional and psychological stability of minority group workers,'" Id., at 66, quoting Rogers v. EEOC, 454 F.2d 234, 238 (CA5 1971), cert. denied, 406 U.S. 957,32 L. Ed. 2d 343, 92 S. Ct. 2058 (1972), merely present some especially egregious examples of harassment. They do not mark the boundary of what is actionable.

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

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

III

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

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

So ordered.

Note to Students

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

CASE QUESTIONS

1. Is this a criminal case or a civil-law case? How can you tell?
2. Is the court concerned with making a procedural rule here, or is the court making a statement about the substantive law?

CC BY NC SA

3. Is this a case where the court is interpreting the Constitution, a federal statute, a state statute, or the common law?
4. In *Harris v. Forklift*, what if the trial judge does not personally agree that women should have any rights to equal treatment in the workplace? Why shouldn't that judge dismiss the case even before trial? Or should the judge dismiss the case after giving the female plaintiff her day in court?
5. What was the employer's argument in this case? Do you agree or disagree with it? What if those who legislated Title VII gave no thought to the question of seriousness of injury at all?

1.7 Summary and Exercises

Summary

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

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

EXERCISES

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

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

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

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

a. The state statute conflicts with the common law of that state.

b. A federal statute conflicts with the US Constitution.

c. A common-law decision in one state conflicts with the US Constitution.

d. A federal statute conflicts with a state constitution.

SELF-TEST QUESTIONS

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

a. the common law

b. statutory law

c. constitutional law

d. administrative law

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

a. civil law

b. constitutional law

c. natural law

d. ecofeminist law

e. positive law

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

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

4 Where was natural law discovered?

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

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

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

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

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

d. Moore may follow the California case if he believes that it offers the best reasoning for a similar case.

SELF-TEST ANSWERS

1. c
2. e
3. a
4. c
5. d
6. d

Chapter 2
Corporate Social Responsibility and Business Ethics

CC BY NC SA

A great society is a society in which [leaders] of business think greatly about their functions.

- Alfred North Whitehead

LEARNING OBJECTIVES

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

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

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

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

2.1 What Is Ethics?

LEARNING OBJECTIVES

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

Most of those who write about ethics do not make a clear distinction between ethics and morality. The question of what is "right" or "morally correct" or "ethically correct" or "morally desirable" in any situation is variously phrased, but all of the words and phrases are after the same thing: what act is "better" in a moral or ethical sense than some other act?

People sometimes speak of morality as something personal but view ethics as having wider social implications. Others see morality as the subject of a field of study, that field being ethics. Ethics would be morality as applied to any number of subjects, including journalistic ethics, business ethics, or the ethics of professionals such as doctors, attorneys, and accountants. We will venture a definition of *ethics*, but for our purposes, *ethics* and *morality* will be used as equivalent terms.

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

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

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

There are three key points here:

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

Here is a cautionary note: for individuals, it is far from easy to recognize an ethical problem, have a clear and usable decision-making process to deal it, and then have the moral courage to do what's

right. All of that is even more difficult within a business organization, where corporate employees vary in their motivations, loyalties, commitments, and character. There is no universally accepted way for developing an organization where employees feel valued, respected, and free to openly disagree; where the actions of top management are crystal clear; and where all the employees feel loyal and accountable to one another.

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

How Do Law and Ethics Differ?

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

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

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

- Individuals and organizations have reputations. (For an individual, moral reputation is most often tied to others' perceptions of his or her character: is the individual honest, diligent, reliable, fair, and caring? The reputation of an organization is built on the goodwill that suppliers, customers, the community, and employees feel toward it. Although an organization is not a person in the usual sense, the goodwill that people feel about the organization is based on their

perception of its better qualities by a variety of stakeholders: customers or clients, suppliers, investors, employees, government officials).

- The goodwill of an organization is to a great extent based on the actions it takes and on whether the actions are favorably viewed. (This goodwill is usually specifically counted in the sale of a business as an asset that the buyer pays for. While it is difficult to place a monetary value on goodwill, a firm's good reputation will generally call for a higher evaluation in the final accounting before the sale. Legal troubles or a reputation for having legal troubles will only lessen the price for a business and will even lessen the value of the company's stock as bad legal news comes to the public's attention.)

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

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

Why Should an Individual or a Business Entity Be Ethical?

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

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

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

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

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

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

KEY TAKEAWAY

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

EXERCISES

1. Think of a person who did something morally wrong, at least to your way of thinking. What was it? Explain to a friend of yours—or a classmate—why you think it was wrong. Does your friend agree? Why or why not? What is the basic principle that forms the basis for your judgment that it was wrong?
2. Think of a person who did something morally right, at least to your way of thinking. (This is not a matter of finding something they did well, like efficiently changing a tire, but something good.) What was it? Explain to a friend of yours—or a classmate—why you think it was right. Does your friend agree? Why or why not? What is the basic principle that forms the basis for your judgment that it was right?

3. Think of an action by a business organization (sole proprietor, partnership, or corporation) that was legal but still strikes you as wrong. What was it? Why do you think it was wrong?
4. Think of an act by an individual or a corporation that is ethical but not legal. Compare your answer with those of your classmates: were you more likely to find an example from individual action or corporate action? Do you have any thoughts as to why?

2.2 Major Ethical Perspectives

LEARNING OBJECTIVES

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

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

Utilitarianism

CC BY NC SA

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

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

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

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

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

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

1. Failing to come up with lots of options that seem reasonable and then choosing the one that has the greatest benefit for the greatest number. Often, a decision maker seizes on one or two alternatives without thinking carefully about other courses of action. If the alternative does more good than harm, the decision maker assumes it's ethically okay.
2. Assuming that the greatest good for you or your company is in fact the greatest good for all—that is, looking at situations subjectively or with your own interests primarily in mind.
3. Underestimating the costs of a certain decision to you or your company. The now-classic Ford Pinto case demonstrates how Ford Motor Company executives drastically underestimated the legal costs of not correcting a feature on their Pinto models that they knew could cause death or injury. General Motors was often taken to task by juries that came to understand that the company would not recall or repair known and dangerous defects because it seemed more profitable not to. In 2010, Toyota learned the same lesson.
4. Underestimating the cost or harm of a certain decision to someone else or some other group of people.
5. Favoring short-term benefits, even though the long-term costs are greater.

6. Assuming that all values can be reduced to money. In comparing the risks to human health or safety against, say, the risks of job or profit losses, cost-benefit analyses will often try to compare apples to oranges and put arbitrary numerical values on human health and safety.

Rules and Duty: Deontology

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

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

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

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

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

Social Justice Theory and Social Contract Theory

Social justice theorists worry about "distributive justice"—that is, what is the fair way to distribute goods among a group of people? Marxist thought emphasizes that members of society should be given goods to according to their needs. But this redistribution would require a governing power to decide who gets what and when. Capitalist thought takes a different approach, rejecting any giving that is not voluntary. Certain economists, such as the late Milton Friedman (see the sidebar in Section 2.4 "Corporations and Corporate Governance") also reject the notion that a corporation has a duty to give to unmet needs in society, believing that the government should play that role. Even the most dedicated free-market capitalist will

often admit the need for some government and some forms of welfare—Social Security, Medicare, assistance to flood-stricken areas, help for AIDs patients—along with some public goods (such as defense, education, highways, parks, and support of key industries affecting national security).

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

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

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

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

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

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

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

1. If you have a right of free expression, the government has a duty to respect that right but can put reasonable limits on it. For example, you can legally say whatever you want about the US president, but you can't get away with threatening the president's life. Even if your criticisms are strong and insistent, you have the right (and our government has the duty to protect your right) to speak freely. In Singapore during the 1990s, even indirect criticisms—mere hints—of the political leadership were enough to land you in jail or at least silence you with a libel suit.

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

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

Aristotle and Virtue Theory

Virtue theory, or virtue ethics, has received increasing attention over the past twenty years, particularly in contrast to utilitarian and deontological approaches to ethics. Virtue theory emphasizes the value of virtuous qualities rather than formal rules or useful results. Aristotle is often recognized as the first philosopher to advocate the ethical value of certain qualities, or virtues, in a person's character. As LaRue Hosmer has noted, Aristotle saw the goal of human existence as the active, rational search for excellence, and excellence requires the personal virtues of honesty, truthfulness, courage, temperance, generosity, and high-mindedness. This pursuit is also termed "knowledge of the good" in Greek philosophy.[1]

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

reason. The use of reason leads to excellence, and so happiness can be defined as the active, rational pursuit of personal excellence, or virtue.

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

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

As to the third question, whether corporations can "have" virtues or values is a matter of lively debate. A corporation is obviously not the same as an individual. But there seems to be growing agreement that organizations do differ in their practices and that these practices are value driven. If all a company cares about is the bottom line, other values will diminish or disappear. Quite a few books have been written in the past twenty years that emphasize the need for businesses to define their values in order to be competitive in today's global economy.[2]

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

Josephson's Core Values Analysis and Decision Process

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

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

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

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

Notice also that these six core values share something in common with other ethical values that are less universally agreed upon. Many values taught in the family or in places of worship are not generally agreed on, practiced, or admired by all. Some families and individuals believe strongly in the virtue of saving

money or in abstaining from alcohol or sex prior to marriage. Others clearly do not, or at least don't act on their beliefs. Moreover, it is possible to have and practice core ethical values even if you take on heavy debt, knock down several drinks a night, or have frequent premarital sex. Some would dispute this, saying that you can't really lead a virtuous life if you get into debt, drink heavily, or engage in premarital sex. But the point here is that since people do disagree in these areas, the ethical traits of thrift, temperance, and sexual abstinence do not have the unanimity of approval that the six core values do.

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

KEY TAKEAWAY

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

EXERCISES

XYZ Motor Corporation begins to get customer complaints about two models of its automobiles. Customers have had near-death experiences from sudden acceleration; they would be driving along a highway at normal

speed when suddenly the car would begin to accelerate, and efforts to stop the acceleration by braking fail to work. Drivers could turn off the ignition and come to a safe stop, but XYZ does not instruct buyers of its cars to do so, nor is this a common reaction among drivers who experience sudden acceleration.

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

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

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

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

---

[1] LaRue Tone Hosmer, *Moral Leadership in Business* (Chicago: Irwin Professional Publishing, 1994), 72.

[2] James O'Toole and Don Mayer, eds., *Good Business: Exercising Effective and Ethical Leadership* (London: Routledge, 2010).

2.3 An Ethical Decision Model

LEARNING OBJECTIVE

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

Josephson's Core Values Model

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

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

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

The Core Values

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

Trustworthiness: *Be honest—tell the truth, the whole truth, and nothing but the truth; be sincere, forthright; don't deceive, mislead, or be tricky with the truth; don't cheat or steal, and don't betray a trust. Demonstrate integrity—stand up for what you believe, walk the walk as well as talking the talk; be what you seem to be; show commitment and courage. Be loyal—stand by your family, friends, co-workers, community, and nation; be discreet with information that comes into your hands; don't spread rumors or engage in harmful gossip; don't violate your principles just to win friendship or approval; don't ask a friend to do something that is wrong. Keep promises—keep your word, honor your commitments, and pay your debts; return what you borrow.*

Respect: *Judge people on their merits, not their appearance; be courteous, polite, appreciative, and accepting of differences; respect others' right to make decisions about their own lives; don't abuse, demean, mistreat anyone; don't use, manipulate, exploit, or take advantage of others.*

Responsibility: *Be accountable—think about the consequences on yourself and others likely to be affected before you act; be reliable; perform your duties; take responsibility for the consequences of your choices; set a good example and don't make excuses or take credit for other people's work. Pursue excellence: Do your best, don't quit easily, persevere, be diligent, make all you do worthy of pride. Exercise self-restraint—be disciplined, know the difference between what you have a right to do and what is right to do.*

Fairness: *Treat all people fairly, be open-minded; listen; consider opposing viewpoints; be consistent; use only appropriate considerations; don't let personal feelings improperly interfere with decisions; don't take unfair advantage of mistakes; don't take more than your fair share.*

Caring: *Show you care about others through kindness, caring, sharing, compassion, and empathy; treat others the way you want to be treated; don't be selfish, mean, cruel, or insensitive to others' feelings.*

Citizenship: *Play by the rules, obey laws; do your share, respect authority, stay informed, vote, protect your neighbors, pay your taxes; be charitable, help your community; protect the environment, conserve resources.*

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

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

KEY TAKEAWAY

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

EXERCISE

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

2.4 Corporations and Corporate Governance

LEARNING OBJECTIVES

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

Legal Organization of the Corporation

Figure 2.1 Corporate Legal Structure

CC BY NC SA

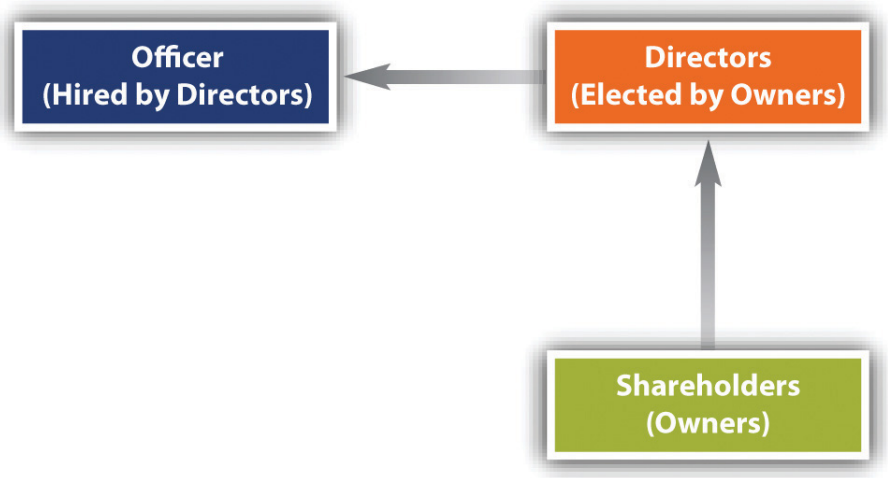


Figure 2.1 "Corporate Legal Structure", though somewhat oversimplified, shows the basic legal structure of a corporation under Delaware law and the laws of most other states in the United States. Shareholders elect directors, who then hire officers to manage the company. From this structure, some very basic realities follow. Because the directors of a corporation do not meet that often, it's possible for the officers hired (top management, or the "C-suite") to be selective of what the board knows about, and directors are not always ready and able to provide the oversight that the shareholders would like. Nor does the law require officers to be shareholders, so that officers' motivations may not align with the best interests of the company. This is the "agency problem" often discussed in corporate governance: how to get officers and other top management to align their own interests with those of the shareholders. For example, a CEO might trade insider information to the detriment of the company's shareholders. Even board members are susceptible to misalignment of interets; for example, board members might resist hostile takeover bids because they would likely lose their perks (short for *perquisites*) as directors, even though the tender offer would benefit stockholders. Among other attempted realignments, the use of stock options was an attempt to make managers more attentive to the value of company stock, but the law of unintended consequences was in full force; managers tweaked and managed earnings in the bubble of the 1990s bull market, and "managing by numbers" became an epidemic in corporations organized under US corporate law. The rights of shareholders can be bolstered by changes in state and federal law, and there have been some attempts to do that since the late 1990s. But as owners, shareholders have the ultimate power to

replace nonperforming or underperforming directors, which usually results in changes at the C-suite level as well.

Shareholders and Stakeholders

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

Maximizing Profits: Milton Friedman

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

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

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

> *What does it mean to say that "business" has responsibilities? Only people can have responsibilities. A corporation is an artificial person and in this sense may have artificial*

responsibilities, but "business" as a whole cannot be said to have responsibilities, even in this vague sense....

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

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

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

instead of better qualified available workmen to contribute to the social objective of reducing poverty.

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

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

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

Stakeholder Theory

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

There is one vital fact about corporations: the corporation is a creation of the law. Without law (and government), corporations would not have existence. The key concept for corporations is the legal fact of limited liability. The benefit of limited liability for shareholders of a corporation meant that larger pools of

capital could be aggregated for larger enterprises; shareholders could only lose their investments should the venture fail in any way, and there would be no personal liability and thus no potential loss of personal assets other than the value of the corporate stock. Before New Jersey and Delaware competed to make incorporation as easy as possible and beneficial to the incorporators and founders, those who wanted the benefits of incorporation had to go to legislatures—usually among the states—to show a public purpose that the company would serve.

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

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

According to stakeholder theorists, corporations (and other business organizations) must pay attention not only to the bottom line but also to their overall effect on the community. Public perception of a company's unfairness, uncaring, disrespect, or lack of trustworthiness often leads to long-term failure, whatever the short-term successes or profits may be. A socially responsible corporation is likely to consider the impact of its decisions on a wide range of stakeholders, not just shareholders. As Table 2.1

"The Stakes of Various Stakeholders" indicates, stakeholders have very different kinds of interests ("stakes") in the actions of a corporation.

Table 2.1 The Stakes of Various Stakeholders

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

Corporate Culture and Codes of Ethics

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

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

Ethical Leadership Is Top-Down

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

Accountability Is Often Weak

Clever managers can learn to shift blame to others, take credit for others' work, and move on before "funny numbers" or other earnings management tricks come to light.[1] Again, we see that the manager is often an agent for himself or herself and will often act more in his or her self-interest than for the corporate interest.

Killing the Messenger

Where organizations no longer function, inevitably some employees are unhappy. If they call attention to problems that are being covered up by coworkers or supervisors, they bring bad news. Managers like to hear good news and discourage bad news. Intentionally or not, those who told on others, or blew the whistle, have rocked the boat and become unpopular with those whose defalcations they report on and with the managers who don't really want to hear the bad news. In many organizations, "killing the messenger" solves the problem. Consider James Alexander at Enron Corporation, who was deliberately shut out after bringing problems to CEO Ken Lay's attention.[2] When Sherron Watkins sent Ken Lay a letter warning him about Enron's accounting practices, CFO Andrew Fastow tried to fire her.[3]

Ethics Codes

Without strong leadership and a willingness to listen to bad news as well as good news, managers do not have the feedback necessary to keep the organization healthy. Ethics codes have been put in place—partly in response to federal sentencing guidelines and partly to encourage feedback loops to top management. The best ethics codes are aspirational, or having an ideal to be pursued, not legalistic or compliance driven. The Johnson & Johnson ethics code predated the Tylenol scare and the company's oft-celebrated corporate response.[4] The corporate response was consistent with that code, which was lived and modeled by the top of the organization.

It's often noted that a code of ethics is only as important as top management is willing to make it. If the code is just a document that goes into a drawer or onto a shelf, it will not effectively encourage good conduct within the corporation. The same is true of any kind of training that the company undertakes, whether it be in racial sensitivity or sexual harassment. If the message is not continuously reinforced, or (worse yet) if the message is undermined by management's actions, the real message to employees is that violations of the ethics code will not be taken seriously, or that efforts to stop racial discrimination or sexual harassment are merely token efforts, and that the important things are profits and performance. The ethics code at Enron seems to have been one of those "3-P" codes that wind up sitting on shelves—"Print, Post, and Pray." Worse, the Enron board twice suspended the code in 1999 to allow outside partnerships to be led by a top Enron executive who stood to gain financially from them.[5]

Ethics Hotlines and Federal Sentencing Guidelines

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

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

Managing by the Numbers

If you manage by the numbers, there is a temptation to lie about those numbers, based on the need to get stock price ever higher. At Enron, "15 percent a year or better earnings growth" was the mantra. Jeffrey Pfeffer, professor of organizational behavior at Stanford University, observes how the belief that "stock price is all that matters" has been hardwired into the corporate psyche. It dictates not only how people judge the worth of their company but also how they feel about themselves and the work that they are doing. And, over time, it has clouded judgments about what is acceptable corporate behavior.[6]

Managing by Numbers: The Sears Auto Center Story

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

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

> *Sears Roebuck & Company has been a fixture in American retailing throughout the twentieth century. At one time, people in rural America could order virtually anything (including a house) from Sears. Not without some accuracy, the company billed itself as "the place where Americans shop." But in 1992, Sears was charged by California authorities with gross and deliberate fraud in many of its auto centers.*
>
> *The authorities were alerted by a 50 percent increase in consumer complaints over a three-year period. New Jersey's division of consumer affairs also investigated Sears Auto Centers and found that all six visited by investigators had recommended unnecessary repairs. California's department of consumer affairs found that Sears had systematically overcharged by an average*

of $223 for repairs and routinely billed for work that was not done. Sears Auto Centers were the largest providers of auto repair services in the state.

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

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

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

- People generally choose short-term gains over potential long-term losses.
- People often justify the harm to others as being minimal or "necessary" to achieve the desired sales quota or financial goal.
- In working as a group, we often form an "us versus them" mentality. In the Sears case, it is likely that Sears "insiders" looked at customers as "outsiders," effectively treating them (in Kantian terms) as means rather than ends in themselves. In short, outsiders were used for the benefit of insiders.

- The long-term losses to Sears are difficult to quantify, while the short-term gains were easy to measure and (at least for a brief while) quite satisfying financially.
- Sears' ongoing rip-offs were possible only because individual consumers lacked the relevant information about the service being offered. This lack of information is a market failure, since many consumers were demanding more of Sears Auto Center services than they would have (and at a higher price) if relevant information had been available to them earlier. Sears, like other sellers of goods and services, took advantage of a market system, which, in its ideal form, would not permit such information distortions.
- People in the organization probably thought that the actions they took were necessary.

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

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

Conscious Capitalism

One effort to integrate the two viewpoints of stakeholder theory and shareholder primacy is the conscious capitalism movement. Companies that practice **conscious capitalism** embrace the idea that profit and prosperity can and must go hand in hand with social justice and environmental stewardship. They operate with a holistic or systems view. This means that they understand that all stakeholders are connected and interdependent. They reject false trade-offs between stakeholder interests and strive for creative ways to achieve win-win-win outcomes for all.[7]

The "conscious business" has a purpose that goes beyond maximizing profits. It is designed to maximize profits but is focused more on its higher purpose and does not fixate solely on the bottom line. To do so, it focuses on delivering value to all its stakeholders, harmonizing as best it can the interests of consumers,

partners, investors, the community, and the environment. This requires that company managers take a "servant leadership" role, serving as stewards to the company's deeper purpose and to the company's stakeholders.

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

---

[1] See Robert Jackall, *Moral Mazes: The World of Corporate Managers* (New York: Oxford University Press, 1988).

[2] John Schwartz, "An Enron Unit Chief Warned, and Was Rebuffed," *New York Times*, February 20, 2002.

[3] Warren Bennis, "A Corporate Fear of Too Much Truth," *New York Times*, February 17, 2002.

[4] University of Oklahoma Department of Defense Joint Course in Communication, *Case Study: The Johnson & Johnson Tylenol Crisis*, accessed April 5, 2011.

[5] FindLaw, *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.*, February 1, 2002, accessed April 5, 2011,http://news.findlaw.com/wsj/docs/enron/sicreport.

[6] Steven Pearlstein, "Debating the Enron Effect," *Washington Post*, February 17, 2002.

[7] Milton Friedman, John Mackey, and T. J. Rodgers, "Rethinking the Social Responsibility of Business," Reason.com, October 2005,http://reason.com/archives/2005/10/01/rethinking-the-social-responsi.

2.5 Summary and Exercises

Summary

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

EXERCISES

1 Consider again Milton Friedman's article.

a. What does Friedman mean by "ethical custom"?

b. If the laws of the society are limiting the company's profitability, would the company be within its rights to disobey the law?

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

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

a. Which of his actions, if any, were contrary to utilitarian thinking?

b. If Kant were his second-in-command and advising him on ethical matters, would he have approved of Mr. Hardy's behavior? Why or why not?

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

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

5 Assume that the year is 1963, prior to the passage of the Civil Rights Act of 1964 and the Title VII provisions regarding equal employment opportunity that prohibit discrimination based on sex. So, Mr. Hardy's actions are not illegal, fraudulent, or deceitful. Assume also that he heads a large public company and that there is a large amount of turnover and unhappiness among the women who work for the company. No one can sue him for being sexist or lecherous, but are his actions consistent with maximizing shareholder returns? Should the board be concerned?

Notice that this question is really a stand-in for any situation faced by a company today regarding its CEO where the actions are not illegal but are ethically questionable. What would conscious capitalism tell a CEO or a board to do where some group of its employees are regularly harassed or disadvantaged by top management?

SELF-TEST QUESTIONS

1 Milton Friedman would have been most likely to agree to which of the following statements?

a. The purpose of the corporation is to find a path to sustainable corporate profits by paying careful attention to key stakeholders.
b. The business of business is business.
c. The CEO and the board should have a single-minded focus on delivering maximum value to shareholders of the business.
d. All is fair in love, war, and business.

2 Milton Friedman meant (using the material quoted in this chapter) that companies should

a. Find a path to sustainable profits by looking at the interconnected needs and desires of all the stakeholders.
b. Always remember that the business of business is business.
c. Remind the CEO that he or she has one duty: to maximize shareholder wealth by any means possible.
d. Maximize shareholder wealth by engaging in open competition without fraud or deceit.

3 What are some key drawbacks to utilitarian thinking at the corporate level?

a. The corporation may do a cost-benefit analysis that puts the greatest good of the firm above all other considerations.
b. It is difficult to predict future consequences; decision makers in for-profit organizations will tend to overestimate the upside of certain decisions and underestimate the downside.
c. Short-term interests will be favored over long-term consequences.
d. all of the above
e. a and b only

4 Which ethical perspective would allow that under certain circumstances, it might be ethical to lie to a liar?

a. deontology
b. virtue ethics
c. utilitarianism
d. all of the above

5 Under conscious capitalism,

a. Virtue ethics is ignored.
b. Shareholders, whether they be traders or long-term investors, are always the first and last consideration for the CEO and the board.
c. Maximizing profits comes from a focus on higher purposes and harmonizing the interests of various stakeholders.
d. Kantian duties take precedence over cost-benefit analyses.

SELF-TEST ANSWERS

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

Chapter 3
Courts and the Legal Process

LEARNING OBJECTIVES

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

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

CC BY NC SA

3. Explain the importance of subject matter jurisdiction and personal jurisdiction and know the difference between the two.
4. Describe the various stages of a civil action: from pleadings, to discovery, to trial, and to appeals.
5. Describe two alternatives to litigation: mediation and arbitration.

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

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

Robinson v. Audi

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

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

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

LEARNING OBJECTIVES

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

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

State and local courts must honor both federal law and the laws of the other states. First, state courts must honor federal law where state laws are in conflict with federal laws (under the supremacy clause of the Constitution; see Chapter 4 "Constitutional Law and US Commerce"). Second, claims arising under federal statutes can often be tried in the state courts, where the Constitution or Congress has not explicitly required that only federal courts can hear that kind of claim. Third, under the full faith and credit clause, each state court is obligated to respect the final judgments of courts in other states. Thus a contract dispute resolved by an Arkansas court cannot be relitigated in North Dakota when the plaintiff wants to collect on the Arkansas judgment in North Dakota. Fourth, state

courts often must consider the laws of other states in deciding cases involving issues where two states have an interest, such as when drivers from two different states collide in a third state. Under these circumstances, state judges will consult their own state's case decisions involving conflicts of laws and sometimes decide that they must apply another state's laws to decide the case (see Table 3.1 "Sample Conflict-of-Law Principles").

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

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

Why are there so many diversity cases in federal courts? Defense lawyers believe that there is sometimes a "home-court advantage" for an in-state plaintiff who brings a lawsuit against a nonresident in his local state court. The defense attorney is entitled to ask for **removal** to a federal

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

State Court Systems

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

Limited Jurisdiction Courts

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

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

General Jurisdiction Courts

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

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

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

Appellate Courts

The losing party in a general jurisdiction court can almost always appeal to either one or two higher courts. These intermediate appellate courts—usually called courts of appeal—have been established in

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

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

The Federal Court System

District Courts

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

Courts of Appeal

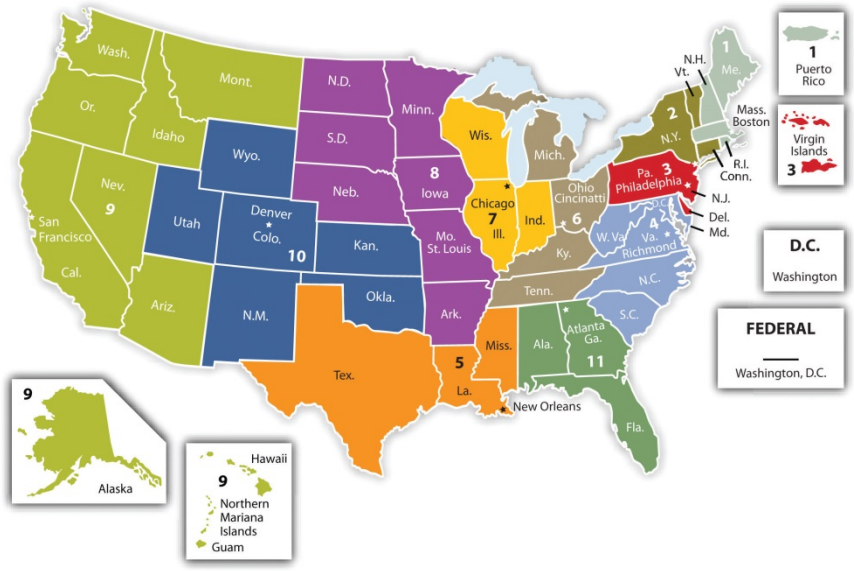
Cases from the district courts can then be appealed to the circuit courts of appeal, of which there are thirteen (Figure 3.1 "The Federal Judicial Circuits"). Each circuit oversees the work of the district courts in several states. For example, the US Court of Appeals for the Second Circuit hears appeals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

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

United States Supreme Court

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

Figure 3.1 *The Federal Judicial Circuits*



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

KEY TAKEAWAY

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

EXERCISES

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

claim. In trying to collect from James in New Jersey, Jonah must have the New Jersey court certify the Iowa judgment. Why, ordinarily, must the New Jersey court do so?

3.2 The Problem of Jurisdiction

LEARNING OBJECTIVES

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

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

There are two questions about jurisdiction in each case that must be answered before a judge will hear a case: the question of **subject matter jurisdiction** and the question of personal jurisdiction. We will consider the question of subject matter jurisdiction first, because judges do; if they

determine, on the basis of the initial documents in the case (the "pleadings"), that they have no power to hear and decide that kind of case, they will dismiss it.

The Federal-State Balance: Federalism

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

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

The Constitution was constructed with the idea that state courts would continue to deal with basic kinds of claims such as tort, contract, or property claims. Since states sanction marriages and divorce, state courts would deal with "domestic" (family) issues. Since states deal with birth and death records, it stands to reason that paternity suits, probate disputes, and the like usually wind up in state courts. You wouldn't go to the federal building or courthouse to get a marriage license, ask for a divorce, or probate a will: these matters have traditionally been dealt with by the states (and the thirteen original colonies before them). Matters that historically get raised and settled in state court under state law include not only domestic and

probate matters but also law relating to corporations, partnerships, agency, contracts, property, torts, and commercial dealings generally. You cannot get married or divorced in federal court, because federal courts have no jurisdiction over matters that are historically (and are still) exclusively within the domain of state law.

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

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

Because there are two court systems, it is important for a plaintiff to file in the right court to begin with. The right court is the one that has subject matter jurisdiction over the case—that is, the power to hear and decide the kind of case that is filed. Not only is it a waste of time to file in the wrong court system and be dismissed, but if the dismissal comes after the filing period imposed by the applicable **statute of limitations**, it will be too late to refile in the correct court system. Such cases will

be routinely dismissed, regardless of how deserving the plaintiff might be in his quest for justice. (The plaintiff's only remedy at that point would be to sue his lawyer for negligence for failing to mind the clock and get to the right court in time!)

Exclusive Jurisdiction in Federal Courts

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

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

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

1. *Suits between states*. Cases in which two or more states are a party.
2. *Cases involving ambassadors and other high-ranking public figures*. Cases arising between foreign ambassadors and other high-ranking public officials.
3. *Federal crimes*. Crimes defined by or mentioned in the US Constitution or those defined or punished by federal statute. Such crimes include treason against the United States, piracy, counterfeiting, crimes against the law of nations, and crimes relating to the federal government's authority to regulate interstate commerce. However, most crimes are state matters.

4 *Bankruptcy*. The statutory procedure, usually triggered by insolvency, by which a person is relieved of most debts and undergoes a judicially supervised reorganization or liquidation for the benefit of the person's creditors.

5 *Patent, copyright, and trademark cases*

   a. *Patent*. The exclusive right to make, use, or sell an invention for a specified period (usually seventeen years), granted by the federal government to the inventor if the device or process is novel, useful, and nonobvious.

   b. *Copyright*. The body of law relating to a property right in an original work of authorship (such as a literary, musical, artistic, photographic, or film work) fixed in any tangible medium of expression, giving the holder the exclusive right to reproduce, adapt, distribute, perform, and display the work.

   c. *Trademark*. A word, phrase, logo, or other graphic symbol used by a manufacturer or seller to distinguish its product or products from those of others.

6 *Admiralty*. The system of laws that has grown out of the practice of admiralty courts: courts that exercise jurisdiction over all maritime contracts, torts, injuries, and offenses.

7 *Antitrust*. Federal laws designed to protect trade and commerce from restraining monopolies, price fixing, and price discrimination.

8 *Securities and banking regulation*. The body of law protecting the public by regulating the registration, offering, and trading of securities and the regulation of banking practices.

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

Concurrent Jurisdiction

When a plaintiff takes a case to state court, it will be because state courts typically hear that kind of case (i.e., there is subject matter jurisdiction). If the plaintiff's main cause of action comes from a certain state's constitution, statutes, or court decisions, the state courts have subject matter jurisdiction over the case. If the plaintiff's main cause of action is based on federal law (e.g., Title VII of the Civil Rights Act of 1964), the federal courts have subject matter jurisdiction over the case. But federal courts will also have subject matter jurisdiction over certain cases that have only a state-based cause of action; those cases are

ones in which the plaintiff(s) and the defendant(s) are from different states and the amount in controversy is more than $75,000. State courts can have subject matter jurisdiction over certain cases that have only a federal-based cause of action. The Supreme Court has now made clear that state courts have **concurrent jurisdiction** of any federal cause of action unless Congress has given exclusive jurisdiction to federal courts.

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

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

Summary of Rules on Subject Matter Jurisdiction

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

2 A state court will have subject matter jurisdiction over any case that is not required to be brought in a federal court.

Some cases can *only* be brought in federal court, such as bankruptcy cases, cases involving federal crimes, patent cases, and Internal Revenue Service tax court claims. The list of cases for exclusive federal jurisdiction is fairly short. That means that almost any state court will have subject matter jurisdiction over almost any kind of case. If it's a case based on state law, a state court will always have subject matter jurisdiction.

3 A federal court will have subject matter jurisdiction over any case that is either based on a federal law (statute, case, or US Constitution)

OR

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

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

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

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

4 In diversity cases, the following rules apply.

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

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

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

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

under the jurisdiction of New Mexico's laws at the time, it makes sense to apply New Mexico law.

(3) Why do some nonresident defendants prefer to be in federal court?
   (a) In the state court, the judge is elected, and the jury may be familiar with or sympathetic to the "local" plaintiff.
   (b) The federal court provides a more neutral forum, with an appointed, life-tenured judge and a wider pool of potential jurors (drawn from a wider geographical area).

(4) If a defendant does not want to be in state court and there is diversity, what is to be done?
   (a) Make a motion for removal to the federal court.
   (b) The federal court will not want to add to its caseload, or docket, but must take the case unless there is *not* complete diversity of citizenship or the amount in controversy is *less than* $75,000.

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

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

Robinson v. Audi

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

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

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

Table 3.1 Sample Conflict-of-Law Principles

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

Legal Procedure, Including Due Process and Personal Jurisdiction

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

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

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

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

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

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

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

Criminal prosecutions carry the most rigorous burden of proof: the government must prove its case against the defendant *beyond a reasonable doubt*. That is, even if it seems very likely that the defendant

committed the crime, as long as there remains some reasonable doubt—perhaps he was not clearly identified as the culprit, perhaps he has an alibi that could be legitimate—the jury must vote to acquit rather than convict.

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

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

How a Case Proceeds

Complaint and Summons

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

The timing of the filing can be important. Almost every possible legal complaint is governed by a federal or state statute of limitations, which requires a lawsuit to be filed within a certain period of time. For

example, in many states a lawsuit for injuries resulting from an automobile accident must be filed within two years of the accident or the plaintiff forfeits his right to proceed. As noted earlier, making a correct initial filing in a court that has subject matter jurisdiction is critical to avoiding statute of limitations problems.

Jurisdiction and Venue

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

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

Service of Process and Personal Jurisdiction

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

One of the most troublesome problems is service on an out-of-state defendant. The personal jurisdiction of a state court over persons is clear for those defendants found within the state. If the plaintiff claims that an out-of-state defendant injured him in some way, must the plaintiff go to the defendant's home state to

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

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

Summary of Rules on Personal Jurisdiction

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

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

3. Service of process is a necessary (but not sufficient) condition for getting personal jurisdiction over a particular defendant (see rule 4).
    1. In order to get a judgment in a civil action, the plaintiff must serve a copy of the complaint and a summons on the defendant.
    2. There are many ways to do this.
        - The process server personally serves a complaint on the defendant.
        - The process server leaves a copy of the summons and complaint at the residence of the defendant, in the hands of a competent person.
        - The process server sends the summons and complaint by certified mail, return receipt requested.
        - The process server, if all other means are not possible, notifies the defendant by publication in a newspaper having a minimum number of readers (as may be specified by law).
4. In addition to successfully serving the defendant with process, a plaintiff must convince the court that exercising personal jurisdiction over the defendant is consistent with due process and any statutes in that state that prescribe the jurisdictional reach of that state (the so-called long-arm statutes). The Supreme Court has long recognized various bases for judging whether such process is fair.
    1. Consent. The defendant agrees to the court's jurisdiction by coming to court, answering the complaint, and having the matter litigated there.
    2. Domicile. The defendant is a permanent resident of that state.
    3. Event. The defendant did something in that state, related to the lawsuit, that makes it fair for the state to say, "Come back and defend!"

4. Service of process within the state will effectively provide personal jurisdiction over the nonresident.

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

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

Choice of Law and Choice of Forum Clauses

In a series of cases, the Supreme Court has made clear that it will honor contractual choices of parties in a lawsuit. Suppose the parties to a contract wind up in court arguing over the application of the contract's terms. If the parties are from two different states, the judge may have difficulty determining which law to apply (see Table 3.1 "Sample Conflict-of-Law Principles"). But if the contract says that a particular state's law will be applied if there is a dispute, then ordinarily the judge will apply that state's law as a rule of

decision in the case. For example, Kumar Patel (a Missouri resident) opens a brokerage account with Goldman, Sachs and Co., and the contractual agreement calls for "any disputes arising under this agreement" to be determined "according to the laws of the state of New York." When Kumar claims in a Missouri court that his broker is "churning" his account, and, on the other hand, Goldman, Sachs claims that Kumar has failed to meet his margin call and owes $38,568.25 (plus interest and attorney's fees), the judge in Missouri will apply New York law based on the contract between Kumar and Goldman, Sachs.

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

KEY TAKEAWAY

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

EXERCISES

1. The Constitution specifies that federal courts have exclusive jurisdiction over admiralty claims. Mr. and Mrs. Shute have a claim against Carnival Cruise lines for the negligence of the cruise line. Mrs. Shute sustained injuries as a result of the company's negligence. Mr. and Mrs. Shute live in the state of Washington. Can they bring their claim in state court? Must they bring their claim in federal court?
2. Congress passed Title VII of the Civil Rights Act of 1964. In Title VII, employers are required not to discriminate against employees on the basis of race, color, sex, religion, or national origin. In passing Title VII, Congress did not require plaintiffs to file only in federal courts. That is, Congress made no statement in Title VII that federal courts had "exclusive jurisdiction" over Title VII claims. Mrs. Harris wishes to sue Forklift Systems, Inc. of Nashville, Tennessee, for sexual harassment under Title VII. She has gone through the Equal Employment Opportunity Commission process and has a right-to-sue letter, which is required before a Title VII action can be brought to court. Can she file a complaint that will be heard by a state court?
3. Mrs. Harris fails to go to the Equal Employment Opportunity Commission to get her right-to-sue letter against Forklift Systems, Inc. She therefore does not have a viable Title VII cause of action against Forklift. She does, however, have her rights under Tennessee's equal employment statute and various court decisions from Tennessee courts regarding sexual harassment. Forklift is incorporated in Tennessee and has its principal place of business in Nashville. Mrs. Harris is also a citizen of Tennessee. Explain why, if she brings her employment discrimination and sexual harassment lawsuit in a federal court, her lawsuit will be dismissed for lack of subject matter jurisdiction.
4. Suppose Mr. and Mrs. Robinson find in the original paperwork with Seaway Volkswagen that there is a contractual agreement with a provision that says "all disputes arising between buyer and Seaway Volkswagen will be litigated, if at all, in the county courts of Westchester County, New York." Will the Oklahoma court take personal jurisdiction over Seaway Volkswagen, or will it require the Robinsons to litigate their claim in New York?

3.3 Motions and Discovery

LEARNING OBJECTIVES

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

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

Initial Pleadings, and Motions to Dismiss

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

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

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

Discovery

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

Beginning with a change in the Federal Rules of Civil Procedure adopted by the Supreme Court in 1938 and subsequently followed by many of the states, the parties are entitled to learn the facts of the case before trial. The basic idea is to help the parties determine what the evidence might be, who the potential witnesses are, and what specific issues are relevant. Discovery can proceed by several methods. A party may serve an interrogatory on his adversary—a written request for answers to specific questions. Or a party may depose the other party or a witness. A deposition is a live question-and-answer session at which the witness answers questions put to him by one of the parties' lawyers. His answers are recorded verbatim and may be used at trial. Each party is also entitled to inspect books, documents, records, and other physical items in the possession of the other. This is a broad right, as it is not limited to just evidence that is admissible at trial. Discovery of physical evidence means that a plaintiff may inspect a company's accounts, customer lists, assets, profit-and-loss statements, balance sheets, engineering and quality-control reports, sales reports, and virtually any other document.

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

KEY TAKEAWAY

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

EXERCISES

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

3.4 The Pretrial and Trial Phase

LEARNING OBJECTIVES

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

After considerable discovery, one of the parties may believe that there is no triable issue of law or fact for the court to consider and may file a motion with the court for summary judgment. Unless it is very clear, the judge will deny a summary judgment motion, because that ends the case at the trial

level; it is a “final order” in the case that tells the plaintiff “no” and leaves no room to bring another lawsuit against the defendant for that particular set of facts (res judicata). If the plaintiff successfully appeals a summary judgment motion, the case will come back to the trial court.

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

Pretrial Conference

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

Trial

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

In both criminal and civil trials, each side has opportunities to challenge potential jurors for cause. For example, in the Robinsons’ case against Audi, the attorneys representing Audi will want to know if any

prospective jurors have ever owned an Audi, what their experience has been, and if they had a similar problem (or worse) with their Audi that was not resolved to their satisfaction. If so, the defense attorney could well believe that such a juror has a potential for a bias against her client. In that case, she could use a challenge for cause, explaining to the judge the basis for her challenge. The judge, at her discretion, could either accept the for-cause reason or reject it.

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

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

The plaintiff's lawyer then calls witnesses and presents the physical evidence that is relevant to her proof. The direct testimony at trial is usually far from a smooth narration. The rules of evidence (that govern the kinds of testimony and documents that may be introduced at trial) and the question-and-answer format tend to make the presentation of evidence choppy and difficult to follow.

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

After direct testimony of each witness is over, the opposing lawyer may conduct cross-examination. This is a crucial constitutional right; in criminal cases it is preserved in the Constitution's Sixth Amendment (the right to confront one's accusers in open court). The formal rules of direct testimony are then relaxed,

and the cross-examiner may probe the witness more informally, asking questions that may not seem immediately relevant. This is when the opposing attorney may become harsh, casting doubt on a witness's credibility, trying to trip her up and show that the answers she gave are false or not to be trusted. This use of cross-examination, along with the requirement that the witness must respond to questions that are at all relevant to the questions raised by the case, distinguishes common-law courts from those of authoritarian regimes around the world.

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

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

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

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

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

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

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

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

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

Posttrial Motions

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

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

Rule 50(b) says,

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

returned the court may allow the judgment to stand or may reopen the judgment and either order a new trial or direct the entry of judgment as if the requested verdict had been directed.

KEY TAKEAWAY

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

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

EXERCISES

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

3.5 Judgment, Appeal, and Execution

LEARNING OBJECTIVES

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

Judgment or Order

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

Appeal

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

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

Appellate and trial procedures are different. The appellate court does not hear witnesses or accept evidence. It reviews the *record* of the case—the transcript of the witnesses' testimony and the documents

received into evidence at trial—to try to find a legal error on a specific request of one or both of the parties. The parties' lawyers prepare briefs (written statements containing the facts in the case), the procedural steps taken, and the argument or discussion of the meaning of the law and how it applies to the facts. After reading the briefs on appeal, the appellate court may dispose of the appeal without argument, issuing a written opinion that may be very short or many pages. Often, though, the appellate court will hear oral argument. (This can be months, or even more than a year after the briefs are filed.) Each lawyer is given a short period of time, usually no more than thirty minutes, to present his client's case. The lawyer rarely gets a chance for an extended statement because he is usually interrupted by questions from the judges. Through this exchange between judges and lawyers, specific legal positions can be tested and their limits explored.

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

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

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

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

Judgment and Order

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

KEY TAKEAWAY

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

EXERCISES

1. Mrs. Robinson has a key witness on auto safety that the judge believes is not qualified as an expert. The judge examines the witness while the jury is in the jury room and disqualifies him from testifying. The jury does not get to hear this witness. Her attorney objects. She loses her case. What argument would you expect Mrs. Robinson's attorney to make in an appeal?
2. Why don't appellate courts need a witness box for witnesses to give testimony under oath?

3. A trial judge in Nevada is wondering whether to enforce a surrogate motherhood contract. Penelope Barr, of Reno, Nevada, has contracted with Reuben and Tina Goldberg to bear the in vitro fertilized egg of Mrs. Goldberg. After carrying the child for nine months, Penelope gives birth, but she is reluctant to give up the child, even though she was paid $20,000 at the start of the contract and will earn an additional $20,000 on handing over the baby to the Goldbergs. (Barr was an especially good candidate for surrogate motherhood: she had borne two perfect children and at age 28 drinks no wine, does not smoke or use drugs of any kind, practices yoga, and maintains a largely vegetarian diet with just enough meat to meet the needs of the fetus within.)

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

3.6 When Can Someone Bring a Lawsuit?

LEARNING OBJECTIVES

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

CC BY NC SA

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

Case or Controversy: Standing to Sue

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

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

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

Class Actions

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

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

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

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

Usually a person who doesn't want to be in the class can decide to leave. If she does, she will not be included in an eventual judgment or settlement. But a potential plaintiff who is included in the class

cannot, after a final judgment is awarded, seek to relitigate the issue if she is dissatisfied with the outcome, even though she did not participate at all in the legal proceeding.

KEY TAKEAWAY

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

EXERCISE

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

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

3.7 Relations with Lawyers

LEARNING OBJECTIVES

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

Legal Fees

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

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

A contingent fee is one that is paid only if the lawyer wins—that is, it is contingent, or depends upon, the success of the case. This type of fee arrangement is used most often in personal injury cases (e.g., automobile accidents, products liability, and professional malpractice). Although used quite often, the

contingent fee is controversial. Trial lawyers justify it by pointing to the high cost of preparing for such lawsuits. A typical automobile accident case can cost at least ten thousand dollars to prepare, and a complicated products-liability case can cost tens of thousands of dollars. Few people have that kind of money or would be willing to spend it on the chance that they might win a lawsuit. Corporate and professional defendants complain that the contingent fee gives lawyers a license to go big game hunting, or to file suits against those with deep pockets in the hopes of forcing them to settle.

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

Costs

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

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

KEY TAKEAWAY

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

EXERCISES

1. Mrs. Robinson's attorney estimates that they will recover a million dollars from Volkswagen in the Audi lawsuit. She has Mrs. Robinson sign a contract that gives her firm one-third of any recovery after the firm's expenses are deducted. The judge does in fact award a million dollars, and the defendant pays. The firm's expenses are $100,000. How much does Mrs. Robinson get?
2. Harry Potter brings a lawsuit against Draco Malfoy in Chestershire, England, for slander, a form of defamation. Potter alleges that Malfoy insists on calling him a mudblood. Ron Weasley testifies, as does Neville Chamberlain. But Harry loses, because the court has no conception of wizardry and cannot make sense of the case at all. In dismissing the case, however, who (under English law) will bear the costs of the attorneys who have brought the case for Potter and defended the matter for Malfoy?

3.8 Alternative Means of Resolving Disputes

LEARNING OBJECTIVES

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

Disputes do not have to be settled in court. No law requires parties who have a legal dispute to seek judicial resolution if they can resolve their disagreement privately or through some other public forum. In fact, the threat of a lawsuit can frequently motivate parties toward private negotiation. Filing a lawsuit may convince one party that the other party is serious. Or the parties may decide that

they will come to terms privately rather than wait the three or four years it can frequently take for a case to move up on the court calendar.

Arbitration

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

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

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

Many arbitrations take place under the auspices of the American Arbitration Association, a private organization headquartered in New York, with regional offices in many other cities. The association uses published sets of rules for various types of arbitration (e.g., labor arbitration or commercial arbitration);

parties who provide in contracts for arbitration through the association are agreeing to be bound by the association's rules. Similarly, the National Association of Securities Dealers provides arbitration services for disputes between clients and brokerage firms. International commercial arbitration often takes place through the auspices of the International Chamber of Commerce. A multilateral agreement known as the Convention on the Recognition and Enforcement of Arbitral Awards provides that agreements to arbitrate—and arbitral awards—will be enforced across national boundaries.

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

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

Mediation

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

KEY TAKEAWAY

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

EXERCISES

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

3.9 Cases

CC BY NC SA

Burger King v. Rudzewicz

Burger King Corp. v. Rudzewicz

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

Summary

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

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

The Drayton Plains restaurant did fairly well at first, but a recession in late 1979 caused the franchisees to fall far behind in their monthly payments to Miami. Notice of default was sent from Miami to Rudzewicz, who nevertheless continued to operate the restaurant as a Burger King franchise. Burger King sued in

federal district court for the southern district of Florida. Rudzewicz contested the court's personal jurisdiction over him, since he had never been to Florida.

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

Justice Brennan delivered the opinion of the court.

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

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

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

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

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

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

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

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

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

It is so ordered.

CASE QUESTIONS

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

Ferlito v. Johnson & Johnson

Ferlito v. Johnson & Johnson Products, Inc.

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

Gadola, J.

Plaintiffs Susan and Frank Ferlito, husband and wife, attended a Halloween party in 1984 dressed as Mary (Mrs. Ferlito) and her little lamb (Mr. Ferlito). Mrs. Ferlito had constructed a lamb costume for her husband by gluing cotton batting manufactured by defendant Johnson & Johnson Products ("JJP") to a suit of long underwear. She had also used defendant's product to fashion a headpiece, complete with ears.

The costume covered Mr. Ferlito from his head to his ankles, except for his face and hands, which were blackened with Halloween paint. At the party Mr. Ferlito attempted to light his cigarette by using a butane lighter. The flame passed close to his left arm, and the cotton batting on his left sleeve ignited. Plaintiffs sued defendant for injuries they suffered from burns which covered approximately one-third of Mr. Ferlito's body.

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

MOTION FOR JUDGMENT NOTWITHSTANDING THE VERDICT

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

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

In determining whether the evidence is sufficient, the trial court may neither weigh the evidence, pass on the credibility of witnesses nor substitute its judgment for that of the jury. Rather, the evidence must be viewed in the light most favorable to the party against whom the motion is made, drawing from that evidence all reasonable inferences in his favor. If after reviewing the evidence...the trial court is of the

opinion that reasonable minds could not come to the result reached by the jury, then the motion for j.n.o.v. should be granted.

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

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

...

A manufacturer has a duty "to warn the purchasers or users of its product about dangers associated with intended use." Conversely, a manufacturer has no duty to warn of a danger arising from an unforeseeable misuse of its product. [Citation] Thus, whether a manufacturer has a duty to warn depends on whether the use of the product and the injury sustained by it are foreseeable. Gootee v. Colt Industries Inc., 712 F.2d 1057, 1065 (6th Cir. 1983); Owens v. Allis-Chalmers Corp., 414 Mich. 413, 425, 326 N.W.2d 372 (1982). Whether a plaintiff's use of a product is foreseeable is a legal question to be resolved by the court. Trotter, *supra*. Whether the resulting injury is foreseeable is a question of fact for the jury.[2] Thomas v. International Harvester Co., 57 Mich. App. 79, 225 N.W.2d 175 (1974).

In the instant action no reasonable jury could find that JJP's failure to warn of the flammability of cotton batting was a proximate cause of plaintiffs' injuries because plaintiffs failed to offer any evidence to

establish that a flammability warning on JJP's cotton batting would have dissuaded them from using the product in the manner that they did.

Plaintiffs repeatedly stated in their response brief that plaintiff Susan Ferlito testified that "she would never again use cotton batting to make a costume...However, a review of the trial transcript reveals that plaintiff Susan Ferlito never testified that she would never again use cotton batting to make a costume. More importantly, the transcript contains no statement by plaintiff Susan Ferlito that a flammability warning on defendant JJP's product would have dissuaded her from using the cotton batting to construct the costume in the first place. At oral argument counsel for plaintiffs conceded that there was no testimony during the trial that either plaintiff Susan Ferlito or her husband, plaintiff Frank J. Ferlito, would have acted any different if there had been a flammability warning on the product's package. The absence of such testimony is fatal to plaintiffs' case; for without it, plaintiffs have failed to prove proximate cause, one of the essential elements of their negligence claim.
In addition, both plaintiffs testified that they knew that cotton batting burns when it is exposed to flame. Susan Ferlito testified that she knew at the time she purchased the cotton batting that it would burn if exposed to an open flame. Frank Ferlito testified that he knew at the time he appeared at the Halloween party that cotton batting would burn if exposed to an open flame. His additional testimony that he would not have intentionally put a flame to the cotton batting shows that he recognized the risk of injury of which he claims JJP should have warned. Because both plaintiffs were already aware of the danger, a warning by JJP would have been superfluous. Therefore, a reasonable jury could not have found that JJP's failure to provide a warning was a proximate cause of plaintiffs' injuries.

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

ORDER

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

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

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

CASE QUESTIONS

1. The opinion focuses on proximate cause. As we will see in Chapter 7 "Introduction to Tort Law", a negligence case cannot be won unless the plaintiff shows that the defendant has breached a duty and that the defendant's breach has actually and proximately caused the damage complained of. What, exactly, is the alleged breach of duty by the defendant here?
2. Explain why Judge Gadola reasoning that JJP had no duty to warn in this case. After this case, would they then have a duty to warn, knowing that someone might use their product in this way?

---

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

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

Chapter 4
Constitutional Law and US Commerce

LEARNING OBJECTIVES

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

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

7. Explain how the Bill of Rights relates to business activities in the United States.

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

4.1 Basic Aspects of the US Constitution

LEARNING OBJECTIVES

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

The Constitution as Reflecting American Values

In the US, the one document to which all public officials and military personnel pledge their unswerving allegiance is the Constitution. If you serve, you are asked to "support and defend" the Constitution "against all enemies, foreign and domestic." The oath usually includes a statement that you swear that this oath is taken freely, honestly, and without "any purpose of evasion." This loyalty oath may be related to a

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

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

The Constitution itself speaks of rights in fairly general terms, and the judicial interpretation of various rights has been in flux. The "right" of a person to own another person was notably affirmed by the Supreme Court in the *Dred Scott* decision in 1857.[1] The "right" of a child to freely contract for long, tedious hours of work was upheld by the court in *Hammer v. Dagenhart* in 1918. Both decisions were later repudiated, just as the decision that a woman has a "right" to an abortion in the first trimester of pregnancy could later be repudiated if *Roe v. Wade* is overturned by the Supreme Court.[2]

General Structure of the Constitution

Look at the Constitution. Notice that there are seven articles, starting with Article I (legislative powers), Article II (executive branch), and Article III (judiciary). Notice that there is no separate article for administrative agencies. The Constitution also declares that it is "the supreme Law of the Land" (Article VI). Following Article VII are the ten amendments adopted in 1791 that are referred to as the Bill of

Rights. Notice also that in 1868, a new amendment, the Fourteenth, was adopted, requiring states to provide "due process" and "equal protection of the laws" to citizens of the United States.

Federalism

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

Separation of Powers and Judicial Review

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

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

Because the Constitution often speaks in general terms (with broad phrases such as "due process" and "equal protection"), reasonable people have disagreed as to how those terms apply in specific cases. The United States is unique among industrialized democracies in having a Supreme Court that reserves for itself that exclusive power to interpret what the Constitution means. The famous case of *Marbury v.*

Madison began that tradition in 1803, when the Supreme Court had marginal importance in the new republic. The decision in *Bush v. Gore*, decided in December of 2000, illustrates the power of the court to shape our destiny as a nation. In that case, the court overturned a ruling by the Florida Supreme Court regarding the way to proceed on a recount of the Florida vote for the presidency. The court's ruling was purportedly based on the "equal protection of the laws" provision in the Fourteenth Amendment.

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

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

Because the Supreme Court has this power of judicial review, there have been many arguments about how it should be exercised and what kind of "philosophy" a Supreme Court justice should have. President Richard Nixon often said that a Supreme Court justice should "strictly construe" the Constitution and not add to its language. Finding law in the Constitution was "judicial activism" rather than "judicial restraint." The general philosophy behind the call for "strict constructionist" justices is that legislatures make laws in accord with the wishes of the majority, and so unelected judges should not make law according to their own views and values. Nixon had in mind the 1960s Warren court, which "found" rights in the Constitution that were not specifically mentioned—the right of privacy, for example. In later years, critics of the Rehnquist court would charge that it "found" rights that were not specifically mentioned, such as the right of states to be free from federal antidiscrimination laws. See, for example, *Kimel v. Florida Board of Regents*, or the *Citizens United v. Federal Election Commission* case (Section 4.6.5), which held that corporations are "persons" with "free speech rights" that include spending unlimited amounts of money in campaign donations and political advocacy.[3]

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

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

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

KEY TAKEAWAY

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

EXERCISES

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

---

[1] In *Scott v. Sanford* (the Dred Scott decision), the court states that Scott should remain a slave, that as a slave he is not a citizen of the United States and thus not eligible to bring suit in a federal court, and that as a slave he is personal property and thus has never been free.

[2] *Roe v. Wade*, 410 US 113 (1973).

[3] *Kimel v. Florida Board of Regents*, 528 US 62 (2000).

4.2 The Commerce Clause

LEARNING OBJECTIVES

CC BY NC SA

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

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

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

Section 8

[Clause 1] The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States;
[Clause 2] To borrow Money on the credit of the United States;

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

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

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

Early Commerce Clause Cases

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

The Supreme Court saw the issue as whether Congress had the power under the commerce clause to control interstate shipment of goods made by children under the age of fourteen. The court found that Congress did not. The court cited several cases that had considered what interstate commerce could be constitutionally regulated by Congress. In *Hipolite Egg Co. v. United States*, the Supreme Court had sustained the power of Congress to pass the Pure Food and Drug Act, which prohibited the introduction into the states by means of interstate commerce impure foods and drugs.[1] In *Hoke v. United States*, the Supreme Court had sustained the constitutionality of the so-called White Slave Traffic Act of 1910, whereby the transportation of a woman in interstate commerce for the purpose of prostitution was forbidden. In that case, the court said that Congress had the power to protect the channels of interstate commerce: "If the facility of interstate transportation can be taken away from the demoralization of lotteries, the debasement of obscene literature, the contagion of diseased cattle or persons, the impurity of

food and drugs, the like facility can be taken away from the systematic enticement to, and the enslavement in prostitution and debauchery of women, and, more insistently, of girls." [2]

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

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

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

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

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

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

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

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

Ollie McClung's barbeque place in Birmingham, Alabama, allowed "colored" people to buy takeout at the back of the restaurant but not to sit down with "white" folks inside. The US attorney sought a court order to require Ollie to serve all races and colors, but Ollie resisted on commerce clause grounds: the federal

government had no business regulating a purely local establishment. Indeed, Ollie did not advertise nationally, or even regionally, and had customers only from the local area. But the court found that some 42 percent of the supplies for Ollie's restaurant had moved in the channels of interstate commerce. This was enough to sustain federal regulation based on the commerce clause.[3]

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

Congress made no attempt to pass similar legislation after the case was decided. But in passing subsequent legislation, Congress was often careful to make a record as to why it believed it was addressing a problem that related to interstate commerce. In 1994, Congress passed the Violence Against Women Act (VAWA), having held hearings to establish why violence against women on a local level would impair interstate commerce. In 1994, while enrolled at Virginia Polytechnic Institute (Virginia Tech), Christy Brzonkala alleged that Antonio Morrison and James Crawford, both students and varsity football players at Virginia Tech, had raped her. In 1995, Brzonkala filed a complaint against Morrison and Crawford under Virginia Tech's sexual assault policy. After a hearing, Morrison was found guilty of sexual assault and sentenced to immediate suspension for two semesters. Crawford was not punished. A second hearing again found Morrison guilty. After an appeal through the university's administrative system, Morrison's

punishment was set aside, as it was found to be "excessive." Ultimately, Brzonkala dropped out of the university. Brzonkala then sued Morrison, Crawford, and Virginia Tech in federal district court, alleging that Morrison's and Crawford's attack violated 42 USC Section 13981, part of the VAWA), which provides a federal civil remedy for the victims of gender-motivated violence. Morrison and Crawford moved to dismiss Brzonkala's suit on the ground that Section 13981's civil remedy was unconstitutional. In dismissing the complaint, the district court found that that Congress lacked authority to enact Section 13981 under either the commerce clause or the Fourteenth Amendment, which Congress had explicitly identified as the sources of federal authority for the VAWA. Ultimately, the court of appeals affirmed, as did the Supreme Court.

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

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

The medical marijuana users argued that the CSA—which Congress passed using its constitutional power to regulate interstate commerce—exceeded Congress's commerce clause power. The district court ruled against the group, but the Ninth Circuit Court of Appeals reversed and ruled the CSA unconstitutional because it applied to medical marijuana use solely within one state. In doing so, the Ninth Circuit relied

on *U.S. v. Lopez* (1995) and *U.S. v. Morrison* (2000) to say that using medical marijuana did not "substantially affect" interstate commerce and therefore could not be regulated by Congress.

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

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

KEY TAKEAWAY

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

EXERCISES

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

---

[1] *Hipolite Egg Co. v. United States*, 220 US 45 (1911).

[2] *Hoke v. United States*, 227 US 308 (1913).

[3] *Katzenbach v. McClung*, 379 US 294 (1964).

4.3 Dormant Commerce Clause

LEARNING OBJECTIVES

1. Understand that when Congress does not exercise its powers under the commerce clause, the Supreme Court may still limit state legislation that discriminates against interstate commerce or places an undue burden on interstate commerce.

CC BY NC SA

2. Distinguish between “discrimination” dormant-commerce-clause cases and “undue burden” dormant-commerce-clause cases.

Congress has the power to legislate under the commerce clause and often does legislate. For example, Congress might say that trucks moving on interstate highways must not be more than seventy feet in length. But if Congress does not exercise its powers and regulate in certain areas (such as the size and length of trucks on interstate highways), states may make their own rules. States may do so under the so-called historic police powers of states that were never yielded up to the federal government.
These police powers can be broadly exercised by states for purposes of health, education, welfare, safety, morals, and the environment. But the Supreme Court has reserved for itself the power to determine when state action is excessive, even when Congress has not used the commerce clause to regulate. This power is claimed to exist in the **dormant commerce clause**.

There are two ways that a state may violate the dormant commerce clause. If a state passes a law that is an “undue burden” on interstate commerce or that “discriminates” against interstate commerce, it will be struck down. *Kassel v. Consolidated Freightways*, in Section 4.7 "Summary and Exercises", is an example of a case where Iowa imposed an undue burden on interstate commerce by prohibiting double trailers on its highways.[1] Iowa’s prohibition was judicially declared void when the Supreme Court judged it to be an undue burden.

Discrimination cases such as *Hunt v. Washington Apple Advertising Commission* (Section 4.6 "Cases") pose a different standard. The court has been fairly inflexible here: if one state discriminates in its treatment of any article of commerce based on its state of origin, the court will strike down the law. For example, in *Oregon Waste Systems v. Department of Environmental Quality*, the state wanted to place a slightly higher charge on waste coming from out of state.[2] The state’s reasoning was that in-state residents had already contributed to roads and other infrastructure and that tipping fees at waste facilities should reflect the prior contributions of in-state companies and residents. Out-of-state waste handlers who wanted to use Oregon landfills objected and won their dormant commerce clause claim that Oregon’s

law discriminated "on its face" against interstate commerce. Under the Supreme Court's rulings, anything that moves in channels of interstate commerce is "commerce," even if someone is paying to get rid of something instead of buying something.

Thus the states are bound by Supreme Court decisions under the dormant commerce clause to do nothing that differentiates between articles of commerce that originate from within the state from those that originate elsewhere. If Michigan were to let counties decide for themselves whether to take garbage from outside of the county or not, this could also be a discrimination based on a place of origin outside the state. (Suppose, for instance, each county were to decide not to take waste from outside the county; then all Michigan counties would effectively be excluding waste from outside of Michigan, which is discriminatory.)[3]

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

Dealing with Unwelcome Waste

Senator Carl Levin, January 2003

> *Michigan is facing an intolerable situation with regard to the importation of waste from other states and Canada.*
>
> *Canada is the largest source of waste imports to Michigan. Approximately 65 truckloads of waste come in to Michigan per day from Toronto alone, and an estimated 110–130 trucks come in from Canada each day.*

CC BY NC SA

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

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

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

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

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

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

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

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

KEY TAKEAWAY

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

EXERCISES

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

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

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

---

[1] *Kassell v. Consolidated Freightways*, 450 US 662 (1981).

[2] *Oregon Waste Systems v. Department of Environmental Quality*, 511 US 93 (1994).

[3] *Fort Gratiot Sanitary Landfill v. Michigan Dep't of Natural Resources*, 504 US 353 (1992).

4.4 Preemption: The Supremacy Clause

LEARNING OBJECTIVES

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

When Congress does use its power under the commerce clause, it can expressly state that it wishes to have exclusive regulatory authority. For example, when Congress determined in the 1950s to promote nuclear power ("atoms for peace"), it set up the Nuclear Regulatory Commission and provided a limitation of liability for nuclear power plants in case of a nuclear accident. The states were expressly told to stay out of the business of regulating nuclear power or the movement of nuclear materials. Thus Rochester,

Minnesota, or Berkeley, California, could declare itself a nuclear-free zone, but the federal government would have preempted such legislation. If Michigan wished to set safety standards at Detroit Edison's Fermi II nuclear reactor that were more stringent than the federal Nuclear Regulatory Commission's standards, Michigan's standards would be preempted and thus be void.

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

But Congress can allow what might appear to be inconsistencies; the existence of federal statutory standards does not always mean that local and state standards cannot be more stringent. If California wants cleaner air or water than other states, it can set stricter standards—nothing in the Clean Water Act or Clean Air Act forbids the state from setting stricter pollution standards. As the auto industry well knows, California has set stricter standards for auto emissions. Since the 1980s, most automakers have made both a federal car and a California car, because federal Clean Air Act emissions restrictions do not preempt more rigorous state standards.

Large industries and companies actually prefer regulation at the national level. It is easier for a large company or industry association to lobby in Washington, DC, than to lobby in fifty different states. Accordingly, industry often asks Congress to put preemptive language into its statutes. The tobacco industry is a case in point.

The cigarette warning legislation of the 1960s (where the federal government required warning labels on cigarette packages) effectively preempted state negligence claims based on failure to warn. When the family of a lifetime smoker who had died sued in New Jersey court, one cause of action was the company's

failure to warn of the dangers of its product. The Supreme Court reversed the jury's award based on the federal preemption of failure to warn claims under state law.[1]

The Supremacy Clause

Article VI

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

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

Preemption can be either express or implied. When Congress chooses to expressly preempt state law, the only question for courts becomes determining whether the challenged state law is one that the federal law is intended to preempt. Implied preemption presents more difficult issues. The court has to look beyond the express language of federal statutes to determine whether Congress has "occupied the field" in which the state is attempting to regulate, or whether a state law directly conflicts with federal law, or whether enforcement of the state law might frustrate federal purposes.

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

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

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

KEY TAKEAWAY

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

EXERCISES

1. For many years, the United States engaged in discussions with friendly nations as to the reciprocal use of ports and harbors. These discussions led to various multilateral agreements between the nations as to the

configuration of oceangoing vessels and how they would be piloted. At the same time, concern over oil spills in Puget Sound led the state of Washington to impose fairly strict standards on oil tankers and requirements for the training of oil tanker pilots. In addition, Washington's state law imposed many other requirements that went above and beyond agreed-upon requirements in the international agreements negotiated by the federal government. Are the Washington state requirements preempted by federal law?

2. The Federal Arbitration Act of 1925 requires that all contracts for arbitration be treated as any other contract at common law. Suppose that the state of Alabama wishes to protect its citizens from a variety of arbitration provisions that they might enter into unknowingly. Thus the legislation provides that all predispute arbitration clauses be in bold print, that they be of twelve-point font or larger, that they be clearly placed within the first two pages of any contract, and that they have a separate signature line where the customer, client, or patient acknowledges having read, understood, and signed the arbitration clause in addition to any other signatures required on the contract. The legislation does preserve the right of consumers to litigate in the event of a dispute arising with the product or service provider; that is, with this legislation, consumers will not unknowingly waive their right to a trial at common law. Is the Alabama law preempted by the Federal Arbitration Act?

---

[1] *Cippolone v. Liggett Group*, 505 US 504 (1993).

4.5 Business and the Bill of Rights

LEARNING OBJECTIVES

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

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

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

Here are some very basic principles to remember:

1. The guarantees of the Bill of Rights apply *only* to state and federal government action. They do not limit what a company or person in the private sector may do. For example, states may not impose censorship on the media or limit free speech in a way that offends the First Amendment, but your boss (in the private sector) may order you not to talk to the media.
2. In some cases, a private company may be regarded as participating in "state action." For example, a private defense contractor that gets 90 percent of its business from the federal government has been

held to be public for purposes of enforcing the constitutional right to free speech (the company had a rule barring its employees from speaking out in public against its corporate position). It has even been argued that public regulation of private activity is sufficient to convert the private into public activity, thus subjecting it to the requirements of due process. But the Supreme Court rejected this extreme view in 1974 when it refused to require private power companies, regulated by the state, to give customers a hearing before cutting off electricity for failure to pay the bill.[1]

3. States have rights, too. While "states rights" was a battle cry of Southern states before the Civil War, the question of what balance to strike between state sovereignty and federal union has never been simple. In *Kimel v. Florida*, for example, the Supreme Court found in the words of the Eleventh Amendment a basis for declaring that states may not have to obey certain federal statutes.

First Amendment

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

Because of its higher level of protection, political speech can be false, malicious, mean-spirited, or even a pack of lies. A public official in the United States must be prepared to withstand all kinds of false accusations and cannot succeed in an action for defamation unless the defendant has acted with "malice" and "reckless disregard" of the truth. Public figures, such as CEOs of the largest US banks, must also be prepared to withstand accusations that are false. In any defamation action, truth is a defense, but a defamation action brought by a public figure or public official must prove that the defendant not only has

his facts wrong but also lies to the public in a malicious way with reckless disregard of the truth. Celebrities such as Lindsay Lohan and Jon Stewart have the same burden to go forward with a defamation action. It is for this reason that the *National Enquirer* writes exclusively about public figures, public officials, and celebrities; it is possible to say many things that aren't completely true and still have the protection of the First Amendment.

Political speech is so highly protected that the court has recognized the right of people to support political candidates through campaign contributions and thus promote the particular viewpoints and speech of those candidates. Fearing the influence of money on politics, Congress has from time to time placed limitations on corporate contributions to political campaigns. But the Supreme Court has had mixed reactions over time. Initially, the court recognized the First Amendment right of a corporation to donate money, subject to certain limits.[2] In another case, *Austin v. Michigan Chamber of Commerce* (1990), the Michigan Campaign Finance Act prohibited corporations from using treasury money for independent expenditures to support or oppose candidates in elections for state offices. But a corporation could make such expenditures if it set up an independent fund designated solely for political purposes. The law was passed on the assumption that "the unique legal and economic characteristics of corporations necessitate some regulation of their political expenditures to avoid corruption or the appearance of corruption."

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

Fourth Amendment

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

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

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

Note again that constitutional guarantees like the Fourth Amendment apply to governmental action. Your employer or any private enterprise is not bound by constitutional limits. For example, if drug testing of all employees every week is done by government agency, the employees may have a cause of action to object based on the Fourth Amendment. However, if a private employer begins the same kind of routine drug testing, employees have no constitutional arguments to make; they can simply leave that employer, or they may pursue whatever statutory or common-law remedies are available.

Fifth Amendment

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

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

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

In *Kelo v. City of New London*, Mrs. Kelo and other residents fought the city of New London, in its attempt to use powers of eminent domain to create an industrial park and recreation area that would have Pfizer & Co. as a principal tenant.[3] The city argued that increasing its tax base was a sufficient public purpose. In a very close decision, the Supreme Court determined that New London's actions did not violate the takings clause. However, political reactions in various states resulted in a great deal of new state legislation that would limit the scope of public purpose in eminent domain takings and provide additional compensation to property owners in many cases.

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

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

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

The second category of fundamental liberties includes those liberties that are not expressly stated in the Bill of Rights but that can be seen as essential to the concepts of freedom and equality in a democratic society. These unstated liberties come from Supreme Court precedents, common law, moral philosophy, and deeply rooted traditions of US legal history. The Supreme Court has stressed that he word *liberty* cannot be defined by a definitive list of rights; rather, it must be viewed as a rational continuum of freedom through which every aspect of human behavior is protected from arbitrary impositions and random restraints. In this regard, as the Supreme Court has observed, the due process clause protects abstract liberty interests, including the right to personal autonomy, bodily integrity, self-dignity, and self-determination.

These liberty interests often are grouped to form a general right to privacy, which was first recognized in *Griswold v. Connecticut* (Section 4.6.1), where the Supreme Court struck down a state statute forbidding married adults from using, possessing, or distributing contraceptives on the ground that the law violated the sanctity of the marital relationship. According to Justice Douglas's plurality opinion, this penumbra of privacy, though not expressly mentioned in the Bill of Rights, must be protected to establish a buffer zone or breathing space for those freedoms that are constitutionally enumerated.

But substantive due process has seen fairly limited use since the 1930s. During the 1990s, the Supreme Court was asked to recognize a general right to die under the doctrine of substantive due process. Although the court stopped short of establishing such a far-reaching right, certain patients may exercise a constitutional liberty to hasten their deaths under a narrow set of circumstances. In *Cruzan v. Missouri Department of Health*, the Supreme Court ruled that the due process clause guarantees the right of competent adults to make advanced directives for the withdrawal of life-sustaining measures should they become incapacitated by a disability that leaves them in a persistent vegetative state.[4] Once it has been established by clear and convincing evidence that a mentally incompetent and persistently vegetative patient made such a prior directive, a spouse, parent, or other appropriate guardian may seek to terminate any form of artificial hydration or nutrition.

Fourteenth Amendment: Due Process and Equal Protection Guarantees

The Fourteenth Amendment (1868) requires that states treat citizens of other states with due process. This can be either an issue of procedural due process (as in Section 3.9 "Cases", *Burger King v. Rudzewicz*) or an issue of substantive due process. For substantive due process, consider what happened in an Alabama court not too long ago.[5]

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

"Equal protection of the laws" is a phrase that originates in the Fourteenth Amendment, adopted in 1868. The amendment provides that no state shall "deny to any person within its jurisdiction the equal protection of the laws." This is the equal protection clause. It means that, generally speaking, governments must treat people equally. Unfair classifications among people or corporations will not be permitted. A well-known example of unfair classification would be race discrimination: requiring white children and black children to attend different public schools or requiring "separate but equal" public services, such as water fountains or restrooms. Yet despite the clear intent of the 1868 amendment, "separate but equal" was the law of the land until *Brown v. Board of Education* (1954).[6]

Governments make classifications every day, so not all classifications can be illegal under the equal protection clause. People with more income generally pay a greater percentage of their income in taxes.

People with proper medical training are licensed to become doctors; people without that training cannot be licensed and commit a criminal offense if they do practice medicine. To know what classifications are permissible under the Fourteenth Amendment, we need to know what is being classified. The court has created three classifications, and the outcome of any equal protection case can usually be predicted by knowing how the court is likely to classify the case:

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

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

Under intermediate scrutiny, the city of New Orleans might limit the number of street vendors who are men. For example, suppose that the city council decreed that all street vendors must be women, thinking that would attract even more tourism. A classification like this, based on sex, will have to meet a sterner test than a classification resulting from economic or social regulation. A law like this would have to substantially relate to important government objectives. Increasingly, courts have nullified government sex classifications as societal concern with gender equality has grown. (See Shannon Faulkner's case against The Citadel, an all-male state school.)[7]

Suppose, however, that the city of New Orleans decided that no one of Middle Eastern heritage could drive a taxicab or be a street vendor. That kind of classification would be examined with strict scrutiny to see if there was any compelling justification for it. As noted, classifications such as this one are almost

never upheld. The law would be upheld only if it were necessary to promote a compelling state interest. Very few laws that have a racial or ethnic classification meet that test.

The strict scrutiny test will be applied to classifications involving racial and ethnic criteria as well as classifications that interfere with a fundamental right. In *Palmore v. Sidoti*, the state refused to award custody to the mother because her new spouse was racially different from the child.[8] This practice was declared unconstitutional because the state had made a racial classification; this was presumptively invalid, and the government could not show a compelling need to enforce such a classification through its law. An example of government action interfering with a fundamental right will also receive strict scrutiny. When New York State gave an employment preference to veterans who had been state residents at the time of entering the military, the court declared that veterans who were new to the state were less likely to get jobs and that therefore the statute interfered with the right to travel, which was deemed a fundamental right.[9]

KEY TAKEAWAY

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

EXERCISES

1. John Hanks works at ProLogis. The company decides to institute a drug-testing policy. John is a good and longtime employee but enjoys smoking marijuana on the weekends. The drug testing will involve urine samples and, semiannually, a hair sample. It is nearly certain that the drug-testing protocol that ProLogis proposes will find that Hanks is a marijuana user. The company has made it clear that it will have zero tolerance for any kind of nonprescribed controlled substances. John and several fellow employees wish to

go to court to challenge the proposed testing as “an unreasonable search and seizure.” Can he possibly succeed?

2. Larry Reed, majority leader in the Senate, is attacked in his reelection campaign by a series of ads sponsored by a corporation (Global Defense, Inc.) that does not like his voting record. The corporation is upset that Reed would not write a special provision that would favor Global Defense in a defense appropriations bill. The ads run constantly on television and radio in the weeks immediately preceding election day and contain numerous falsehoods. For example, in order to keep the government running financially, Reed found it necessary to vote for a bill that included a last-minute rider that defunded a small government program for the handicapped, sponsored by someone in the opposing party that wanted to privatize all programs for the handicapped. The ad is largely paid for by Global Defense and depicts a handicapped child being helped by the existing program and large letters saying “Does Larry Reed Just Not Care?” The ad proclaims that it is sponsored by Citizens Who Care for a Better Tomorrow. Is this protected speech? Why or why not? Can Reed sue for defamation? Why or why not?

---

[1] *Jackson v. Metropolitan Edison Co.*, 419 US 345 (1974).

[2] *Buckley v. Valeo*, 424 US 1 (1976).

[3] *Kelo v. City of New London*, 545 US 469 (2005).

[4] *Cruzan v. Missouri Department of Health*, 497 US 261 (1990).

[5] BMW of North America, Inc. v. Gore, 517 U.S. 559 (1996)

[6] *Plessy v. Ferguson*, 163 US 537 (1896).

[7] *United States v. Virginia*, 518 US 515 (1996).

[8] *Palmore v. Sidoti*, 466 US 429 (1984).

[9] *Atty. Gen. of New York v. Soto-Lopez*, 476 US 898 (1986).

4.6 Cases

Griswold v. Connecticut

Griswold v. Connecticut

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

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

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

Plurality Opinion by Justice William O. Douglass

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

[Previous] cases suggest that specific guarantees in the Bill of Rights have penumbras, formed by emanations from those guarantees that help give them life and substance....Various guarantees create zones of privacy. The right of association contained in the penumbra of the First Amendment is one....The Third Amendment in its prohibition against the quartering of soldiers "in any house" in time of peace without the consent of the owner is another facet of that privacy.

The Fourth Amendment explicitly affirms the "right of the people to be secure in their persons, houses, papers and effects, against unreasonable searches and seizures." The Fifth Amendment in its Self-Incrimination Clause enables the citizen to create a zone of privacy which the government may not force him to surrender to his detriment. The Ninth Amendment provides: "The enumeration in the Constitution, of certain rights, shall not be construed to deny or disparage others retained by the people."

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

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

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

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

Since 1879 Connecticut has had on its books a law which forbids the use of contraceptives by anyone. I think this is an uncommonly silly law. As a practical matter, the law is obviously unenforceable, except in the oblique context of the present case. As a philosophical matter, I believe the use of contraceptives in the relationship of marriage should be left to personal and private choice, based upon each individual's moral,

ethical, and religious beliefs. As a matter of social policy, I think professional counsel about methods of birth control should be available to all, so that each individual's choice can be meaningfully made. But we are not asked in this case to say whether we think this law is unwise, or even asinine. We are asked to hold that it violates the United States Constitution. And that I cannot do.

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

...

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

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

passed by the elected representatives of the people of the State of Connecticut would have caused James Madison no little wonder.

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

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

CASE QUESTIONS

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

Wickard v. Filburn

Wickard v. Filburn

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

Mr. Justice Jackson delivered the opinion of the Court.

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

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

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

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

Kassel v. Consolidated Freightways Corp.

Kassel v. Consolidated Freightways Corp.

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

CC BY NC SA

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

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

I

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

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

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

...

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

In a 14-day trial, both sides adduced evidence on safety and on the burden on interstate commerce imposed by Iowa's law. On the question of safety, the District Court found that the "evidence clearly establishes that the twin is as safe as the semi." 475 F.Supp. 544, 549 (SD Iowa 1979). For that reason, "there is no valid safety reason for barring twins from Iowa's highways because of their configuration....The evidence convincingly, if not overwhelmingly, establishes that the 65-foot twin is as safe as, if not safer than, the 60-foot twin and the 55-foot semi...."

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

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

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

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

II

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

The Commerce Clause does not, of course, invalidate all state restrictions on commerce. It has long been recognized that, "in the absence of conflicting legislation by Congress, there is a residuum of power in the

state to make laws governing matters of local concern which nevertheless in some measure affect interstate commerce or even, to some extent, regulate it." *Southern Pacific Co. v. Arizona*, 325 U.S. 761 (1945).

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

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

III

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

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

A

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

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

The first two of these characteristics are of limited relevance on modern interstate highways. As the District Court found, the negligible difference in the time required to pass, and to cross intersections, is insignificant on 4-lane divided highways, because passing does not require crossing into oncoming traffic

lanes, *Raymond*, 434 U.S. at 444, and interstates have few, if any, intersections. The concern over backing capability also is insignificant, because it seldom is necessary to back up on an interstate. In any event, no evidence suggested any difference in backing capability between the 60-foot doubles that Iowa permits and the 65-foot doubles that it bans. Similarly, although doubles tend to jackknife somewhat more than singles, 65-foot doubles actually are less likely to jackknife than 60-foot doubles.

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

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

B

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

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

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

[IV. Omitted]

V

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

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

It is so ordered.

CASE QUESTIONS

1. Under the Constitution, what gives Iowa the right to make rules regarding the size or configuration of trucks upon highways within the state?
2. Did Iowa try to exempt trucking lines based in Iowa, or was the statutory rule nondiscriminatory as to the origin of trucks that traveled on Iowa highways?

3. Are there any federal size or weight standards noted in the case? Is there any kind of truck size or weight that could be limited by Iowa law, or must Iowa simply accept federal standards or, if none, impose no standards at all?

Hunt v. Washington Apple Advertising Commission

Hunt v. Washington Apple Advertising Commission

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

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

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

[In] 1972, the North Carolina Board of Agriculture adopted an administrative regulation, unique in the 50 States, which in effect required all closed containers of apples shipped into or sold in the State to display either the applicable USDA grade or a notice indicating no classification. State grades were expressly prohibited. In addition to its obvious consequence—prohibiting the display of Washington State apple grades on containers of apples shipped into North Carolina—the regulation presented the Washington apple industry with a marketing problem of potentially nationwide significance. Washington apple

growers annually ship in commerce approximately 40 million closed containers of apples, nearly 500,000 of which eventually find their way into North Carolina, stamped with the applicable Washington State variety and grade. [Compliance] with North Carolina's unique regulation would have required Washington growers to obliterate the printed labels on containers shipped to North Carolina, thus giving their product a damaged appearance. Alternatively, they could have changed their marketing practices to accommodate the needs of the North Carolina market, i.e., repack apples to be shipped to North Carolina in containers bearing only the USDA grade, and/or store the estimated portion of the harvest destined for that market in such special containers. As a last resort, they could discontinue the use of the preprinted containers entirely. None of these costly and less efficient options was very attractive to the industry. Moreover, in the event a number of other States followed North Carolina's lead, the resultant inability to display the Washington grades could force the Washington growers to abandon the State's expensive inspection and grading system which their customers had come to know and rely on over the 60-odd years of its existence....

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

...

[North Carolina] maintains that [the] burdens on the interstate sale of Washington apples were far outweighed by the local benefits flowing from what they contend was a valid exercise of North Carolina's [police powers]. Prior to the statute's enactment,...apples from 13 different States were shipped into North Carolina for sale. Seven of those States, including [Washington], had their own grading systems which, while differing in their standards, used similar descriptive labels (e.g., fancy, extra fancy, etc.). This multiplicity of inconsistent state grades [posed] dangers of deception and confusion not only in the North

Carolina market, but in the Nation as a whole. The North Carolina statute, appellants claim, was enacted to eliminate this source of deception and confusion. [Moreover], it is contended that North Carolina sought to accomplish this goal of uniformity in an evenhanded manner as evidenced by the fact that its statute applies to all apples sold in closed containers in the State without regard to their point of origin. [As] the appellants properly point out, not every exercise of state authority imposing some burden on the free flow of commerce is invalid, [especially] when the State acts to protect its citizenry in matters pertaining to the sale of foodstuffs. By the same token, however, a finding that state legislation furthers matters of legitimate local concern, even in the health and consumer protection areas, does not end the inquiry. Rather, when such state legislation comes into conflict with the Commerce Clause's overriding requirement of a national "common market," we are confronted with the task of effecting an accommodation of the competing national and local interests. We turn to that task.

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

Second, the statute has the effect of *stripping away* from the Washington apple industry the competitive and economic advantages it has earned for itself through its expensive inspection and grading system. The record demonstrates that the Washington apple-grading system has gained nationwide acceptance in the apple trade. [The record] contains numerous affidavits [stating a] preference [for] apples graded under the Washington, as opposed to the USDA, system because of the former's greater consistency, its

CC BY NC SA

emphasis on color, and its supporting mandatory inspections. Once again, the statute had no similar impact on the North Carolina apple industry and thus operated to its benefit.

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

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

...

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

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

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

CASE QUESTIONS

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

Citizens United v. Federal Election Commission

Citizens United v. Federal Election Commission

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

Justice Kennedy delivered the opinion of the Court.

CC BY NC SA

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

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

I

A

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

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

In December 2007, a cable company offered, for a payment of $1.2 million, to make *Hillary* available on a video-on-demand channel called "Elections '08."...Citizens United was prepared to pay for the video-on-demand; and to promote the film, it produced two 10-second ads and one 30-second ad for *Hillary*. Each

CC BY NC SA

ad includes a short (and, in our view, pejorative) statement about Senator Clinton, followed by the name of the movie and the movie's Website address. Citizens United desired to promote the video-on-demand offering by running advertisements on broadcast and cable television.

B

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

C

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

disclosure requirements, BCRA §§201 and 311, are unconstitutional as applied to *Hillary* and to the three ads for the movie.

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

...

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

II

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

III

The First Amendment provides that "Congress shall make no law...abridging the freedom of speech." Laws enacted to control or suppress speech may operate at different points in the speech process....The law before us is an outright ban, backed by criminal sanctions. Section 441b makes it a felony for all corporations—including nonprofit advocacy corporations—either to expressly advocate the election or defeat of candidates or to broadcast electioneering communications within 30 days of a primary election and 60 days of a general election. Thus, the following acts would all be felonies under §441b: The Sierra

CC BY NC SA

Club runs an ad, within the crucial phase of 60 days before the general election, that exhorts the public to disapprove of a Congressman who favors logging in national forests; the National Rifle Association publishes a book urging the public to vote for the challenger because the incumbent U.S. Senator supports a handgun ban; and the American Civil Liberties Union creates a Web site telling the public to vote for a Presidential candidate in light of that candidate's defense of free speech. These prohibitions are classic examples of censorship.

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

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

PACs have to comply with these regulations just to speak. This might explain why fewer than 2,000 of the millions of corporations in this country have PACs. PACs, furthermore, must exist before they can speak. Given the onerous restrictions, a corporation may not be able to establish a PAC in time to make its views known regarding candidates and issues in a current campaign.
Section 441b's prohibition on corporate independent expenditures is thus a ban on speech. As a "restriction on the amount of money a person or group can spend on political communication during a campaign," that statute "necessarily reduces the quantity of expression by restricting the number of issues discussed, the depth of their exploration, and the size of the audience reached." *Buckley v. Valeo*, 424 U.S. 1 at 19 (1976)....

Speech is an essential mechanism of democracy, for it is the means to hold officials accountable to the people. See *Buckley*, *supra*, at 14–15 ("In a republic where the people are sovereign, the ability of the

citizenry to make informed choices among candidates for office is essential.") The right of citizens to inquire, to hear, to speak, and to use information to reach consensus is a precondition to enlightened self-government and a necessary means to protect it. The First Amendment "'has its fullest and most urgent application' to speech uttered during a campaign for political office."

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

...

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

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

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

associations of citizens—those that have taken on the corporate form—are penalized for engaging in the same political speech.

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

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

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

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

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

and not a mechanical formula of adherence to the latest decision." *Helvering* v. *Hallock*, 309 U.S. 106 at 119 (1940).

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

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

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

[IV. Omitted]

V

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

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

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

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

It is so ordered.

CASE QUESTIONS

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

4.7 Summary and Exercises

Summary

The US. Constitution sets the framework for all other laws of the United States, at both the federal and the state level. It creates a shared balance of power between states and the federal government (federalism) and shared power among the branches of government (separation of powers), establishes individual rights

against governmental action (Bill of Rights), and provides for federal oversight of matters affecting interstate commerce and commerce with foreign nations. Knowing the contours of the US legal system is not possible without understanding the role of the US Constitution.

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

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

EXERCISES

1. For many years, the Supreme Court believed that "commercial speech" was entitled to less protection than other forms of speech. One defining element of commercial speech is that its dominant theme is to propose a commercial transaction. This kind of speech is protected by the First Amendment, but the government is permitted to regulate it more closely than other forms of speech. However, the government must make reasonable distinctions, must narrowly tailor the rules restricting commercial speech, and must show that government has a legitimate goal that the law furthers.

   Edward Salib owned a Winchell's Donut House in Mesa, Arizona. To attract customers, he displayed large signs in store windows. The city ordered him to remove the signs because they violated the city's sign code, which prohibited covering more than 30 percent of a store's windows with signs. Salib sued, claiming that the sign code violated his First Amendment rights. What was the result, and why?
2. Jennifer is a freshman at her local public high school. Her sister, Jackie, attends a nearby private high school. Neither school allows them to join its respective wrestling team; only boys can wrestle at either

school. Do either of them have a winning case based on the equal protection clause of the Fourteenth Amendment?

3. The employees of the US Treasury Department that work the border crossing between the United States and Mexico learned that they will be subject to routine drug testing. The customs bureau, which is a division of the treasury department, announces this policy along with its reasoning: since customs agents must routinely search for drugs coming into the United States, it makes sense that border guards must themselves be completely drug-free. Many border guards do not use drugs, have no intention of using drugs, and object to the invasion of their privacy. What is the constitutional basis for their objection?
4. Happy Time Chevrolet employs Jim Bydalek as a salesman. Bydalek takes part in a Gay Pride March in Los Angeles, is interviewed by a local news camera crew, and reports that he is gay and proud of it. His employer is not, and he is fired. Does he have any constitutional causes of action against his employer?
5. You begin work at the Happy-Go-Lucky Corporation on Halloween. On your second day at work, you wear a political button on your coat, supporting your choice for US senator in the upcoming election. Your boss, who is of a different political persuasion, looks at the button and says, “Take that stupid button off or you’re fired.” Has your boss violated your constitutional rights?
6. David Lucas paid $975,000 for two residential parcels on the Isle of Palms near Charleston, South Carolina. His intention was to build houses on them. Two years later, the South Carolina legislature passed a statute that prohibited building beachfront properties. The purpose was to leave the dunes system in place to mitigate the effects of hurricanes and strong storms. The South Carolina Coastal Commission created the rules and regulations with substantial input from the community and from experts and with protection of the dune system primarily in mind. People had been building on the shoreline for years, with harmful results to localities and the state treasury. When Lucas applied for permits to build two houses near the shoreline, his permits were rejected. He sued, arguing that the South Carolina legislation had effectively “taken” his property. At trial, South Carolina conceded that because of the legislation, Lucas’s property was effectively worth zero. Has there been a taking under the Fifth Amendment (as incorporated through the Fourteenth Amendment), and if so, what should the state owe to Lucas? Suppose that Lucas could have made an additional $1 million by building a house on each of his parcels. Is he entitled to recover his original purchase price or his potential profits?

SELF-TEST QUESTIONS

1 Harvey filed a suit against the state of Colorado, claiming that a Colorado state law violates the commerce clause. The court will agree if the statute

a. places an undue burden on interstate commerce

b. promotes the public health, safety, morals, or general welfare of Colorado

c. regulates economic activities within the state's borders

d. a and b

e. b and c

2 The state legislature in Maine enacts a law that directly conflicts with a federal law. Mapco Industries, located in Portland, Maine, cannot comply with both the state and the federal law.

a. Because of federalism, the state law will have priority, as long as Maine is using its police powers.

b. Because there's a conflict, both laws are invalid; the state and the federal government will have to work out a compromise of some sort.

c. The federal law preempts the state law.

d. Both laws govern concurrently.

3 Hannah, who lives in Ada, is the owner of Superior Enterprises, Inc. She believes that certain actions in the state of Ohio infringe on her federal constitutional rights, especially those found in the Bill of Rights. Most of these rights apply to the states under

a. the supremacy clause

b. the protection clause

c. the due process clause of the Fourteenth Amendment

d. the Tenth Amendment

4 Minnesota enacts a statute that bans all advertising that is in "bad taste," "vulgar," or "indecent." In Michigan, Aaron Calloway and his brother, Clarence "Cab" Calloway, create unique beer that they decide to call Old Fart Ale. In their marketing, the brothers have a label in which an older man in a dirty T-shirt is sitting in easy chair, looking disheveled and having a three-day growth of stubble on

his chin. It appears that the man is in the process of belching. He is also holding a can of Old Fart Ale. The Minnesota liquor commission orders all Minnesota restaurants, bars, and grocery stores to remove Old Fart Ale from their shelves. The state statute and the commission's order are likely to be held by a court to be

a. a violation of the Tenth Amendment
b. a violation of the First Amendment
c. a violation of the Calloways' right to equal protection of the laws
d. a violation of the commerce clause, since only the federal laws can prevent an article of commerce from entering into Minnesota's market

5 Raunch Unlimited, a Virginia partnership, sells smut whenever and wherever it can. Some of its material is "obscene" (meeting the Supreme Court's definition under *Miller v. California*) and includes child pornography. North Carolina has a statute that criminalizes obscenity. What are possible results if a store in Raleigh, North Carolina, carries Raunch merchandise?

a. The partners could be arrested in North Carolina and may well be convicted.
b. The materials in Raleigh may be the basis for a criminal conviction.
c. The materials are protected under the First Amendment's right of free speech.
d. The materials are protected under state law.
e. a and b

SELF-TEST ANSWERS

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

CC BY NC SA

Chapter 5
Administrative Law

LEARNING OBJECTIVES

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

1. Understand the purpose served by federal administrative agencies.
2. Know the difference between executive branch agencies and independent agencies.
3. Understand the political control of agencies by the president and Congress.
4. Describe how agencies make rules and conduct hearings.
5. Describe how courts can be used to challenge administrative rulings.

From the 1930s on, administrative agencies, law, and procedures have virtually remade our government and much of private life. Every day, business must deal with rules and decisions of state and federal administrative agencies. Informally, such rules are often called regulations, and they differ (only in their source) from laws passed by Congress and signed into law by the president. The rules created by agencies are voluminous: thousands of new regulations pour forth each year. The overarching question of whether there is too much regulation—or the wrong kind of regulation—of our economic activities is an important one but well beyond the scope of this chapter, in which we offer an overview of the purpose of administrative agencies, their structure, and their impact on business.

5.1 Administrative Agencies: Their Structure and Powers

LEARNING OBJECTIVES

1. Explain the reasons why we have federal administrative agencies.
2. Explain the difference between executive branch agencies and independent agencies.
3. Describe the constitutional issue that questions whether administrative agencies could have authority to make enforceable rules that affect business.

Why Have Administrative Agencies?

The US Constitution mentions only three branches of government: legislative, executive, and judicial (Articles I, II, and III). There is no mention of agencies in the Constitution, even though federal agencies are sometimes referred to as "the fourth branch of government." The Supreme Court has recognized the legitimacy of federal **administrative agencies** to make rules that have the same binding effect as statutes by Congress.

Most commentators note that having agencies with rule-making power is a practical necessity: (1) Congress does not have the expertise or continuity to develop specialized knowledge in various areas (e.g., communications, the environment, aviation). (2) Because of this, it makes sense for Congress to set forth broad statutory guidance to an agency and delegate authority to the agency to propose rules that further the statutory purposes. (3) As long as Congress makes this delegating guidance sufficiently clear, it is not delegating improperly. If Congress's guidelines are too vague or undefined, it is (in essence) giving away its constitutional power to some other group, and this it cannot do.

Why Regulate the Economy at All?

The market often does not work properly, as economists often note. Monopolies, for example, happen in the natural course of human events but are not always desirable. To fix this, well-conceived and objectively enforced competition law (what is called antitrust law in the United States) is needed.

Negative externalities must be "fixed," as well. For example, as we see in tort law (Chapter 7 "Introduction to Tort Law"), people and business organizations often do things that impose costs (damages) on others, and the legal system will try—through the award of compensatory damages—to make fair adjustments. In terms of the ideal conditions for a free market, think of tort law as the legal system's attempt to compensate for negative externalities: those costs imposed on people who have not voluntarily consented to bear those costs.

In terms of freedoms to enter or leave the market, the US constitutional guarantees of equal protection can prevent local, state, and federal governments from imposing discriminatory rules for commerce that would keep minorities, women, and gay people from full participation in business. For example, if the small town of Xenophobia, Colorado, passed a law that required all business owners and their employees to be Christian, heterosexual, and married, the equal protection clause (as well as numerous state and federal equal opportunity employment laws) would empower plaintiffs to go to court and have the law struck down as unconstitutional.

Knowing that information is power, we will see many laws administered by regulatory agencies that seek to level the playing field of economic competition by requiring disclosure of the most pertinent information for consumers (consumer protection laws), investors (securities laws), and citizens (e.g., the toxics release inventory laws in environmental law).

Ideal Conditions for a Free Market

1. There are many buyers and many sellers, and none of them has a substantial share of the market.
2. All buyers and sellers in the market are free to enter the market or leave it.

3. All buyers and all sellers have full and perfect knowledge of what other buyers and sellers are up to, including knowledge of prices, quantity, and quality of all goods being bought or sold.
4. The goods being sold in the market are similar enough to each other that participants do not have strong preferences as to which seller or buyer they deal with.
5. The costs and benefits of making or using the goods that are exchanged in the market are borne only by those who buy or sell those goods and not by third parties or people "external" to the market transaction. (That is, there are no "externalities.")
6. All buyers and sellers are utility maximizers; each participant in the market tries to get as much as possible for as little as possible.
7. There are no parties, institutions, or governmental units regulating the price, quantity, or quality of any of the goods being bought and sold in the market.

In short, some forms of legislation and regulation are needed to counter a tendency toward consolidation of economic power and discriminatory attitudes toward certain individuals and groups and to insist that people and companies clean up their own messes and not hide information that would empower voluntary choices in the free market.

But there are additional reasons to regulate. For example, in economic systems, it is likely for natural monopolies to occur. These are where one firm can most efficiently supply all of the good or service. Having duplicate (or triplicate) systems for supplying electricity, for example, would be inefficient, so most states have a public utilities commission to determine both price and quality of service. This is direct regulation.

Sometimes destructive competition can result if there is no regulation. Banking and insurance are good examples of this. Without government regulation of banks (setting standards and methods), open and fierce competition would result in widespread bank failures. That would erode public confidence in banks and business generally. The current situation (circa 2011) of six major banks that are "too big to fail" is, however, an example of destructive *noncompetition*.

Other market imperfections can yield a demand for regulation. For example, there is a need to regulate frequencies for public broadcast on radio, television, and other wireless transmissions (for police, fire, national defense, etc.). Many economists would also list an adequate supply of public goods as something that must be created by government. On its own, for example, the market would not provide public goods such as education, a highway system, lighthouses, a military for defense.

True laissez-faire capitalism—a market free from any regulation—would not try to deal with market imperfections and would also allow people to freely choose products, services, and other arrangements that historically have been deemed socially unacceptable. These would include making enforceable contracts for the sale and purchase of persons (slavery), sexual services, "street drugs" such as heroin or crack cocaine, votes for public office, grades for this course in business law, and even marriage partnership.

Thus the free market in actual terms—and not in theory—consists of commerce legally constrained by what is economically desirable and by what is socially desirable as well. Public policy objectives in the social arena include ensuring equal opportunity in employment, protecting employees from unhealthy or unsafe work environments, preserving environmental quality and resources, and protecting consumers from unsafe products. Sometimes these objectives are met by giving individuals statutory rights that can be used in bringing a complaint (e.g., Title VII of the Civil Rights Act of 1964, for employment discrimination), and sometimes they are met by creating agencies with the right to investigate and monitor and enforce statutory law and regulations created to enforce such law (e.g., the Environmental Protection Agency, for bringing a lawsuit against a polluting company).

History of Federal Agencies

Through the commerce clause in the US Constitution, Congress has the power to regulate trade between the states and with foreign nations. The earliest federal agency therefore dealt with trucking and railroads, to literally set the rules of the road for interstate commerce. The first federal agency, the Interstate Commerce Commission (ICC), was created in 1887. Congress delegated to the ICC the power to enforce

federal laws against railroad rate discrimination and other unfair pricing practices. By the early part of this century, the ICC gained the power to fix rates. From the 1970s through 1995, however, Congress passed deregulatory measures, and the ICC was formally abolished in 1995, with its powers transferred to the Surface Transportation Board.

Beginning with the Federal Trade Commission (FTC) in 1914, Congress has created numerous other agencies, many of them familiar actors in American government. Today more than eighty-five federal agencies have jurisdiction to regulate some form of private activity. Most were created since 1930, and more than a third since 1960. A similar growth has occurred at the state level. Most states now have dozens of regulatory agencies, many of them overlapping in function with the federal bodies.

Classification of Agencies

Independent agencies are different from federal executive departments and other executive agencies by their structural and functional characteristics. Most executive departments have a single director, administrator, or secretary appointed by the president of the United States. Independent agencies almost always have a commission or board consisting of five to seven members who share power over the agency. The president appoints the commissioners or board subject to Senate confirmation, but they often serve with staggered terms and often for longer terms than a usual four-year presidential term. They cannot be removed except for "good cause." This means that most presidents will not get to appoint all the commissioners of a given independent agency. Most independent agencies have a statutory requirement of bipartisan membership on the commission, so the president cannot simply fill vacancies with members of his own political party.

In addition to the ICC and the FTC, the major independent agencies are the Federal Communications Commission (1934), Securities and Exchange Commission (1934), National Labor Relations Board (1935), and Environmental Protection Agency (1970). See Note 5.4 "Ideal Conditions for a Free Market" in the sidebar.

By contrast, members of executive branch agencies serve at the pleasure of the president and are therefore far more amenable to political control. One consequence of this distinction is that the rules that independent agencies promulgate may not be reviewed by the president or his staff—only Congress may directly overrule them—whereas the White House or officials in the various cabinet departments may oversee the work of the agencies contained within them (unless specifically denied the power by Congress).

Powers of Agencies

Agencies have a variety of powers. Many of the original statutes that created them, like the Federal Communications Act, gave them licensing power. No party can enter into the productive activity covered by the act without prior license from the agency—for example, no utility can start up a nuclear power plant unless first approved by the Nuclear Regulatory Commission. In recent years, the move toward deregulation of the economy has led to diminution of some licensing power. Many agencies also have the authority to set the rates charged by companies subject to the agency's jurisdiction. Finally, the agencies can regulate business practices. The FTC has general jurisdiction over all business in interstate commerce to monitor and root out "unfair acts" and "deceptive practices." The Securities and Exchange Commission (SEC) oversees the issuance of corporate securities and other investments and monitors the practices of the stock exchanges.

Unlike courts, administrative agencies are charged with the responsibility of carrying out a specific assignment or reaching a goal or set of goals. They are not to remain neutral on the various issues of the day; they must act. They have been given legislative powers because in a society growing ever more complex, Congress does not know how to legislate with the kind of detail that is necessary, nor would it have the time to approach all the sectors of society even if it tried. Precisely because they are to do what general legislative bodies cannot do, agencies are specialized bodies. Through years of experience in dealing with similar problems they accumulate a body of knowledge that they can apply to accomplish their statutory duties.

All administrative agencies have two different sorts of personnel. The heads, whether a single administrator or a collegial body of commissioners, are political appointees and serve for relatively limited terms. Below them is a more or less permanent staff—the bureaucracy. Much policy making occurs at the staff level, because these employees are in essential control of gathering facts and presenting data and argument to the commissioners, who wield the ultimate power of the agencies.

The Constitution and Agencies

Congress can establish an agency through legislation. When Congress gives powers to an agency, the legislation is known as an **enabling act**. The concept that Congress can delegate power to an agency is known as the **delegation doctrine**. Usually, the agency will have all three kinds of power: executive, legislative, and judicial. (That is, the agency can set the rules that business must comply with, can investigate and prosecute those businesses, and can hold administrative hearings for violations of those rules. They are, in effect, rule maker, prosecutor, and judge.) Because agencies have all three types of governmental powers, important constitutional questions were asked when Congress first created them. The most important question was whether Congress was giving away its legislative power. Was the separation of powers violated if agencies had power to make rules that were equivalent to legislative statutes?

In 1935, in *Schechter Poultry Corp. v. United States*, the Supreme Court overturned the National Industrial Recovery Act on the ground that the congressional delegation of power was too broad.[1] Under the law, industry trade groups were granted the authority to devise a code of fair competition for the entire industry, and these codes became law if approved by the president. No administrative body was created to scrutinize the arguments for a particular code, to develop evidence, or to test one version of a code against another. Thus it was unconstitutional for the Congress to transfer all of its legislative powers to an agency. In later decisions, it was made clear that Congress could delegate some of its legislative powers, but only if the delegation of authority was not overly broad.

Still, some congressional enabling acts are very broad, such as the enabling legislation for the Occupational Safety and Health Administration (OSHA), which is given the authority to make rules to

provide for safe and healthful working conditions in US workplaces. Such a broad initiative power gives OSHA considerable discretion. But, as noted in Section 5.2 "Controlling Administrative Agencies", there are both executive and judicial controls over administrative agency activities, as well as ongoing control by Congress through funding and the continuing oversight of agencies, both in hearings and through subsequent statutory amendments.

KEY TAKEAWAY

Congress creates administrative agencies through enabling acts. In these acts, Congress must delegate authority by giving the agency some direction as to what it wants the agency to do. Agencies are usually given broad powers to investigate, set standards (promulgating regulations), and enforce those standards. Most agencies are executive branch agencies, but some are independent.

EXERCISES

1. Explain why Congress needs to delegate rule-making authority to a specialized agency.
2. Explain why there is any need for interference in the market by means of laws or regulations.

---

[1] *Schechter Poultry Corp. v. United States*, 295 US 495 (1935).

5.2 Controlling Administrative Agencies

LEARNING OBJECTIVES

1. Understand how the president controls administrative agencies.

CC BY NC SA

2. Understand how Congress controls administrative agencies.
3. Understand how the courts can control administrative agencies.

During the course of the past seventy years, a substantial debate has been conducted, often in shrill terms, about the legitimacy of administrative lawmaking. One criticism is that agencies are "captured" by the industry they are directed to regulate. Another is that they overregulate, stifling individual initiative and the ability to compete. During the 1960s and 1970s, a massive outpouring of federal law created many new agencies and greatly strengthened the hands of existing ones. In the late 1970s during the Carter administration, Congress began to deregulate American society, and deregulation increased under the Reagan administration. But the accounting frauds of WorldCom, Enron, and others led to the Sarbanes-Oxley Act of 2002, and the financial meltdown of 2008 has led to reregulation of the financial sector. It remains to be seen whether the Deepwater Horizon oil blowout of 2010 will lead to more environmental regulations or a rethinking on how to make agencies more effective regulators.

Administrative agencies are the focal point of controversy because they are policy-making bodies, incorporating facets of legislative, executive, and judicial power in a hybrid form that fits uneasily at best in the framework of American government (see Figure 5.1 "Major Administrative Agencies of the United States"). They are necessarily at the center of tugging and hauling by the legislature, the executive branch, and the judiciary, each of which has different means of exercising political control over them. In early 1990, for example, the Bush administration approved a Food and Drug Administration regulation that limited disease-prevention claims by food packagers, reversing a position by the Reagan administration in 1987 permitting such claims.

Figure 5.1 *Major Administrative Agencies of the United States*



The major independent regulatory agencies
- Consumer Product Safety Commission
- Environmental Protection Agency
- Equal Employment Opportunity Commission
- Federal Communications Commission
- Federal Energy Regulatory Commission
- Federal Reserve Commission
- Federal Trade Commission
- National Labor Relations Board
- Occupational Safety and Health Administration
- Securities ad Exchange Commission

The major agencies within the Executive Branch*
- **Department of Agriculture**
  - Farmers Home Administration
  - Forest Service
  - Food Safety and Inspection Service
  - Rural Electrification Administration
- **Department of Commerce**
  - Bureau of the Census
  - Bureau of Export Administration
  - Patent and Trademark Office
  - National Institute of Standards
- **Department of Defense**
  - Army, Air Force, Navy, Marines
- **Department of Education**
- **Department of Energy**
- **Department of Health and Human Services**
- **Department of Homeland Security**
  - Transportation Security Administration
  - U.S. Customs and Border Protection
  - U.S. Citizenship and Immigration Services
  - United States Coast Guard
  - United States Secret Service
- **Department of Housing and Urban Development**
- **Department of the Interior**
  - U.S. Fish and Wildlife Service
  - National Park Service
  - Bureau of Indian Affairs
  - Minerals Management Service
- **Department of Justice**
  - F.B.I. (Federal Bureau of Investigation)
  - Antitrust Division
  - Civil Division
  - Criminal Division
  - Civil Rights Division
  - Drug Enforcement Administration
- **Department of Labor**
- **Department of State**
- **Department of Transportation**
  - Federal Aviation Administration
  - Federal Highway Administration
  - Federal Railroad Administration
  - National Highway Traffic Safety Administration
  - United States Coast Guard
- **Department of Treasury**
  - Bureau of Alcohol, Tobacco, and Firearms
  - Internal Revenue Service
  - United States Mint
  - Bureau of Engraving and Printing

* With selected well-known sub-departments.

Legislative Control

Congress can always pass a law repealing a regulation that an agency promulgates. Because this is a time-consuming process that runs counter to the reason for creating administrative bodies, it happens rarely. Another approach to controlling agencies is to reduce or threaten to reduce their appropriations. By retaining ultimate control of the purse strings, Congress can exercise considerable informal control over regulatory policy.

Executive Control

The president (or a governor, for state agencies) can exercise considerable control over agencies that are part of his cabinet departments and that are not statutorily defined as independent. Federal agencies, moreover, are subject to the fiscal scrutiny of the Office of Management and Budget (OMB), subject to the direct control of the president. Agencies are not permitted to go directly to Congress for increases in budget; these requests must be submitted through the OMB, giving the president indirect leverage over the continuation of administrators' programs and policies.

Judicial Review of Agency Actions

Administrative agencies are creatures of law and like everyone else must obey the law. The courts have jurisdiction to hear claims that the agencies have overstepped their legal authority or have acted in some unlawful manner.

Courts are unlikely to overturn administrative actions, believing in general that the agencies are better situated to judge their own jurisdiction and are experts in rulemaking for those matters delegated to them by Congress. Some agency activities are not reviewable, for a number of reasons. However, after a business (or some other interested party) has exhausted all administrative remedies, it may seek judicial review of a final agency decision. The reviewing court is often asked to strike down or modify agency actions on several possible bases (see Section 5.5.2 "Strategies for Obtaining Judicial Review" on "Strategies for Obtaining Judicial Review").

KEY TAKEAWAY

Administrative agencies are given unusual powers: to legislate, investigate, and adjudicate. But these powers are limited by executive and legislative controls and by judicial review.

EXERCISES

1. Find the website of the Consumer Product Safety Commission (CPSC). Identify from that site a product that has been banned by the CPSC for sale in the United States. What reasons were given for its exclusion from the US market?
2. What has Congress told the CPSC to do in its enabling act? Is this a clear enough mandate to guide the agency? What could Congress do if the CPSC does something that may be outside of the scope of its powers? What can an affected business do?

5.3 The Administrative Procedure Act

LEARNING OBJECTIVES

1. Understand why the Administrative Procedure Act was needed.
2. Understand how hearings are conducted under the act.
3. Understand how the act affects rulemaking by agencies.

In 1946, Congress enacted the **Administrative Procedure Act (APA)**. This fundamental statute detailed for all federal administrative agencies how they must function when they are deciding cases or issuing regulations, the two basic tasks of administration. At the state level, the Model State Administrative Procedure Act, issued in 1946 and revised in 1961, has been adopted in twenty-eight states and the District of Columbia; three states have adopted the 1981 revision. The other states have statutes that resemble the model state act to some degree.

Trial-Type Hearings

Deciding cases is a major task of many agencies. For example, the Federal Trade Commission (FTC) is empowered to charge a company with having violated the Federal Trade Commission Act. Perhaps a seller is accused of making deceptive claims in its advertising. Proceeding in a manner similar to a court, staff counsel will prepare a case against the company, which can defend itself through its lawyers. The case is tried before an **administrative law judge (ALJ)**, formerly known as an administrative hearing examiner. The change in nomenclature was made in 1972 to enhance the prestige of ALJs and more accurately reflect their duties. Although not appointed for life as federal judges are, the ALJ must be free of assignments inconsistent with the judicial function and is not subject to supervision by anyone in the agency who carries on an investigative or prosecutorial function.

The accused parties are entitled to receive notice of the issues to be raised, to present evidence, to argue, to cross-examine, and to appear with their lawyers. Ex parte (eks PAR-tay) communications—contacts between the ALJ and outsiders or one party when both parties are not present—are prohibited. However, the usual burden-of-proof standard followed in a civil proceeding in court does not apply: the ALJ is not bound to decide in favor of that party producing the more persuasive evidence. The rule in most administrative proceedings is “substantial evidence,” evidence that is not flimsy or weak, but is not necessarily overwhelming evidence, either. The ALJ in most cases will write an opinion. That opinion is

not the decision of the agency, which can be made only by the commissioners or agency head. In effect, the ALJ's opinion is appealed to the commission itself.

Certain types of agency actions that have a direct impact on individuals need not be filtered through a full-scale hearing. Safety and quality inspections (grading of food, inspection of airplanes) can be made on the spot by skilled inspectors. Certain licenses can be administered through tests without a hearing (a test for a driver's license), and some decisions can be made by election of those affected (labor union elections).

Rulemaking

Trial-type hearings generally impose on particular parties liabilities based on past or present facts. Because these cases will serve as precedents, they are a partial guide to future conduct by others. But they do not directly apply to nonparties, who may argue in a subsequent case that their conduct does not fit within the holding announced in the case. Agencies can affect future conduct far more directly by announcing rules that apply to all who come within the agency's jurisdiction.

The acts creating most of the major federal agencies expressly grant them authority to engage in rulemaking. This means, in essence, authority to legislate. The outpouring of federal regulations has been immense. The APA directs agencies about to engage in rulemaking to give notice in the **Federal Register** of their intent to do so. The *Federal Register* is published daily, Monday through Friday, in Washington, DC, and contains notice of various actions, including announcements of proposed rulemaking and regulations as adopted. The notice must specify the time, place, and nature of the rulemaking and offer a description of the proposed rule or the issues involved. Any interested person or organization is entitled to participate by submitting written "data, views or arguments." Agencies are not legally required to air debate over proposed rules, though they often do so.

The procedure just described is known as "informal" rulemaking. A different procedure is required for "formal" rulemaking, defined as those instances in which the enabling legislation directs an agency to make rules "on the record after opportunity for an agency hearing." When engaging in formal rulemaking, agencies must *hold* an adversary hearing.

Administrative regulations are not legally binding unless they are published. Agencies must publish in the *Federal Register* the text of final regulations, which ordinarily do not become effective until thirty days later. Every year the annual output of regulations is collected and reprinted in the **Code of Federal Regulations (CFR)**, a multivolume paperback series containing all federal rules and regulations keyed to the fifty titles of the US Code (the compilation of *all* federal statutes enacted by Congress and grouped according to subject).

KEY TAKEAWAY

Agencies make rules that have the same effect as laws passed by Congress and the president. But such rules (regulations) must allow for full participation by interested parties. The Administrative Procedure Act (APA) governs both rulemaking and the agency enforcement of regulations, and it provides a process for fair hearings.

EXERCISES

1. Go to http://www.regulations.gov/search/Regs/home.html#home. Browse the site. Find a topic that interests you, and then find a proposed regulation. Notice how comments on the proposed rule are invited.
2. Why would there be a trial by an administrative agency? Describe the process.

5.4 Administrative Burdens on Business Operations

LEARNING OBJECTIVES

CC BY NC SA

1. Describe the paperwork burden imposed by administrative agencies.
2. Explain why agencies have the power of investigation, and what limits there are to that power.
3. Explain the need for the Freedom of Information Act and how it works in the US legal system.

The Paperwork Burden

The administrative process is not frictionless. The interplay between government agency and private enterprise can burden business operations in a number of ways. Several of these are noted in this section.

Deciding whether and how to act are not decisions that government agencies reach out of the blue. They rely heavily on information garnered from business itself. Dozens of federal agencies require corporations to keep hundreds of types of records and to file numerous periodic reports. The Commission on Federal Paperwork, established during the Ford administration to consider ways of reducing the paperwork burden, estimated in its final report in 1977 that the total annual cost of federal paperwork amounted to $50 billion and that the 10,000 largest business enterprises spent $10 billion annually on paperwork alone. The paperwork involved in licensing a single nuclear power plant, the commission said, costs upward of $15 million.

Not surprisingly, therefore, businesses have sought ways of avoiding requests for data. Since the 1940s, the Federal Trade Commission (FTC) has collected economic data on corporate performance from individual companies for statistical purposes. As long as each company engages in a single line of business, data are comparable. When the era of conglomerates began in the 1970s, with widely divergent types of businesses brought together under the roof of a single corporate parent, the data became useless for purposes of examining the competitive behavior of different industries. So the FTC ordered dozens of large companies to break out their economic information according to each line of business that they carried on. The companies resisted, but the US Court of Appeals for the District of Columbia Circuit, where much of the litigation over federal administrative action is decided, directed the companies to

comply with the commission's order, holding that the Federal Trade Commission Act clearly permits the agency to collect information for investigatory purposes.[1]

In 1980, responding to cries that businesses, individuals, and state and local governments were being swamped by federal demands for paperwork, Congress enacted the Paperwork Reduction Act. It gives power to the federal Office of Management and Budget (OMB) to develop uniform policies for coordinating the gathering, storage, and transmission of all the millions of reports flowing in each year to the scores of federal departments and agencies requesting information. These reports include tax and Medicare forms, financial loan and job applications, questionnaires of all sorts, compliance reports, and tax and business records. The OMB was given the power also to determine whether new kinds of information are needed. In effect, any agency that wants to collect new information from outside must obtain the OMB's approval.

Inspections

No one likes surprise inspections. A section of the Occupational Safety and Health Act of 1970 empowers agents of the Occupational Safety and Health Administration (OSHA) to search work areas for safety hazards and for violations of OSHA regulations. The act does not specify whether inspectors are required to obtain search warrants, required under the Fourth Amendment in criminal cases. For many years, the government insisted that surprise inspections are not unreasonable and that the time required to obtain a warrant would defeat the surprise element. The Supreme Court finally ruled squarely on the issue in 1978. In *Marshall v. Barlow's, Inc.*, the court held that no less than private individuals, businesses are entitled to refuse police demands to search the premises unless a court has issued a search warrant.[2]

But where a certain type of business is closely regulated, surprise inspections are the norm, and no warrant is required. For example, businesses with liquor licenses that might sell to minors are subject to both overt and covert inspections (e.g., an undercover officer may "search" a liquor store by sending an underage patron to the store). Or a junkyard that specializes in automobiles and automobile parts may also be subject to surprise inspections, on the rationale that junkyards are highly likely to be active in the resale of stolen autos or stolen auto parts.[3]

It is also possible for inspections to take place without a search warrant and without the permission of the business. For example, the Environmental Protection Agency (EPA) wished to inspect parts of the Dow Chemical facility in Midland, Michigan, without the benefit of warrant. When they were refused, agents of the EPA obtained a fairly advanced aerial mapping camera and rented an airplane to fly over the Dow facility. Dow went to court for a restraining order against the EPA and a request to have the EPA turn over all photographs taken. But the Supreme Court ruled that the areas photographed were "open fields" and not subject to the protections of the Fourth Amendment.[4]

Access to Business Information in Government Files

In 1966, Congress enacted the Freedom of Information Act (FOIA), opening up to the citizenry many of the files of the government. (The act was amended in 1974 and again in 1976 to overcome a tendency of many agencies to stall or refuse access to their files.) Under the FOIA, any person has a legally enforceable right of access to all government documents, with nine specific exceptions, such as classified military intelligence, medical files, and trade secrets and commercial or financial information if "obtained from a person and privileged or confidential." Without the trade-secret and financial-information exemptions, business competitors could, merely by requesting it, obtain highly sensitive competitive information sitting in government files.

A federal agency is required under the FOIA to respond to a document request within ten days. But in practice, months or even years may pass before the government actually responds to an FOIA request. Requesters must also pay the cost of locating and copying the records. Moreover, not all documents are available for public inspection. Along with the trade-secret and financial-information exemptions, the FOIA specifically exempts the following:

- records required by executive order of the president to be kept secret in the interest of national defense or public policy
- records related solely to the internal personnel rules and practice of an agency
- records exempted from disclosure by another statute

- interagency memos or decisions reflecting the deliberative process
- personnel files and other files that if disclosed, would constitute an unwarranted invasion of personal privacy
- information compiled for law enforcement purposes
- geological information concerning wells

Note that the government may provide such information but is not required to provide such information; it retains discretion to provide information or not.

Regulated companies are often required to submit confidential information to the government. For these companies, submitting such information presents a danger under the FOIA of disclosure to competitors. To protect information from disclosure, the company is well advised to mark each document as privileged and confidential so that government officials reviewing it for a FOIA request will not automatically disclose it. Most agencies notify a company whose data they are about to disclose. But these practices are not legally required under the FOIA.

KEY TAKEAWAY

Government agencies, in order to do their jobs, collect a great deal of information from businesses. This can range from routine paperwork (often burdensome) to inspections, those with warrants and those without. Surprise inspections are allowed for closely regulated industries but are subject to Fourth Amendment requirements in general. Some information collected by agencies can be accessed using the Freedom of Information Act.

EXERCISES

1. Give two examples of a closely regulated industry. Explain why some warrantless searches would be allowed.
2. Find out why FOIA requests often take months or years to accomplish.

[1] *In re FTC Line of Business Report Litigation*, 595 F.2d 685 (D.C. Cir. 1978).

[2] *Marshall v. Barlow's, Inc.*, 436 US 307 (1978).

[3] *New York v. Burger*, 482 US 691 (1987).

[4] *Dow Chemical Co. v. United States Environmental Protection Agency*, 476 US 227 (1986).

5.5 The Scope of Judicial Review

LEARNING OBJECTIVES

1. Describe the "exhaustion of remedies" requirement.
2. Detail various strategies for obtaining judicial review of agency rules.
3. Explain under what circumstances it is possible to sue the government.

Neither an administrative agency's adjudication nor its issuance of a regulation is necessarily final. Most federal agency decisions are appealable to the federal circuit courts. To get to court, the appellant must overcome numerous complex hurdles. He or she must have standing—that is, be in some sense directly affected by the decision or regulation. The case must be ripe for review; administrative remedies such as further appeal within the agency must have been exhausted.

Exhaustion of Administrative Remedies

Before you can complain to court about an agency's action, you must first try to get the agency to reconsider its action. Generally, you must have asked for a hearing at the hearing examiner level, there must have been a decision reached that was unfavorable to you, and you must have appealed the decision to the full board. The full board must rule against you, and only then will you be heard by a court. The broadest exception to this **exhaustion of administrative remedies** requirement is if the agency had no authority to issue the rule or regulation in the first place, if exhaustion of remedies would be impractical or futile, or if great harm would happen should the rule or regulation continue to apply. Also, if the agency is not acting in good faith, the courts will hear an appeal without exhaustion.

Strategies for Obtaining Judicial Review

Once these obstacles are cleared, the court may look at one of a series of claims. The appellant might assert that the agency's action was ultra vires (UL-truh VI-reez)—beyond the scope of its authority as set down in the statute. This attack is rarely successful. A somewhat more successful claim is that the agency did not abide by its own procedures or those imposed upon it by the Administrative Procedure Act.

In formal rulemaking, the appellant also might insist that the agency lacked substantial evidence for the determination that it made. If there is virtually no evidence to support the agency's findings, the court may reverse. But findings of fact are not often overturned by the courts.

Likewise, there has long been a presumption that when an agency issues a regulation, it has the authority to do so: those opposing the regulation must bear a heavy burden in court to upset it. This is not a surprising rule, for otherwise courts, not administrators, would be the authors of regulations. Nevertheless, regulations cannot exceed the scope of the authority conferred by Congress on the agency. In an important 1981 case before the Supreme Court, the issue was whether the secretary of labor, acting through the Occupational Health and Safety Administration (OSHA), could lawfully issue a standard limiting exposure to cotton dust in the workplace without first undertaking a cost-benefit analysis. A dozen cotton textile manufacturers and the American Textile Manufacturers Institute, representing 175 companies, asserted that the cotton dust standard was unlawful because it did not rationally relate the

benefits to be derived from the standard to the costs that the standard would impose. See Section 5.6 "Cases", *American Textile Manufacturers Institute v. Donovan*.

In summary, then, an individual or a company may (after exhaustion of administrative remedies) challenge agency action where such action is the following:

- not in accordance with the agency's scope of authority
- not in accordance with the US Constitution or the Administrative Procedure Act
- not in accordance with the substantial evidence test
- unwarranted by the facts
- arbitrary, capricious, an abuse of discretion, or otherwise not in accord with the law

Section 706 of the Administrative Procedure Act sets out those standards. While it is difficult to show that an agency's action is arbitrary and capricious, there are cases that have so held. For example, after the Reagan administration set aside a Carter administration rule from the National Highway Traffic and Safety Administration on passive restraints in automobiles, State Farm and other insurance companies challenged the reversal as arbitrary and capricious. Examining the record, the Supreme Court found that the agency had failed to state enough reasons for its reversal and required the agency to review the record and the rule and provide adequate reasons for its reversal. State Farm and other insurance companies thus gained a legal benefit by keeping an agency rule that placed costs on automakers for increased passenger safety and potentially reducing the number of injury claims from those it had insured.[1]

Suing the Government

In the modern administrative state, the range of government activity is immense, and administrative agencies frequently get in the way of business enterprise. Often, bureaucratic involvement is wholly legitimate, compelled by law; sometimes, however, agencies or government officials may overstep their bounds, in a fit of zeal or spite. What recourse does the private individual or company have?

Mainly for historical reasons, it has always been more difficult to sue the government than to sue private individuals or corporations. For one thing, the government has long had recourse to the doctrine of

sovereign immunity as a shield against lawsuits. Yet in 1976, Congress amended the Administrative Procedure Act to waive any federal claim to sovereign immunity in cases of injunctive or other nonmonetary relief. Earlier, in 1946, in the Federal Tort Claims Act, Congress had waived sovereign immunity of the federal government for most tort claims for money damages, although the act contains several exceptions for specific agencies (e.g., one cannot sue for injuries resulting from fiscal operations of the Treasury Department or for injuries stemming from activities of the military in wartime). The act also contains a major exception for claims "based upon [an official's] exercise or performance or the failure to exercise or perform a discretionary function or duty." This exception prevents suits against parole boards for paroling dangerous criminals who then kill or maim in the course of another crime and suits against officials whose decision to ship explosive materials by public carrier leads to mass deaths and injuries following an explosion en route.[2]

In recent years, the Supreme Court has been stripping away the traditional immunity enjoyed by many government officials against personal suits. Some government employees—judges, prosecutors, legislators, and the president, for example—have absolute immunity against suit for official actions. But many public administrators and government employees have at best a qualified immunity. Under a provision of the Civil Rights Act of 1871 (so-called Section 1983 actions), *state* officials can be sued in federal court for money damages whenever "under color of any state law" they deprive anyone of his rights under the Constitution or federal law. In *Bivens v. Six Unknown Federal Narcotics Agents*, the Supreme Court held that *federal* agents may be sued for violating the plaintiff's Fourth Amendment rights against an unlawful search of his home.[3] Subsequent cases have followed this logic to permit suits for violations of other constitutional provisions. This area of the law is in a state of flux, and it is likely to continue to evolve.

Sometimes damage is done to an individual or business because the government has given out erroneous information. For example, suppose that Charles, a bewildered, disabled navy employee, is receiving a federal disability annuity. Under the regulations, he would lose his pension if he took a job that paid him in each of two succeeding years more than 80 percent of what he earned in his old navy job. A few years later, Congress changed the law, making him ineligible if he earned more than 80 percent in anyone year.

For many years, Charles earned considerably less than the ceiling amount. But then one year he got the opportunity to make some extra money. Not wishing to lose his pension, he called an employee relations specialist in the US Navy and asked how much he could earn and still keep his pension. The specialist gave him erroneous information over the telephone and then sent him an out-of-date form that said Charles could safely take on the extra work. Unfortunately, as it turned out, Charles did exceed the salary limit, and so the government cut off his pension during the time he earned too much. Charles sues to recover his lost pension. He argues that he relied to his detriment on false information supplied by the navy and that in fairness the government should be estopped from denying his claim.

Unfortunately for Charles, he will lose his case. In *Office of Personnel Management v. Richmond*, the Supreme Court reasoned that it would be unconstitutional to permit recovery.[4] The appropriations clause of Article I says that federal money can be paid out only through an appropriation made by law. The law prevented this particular payment to be made. If the court were to make an exception, it would permit executive officials in effect to make binding payments, even though unauthorized, simply by misrepresenting the facts. The harsh reality, therefore, is that mistakes of the government are generally held against the individual, not the government, unless the law specifically provides for recompense (as, for example, in the Federal Tort Claims Act just discussed).

KEY TAKEAWAY

After exhausting administrative remedies, there are numerous grounds for seeking judicial review of an agency's order or of a final rule. While courts defer to agencies to some degree, an agency must follow its own rules, comply with the Administrative Procedure Act, act within the scope of its delegated authority, avoid acting in an arbitrary manner, and make final rules that are supported by substantial evidence.

EXERCISES

1. Why would US courts require that someone seeking judicial review of an agency order first exhaust administrative remedies?

CC BY NC SA

2. On the Internet, find a case where someone has successfully sued the US government under the Federal Tort Claims Act. What kind of case was it? Did the government argue sovereign immunity? Does sovereign immunity even make sense to you?

---

[1] *Motor Vehicle Manufacturers' Assn. v. State Farm Mutual Ins.*, 463 US 29 (1983).

[2] *Dalehite v. United States*, 346 US 15 (1953).

[3] *Bivens v. Six Unknown Federal Narcotics Agents*, 403 US 388 (1971).

[4] *Office of Personnel Management v. Richmond*, 110 S. Ct. 2465 (1990).

5.6 Cases

Marshall v. Barlow's, Inc.

Marshall v. Barlow's, Inc.

436 U.S. 307 (U.S. Supreme Court 1978)

MR. JUSTICE WHITE delivered the opinion of the Court.

Section 8(a) of the Occupational Safety and Health Act of 1970 (OSHA or Act) empowers agents of the Secretary of Labor (Secretary) to search the work area of any employment facility within the Act's jurisdiction. The purpose of the search is to inspect for safety hazards and violations of OSHA regulations. No search warrant or other process is expressly required under the Act.

On the morning of September 11, 1975, an OSHA inspector entered the customer service area of Barlow's, Inc., an electrical and plumbing installation business located in Pocatello, Idaho. The president and general manager, Ferrol G. "Bill" Barlow, was on hand; and the OSHA inspector, after showing his credentials, informed Mr. Barlow that he wished to conduct a search of the working areas of the business.

Mr. Barlow inquired whether any complaint had been received about his company. The inspector answered no, but that Barlow's, Inc., had simply turned up in the agency's selection process. The inspector again asked to enter the nonpublic area of the business; Mr. Barlow's response was to inquire whether the inspector had a search warrant.

The inspector had none. Thereupon, Mr. Barlow refused the inspector admission to the employee area of his business. He said he was relying on his rights as guaranteed by the Fourth Amendment of the United States Constitution.

Three months later, the Secretary petitioned the United States District Court for the District of Idaho to issue an order compelling Mr. Barlow to admit the inspector. The requested order was issued on December 30, 1975, and was presented to Mr. Barlow on January 5, 1976. Mr. Barlow again refused admission, and he sought his own injunctive relief against the warrantless searches assertedly permitted by OSHA....The Warrant Clause of the Fourth Amendment protects commercial buildings as well as private homes. To hold otherwise would belie the origin of that Amendment, and the American colonial experience.

An important forerunner of the first 10 Amendments to the United States Constitution, the Virginia Bill of Rights, specifically opposed "general warrants, whereby an officer or messenger may be commanded to search suspected places without evidence of a fact committed." The general warrant was a recurring point of contention in the Colonies immediately preceding the Revolution. The particular offensiveness it engendered was acutely felt by the merchants and businessmen whose premises and products were inspected for compliance with the several parliamentary revenue measures that most irritated the colonists....

* * *

This Court has already held that warrantless searches are generally unreasonable, and that this rule applies to commercial premises as well as homes. In *Camara v. Municipal Court*, we held:

CC BY NC SA

[E]xcept in certain carefully defined classes of cases, a search of private property without proper consent is 'unreasonable' unless it has been authorized by a valid search warrant.

On the same day, we also ruled: As we explained in Camara, a search of private houses is presumptively unreasonable if conducted without a warrant. The businessman, like the occupant of a residence, has a constitutional right to go about his business free from unreasonable official entries upon his private commercial property. The businessman, too, has that right placed in jeopardy if the decision to enter and inspect for violation of regulatory laws can be made and enforced by the inspector in the field without official authority evidenced by a warrant. These same cases also held that the Fourth Amendment prohibition against unreasonable searches protects against warrantless intrusions during civil as well as criminal investigations. The reason is found in the "basic purpose of this Amendment...[which] is to safeguard the privacy and security of individuals against arbitrary invasions by governmental officials." If the government intrudes on a person's property, the privacy interest suffers whether the government's motivation is to investigate violations of criminal laws or breaches of other statutory or regulatory standards....

[A]n exception from the search warrant requirement has been recognized for "pervasively regulated business[es]," *United States v. Biswell*, 406 U.S. 311, 316 (1972), and for "closely regulated" industries "long subject to close supervision and inspection," *Colonnade Catering Corp. v. United States*, 397 U.S. 72, 74, 77 (1970). These cases are indeed exceptions, but they represent responses to relatively unique circumstances. Certain industries have such a history of government oversight that no reasonable expectation of privacy could exist for a proprietor over the stock of such an enterprise. Liquor (*Colonnade*) and firearms (*Biswell*) are industries of this type when an entrepreneur embarks upon such a business, he has voluntarily chosen to subject himself to a full arsenal of governmental regulation.

* * *

The clear import of our cases is that the closely regulated industry of the type involved in *Colonnade* and *Biswell* is the exception. The Secretary would make it the rule. Invoking the Walsh-Healey Act of 1936, 41 U.S.C. § 35 et *seq.*, the Secretary attempts to support a conclusion that all businesses involved in interstate commerce have long been subjected to close supervision of employee safety and health conditions. But...it is quite unconvincing to argue that the imposition of minimum wages and maximum hours on employers who contracted with the Government under the Walsh-Healey Act prepared the entirety of American interstate commerce for regulation of working conditions to the minutest detail. Nor can any but the most fictional sense of voluntary consent to later searches be found in the single fact that one conducts a business affecting interstate commerce. Under current practice and law, few businesses can be conducted without having some effect on interstate commerce.

* * *

The critical fact in this case is that entry over Mr. Barlow's objection is being sought by a Government agent. Employees are not being prohibited from reporting OSHA violations. What they observe in their daily functions is undoubtedly beyond the employer's reasonable expectation of privacy. The Government inspector, however, is not an employee. Without a warrant he stands in no better position than a member of the public. What is observable by the public is observable, without a warrant, by the Government inspector as well. The owner of a business has not, by the necessary utilization of employees in his operation, thrown open the areas where employees alone are permitted to the warrantless scrutiny of Government agents. That an employee is free to report, and the Government is free to use, any evidence of noncompliance with OSHA that the employee observes furnishes no justification for federal agents to enter a place of business from which the public is restricted and to conduct their own warrantless search.

* * *

[The District Court judgment is affirmed.]

CASE QUESTIONS

1. State, as briefly and clearly as possible, the argument that Barlow's is making in this case.
2. Why would some industries or businesses be "closely regulated"? What are some of those businesses?
3. The Fourth Amendment speaks of "people" being secure in their "persons, houses, papers, and effects." Why would the Fourth Amendment apply to a business, which is not in a "house"?
4. If the Fourth Amendment does not distinguish between closely regulated industries and those that are not, why does the court do so?

American Textile Manufacturers Institute v. Donovan

American Textile Manufacturers Institute v. Donovan

452 U.S. 490 (1981)

JUSTICE BRENNAN delivered the opinion of the Court.

Congress enacted the Occupational Safety and Health Act of 1970 (Act) "to assure so far as possible every working man and woman in the Nation safe and healthful working conditions...."The Act authorizes the Secretary of Labor to establish, after notice and opportunity to comment, mandatory nationwide standards governing health and safety in the workplace. In 1978, the Secretary, acting through the Occupational Safety and Health Administration (OSHA), promulgated a standard limiting occupational exposure to cotton dust, an airborne particle byproduct of the preparation and manufacture of cotton products, exposure to which produces a "constellation of respiratory effects" known as "byssinosis." This disease was one of the expressly recognized health hazards that led to passage of the Act.

Petitioners in these consolidated cases representing the interests of the cotton industry, challenged the validity of the "Cotton Dust Standard" in the Court of Appeals for the District of Columbia Circuit pursuant to § 6 (f) of the Act, 29 U.S.C. § 655 (f). They contend in this Court, as they did below, that the Act requires OSHA to demonstrate that its Standard reflects a reasonable relationship between the costs

and benefits associated with the Standard. Respondents, the Secretary of Labor and two labor organizations, counter that Congress balanced the costs and benefits in the Act itself, and that the Act should therefore be construed not to require OSHA to do so. They interpret the Act as mandating that OSHA enact the most protective standard possible to eliminate a significant risk of material health impairment, subject to the constraints of economic and technological feasibility.

The Court of Appeals held that the Act did not require OSHA to compare costs and benefits.

We granted certiorari, 449 U.S. 817 (1980), to resolve this important question, which was presented but not decided in last Term's *Industrial Union Dept. v. American Petroleum Institute*, 448 U.S. 607 (1980), and to decide other issues related to the Cotton Dust Standard.

* * *

Not until the early 1960's was byssinosis recognized in the United States as a distinct occupational hazard associated with cotton mills. In 1966, the American Conference of Governmental Industrial Hygienists (ACGIH), a private organization, recommended that exposure to total cotton dust be limited to a "threshold limit value" of 1,000 micrograms per cubic meter of air (1,000 g/m^3.) averaged over an 8-hour workday. See 43 Fed. Reg. 27351, col. 1 (1978). The United States Government first regulated exposure to cotton dust in 1968, when the Secretary of Labor, pursuant to the Walsh-Healey Act, 41 U.S.C. 35 (e), promulgated airborne contaminant threshold limit values, applicable to public contractors, that included the 1,000 g/m^3 limit for total cotton dust. 34 Fed. Reg. 7953 (1969). Following passage of the Act in 1970, the 1,000 g/m^3. standard was adopted as an "established Federal standard" under 6 (a) of the Act, 84 Stat. 1593, 29 U.S.C. 655 (a), a provision designed to guarantee immediate protection of workers for the period between enactment of the statute and promulgation of permanent standards.

That same year, the Director of the National Institute for Occupational Safety and Health (NIOSH), pursuant to the Act, 29 U.S.C. §§ 669(a)(3), 671 (d)(2), submitted to the Secretary of Labor a recommendation for a cotton dust standard with a permissible exposure limit (PEL) that "should be set at the lowest level feasible, but in no case at an environmental concentration as high as 0.2 mg lint-free

cotton dust/cu m," or 200 g/m^3. of lint-free respirable dust. Several months later, OSHA published an Advance Notice of Proposed Rulemaking, 39 Fed. Reg. 44769 (1974), requesting comments from interested parties on the NIOSH recommendation and other related matters. Soon thereafter, the Textile Worker's Union of America, joined by the North Carolina Public Interest Research Group, petitioned the Secretary, urging a more stringent PEL of 100 g/m^3.

On December 28, 1976, OSHA published a proposal to replace the existing federal standard on cotton dust with a new permanent standard, pursuant to § 6(b)(5) of the Act, 29 U.S.C. § 655(b)(5). 41 Fed. Reg. 56498. The proposed standard contained a PEL of 200 g/m^3 of vertical elutriated lint-free respirable cotton dust for all segments of the cotton industry. *Ibid*. It also suggested an implementation strategy for achieving the PEL that relied on respirators for the short term and engineering controls for the long-term. OSHA invited interested parties to submit written comments within a 90-day period.

* * *

The starting point of our analysis is the language of the statute itself. Section 6(b)(5) of the Act, 29 U.S.C. § 655(b)(5) (emphasis added), provides:

> *The Secretary, in promulgating standards dealing with toxic materials or harmful physical agents under this subsection, shall set the standard which most adequately assures,* ***to the extent feasible****, on the basis of the best available evidence, that no employee will suffer material impairment of health or functional capacity even if such employee has regular exposure to the hazard dealt with by such standard for the period of his working life. Although their interpretations differ, all parties agree that the phrase "to the extent feasible" contains the critical language in § 6(b)(5) for purposes of these cases.*

The plain meaning of the word "feasible" supports respondents' interpretation of the statute. According to Webster's Third New International Dictionary of the English Language 831 (1976), "feasible" means "capable of being done, executed, or effected." In accord, the Oxford English Dictionary 116 (1933)

("Capable of being done, accomplished or carried out"); Funk & Wagnalls New "Standard" Dictionary of the English Language 903 (1957) ("That may be done, performed or effected"). Thus, § 6(b)(5) directs the Secretary to issue the standard that "most adequately assures...that no employee will suffer material impairment of health," limited only by the extent to which this is "capable of being done." In effect then, as the Court of Appeals held, Congress itself defined the basic relationship between costs and benefits, by placing the "benefit" of worker health above all other considerations save those making attainment of this "benefit" unachievable. Any standard based on a balancing of costs and benefits by the Secretary that strikes a different balance than that struck by Congress would be inconsistent with the command set forth in § 6(b)(5). Thus, cost-benefit analysis by OSHA is not required by the statute because feasibility analysis is.

When Congress has intended that an agency engage in cost-benefit analysis, it has clearly indicated such intent on the face of the statute. One early example is the Flood Control Act of 1936, 33 U.S.C. § 701:

> *[T]he Federal Government should improve or participate in the improvement of navigable waters or their tributaries, including watersheds thereof, for flood control purposes if the* ***benefits to whomsoever they may accrue are in excess of the estimated costs****, and if the lives and social security of people are otherwise adversely affected. (emphasis added)*

A more recent example is the Outer Continental Shelf Lands Act Amendments of 1978, providing that offshore drilling operations shall use the best available and safest technologies which the Secretary determines to be economically *feasible*, wherever failure of equipment would have a significant effect on safety, health, or the environment, except where the Secretary determines that the *incremental benefits are clearly insufficient to justify the incremental costs of using such technologies*.

These and other statutes demonstrate that Congress uses specific language when intending that an agency engage in cost-benefit analysis. Certainly in light of its ordinary meaning, the word "feasible" cannot be construed to articulate such congressional intent. We therefore reject the argument that Congress required cost-benefit analysis in § 6(b)(5).

CASE QUESTIONS

1. What is byssinosis? Why should byssinosis be anything that the textile companies are responsible for, ethically or legally? If it is well-known that textile workers get cotton dust in their systems and develop brown lung, don't they nevertheless choose to work there and assume the risk of all injuries?
2. By imposing costs on the textile industry, what will be the net effect on US textile manufacturing jobs?
3. How is byssinosis a "negative externality" that is not paid for by either the manufacturer or the consumer of textile products? How should the market, to be fair and efficient, adjust for these negative externalities *other* than by setting a reasonable standard that shares the burden between manufacturers and their employees? Should *all* the burden be on the manufacturer?

5.7 Summary and Exercises

Summary

Administrative rules and regulations constitute the largest body of laws that directly affect business. These regulations are issued by dozens of federal and state agencies that regulate virtually every aspect of modern business life, including the natural environment, corporate finance, transportation, telecommunications, energy, labor relations, and trade practices. The administrative agencies derive their power to promulgate regulations from statutes passed by Congress or state legislatures.

The agencies have a variety of powers. They can license companies to carry on certain activities or prohibit them from doing so, lay down codes of conduct, set rates that companies may charge for their services, and supervise various aspects of business.

EXERCISES

1. The Equal Employment Opportunity Commission seeks data about the racial composition of Terrific Textiles' labor force. Terrific refuses on the grounds that inadvertent disclosure of the numbers might cause certain "elements" to picket its factories. The EEOC takes Terrific to court to get the data. What is the result?
2. In order to police the profession, the state legislature has just passed a law permitting the State Plumbers' Association the power to hold hearings to determine whether a particular plumber has violated the plumbing code of ethics, written by the association. Sam, a plumber, objects to the convening of a hearing when he is accused by Roger, a fellow plumber, of acting unethically by soliciting business from Roger's customers. Sam goes to court, seeking to enjoin the association's disciplinary committee from holding the hearing. What is the result? How would you argue Sam's case? The association's case?
3. Assume that the new president of the United States was elected overwhelmingly by pledging in his campaign to "do away with bureaucrats who interfere in your lives." The day he takes the oath of office he determines to carry out his pledge. Discuss which of the following courses he may lawfully follow: (a) Fire all incumbent commissioners of federal agencies in order to install new appointees. (b) Demand that all pending regulations being considered by federal agencies be submitted to the White House for review and redrafting, if necessary. (c) Interview potential nominees for agency positions to determine whether their regulatory philosophy is consistent with his.
4. Dewey owned a mine in Wisconsin. He refused to allow Department of Labor agents into the mine to conduct warrantless searches to determine whether previously found safety violations had been corrected. The Federal Mine Safety and Health Amendments Act of 1977 authorizes four warrantless inspections per year. Is the provision for warrantless inspections by this agency constitutional?[1]
5. In determining the licensing requirements for nuclear reactors, the Nuclear Regulatory Commission (NRC) adopted a zero-release assumption: that the permanent storage of certain nuclear waste would have no significant environmental impact and that potential storage leakages should not be a factor discussed in the appropriate environmental impact statement (EIS) required before permitting construction of a nuclear power plant. This assumption is based on the NRC's belief that technology would be developed to isolate the wastes from the environment, and it was clear from the record that the NRC had "digested a massive material and disclosed all substantial risks" and had considered that the zero-release assumption was

uncertain. There was a remote possibility of contamination by water leakage into the storage facility. An environmental NGO sued, asserting that the NRC had violated the regulations governing the EIS by arbitrarily and capriciously ignoring the potential contamination. The court of appeals agreed, and the power plant appealed. Had the NRC acted arbitrarily and capriciously? [2]

SELF-TEST QUESTIONS

1 Most federal administrative agencies are created by

a. an executive order by the president

b. a Supreme Court decision

c. the passage of enabling legislation by Congress, signed by the president

d. a and c

2 The Federal Trade Commission, like most administrative agencies of the federal government, is part of

a. the executive branch of government

b. the legislative branch of government

c. the judicial branch of government

d. the administrative branch of government

3 In the Clean Water Act, Congress sets broad guidelines, but it is the Environmental Protection Agency that proposes rules to regulate industrial discharges. Where do proposed rules originally appear?

a. in the Congressional record

b. in the *Federal Register*

c. in the *Code of Federal Regulations*

d. in the United States code service

4 The legal basis for all administrative law, including regulations of the Federal Trade Commission, is found in

a. the Administrative Procedure Act

b. the US Constitution

c. the commerce clause

d. none of the above

5 The Federal Trade Commission, like other administrative agencies, has the power to

a. issue proposed rules

b. undertake investigations of firms that may have violated FTC regulations

c. prosecute firms that have violated FTC regulations

d. none of the above

e. all of the above

SELF-TEST ANSWERS

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

---

[1] *Donovan v. Dewey*, 452 US 594 (1981).

[2] *Baltimore Gas and Electric Co. v. Natural Resources Defense Council Inc.*, 462 US 87 (1983).

CC BY NC SA

Chapter 6
Criminal Law

LEARNING OBJECTIVES

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

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

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

6.1 The Nature of Criminal Law

Criminal law is the most ancient branch of the law. Many wise observers have tried to define and explain it, but the explanations often include many complex and subtle distinctions. A traditional criminal law course would include a lot of discussions on criminal intent, the nature of criminal versus civil responsibility, and the constitutional rights accorded the accused. But in this chapter, we will consider only the most basic aspects of intent, responsibility, and constitutional rights.
Unlike civil actions, where plaintiffs seek compensation or other remedies for themselves, crimes involve "the state" (the federal government, a state government, or some subunit of state government). This is because crimes involve some "harm to society" and not just harm to certain individuals. But "harm to society" is not always evident in the act itself. For example, two friends of yours at a party argue, take the argument outside, and blows are struck; one has a bloody nose and immediately goes home. The crimes of assault and battery have been committed, even though no one else knows about the fight and the friends later make up. By contrast, suppose a major corporation publicly announces that it is closing operations in your community and moving operations to Southeast Asia. There is plenty of harm to society as the plant closes down and no new jobs take the place of the company's jobs. Although the effects on society are greater in the second example, only the first example is a crime.

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

What is considered a crime will also vary from society to society and from time to time. For example, while cocaine use was legal in the United States at one time, it is now a controlled substance, and unauthorized use is now a crime. Medical marijuana was not legal fifty years ago when its use began

to become widespread, and in some states its use or possession was a felony. Now, some states make it legal to use or possess it under some circumstances. In the United States, you can criticize and make jokes about the president of the United States without committing a crime, but in many countries it is a serious criminal act to criticize a public official.

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

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

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

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

"suspicious person" statutes on the grounds that they are too vague for people to know what they are being asked not to do.

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

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

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

KEY TAKEAWAY

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

EXERCISES

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

6.2 Types of Crimes

LEARNING OBJECTIVES

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

Most classifications of crime turn on the seriousness of the act. In general, seriousness is defined by the nature or duration of the punishment set out in the statute. A **felony** is a crime punishable (usually) by imprisonment of more than one year or by death. (Crimes punishable by death are sometimes known as capital crimes; they are increasingly rare in the United States.) The major felonies include murder, rape, kidnapping, armed robbery, embezzlement, insider trading, fraud, and racketeering. All other crimes are usually known as **misdemeanors**, petty offenses, or infractions. Another way of viewing crimes is by the type of social harm the statute is intended to prevent or deter, such as offenses against the person, offenses against property, and white-collar crime.

Offenses against the Person

Homicide

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

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

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

Assault and Battery

Ordinarily, we would say that a person who has struck another has "assaulted" him. Technically, that is a **battery**—the unlawful application of force to another person. The force need not be violent. Indeed, a man who kisses a woman is guilty of a battery if he does it against her will. The other person may consent

to the force. That is one reason why surgeons require patients to sign consent forms, giving the doctor permission to operate. In the absence of such a consent, an operation is a battery. That is also why football players are not constantly being charged with battery. Those who agree to play football agree to submit to the rules of the game, which of course include the right to tackle. But the consent does not apply to all acts of physical force: a hockey player who hits an opponent over the head with his stick can be prosecuted for the crime of battery.

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

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

Offenses against Property

Theft: Larceny, Robbery, Embezzlement, False Pretenses

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

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

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

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

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

Statutes against larceny and embezzlement did not cover all the gaps in the law. A conceptual problem arises in the case of one who is tricked into giving up his title to property. In larceny and embezzlement, the thief gains possession or ownership without any consent of the owner or custodian of the property. Suppose, however, that an automobile dealer agrees to take his customer's present car as a trade-in. The customer says that he has full title to the car. In fact, the customer is still paying off an installment loan

and the finance company has an interest in the old car. If the finance company repossesses the car, the customer—who got a new car at a discount because of his false representation—cannot be said to have taken the new car by larceny or embezzlement. Nevertheless, he tricked the dealer into selling, and the dealer will have lost the value of the repossessed car. Obviously, the customer is guilty of a criminal act; the statutes outlawing it refer to this trickery as the crime of **false pretenses**, defined as obtaining ownership of the property of another by making untrue representations of fact with intent to defraud.

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

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

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

Receiving Stolen Property

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

Forgery

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

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

Extortion

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

Offenses against Habitation and Other Offenses

Burglary

CC BY NC SA

Burglary is not a crime against property. It is defined as "the breaking and entering of the dwelling of another in the nighttime with intent to commit a felony." The intent to steal is not an issue: a man who sneaks into a woman's home intent on raping her has committed a burglary, even if he does not carry out the act. The student doing critical thinking will no doubt notice that the definition provides plenty of room for argument. What is "breaking"? (The courts do not require actual destruction; the mere opening of a closed door, even if unlocked, is enough.) What is entry? When does night begin? What kind of intent? Whose dwelling? Can a landlord burglarize the dwelling of his tenant? (Yes.) Can a person burglarize his own home? (No.)

Arson

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

Bribery

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

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

Perjury

Perjury is the crime of giving a false oath, either orally or in writing, in a judicial or other official proceeding (lies made in proceedings other than courts are sometimes termed "false swearing"). To be perjurious, the oath must have been made corruptly—that is, with knowledge that it was false or without sincere belief that it was true. An innocent mistake is not perjury. A statement, though true, is perjury if

the maker of it believes it to be false. Statements such as “I don’t remember” or “to the best of my knowledge” are not sufficient to protect a person who is lying from conviction for perjury. To support a charge of perjury, however, the false statement must be “material,” meaning that the statement is relevant to whatever the court is trying to find out.

White-Collar Crime

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

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

Mail and Wire Fraud

Federal law prohibits the use of the mails or any interstate electronic communications medium for the purpose of furthering a “scheme or artifice to defraud.” The statute is broad, and it is relatively easy for prosecutors to prove a violation. The law also bans attempts to defraud, so the prosecutor need not show that the scheme worked or that anyone suffered any losses. “Fraud” is broadly construed: anyone who uses the mails or telephone to defraud anyone else of virtually anything, not just of money, can be convicted under the law. In one case, a state governor was convicted of mail fraud when he took bribes to influence the setting of racing dates. The court’s theory was that he defrauded the citizenry of its right to his “honest and faithful services” as governor.[1]

Violations of the Food and Drug Act

The federal Food, Drug, and Cosmetic Act prohibits any person or corporation from sending into interstate commerce any adulterated or misbranded food, drug, cosmetics, or related device. For example, in a 2010 case, Allergen had to pay a criminal fine for marketing Botox as a headache or pain reliever, a use that had not been approved by the Food and Drug Administration. Unlike most criminal statutes, willfulness or deliberate misconduct is not an element of the act. As the *United States v. Park* case (Section 6.7 "Cases") shows, an executive can be held criminally liable even though he may have had no personal knowledge of the violation.

Environmental Crimes

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

Violations of the Foreign Corrupt Practices Act

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

to foreign officials or to anyone who will transmit the money to a foreign official to assist the payor (the one offering and delivering the money) in getting business.

Violations of the Racketeering Influenced and Corrupt Organizations Act

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

Computer Crime

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

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

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

KEY TAKEAWAY

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

EXERCISES

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

---

[1] *United States v. Isaacs*, 493 F.2d 1124 (7th Cir. 1974), cert. denied, 417 US 976 (1974).

[2] *U.S. v. Hanousek*, 176 F.3d 1116 (9th Cir. 1999).

6.3 The Nature of a Criminal Act

LEARNING OBJECTIVES

1. Understand how it is possible to commit a criminal act without actually doing anything that you think might be criminal.
2. Analyze and explain the importance of intention in criminal law and criminal prosecutions.

3. Explain how a corporation can be guilty of a crime, even though it is a corporation's agents that commit the crime.

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

Attempt

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

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

Impossibility

What if a defendant is accused of attempting a crime that is factually impossible? For example, suppose that men believed they were raping a drunken, unconscious woman, and were later accused of attempted rape, but defended on the grounds of factual impossibility because the woman was actually dead at the time sexual intercourse took place? Or suppose that a husband intended to poison his wife with strychnine in her coffee, but put sugar in the coffee instead? The "mens rea" or criminal intent was there, but the act itself was not criminal (rape requires a live victim, and murder by poisoning requires the use of

poison). States are divided on this, but thirty-seven states have ruled out factual impossibility as a defense to the crime of attempt.

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

Conspiracy

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

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

Agency and Corporations

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

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

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

KEY TAKEAWAY

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

directly committing criminal acts but may be held criminally responsible for acts of their agents and contractors.

EXERCISES

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

6.4 Responsibility

LEARNING OBJECTIVES

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

In General

The mens rea requirement depends on the nature of the crime and all the circumstances surrounding the act. In general, though, the requirement means that the accused must in some way have intended the criminal consequences of his act. Suppose, for example, that Charlie gives Gabrielle a poison capsule to

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

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

Excuses That Limit or Overcome Responsibility

Mistake of Fact and Mistake of Law

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

Ignorance or mistake of *fact* more frequently will serve as an excuse. If you take a coat from a restaurant, believing it to be yours, you cannot be convicted of larceny if it is not. Your honest mistake of fact negates the requisite intent. In general, the rule is that a mistaken belief of fact will excuse criminal responsibility

if (1) the belief is honestly held, (2) it is reasonable to hold it, and (3) the act would not have been criminal if the facts were as the accused supposed them to have been.

Entrapment

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

But a rule against **entrapment** limits the legal ability of the police to play the role of criminals. The police are permitted to use such techniques to detect criminal activity; they are not permitted to do so to instigate crime. The distinction is usually made between a person who intends to commit a crime and one who does not. If the police provide the former with an opportunity to commit a criminal act—the sale of drugs to an undercover agent, for example—there is no defense of entrapment. But if the police knock on the door of one not known to be a drug user and persist in a demand that he purchase drugs from them, finally overcoming his will to resist, a conviction for purchase and possession of drugs can be overturned on the ground of entrapment.

Other Excuses

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

Lack of Capacity

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

KEY TAKEAWAY

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

EXERCISES

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

6.5 Procedure

CC BY NC SA

LEARNING OBJECTIVES

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

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

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

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

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

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

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

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

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

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

KEY TAKEAWAY

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

EXERCISES

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

6.6 Constitutional Rights of the Accused

LEARNING OBJECTIVES

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

Search and Seizure

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

The courts have devised a remedy for the use at trial of the fruits of an unlawful search or seizure. Evidence that is unconstitutionally seized is excluded from the trial. This is the so-called exclusionary rule, first made applicable in federal cases in 1914 and brought home to the states in 1961.

The **exclusionary rule** is highly controversial, and there are numerous exceptions to it. But it remains generally true that the prosecutor may not use evidence willfully taken by the police in violation of constitutional rights generally, and most often in the violation of Fourth Amendment rights. (The fruits of a coerced confession are also excluded.)

Double Jeopardy

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

Self-Incrimination

The Fifth Amendment is also the source of a person's right against self-incrimination (no person "shall be compelled in any criminal case to be a witness against himself"). The debate over the limits of this right has given rise to an immense literature. In broadest outline, the right against self-incrimination means that the prosecutor may not call a defendant to the witness stand during trial and may not comment to the jury on the defendant's failure to take the stand. Moreover, a defendant's confession must be excluded from evidence if it was not voluntarily made (e.g., if the police beat the person into giving a confession). In *Miranda v. Arizona*, the Supreme Court ruled that no confession is admissible if the police have not first advised a suspect of his constitutional rights, including the right to have a lawyer present to advise him during the questioning.[1] These so-called Miranda warnings have prompted scores of follow-up cases that have made this branch of jurisprudence especially complex.

Speedy Trial

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

Cross-Examination

CC BY NC SA

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

Assistance of Counsel

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

Cruel and Unusual Punishment

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

The Eighth Amendment banned these actions with the words that "cruel and unusual punishments [shall not be] inflicted." Virtually all such punishments either never were enacted or have been eliminated from the statute books in the United States. Nevertheless, the Eighth Amendment has become a source of controversy, first with the Supreme Court's ruling in 1976 that the death penalty, as haphazardly applied in the various states, amounted to cruel and unusual punishment. Later Supreme Court opinions have made it easier for states to administer the death penalty. As of 2010, there were 3,300 defendants on death row in the United States. Of course, no corporation is on death row, and no corporation's charter has ever been revoked by a US state, even though some corporations have repeatedly been indicted and convicted of criminal offenses.

Presumption of Innocence

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

KEY TAKEAWAY

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

EXERCISES

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

---

[1] *Miranda v. Arizona*, 384 US 436 (1966).

6.7 Cases

CC BY NC SA

False Pretenses

State v. Mills

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

LOCKWOOD, VICE CHIEF JUSTICE

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

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

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

Although the due date for Mills' personal notes passed without payment being made, the complainant did not present the notes for payment, did not demand that they be paid, and did not sue upon them. In 1962

the complainant learned that the mortgages which he had taken as security in the transaction were not first mortgages on the Knox Drive and Easy Street properties. These mortgages actually covered two vacant lots on which there were outstanding senior mortgages. On learning this, Pivowar signed a complaint charging the defendants with the crime of theft by false pretenses.

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

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

* * *

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

* * *

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

CASE QUESTIONS

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

White-Collar Crimes

United States v. Park

421 U.S. 658 (1975)

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

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

rodents and to be exposed to contamination by rodents. These acts were alleged to have resulted in the food's being adulterated within the meaning of 21 U.S.C. §§ 342 (a)(3) and (4), in violation of 21 U.S.C. § 331 (k).

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

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

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

Respondent was the only defense witness. He testified that, although all of Acme's employees were in a sense under his general direction, the company had an "organizational structure for responsibilities for certain functions" according to which different phases of its operation were "assigned to individuals who, in turn, have staff and departments under them." He identified those individuals responsible for sanitation, and related that upon receipt of the January 1972 FDA letter, he had conferred with the vice president for legal affairs, who informed him that the Baltimore division vice president "was investigating the situation immediately and would be taking corrective action and would be preparing a summary of the corrective action to reply to the letter." Respondent stated that he did not "believe there was anything [he] could have done more constructively than what [he] found was being done."

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

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

* * *

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

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

* * *

The Court recognized that, because the Act dispenses with the need to prove "consciousness of wrongdoing," it may result in hardship even as applied to those who share "responsibility in the business process resulting in" a violation....The rule that corporate employees who have "a responsible share in the

furtherance of the transaction which the statute outlaws" are subject to the criminal provisions of the Act was not formulated in a vacuum. Cf. *Morissette v. United States*, 342 U.S. 246, 258 (1952). Cases under the Federal Food and Drugs Act of 1906 reflected the view both that knowledge or intent were not required to be proved in prosecutions under its criminal provisions, and that responsible corporate agents could be subjected to the liability thereby imposed.

* * *

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

Thus *Dotterweich* and the cases which have followed reveal that in providing sanctions which reach and touch the individuals who execute the corporate mission—and this is by no means necessarily confined to a single corporate agent or employee—the Act imposes not only a positive duty to seek out and remedy violations when they occur but also, and primarily, a duty to implement measures that will insure that violations will not occur. The requirements of foresight and vigilance imposed on responsible corporate agents are beyond question demanding, and perhaps onerous, but they are no more stringent than the public has a right to expect of those who voluntarily assume positions of authority in business enterprises whose services and products affect the health and well-being of the public that supports them.

* * *

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

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

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

* * *

Reversed.

CASE QUESTIONS

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

6.8 Summary and Exercises

Summary

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

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

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

EXERCISES

1. Bill is the chief executive of a small computer manufacturing company that desperately needs funds to continue operating. One day a stranger comes to Bill to induce him to take part in a cocaine smuggling deal that would net Bill millions of dollars. Unbeknownst to Bill, the stranger is an undercover policeman. Bill tells the stranger to go away. The stranger persists, and after five months of arguing and cajoling, the stranger wears down Bill's will to resist. Bill agrees to take delivery of the cocaine and hands over a down payment of $10,000 to the undercover agent, who promptly arrests him for conspiracy to violate the narcotics laws. What defenses does Bill have?
2. You are the manager of a bookstore. A customer becomes irritated at having to stand in line and begins to shout at the salesclerk for refusing to wait on him. You come out of your office and ask the customer to calm down. He shouts at you. You tell him to leave. He refuses. So you and the salesclerk pick him up and shove him bodily out the door. He calls the police to have you arrested for assault. Should the police arrest you? Assuming that they do, how would you defend yourself in court?
3. Marilyn is arrested for arson against a nuclear utility, a crime under both state and federal law. She is convicted in state court and sentenced to five years in jail. Then the federal government decides to

prosecute her for the same offense. Does she have a double-jeopardy defense against the federal prosecution?

4. Tectonics, a US corporation, is bidding on a project in Nigeria, and its employee wins the bid by secretly giving $100,000 to the Nigerian public official that has the most say about which company will be awarded the contract. The contract is worth $80 million, and Tectonics expects to make at least $50 million on the project. Has a crime under US law been committed?
5. Suppose that the CEO of Tectonics, Ted Nelson, is not actually involved in bribery of the Nigerian public official Adetutu Adeleke. Instead, suppose that the CFO, Jamie Skillset, is very accomplished at insulating both top management and the board of directors from some of the "operational realities" within the company. Skillset knows that Whoopi Goldmine, a Nigerian employee of Tectonics, has made the deal with Adeleke and secured the contract for Tectonics. Is it possible that Nelson, as well as Skillset, can be found guilty of a crime?
6. You have graduated from college and, after working hard for ten years, have scraped enough money together to make a down payment on a forty-acre farm within driving distance to the small city where you work in Colorado. In town at lunch one day, you run into an old friend from high school, Hayley Mills, who tells you that she is saving her money to start a high-end consignment shop in town. You allow her to have a room in your house for a few months until she has enough money to go into business. Over the following weeks, however, you realize that old acquaintances from high school are stopping by almost daily for short visits. When you bring this up to Hayley, she admits that many old friends are now relying on her for marijuana. She is not a licensed caregiver in Colorado and is clearly violating the law. Out of loyalty, you tell her that she has three weeks to move out, but you do not prevent her from continuing sales while she is there. What crime have you committed?
7. The Center Art Galleries—Hawaii sells artwork, and much of it involves art by the famous surrealist painter Salvador Dali. The federal government suspected the center of selling forged Dali artwork and obtained search warrants for six locations controlled by the center. The warrants told the executing officer to seize any items that were "evidence of violations of federal criminal law." The warrants did not describe the specific crime suspected, nor did the warrants limit the seizure of items solely to Dali artwork or suspected Dali forgeries. Are these search warrants valid?[1]

SELF-TEST QUESTIONS

1 Jared has made several loans to debtors who have declared bankruptcy. These are unsecured claims. Jared "doctors" the documentation to show amounts owed that are higher than the debtors actually owe. Later, Jared is charged with the federal criminal offense of filing false claims. The standard (or "burden") of proof that the US attorney must meet in the prosecution is

a. beyond all doubt
b. beyond a reasonable doubt
c. clear and convincing evidence
d. a preponderance of the evidence

2 Jethro, a businessman who resides in Atlanta, creates a disturbance at a local steakhouse and is arrested for being drunk and disorderly. Drunk and disorderly is a misdemeanor under Georgia law. A misdemeanor is a crime punishable by imprisonment for up to

a. one year
b. two years
c. five years
d. none of the above

3 Yuan is charged with a crime. To find him guilty, the prosecutor must show

a. actus reus and mens rea
b. mens rea only
c. the performance of a prohibited act
d. none of the above

4 Kira works for Data Systems Ltd. and may be liable for larceny if she steals

a. a competitor's trade secrets
b. company computer time
c. the use of Data Systems' Internet for personal business
d. any of the above

5 Candace is constructing a new office building that is near its completion. She offers Paul $500 to overlook certain things that are noncompliant with the city's construction code. Paul accepts the money and overlooks the violations. Later, Candace is charged with the crime of bribery. This occurred when

a. Candace offered the bribe.

b. Paul accepted the bribe.

c. Paul overlooked the violations.

d. none of the above

SELF-TEST ANSWERS

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

---

[1] *Center Art Galleries—Hawaii, Inc. v. United States*, 875 F.2d 747 (9th Cir. 1989).

Chapter 7
Introduction to Tort Law

LEARNING OBJECTIVES

CC BY NC SA

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

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

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

7.1 Purpose of Tort Laws

LEARNING OBJECTIVES

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

Definition of *Tort*

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

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

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

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

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

terms, not in terms of prison times or fines, and is the legal system's way of trying to make up for the victim's loss.

Kinds of Torts

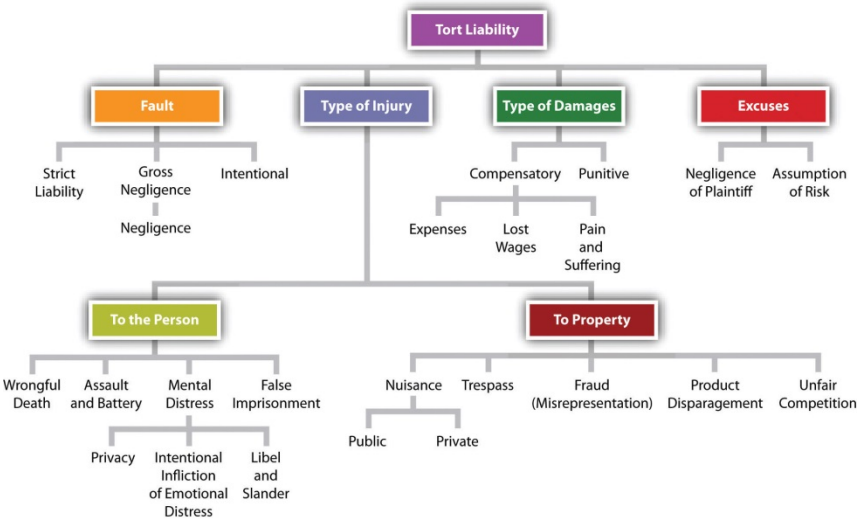
There are three kinds of torts: intentional torts, negligent torts, and strict liability torts. Intentional torts arise from intentional acts, whereas unintentional torts often result from carelessness (e.g., when a surgical team fails to remove a clamp from a patient's abdomen when the operation is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

Dimensions of Tort Liability

There is a clear moral basis for recovery through the legal system where the defendant has been careless (negligent) or has intentionally caused harm. Using the concepts that we are free and autonomous beings with basic rights, we can see that when others interfere with either our freedom or our autonomy, we will usually react negatively. As the old saying goes, "Your right to swing your arm ends at the tip of my nose." The law takes this even one step further: under intentional tort law, if you frighten someone by swinging your arms toward the tip of her nose, you may have committed the tort of assault, even if there is no actual touching (battery).

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

Figure 7.1 *Dimensions of Tort Liability*



Dimensions of Tort: Fault

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

The most obvious standard is willful conduct. If the defendant (often called the **tortfeasor**—i.e., the one committing the tort) intentionally injures another, there is little argument about tort liability. Thus all crimes resulting in injury to a person or property (murder, assault, arson, etc.) are also torts, and the plaintiff may bring a separate lawsuit to recover damages for injuries to his person, family, or property. Most tort suits do not rely on *intentional* fault. They are based, rather, on negligent conduct that in the circumstances is careless or poses unreasonable risks of causing damage. Most automobile accident and medical malpractice suits are examples of negligence suits.

The fault dimension is a continuum. At one end is the deliberate desire to do injury. The middle ground is occupied by careless conduct. At the other end is conduct that most would consider entirely blameless, in the moral sense. The defendant may have observed all possible precautions and yet still be held liable.

This is called **strict liability**. An example is that incurred by the manufacturer of a defective product that is placed on the market despite all possible precautions, including quality-control inspection. In many states, if the product causes injury, the manufacturer will be held liable.

Dimensions of Tort: Nature of Injury

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

Dimensions of Tort: Excuses

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

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

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

Damages

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

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

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

KEY TAKEAWAY

There are three kinds of torts, and in two of them (negligent torts and strict liability torts), damages are usually limited to making the victim whole through an enforceable judgment for money damages. These compensatory damages awarded by a court accomplish only approximate justice for the injuries or property damage caused by a tortfeasor. Tort laws go a step further toward deterrence, beyond compensation to the

plaintiff, in occasionally awarding punitive damages against a defendant. These are almost always in cases where an intentional tort has been committed.

EXERCISES

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

7.2 Intentional Torts

LEARNING OBJECTIVES

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

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

Assault and Battery

One of the most obvious intentional torts is assault and battery. Both criminal law and tort law serve to restrain individuals from using physical force on others. Assault is (1) the threat of immediate harm or

offense of contact or (2) any act that would arouse reasonable apprehension of imminent harm. Battery is unauthorized and harmful or offensive physical contact with another person that causes injury.

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

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

False Imprisonment

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

Intentional Infliction of Emotional Distress

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

In an early California case, bill collectors came to the debtor's home repeatedly and threatened the debtor's pregnant wife. Among other things, they claimed that the wife would have to deliver her child in prison. The wife miscarried and had emotional and physical complications. The court found that the behavior of the collection company's two agents was sufficiently outrageous to prove the tort of intentional infliction of emotional distress. In *Roche v. Stern* (New York), the famous cable television talk show host Howard Stern had tastelessly discussed the remains of Deborah Roche, a topless dancer and cable access television host.[1] The remains had been brought to Stern's show by a close friend of Roche, Chaunce Hayden, and a number of crude comments by Stern and Hayden about the remains were videotaped and broadcast on a national cable television station. Roche's sister and brother sued Howard Stern and Infinity broadcasting and were able to get past the defendant's motion to dismiss to have a jury consider their claim.

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

Trespass and Nuisance

Trespass is intentionally going on land that belongs to someone else or putting something on someone else's property and refusing to remove it. This part of tort law shows how strongly the law values the rights of property owners. The right to enjoy your property without interference from others is also found in

common law of nuisance. There are limits to property owners' rights, however. In *Katko v. Briney*, for example, the plaintiff was injured by a spring gun while trespassing on the defendant's property.[2] The defendant had set up No Trespassing signs after ten years of trespassing and housebreaking events, with the loss of some household items. Windows had been broken, and there was "messing up of the property in general." The defendants had boarded up the windows and doors in order to stop the intrusions and finally had set up a shotgun trap in the north bedroom of the house. One defendant had cleaned and oiled his 20-gauge shotgun and taken it to the old house where it was secured to an iron bed with the barrel pointed at the bedroom door. "It was rigged with wire from the doorknob to the gun's trigger so would fire when the door was opened." The angle of the shotgun was adjusted to hit an intruder in the legs. The spring could not be seen from the outside, and no warning of its presence was posted.

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

In *Katko*, there is an intentional tort. But what if someone trespassing is injured by the negligence of the landowner? States have differing rules about trespass and negligence. In some states, a trespasser is only protected against the gross negligence of the landowner. In other states, trespassers may be owed the duty of due care on the part of the landowner. The burglar who falls into a drained swimming pool, for example, may have a case against the homeowner unless the courts or legislature of that state have made it clear that trespassers are owed the limited duty to avoid gross negligence. Or a very small child may wander off his own property and fall into a gravel pit on a nearby property and suffer death or serious injury; if the pit should (in the exercise of due care) have been filled in or some barrier erected around it, then there was negligence. But if the state law holds that the duty to trespassers is only to avoid gross

negligence, the child's family would lose, unless the state law makes an exception for very young trespassers. In general, guests, licensees, and invitees are owed a duty of due care; a trespasser may not be owed such a duty, but states have different rules on this.

Intentional Interference with Contractual Relations

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

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

In a famous case of contract interference, Texaco was sued by Pennzoil for interfering with an agreement that Pennzoil had with Getty Oil. After complicated negotiations between Pennzoil and Getty, a takeover share price was struck, a memorandum of understanding was signed, and a press release announced the agreement in principle between Pennzoil and Getty. Texaco's lawyers, however, believed that Getty oil was "still in play," and before the lawyers for Pennzoil and Getty could complete the paperwork for their agreement, Texaco announced it was offering Getty shareholders an additional $12.50 per share over what Pennzoil had offered.

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

filed a brief that supported Texaco's interpretation of the law, Texaco agreed to pay $3 billion to Pennzoil to dismiss its claim of tortious interference with a contract.

Malicious Prosecution

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

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

Defamation

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

The Restatement (Second) of Torts defines a defamatory communication as one that "so tends to harm the reputation of another as to lower him in the estimation of the community or to deter third persons from associating or dealing with him." [3]

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

The statement must have reference to a particular person, but he or she need not be identified by name. A statement that "the company president is a crook" is defamatory, as is a statement that "the major network weathermen are imposters." The company president and the network weathermen could show that the words were aimed at them. But statements about large groups will not support an action for defamation (e.g., "all doctors are butchers" is not defamatory of any particular doctor).
The law of defamation is largely built on strict liability. That a person did not intend to defame is ordinarily no excuse; a typographical error that converts a true statement into a false one in a newspaper, magazine, or corporate brochure can be sufficient to make out a case of libel. Even the exercise of due care is usually no excuse if the statement is in fact communicated. Repeating a libel is itself a libel; a libel cannot be justified by showing that you were quoting someone else. Though a plaintiff may be able to prove that a statement was defamatory, he is not necessarily entitled to an award of damages. That is because the law contains a number of privileges that excuse the defamation.

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

Absolute Privilege

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

Qualified Privilege

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

In 1964, the Supreme Court handed down its historic decision in *New York Times v. Sullivan*, holding that under the First Amendment a libel judgment brought by a public official against a newspaper cannot stand unless the plaintiff has shown "actual malice," which in turn was defined as "knowledge that [the statement] was false or with a reckless disregard of whether it was false or not."[4] In subsequent cases, the court extended the constitutional doctrine further, applying it not merely to government officials but to **public figures**, people who voluntarily place themselves in the public eye or who involuntarily find themselves the objects of public scrutiny. Whether a private person is or is not a public figure is a difficult question that has so far eluded rigorous definition and has been answered only from case to case. A CEO of a private corporation ordinarily will be considered a private figure unless he puts himself in the public eye—for example, by starring in the company's television commercials.

Invasion of Privacy

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

Appropriation of Name or Likeness

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

Because the publishing and advertising industries are concentrated heavily in New York, the statute plays an important part in advertising decisions made throughout the country. Deciding what "commercial" or "trade" purposes are is not always easy. Thus a newsmagazine may use a baseball player's picture on its cover without first obtaining written permission, but a chocolate manufacturer could not put the player's picture on a candy wrapper without consent.

Personal Space

One form of intrusion upon a person's solitude—trespass—has long been actionable under common law. Physical invasion of home or other property is not a new tort. But in recent years, the notion of intrusion has been broadened considerably. Now, taking photos of someone else with your cell phone in a locker room could constitute invasion of the right to privacy. Reading someone else's mail or e-mail could also

constitute an invasion of the right to privacy. Photographing someone on a city street is not tortious, but subsequent use of the photograph could be. Whether the invasion is in a public or private space, the amount of damages will depend on how the image or information is disclosed to others.

Public Disclosure of Embarassing Facts

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

False Light

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

KEY TAKEAWAY

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

EXERCISES

1. Name two kinds of intentional torts that could result in damage to a business firm's bottom line.

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

---

[1] *Roche v. Stern*, 675 N.Y.S.2d 133 (1998).

[2] *Katko v. Briney*, 183 N.W.2d 657 (Iowa 1971).

[3] Restatement (Second) of Torts, Section 559 (1965).

[4] *Times v. Sullivan*, 376 US 254 (1964).

7.3 Negligence

LEARNING OBJECTIVES

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

Elements of Negligence

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

Determining **negligence** is not always easy. If a driver runs a red light, we can say that he is negligent because a driver must always be careful to ascertain whether the light is red and be able to stop if it is. Suppose that the driver was carrying a badly injured person to a nearby hospital and that after slowing down at an intersection, went through a red light, blowing his horn, whereupon a driver to his right,

seeing him, drove into the intersection anyway and crashed into him. Must one always stop at a red light? Is proof that the light was red always proof of negligence? Usually, but not always: negligence is an abstract concept that must always be applied to concrete and often widely varying sets of circumstances. Whether someone was or was not negligent is almost always a question of fact for a jury to decide. Rarely is it a legal question that a judge can settle.

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

Standard of Care

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

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

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

Duty of Care and Its Breach

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

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

During the course of the twentieth century, the courts have constantly expanded the notion of “foreseeability,” so that today many more people are held to be within the zone of injury than was once the case. For example, it was once believed that a manufacturer or supplier owed a duty of care only to immediate purchasers, not to others who might use the product or to whom the product might be resold. This limitation was known as the rule of privity. And users who were not immediate purchasers were said not to be in privity with a supplier or manufacturer. In 1916, Judge Benjamin N. Cardozo, then on the

New York Court of Appeals, penned an opinion in a celebrated case that exploded the theory of privity, though it would take half a century before the last state—Mississippi in 1966—would fall in line. Determining a duty of care can be a vexing problem. Physicians, for example, are bound by principles of medical ethics to respect the confidences of their patients. Suppose a patient tells a psychiatrist that he intends to kill his girlfriend. Does the physician then have a higher legal duty to warn prospective victim? The California Supreme Court has said yes.[1]

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

Causation: Actual Cause and Proximate Cause

"For want of a nail, the kingdom was lost," as the old saying has it. Virtually any cause of an injury can be traced to some preceding cause. The problem for the law is to know when to draw the line between causes that are immediate and causes too remote for liability reasonably to be assigned to them. In tort theory, there are two kinds of causes that a plaintiff must prove: actual cause and proximate cause. **Actual cause (causation in fact)** can be found if the connection between the defendant's act and the plaintiff's injuries passes the "but for" test: if an injury would not have occurred "but for" the defendant's conduct, then the defendant is the cause of the injury. Still, this is not enough causation to create liability. The injuries to the plaintiff must also be foreseeable, or not "too remote," for the defendant's act to create liability. This is **proximate cause**: a cause that is not too remote or unforseeable.

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

Damages

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

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

Problems of Proof

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

He must show that the defendant took the actions complained of as negligent, demonstrate the circumstances that make the actions negligent, and prove the occurrence and extent of injury. Factual issues are for the jury to resolve. Since it is frequently difficult to make out the requisite proof, the law allows certain presumptions and rules of evidence that ease the plaintiff's task, on the ground that without them substantial injustice would be done. One important rule goes by the Latin phrase **res ipsa loquitur**, meaning "the thing speaks for itself." The best evidence is always the most

direct evidence: an eyewitness account of the acts in question. But eyewitnesses are often unavailable, and in any event they frequently cannot testify directly to the reasonableness of someone's conduct, which inevitably can only be inferred from the circumstances.

In many cases, therefore, **circumstantial evidence** (evidence that is indirect) will be the only evidence or will constitute the bulk of the evidence. Circumstantial evidence can often be quite telling: though no one saw anyone leave the building, muddy footprints tracing a path along the sidewalk are fairly conclusive. Res ipsa loquitur is a rule of circumstantial evidence that permits the jury to draw an inference of negligence. A common statement of the rule is the following: "There must be reasonable evidence of negligence but where the thing is shown to be under the management of the defendant or his servants, and the accident is such as in the ordinary course of things does not happen if those who have the management use proper care, it affords reasonable evidence, in the absence of explanation by the defendants, that the accident arose from want of care." [2]

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

Excuses

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

Contributory and Comparative Negligence

Under an old common-law rule, it was a complete defense to show that the plaintiff in a negligence suit was himself negligent. Even if the plaintiff was only mildly negligent, most of the fault being chargeable to the defendant, the court would dismiss the suit if the plaintiff's conduct contributed to his injury. In a few states today, this rule of **contributory negligence** is still in effect. Although referred to as negligence, the rule encompasses a narrower form than that with which the defendant is charged, because the plaintiff's only error in such cases is in being less careful of himself than he might have been, whereas the defendant is charged with conduct careless toward others. This rule was so manifestly unjust in many cases that most states, either by statute or judicial decision, have changed to some version of **comparative negligence**. Under the rule of comparative negligence, damages are apportioned according to the defendant's degree of culpability. For example, if the plaintiff has sustained a $100,000 injury and is 20 percent responsible, the defendant will be liable for $80,000 in damages.

Assumption of Risk

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

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

The difficulty in many cases is to determine the dividing line between subjectivity and objectivity. If the plaintiff had no actual knowledge of the risk, he cannot be held to have assumed it. On the other hand, it is

easy to claim that you did not appreciate the danger, and the courts will apply an objective standard of community knowledge (a "but you should have known" test) in many situations. When the plaintiff has no real alternative, however, assumption of risk fails as a defense (e.g., a landlord who negligently fails to light the exit to the street cannot claim that his tenants assumed the risk of using it).

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

Act of God

Technically, the rule that no one is responsible for an "act of God," or *force majeure* as it is sometimes called, is not an excuse but a defense premised on a lack of causation. If a force of nature caused the harm, then the defendant was not negligent in the first place. A marina, obligated to look after boats moored at its dock, is not liable if a sudden and fierce storm against which no precaution was possible destroys someone's vessel. However, if it is foreseeable that harm will flow from a negligent condition triggered by a natural event, then there is liability. For example, a work crew failed to remove residue explosive gas from an oil barge. Lightning hit the barge, exploded the gas, and injured several workmen. The plaintiff recovered damages against the company because the negligence consisted in the failure to guard against any one of a number of chance occurrences that could ignite the gas.[3]

Vicarious Liability

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

CC BY NC SA

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

KEY TAKEAWAY

The most common tort claim is based on the negligence of the defendant. In each negligence claim, the plaintiff must establish by a preponderance of the evidence that (1) the defendant had a duty of due care, (2) the defendant breached that duty, (3) that the breach of duty both actually and approximately has caused harm to the plaintiff, and (4) that the harm is measurable in money damages.

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

EXERCISES

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

[1] *Tarasoff v. Regents of University of California*, 551 P.2d 334 (Calif. 1976).

[2] *Scott v. London & St. Katherine Docks Co.*, 3 H. & C. 596, 159 Eng. Rep. 665 (Q.B. 1865).

[3] *Johnson v. Kosmos Portland Cement Co.*, 64 F.2d 193 (6th Cir. 1933).

7.4 Strict Liability

LEARNING OBJECTIVES

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

Historical Basis of Strict Liability: Animals and Ultrahazardous Activities

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

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

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

Strict Liability for Products

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

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

Today, the majority of US states recognize strict liability for defective products, although some states limit strict liability actions to damages for personal injuries rather than property damage. Injured plaintiffs have to prove the product caused the harm but do not have to prove exactly how the manufacturer was

careless. Purchasers of the product, as well as injured guests, bystanders, and others with no direct relationship with the product, may sue for damages caused by the product.

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

1. The product must be in a defective condition when the defendant sells it.
2. The defendant must normally be engaged in the business of selling or otherwise distributing the product.
3. The product must be unreasonably dangerous to the user or consumer because of its defective condition.
4. The plaintiff must incur physical harm to self or to property by using or consuming the product.
5. The defective condition must be the proximate cause of the injury or damage.
6. The goods must not have been substantially changed from the time the product was sold to the time the injury was sustained.

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

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

Under product misuse, a plaintiff who uses a product in an unexpected and unusual way will not recover for injuries caused by such misuse. For example, suppose that someone uses a rotary lawn mower to trim

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

Another defense against strict liability as a cause of action is the knowledgeable user defense. If the parents of obese teenagers bring a lawsuit against McDonald's, claiming that its fast-food products are defective and that McDonald's should have warned customers of the adverse health effects of eating its products, a defense based on the knowledgeable user is available. In one case, the court found that the high levels of cholesterol, fat, salt, and sugar in McDonald's food is well known to users. The court stated, "If consumers know (or reasonably should know) the potential ill health effects of eating at McDonald's, they cannot blame McDonald's if they, nonetheless, choose to satiate their appetite with a surfeit of supersized McDonald's products." [1]

KEY TAKEAWAY

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

EXERCISES

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

---

[1] *Pellman v. McDonald’s Corp.*, 237 F.2d 512 (S.D.N.Y. 2003).

7.5 Cases

Intentional Torts: False Imprisonment

Lester v. Albers Super Markets, Inc.

94 Ohio App. 313, 114 N.E.2d 529 (Ohio 1952)

Facts: The plaintiff, carrying a bag of rolls purchased at another store, entered the defendant’s grocery store to buy some canned fruit. Seeing her bus outside, she stepped out of line and put the can on the counter. The store manager intercepted her and repeatedly demanded that she submit the bag to be searched. Finally she acquiesced; he looked inside and said she could go. She testified that several people witnessed the scene, which lasted about fifteen minutes, and that she was humiliated. The jury awarded her $800. She also testified that no one laid a hand on her or made a move to restrain her from leaving by any one of numerous exits.

* * *

MATTHEWS, JUDGE.

As we view the record, it raises the fundamental question of what is imprisonment. Before any need for a determination of illegality arises there must be proof of imprisonment. In 35 Corpus Juris Secundum (C.J.S.), False Imprisonment, § II, pages 512–13, it is said: "Submission to the mere verbal direction of another, unaccompanied by force or by threats of any character, cannot constitute a false imprisonment, and there is no false imprisonment where an employer interviewing an employee declines to terminate the interview if no force or threat of force is used and false imprisonment may not be predicated on a person's unfounded belief that he was restrained."

Many cases are cited in support of the text.

* * *

In Fenn v. Kroger Grocery & Baking Co., Mo. Sup., 209 S.W. 885, 887, the court said:

> *A case was not made out for false arrest. The plaintiff said she was intercepted as she started to leave the store; that Mr. Krause stood where she could not pass him in going out. She does not say that he made any attempt to intercept her. She says he escorted her back to the desk, that he asked her to let him see the change.*
>
> *...She does not say that she went unwillingly...Evidence is wholly lacking to show that she was detained by force or threats. It was probably a disagreeable experience, a humiliating one to her, but she came out victorious and was allowed to go when she desired with the assurance of Mr. Krause that it was all right. The demurrer to the evidence on both counts was properly sustained.*

The result of the cases is epitomized in 22 Am. Jur. 368, as follows:

A customer or patron who apparently has not paid for what he has received may be detained for a reasonable time to investigate the circumstances, but upon payment of the demand, he has the unqualified right to leave the premises without restraint, so far as the proprietor is concerned, and it is false imprisonment for a private individual to detain one for an unreasonable time, or under unreasonable circumstances, for the purpose of investigating a dispute over the payment of a bill alleged to be owed by the person detained for cash services.

* * *

For these reasons, the judgment is reversed and final judgment entered for the defendant-appellant.

CASE QUESTIONS

1. The court begins by saying what false imprisonment is not. What is the legal definition of false imprisonment?
2. What kinds of detention are permissible for a store to use in accosting those that may have been shoplifting?
3. Jody broke up with Jeremy and refused to talk to him. Jeremy saw Jody get into her car near the business school and parked right behind her so she could not move. He then stood next to the driver's window for fifteen minutes, begging Jody to talk to him. She kept saying, "No, let me leave!" Has Jeremy committed the tort of false imprisonment?

Negligence: Duty of Due Care

Whitlock v. University of Denver

744 P.2d 54 (Supreme Court of Colorado1987)

CC BY NC SA

On June 19, 1978, at approximately 10:00 p.m., plaintiff Oscar Whitlock suffered a paralyzing injury while attempting to complete a one-and-three-quarters front flip on a trampoline. The injury rendered him a quadriplegic. The trampoline was owned by the Beta Theta Pi fraternity (the Beta house) and was situated on the front yard of the fraternity premises, located on the University campus. At the time of his injury, Whitlock was twenty years old, attended the University of Denver, and was a member of the Beta house, where he held the office of acting house manager. The property on which the Beta house was located was leased to the local chapter house association of the Beta Theta Pi fraternity by the defendant University of Denver.

Whitlock had extensive experience jumping on trampolines. He began using trampolines in junior high school and continued to do so during his brief tenure as a cadet at the United States Military Academy at West Point, where he learned to execute the one-and-three-quarters front flip. Whitlock testified that he utilized the trampoline at West Point every other day for a period of two months. He began jumping on the trampoline owned by the Beta house in September of 1977. Whitlock recounted that in the fall and spring prior to the date of his injury, he jumped on the trampoline almost daily. He testified further that prior to the date of his injury, he had successfully executed the one-and-three-quarters front flip between seventy-five and one hundred times.

During the evening of June 18 and early morning of June 19, 1978, Whitlock attended a party at the Beta house, where he drank beer, vodka and scotch until 2:00 a.m. Whitlock then retired and did not awaken until 2:00 p.m. on June 19. He testified that he jumped on the trampoline between 2:00 p.m. and 4:00 p.m., and again at 7:00 p.m. At 10:00 p.m., the time of the injury, there again was a party in progress at the Beta house, and Whitlock was using the trampoline with only the illumination from the windows of the fraternity house, the outside light above the front door of the house, and two street lights in the area. As Whitlock attempted to perform the one-and-three-quarters front flip, he landed on the back of his head, causing his neck to break.

Whitlock brought suit against the manufacturer and seller of the trampoline, the University, the Beta Theta Pi fraternity and its local chapter, and certain individuals in their capacities as representatives of

the Beta Theta Pi organizations. Whitlock reached settlements with all of the named defendants except the University, so only the negligence action against the University proceeded to trial. The jury returned a verdict in favor of Whitlock, assessing his total damages at $ 7,300,000. The jury attributed twenty-eight percent of causal negligence to the conduct of Whitlock and seventy-two percent of causal negligence to the conduct of the University. The trial court accordingly reduced the amount of the award against the University to $ 5,256,000.

The University moved for judgment notwithstanding the verdict, or, in the alternative, a new trial. The trial court granted the motion for judgment notwithstanding the verdict, holding that as a matter of law, no reasonable jury could have found that the University was more negligent than Whitlock, and that the jury's monetary award was the result of sympathy, passion or prejudice.

A panel of the court of appeals reversed...by a divided vote. *Whitlock v. University of Denver,* 712 P.2d 1072 (Colo. App. 1985). The court of appeals held that the University owed Whitlock a duty of due care to remove the trampoline from the fraternity premises or to supervise its use....The case was remanded to the trial court with orders to reinstate the verdict and damages as determined by the jury. The University then petitioned for certiorari review, and we granted that petition.

II.

A negligence claim must fail if based on circumstances for which the law imposes no duty of care upon the defendant for the benefit of the plaintiff. [Citations] Therefore, if Whitlock's judgment against the University is to be upheld, it must first be determined that the University owed a duty of care to take reasonable measures to protect him against the injury that he sustained.

Whether a particular defendant owes a legal duty to a particular plaintiff is a question of law. [Citations] "The court determines, as a matter of law, the existence and scope of the duty—that is, whether the plaintiff's interest that has been infringed by the conduct of the defendant is entitled to legal protection." [Citations] In *Smith v. City & County of Denver,* 726 P.2d 1125 (Colo. 1986), we set forth several factors to be considered in determining the existence of duty in a particular case:

> *Whether the law should impose a duty requires consideration of many factors including, for example, the risk involved, the foreseeability and likelihood of injury as weighed against the social utility of the actor's conduct, the magnitude of the burden of guarding against injury or harm, and the consequences of placing the burden upon the actor.*

...A court's conclusion that a duty does or does not exist is "an expression of the sum total of those considerations of policy which lead the law to say that the plaintiff is [or is not] entitled to protection."

...

We believe that the fact that the University is charged with negligent failure to act rather than negligent affirmative action is a critical factor that strongly militates against imposition of a duty on the University under the facts of this case. In determining whether a defendant owes a duty to a particular plaintiff, the law has long recognized a distinction between action and a failure to act—"that is to say, between active misconduct working positive injury to others [misfeasance] and passive inaction or a failure to take steps to protect them from harm [nonfeasance]." W. Keeton, § 56, at 373. Liability for nonfeasance was slow to receive recognition in the law. "The reason for the distinction may be said to lie in the fact that by 'misfeasance' the defendant has created a new risk of harm to the plaintiff, while by 'nonfeasance' he has at least made his situation no worse, and has merely failed to benefit him by interfering in his affairs." *Id.* The *Restatement (Second) of Torts* § 314 (1965) summarizes the law on this point as follows:

> *The fact that an actor realizes or should realize that action on his part is necessary for another's aid or protection does not of itself impose upon him a duty to take such action.*

Imposition of a duty in all such cases would simply not meet the test of fairness under contemporary standards.

In nonfeasance cases the existence of a duty has been recognized only during the last century in situations involving a limited group of special relationships between parties. Such special relationships are predicated on "some definite relation between the parties, of such a character that social policy justifies the imposition of a duty to act." W. Keeton, § 56, at 374. Special relationships that have been recognized

by various courts for the purpose of imposition of a duty of care include common carrier/passenger, innkeeper/guest, possessor of land/invited entrant, employer/employee, parent/child, and hospital/patient.*See Restatement (Second) of Torts* § 314 A (1965); 3 Harper and James, § 18.6, at 722–23. The authors of the *Restatement (Second) of Torts* § 314 A, comment b (1965), state that "the law appears...to be working slowly toward a recognition of the duty to aid or protect in any relation of dependence or of mutual dependence."

...

III.

The present case involves the alleged negligent failure to act, rather than negligent action. The plaintiff does not complain of any affirmative action taken by the University, but asserts instead that the University owed to Whitlock the duty to assure that the fraternity's trampoline was used only under supervised conditions comparable to those in a gymnasium class, or in the alternative to cause the trampoline to be removed from the front lawn of the Beta house....If such a duty is to be recognized, it must be grounded on a special relationship between the University and Whitlock. According to the evidence, there are only two possible sources of a special relationship out of which such a duty could arise in this case: the status of Whitlock as a student at the University, and the lease between the University and the fraternity of which Whitlock was a member. We first consider the adequacy of the student-university relationship as a possible basis for imposing a duty on the University to control or prohibit the use of the trampoline, and then examine the provisions of the lease for that same purpose.

A.

The student-university relationship has been scrutinized in several jurisdictions, and it is generally agreed that a university is not an insurer of its students' safety. [Citations] The relationship between a university and its students has experienced important change over the years. At one time, college administrators and faculties stood in loco parentis to their students, which created a special relationship "that imposed a duty on the college to exercise control over student conduct and, reciprocally, gave the students certain rights of protection by the college." *Bradshaw*, 612 F.2d at 139. However, in modern times there has evolved a gradual reapportionment of responsibilities from the universities to the students, and a corresponding

departure from the in loco parentis relationship. *Id.* at 139–40. Today, colleges and universities are regarded as educational institutions rather than custodial ones. *Beach*, 726 P.2d at 419 (contrasting colleges and universities with elementary and high schools).

...

...By imposing a duty on the University in this case, the University would be encouraged to exercise more control over private student recreational choices, thereby effectively taking away much of the responsibility recently recognized in students for making their own decisions with respect to private entertainment and personal safety. Such an allocation of responsibility would "produce a repressive and inhospitable environment, largely inconsistent with the objectives of a modern college education." *Beach*, 726 P.2d at 419.

The evidence demonstrates that only in limited instances has the University attempted to impose regulations or restraints on the private recreational pursuits of its students, and the students have not looked to the University to assure the safety of their recreational choices. Nothing in the University's student handbook, which contains certain regulations concerning student conduct, reflects an effort by the University to control the risk-taking decisions of its students in their private recreation....Indeed, fraternity and sorority self-governance with minimal supervision appears to have been fostered by the University.

...

Aside from advising the Beta house on one occasion to put the trampoline up when not in use, there is no evidence that the University officials attempted to assert control over trampoline use by the fraternity members. We conclude from this record that the University's very limited actions concerning safety of student recreation did not give Whitlock or the other members of campus fraternities or sororities any reason to depend upon the University for evaluation of the safety of trampoline use....Therefore, we conclude that the student-university relationship is not a special relationship of the type giving rise to a duty of the University to take reasonable measures to protect the members of fraternities and sororities from risks of engaging in extra-curricular trampoline jumping.

The plaintiff asserts, however, that we should recognize a duty of the University to take affirmative action to protect fraternity members because of the foreseeability of the injury, the extent of the risks involved in trampoline use, the seriousness of potential injuries, and the University's superior knowledge concerning these matters. The argument in essence is that a duty should spring from the University's natural interest in the welfare and safety of its students, its superior knowledge of the nature and degree of risk involved in trampoline use, and its knowledge of the use of trampolines on the University campus. The evidence amply supports a conclusion that trampoline use involves risks of serious injuries and that the potential for an injury such as that experienced by Whitlock was foreseeable. It shows further that prior injuries resulting from trampoline accidents had been reported to campus security and to the student clinic, and that University administrators were aware of the number and severity of trampoline injuries nationwide.

The record, however, also establishes through Whitlock's own testimony that he was aware of the risk of an accident and injury of the very nature that he experienced....

We conclude that the relationship between the University and Whitlock was not one of dependence with respect to the activities at issue here, and provides no basis for the recognition of a duty of the University to take measures for protection of Whitlock against the injury that he suffered.

B.

We next examine the lease between the University and the fraternity to determine whether a special relationship between the University and Whitlock can be predicated on that document. The lease was executed in 1929, extends for a ninety-nine year term, and gives the fraternity the option to extend the term for another ninety-nine years. The premises are to be occupied and used by the fraternity "as a fraternity house, clubhouse, dormitory and boarding house, and generally for religious, educational, social and fraternal purposes." Such occupation is to be "*under control of the tenant.*" (emphasis added) The annual rental at all times relevant to this case appears from the record to be one dollar. The University has the obligation to maintain the grounds and make necessary repairs to the building, and the fraternity is to bear the cost of such maintenance and repair.

...

We conclude that the lease, and the University's actions pursuant to its rights under the lease, provide no basis of dependence by the fraternity members upon which a special relationship can be found to exist between the University and the fraternity members that would give rise to a duty upon the University to take affirmative action to assure that recreational equipment such as a trampoline is not used under unsafe conditions.

IV.

Considering all of the factors presented, we are persuaded that under the facts of this case the University of Denver had no duty to Whitlock to eliminate the private use of trampolines on its campus or to supervise that use. There exists no special relationship between the parties that justifies placing a duty upon the University to protect Whitlock from the well-known dangers of using a trampoline. Here, a conclusion that a special relationship existed between Whitlock and the University sufficient to warrant the imposition of liability for nonfeasance would directly contravene the competing social policy of fostering an educational environment of student autonomy and independence.

We reverse the judgment of the court of appeals and return this case to that court with directions to remand it to the trial court for dismissal of Whitlock's complaint against the University.

CASE QUESTIONS

1. How are comparative negligence numbers calculated by the trial court? How can the jury say that the university is 72 percent negligent and that Whitlock is 28 percent negligent?
2. Why is this not an assumption of risk case?
3. Is there any evidence that Whitlock was contributorily negligent? If not, why would the court engage in comparative negligence calculations?

Negligence: Proximate Cause

Palsgraf v. Long Island R.R.

248 N.Y. 339,162 N.E. 99 (N.Y. 1928)

CARDOZO, Chief Judge

Plaintiff was standing on a platform of defendant's railroad after buying a ticket to go to Rockaway Beach. A train stopped at the station, bound for another place. Two men ran forward to catch it. One of the men reached the platform of the car without mishap, though the train was already moving. The other man, carrying a package, jumped aboard the car, but seemed unsteady as if about to fall. A guard on the car, who had held the door open, reached forward to help him in, and another guard on the platform pushed him from behind. In this act, the package was dislodged, and fell upon the rails. It was a package of small size, about fifteen inches long, and was covered by a newspaper. In fact it contained fireworks, but there was nothing in its appearance to give notice of its contents. The fireworks when they fell exploded. The shock of· the explosion threw down some scales at the other end of the platform many feet away. The scales struck the plaintiff, causing injuries for which she sues.

The conduct of the defendant's guard, if a wrong in its relation to the holder of the package, was not a wrong in its relation to the plaintiff, standing far away. Relatively to her it was not negligence at all. Nothing in the situation gave notice that the falling package had in it the potency of peril to persons thus removed. Negligence is not actionable unless it involves the invasion of a legally protected interest, the violation of a right. "Proof of negligence in the air, so to speak, will not do....If no hazard was apparent to the eye of ordinary vigilance, an act innocent and harmless, at least to outward seeming, with reference to her, did not take to itself the quality of a tort because it happened to be a wrong, though apparently not one involving the risk of bodily insecurity, with reference to someone else....The plaintiff sues in her own right for a wrong personal to her, and not as the vicarious beneficiary of a breach of duty to another.

A different conclusion will involve us, and swiftly too, in a maze of contradictions. A guard stumbles over a package which has been left upon a platform.

It seems to be a bundle of newspapers. It turns out to be a can of dynamite. To the eye of ordinary vigilance, the bundle is abandoned waste, which may be kicked or trod on with impunity. Is a passenger at the other end of the platform protected by the law against the unsuspected hazard concealed beneath the waste? If not, is the result to be any different, so far as the distant passenger is concerned, when the guard stumbles over a valise which a truckman or a porter has left upon the walk?...The orbit of the danger as disclosed to the eye of reasonable vigilance would be the orbit of the duty. One who jostles one's neighbor in a crowd does not invade the rights of others standing at the outer fringe when the unintended contact casts a bomb upon the ground. The wrongdoer as to them is the man who carries the bomb, not the one who explodes it without suspicion of the danger. Life will have to be made over, and human nature transformed, before prevision so extravagant can be accepted as the norm of conduct, the customary standard to which behavior must conform.

The argument for the plaintiff is built upon the shifting meanings of such words as "wrong" and "wrongful" and shares their instability. For what the plaintiff must show is a "wrong" to herself; i.e., a violation of her own right, and not merely a "wrong" to someone else, nor conduct "wrongful" because unsocial, but not a "wrong" to anyone. We are told that one who drives at reckless speed through a crowded city street is guilty of a negligent act and therefore of a wrongful one, irrespective of the consequences.

Negligent the act is, and wrongful in the sense that it is unsocial, but wrongful and unsocial in relation to other travelers, only because the eye of vigilance perceives the risk of damage. If the same act were to be committed on a speedway or a race course, it would lose its wrongful quality. The risk reasonably to be perceived defines the duty to be obeyed, and risk imports relation; it is risk to another or to others within the range of apprehension. This does not mean, of course, that one who launches a destructive force is always relieved of liability, if the force, though known to be destructive, pursues an unexpected path....Some acts, such as shooting are so imminently dangerous to anyone who may come within reach of

the missile however unexpectedly, as to impose a duty of prevision not far from that of an insurer. Even today, and much oftener in earlier stages of the law, one acts sometimes at one's peril....These cases aside, wrong-is defined in terms of the natural or probable, at least when unintentional....Negligence, like risk, is thus a term of relation.

Negligence in the abstract, apart from things related, is surely not a tort, if indeed it is understandable at all....One who seeks redress at law does not make out a cause of action by showing without more that there has been damage to his person. If the harm was not willful, he must show that the act as to him had possibilities of danger so many and apparent as to entitle him to be protected against the doing of it though the harm was unintended.

* * *

The judgment of the Appellate Division and that of the Trial Term should be reversed, and the complaint dismissed, with costs in all courts.

CASE QUESTIONS

1. Is there actual cause in this case? How can you tell?
2. Why should Mrs. Palsgraf (or her insurance company) be made to pay for injuries that were caused by the negligence of the Long Island Rail Road?
3. How is this accident *not* foreseeable?

Klein v. Pyrodyne Corporation

Klein v. Pyrodyne Corporation

810 P.2d 917 (Supreme Court of Washington 1991)

Pyrodyne Corporation (Pyrodyne) is a licensed fireworks display company that contracted to display fireworks at the Western Washington State Fairgrounds in Puyallup, Washington, on July 4,1987. During

the fireworks display, one of the mortar launchers discharged a rocket on a horizontal trajectory parallel to the earth. The rocket exploded near a crowd of onlookers, including Danny Klein. Klein's clothing was set on fire, and he suffered facial burns and serious injury to his eyes. Klein sued Pyrodyne for strict liability to recover for his injuries. Pyrodyne asserted that the Chinese manufacturer of the fireworks was negligent in producing the rocket and therefore Pyrodyne should not be held liable. The trial court applied the doctrine of strict liability and held in favor of Klein. Pyrodyne appealed.

Section 519 of the Restatement (Second) of Torts provides that any party carrying on an "abnormally dangerous activity" is strictly liable for ensuing damages. The public display of fireworks fits this definition. The court stated: "Any time a person ignites rockets with the intention of sending them aloft to explode in the presence of large crowds of people, a high risk of serious personal injury or property damage is created. That risk arises because of the possibility that a rocket will malfunction or be misdirected." Pyrodyne argued that its liability was cut off by the Chinese manufacturer's negligence. The court rejected this argument, stating, "Even if negligence may properly be regarded as an intervening cause, it cannot function to relieve Pyrodyne from strict liability."

The Washington Supreme Court held that the public display of fireworks is an abnormally dangerous activity that warrants the imposition of strict liability.

Affirmed.

CASE QUESTIONS

1. Why would certain activities be deemed ultrahazardous or abnormally dangerous so that strict liability is imposed?
2. If the activities are known to be abnormally dangerous, did Klein assume the risk?
3. Assume that the fireworks were negligently manufactured in China. Should Klein's only remedy be against the Chinese company, as Pyrodyne argues? Why or why not?

7.6 Summary and Exercises

Summary

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

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

What constitutes a legal injury depends very much on the circumstances. A person can assume a risk or consent to the particular action, thus relieving the person doing the injury from tort liability. To be liable, the tortfeasor must be the proximate cause of the injury, not a remote cause. On the other hand, certain people are held to answer for the torts of another—for example, an employer is usually liable for the torts of his employees, and a bartender might be liable for injuries caused by someone to whom he sold too many drinks. Two types of statutes—workers' compensation and no-fault automobile insurance—have eliminated tort liability for certain kinds of accidents and replaced it with an immediate insurance payment plan.

Among the torts of particular importance to the business community are wrongful death and personal injury caused by products or acts of employees, misrepresentation, defamation, and interference with contractual relations.

EXERCISES

1. What is the difference in objectives between tort law and criminal law?
2. A woman fell ill in a store. An employee put the woman in an infirmary but provided no medical care for six hours, and she died. The woman's family sued the store for wrongful death. What arguments could the store make that it was not liable? What arguments could the family make? Which seem the stronger arguments? Why?
3. The signals on a railroad crossing are defective. Although the railroad company was notified of the problem a month earlier, the railroad inspector has failed to come by and repair them. Seeing the all-clear signal, a car drives up and stalls on the tracks as a train rounds the bend. For the past two weeks the car had been stalling, and the driver kept putting off taking the car to the shop for a tune-up. As the train rounds the bend, the engineer is distracted by a conductor and does not see the car until it is too late to stop. Who is negligent? Who must bear the liability for the damage to the car and to the train?
4. Suppose in the *Katko v. Briney* case (Section 7.2 "Intentional Torts") that instead of setting such a device, the defendants had simply let the floor immediately inside the front door rot until it was so weak that anybody who came in and took two steps straight ahead would fall through the floor and to the cellar. Will the defendant be liable in this case? What if they invited a realtor to appraise the place and did not warn her of the floor? Does it matter whether the injured person is a trespasser or an invitee?
5. Plaintiff's husband died in an accident, leaving her with several children and no money except a valid insurance policy by which she was entitled to $5,000. Insurance Company refused to pay, delaying and refusing payment and meanwhile "inviting" Plaintiff to accept less than $5,000, hinting that it had a defense. Plaintiff was reduced to accepting housing and charity from relatives. She sued the insurance company for bad-faith refusal to settle the claim and for the intentional infliction of emotional distress. The lower court dismissed the case. Should the court of appeals allow the matter to proceed to trial?

SELF-TEST QUESTIONS

1 Catarina falsely accuses Jeff of stealing from their employer. The statement is defamatory only if

a. a third party hears it

b. Nick suffers severe emotional distress as a result

c. the statement is the actual and proximate cause of his distress

CC BY NC SA

d. the statement is widely circulated in the local media and on Twitter

2 Garrett files a suit against Colossal Media Corporation for defamation. Colossal has said that Garrett is a "sleazy, corrupt public official" (and provided some evidence to back the claim). To win his case, Garrett will have to show that Colossal acted with

a. malice

b. ill will

c. malice aforethought

d. actual malice

3 Big Burger begins a rumor, using social media, that the meat in Burger World is partly composed of ground-up worms. The rumor is not true, as Big Burger well knows. Its intent is to get some customers to shift loyalty from Burger World to Big Burger. Burger World's best cause of action would be

a. trespass on the case

b. nuisance

c. product disparagement

d. intentional infliction of emotional distress

4 Wilfred Phelps, age 65, is driving his Nissan Altima down Main Street when he suffers the first seizure of his life. He loses control of his vehicle and runs into three people on the sidewalk. Which statement is true?

a. He is liable for an intentional tort.

b. He is liable for a negligent tort.

c. He is not liable for a negligent tort.

d. He is liable under strict liability, because driving a car is abnormally dangerous.

5 Jonathan carelessly bumps into Amanda, knocking her to the ground. He has committed the tort of negligence

a. only if Amanda is injured

b. only if Amanda is not injured

c. whether or not Amanda is injured

SELF-TEST ANSWERS

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

Chapter 8
Contracts

LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. What role contracts play in society today
2. What a contract is
3. The sources of contract law
4. Some basic contract taxonomy
5. The required elements of a contract: mutual assent, consideration, legality, and capacity
6. The circumstances when a contract needs to be in writing to be enforceable
7. The remedies for breach of contract

CC BY NC SA

The two fundamental concepts considered the twin cornerstones of business relationships are contract and tort. Although both involve the concept of duty, creation of the duty differs in a manner that is important to business. The parties create *contract* duties through a bargaining process. The key element in the process is control; individuals are in control of a situation because they have the freedom to decide whether to enter into a contractual relationship. *Tort* duties, in contrast, are obligations the law imposes. Despite the obvious difficulty in controlling tort liability, an understanding of tort theory is important because it is a critical factor in strategic planning and risk management.

8.1 General Perspectives on Contracts

LEARNING OBJECTIVES

1. Understand the role of contract in society: it moves society from status to contract.
2. Know the definition of a contract.
3. Recognize the sources of contract law: the common law, the UCC, and the Convention on the International Sale of Goods—a treaty (the CISG).
4. Understand some fundamental contract taxonomy and terminology.

The Role of Contract in Society

Contract is probably the most familiar legal concept in our society because it is so central to a deeply held conviction about the essence of our political, economic, and social life. In common parlance, the term is

used interchangeably with agreement, bargain, undertaking, or deal; but whatever the word, it embodies our notion of freedom to pursue our own lives together with others. Contract is central because it is the means by which a free society orders what would otherwise be a jostling, frenetic anarchy. So commonplace is the concept of contract—and our freedom to make contracts with each other—that it is difficult to imagine a time when contracts were rare, an age when people's everyday associations with one another were not freely determined. Yet in historical terms, it was not so long ago that contracts were rare, entered into if at all by very few. In "primitive" societies and in the medieval Europe from which our institutions sprang, the relationships among people were largely fixed; traditions spelled out duties that each person owed to family, tribe, or manor. Though he may have oversimplified, Sir Henry Maine, a nineteenth-century historian, sketched the development of society in his classic book *Ancient Law*. *As* he put it:

> *(F)rom a condition of society in which all the relations of Persons are summed up in the relations of Family, we seem to have steadily moved towards a phase of social order in which all these relations arise from the free agreement of Individuals. . . . Thus the status of the Slave has disappeared—it has been superseded by the contractual relation of the servant to his master. . . . The status of the Female under Tutelage . . . has also ceased to exist. . . . So too the status of the Son under Power has no true place in the law of modern European societies. If any civil obligation binds together the Parent and the child of full age, it is one to which only contract gives its legal validity.... If then we employ Status, agreeably with the usage of the best writers, to signify these personal conditions [arising from ancient legal privileges of the Family] only, we may say that the movement of the progressive societies has hitherto been a movement from Status to Contract.*[1]

This movement was not accidental. It went hand-in-glove with the emerging industrial order; from the fifteenth to the nineteenth centuries, as England, especially, evolved into a booming mercantile economy with all that that implies—flourishing trade, growing cities, an expanding monetary system, commercialization of agriculture, mushrooming manufacturing—contract law was created of necessity.

Contract law did not develop, however, according to a conscious, far-seeing plan. It was a response to changing conditions, and the judges who created it frequently resisted, preferring the quieter, imagined pastoral life of their forefathers. Not until the nineteenth century, in both the United States and England, did a full-fledged law of contracts arise together with modem capitalism.

Contract Defined

As usual in the law, the legal definition of "**contract**" is formalistic. The Restatement says: "A contract is a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty." *(Restatement* (Second) *of Contracts*, Section 1) Similarly, the Uniform Commercial Code says: "'Contract' means the total legal obligation which results from the parties' agreement as affected by this Act and any other applicable rules of law." (Section 1-201(11)) A short-hand definition is: "A contract is a legally enforceable promise."

Economic View of Contract Law

In *An Economic Analysis of Law* (1973), Judge Richard A. Posner (a former University of Chicago law professor) suggests that contract law performs three significant economic functions. First, it helps maintain incentives to individuals to exchange goods and services efficiently. Second, it reduces the costs of economic transactions because its very existence means that the parties need not go to the trouble of negotiating a variety of rules and terms already spelled out. Third, the law of contracts alerts the parties to trouble spots that have arisen in the past, thus making it easier to plan the transactions more intelligently and avoid potential pitfalls.

Sources of Contract Law

There are four basic sources of contract law: the Constitution, federal and state statutes, federal and state case law, and administrative law. For our purposes, the most important of these, and the ones that we will examine at some length, are **case law** and statutes.

Case (Common) Law and the Restatement of Contracts

Because contract law was forged in the common-law courtroom, hammered out case by case on the anvil of individual judges, it grew in the course of time to formidable proportions. By the early twentieth century, tens of thousands of contract disputes had been submitted to the courts for resolution, and the published opinions, if collected in one place, would have filled dozens of bookshelves. Clearly this mass of case law was too unwieldy for efficient use. A similar problem had developed in the other leading branches of the common law. Disturbed by the profusion of cases and the resulting uncertainty of the law, a group of prominent American judges, lawyers, and teachers founded the American law Institute in 1923 to attempt to clarify, simplify, and improve the law. One of its first projects, and ultimately one of its most successful, was the drafting of the **Restatement of the Law of Contracts**, completed in 1932. A revision—the *Restatement (Second) of Contracts*—was undertaken in 1946 and finally completed in 1979. The Restatements (others exist in the fields of torts, agency, conflicts of laws, judgments, property, restitution, security, and trusts) are detailed analyses of the decided cases in the field. These analyses are made with an eye to discerning the various principles that have emerged from the courts, and to the maximum extent possible, the Restatements declare the law as the courts have determined it to be. The Restatements, guided by a Reporter (the director of the project) and a staff of legal scholars, go through several so-called "tentative" drafts—sometimes as many as fifteen or twenty—and are screened by various committees within the American Law Institute before they are eventually published as final documents.

The *Restatement of Contracts* won prompt respect in the courts and has been cited in innumerable cases. The Restatements are not authoritative, in the sense that they are not actual judicial precedents, but they are nevertheless weighty interpretive texts, and judges frequently look to them for guidance. They are as close to "black letter" rules of law as exist anywhere in the American legal system for judge-made (common) law.

Statutory Law: The Uniform Commercial Code

Common law contract principles govern contracts for real estate and for services, obviously very important areas of law. But in one area the common law has been superseded by an important statute: the **Uniform Commercial Code (UCC)**, especially **Article 2**, which deals with the sale of goods.

A Brief History

The UCC is a model law developed by the American law Institute and the National Conference of Commissioners on Uniform State Laws; it has been adopted in one form or another in all fifty states, the District of Columbia, and the American territories. It is the only "national" law not enacted by Congress.

Before the UCC was written, commercial law varied, sometimes greatly, from state to state. This first proved a nuisance and then a serious impediment to business as the American economy became nationwide during the twentieth century. Although there had been some uniform laws concerned with commercial deals—including the Uniform Sales Act, first published in 1906—few were widely adopted and none nationally. As a result, the law governing sales of goods, negotiable instruments, warehouse receipts, securities, and other matters crucial to doing business in an industrial, market economy was a crazy quilt of untidy provisions that did not mesh well from state to state.

Initial drafting of the UCC began in 1942 and was ten years in the making, involving the efforts of hundreds of practicing lawyers, law teachers, and judges. A final draft, promulgated by the Institute and the Conference, was endorsed by the American Bar Association and published in 1951.

Pennsylvania enacted the code in its entirety in 1953. It was the only state to enact the original version, because the Law Revision Commission of the New York State legislature began to examine it line by line and had serious objections. Three years later, in 1956, a revised code was issued. This version, known as the 1957 Official Text, was enacted in Massachusetts and Kentucky. In 1958, the Conference and the Institute amended the Code further and again reissued it, this time as the 1958 Official Text. Sixteen states, including Pennsylvania, adopted this version.

But in so doing, many of these states changed particular provisions. As a consequence, the Uniform Commercial Code was no longer so uniform. Responding to this development the American Law Institute established a permanent editorial board to oversee future revisions of the code. Various subcommittees went to work redrafting, and a 1962 Official Text was eventually published. Twelve more states adopted

the code, eleven of them the 1962 text. By 1966, only three states and two territories had failed to enact any version: Arizona, Idaho, Louisiana, Guam, and Puerto Rico.

Meanwhile, non-uniform provisions continued to be enacted in various states, particularly in Article 9, to which 337 such amendments had been made. In 1971, a redraft of that article was readied and the 1972 Official Text was published. By that time, Louisiana was the only holdout. Two years later, in 1974, Louisiana made the UCC a truly national law when it enacted some but not all of the 1972 text (significantly, Louisiana has not adopted Article 2). One more major change was made, a revision of Article 8, necessitated by the electronics revolution that led to new ways of transferring investment securities from seller to purchaser. This change was incorporated in the 1978 Official Text, the version that remains current.

From this brief history, it is clear that the UCC is now a basic law of relevance to every business and business lawyer in the United States, even though it is not entirely uniform because different states have adopted it at various stages of its evolution—an evolution that continues still.

The Basic Framework of the UCC

The UCC embraces the Jaw of "commercial transactions," a term of some ambiguity. A commercial transaction may seem to be a series of separate transactions; it may include, for example, the making of a contract for the sale of goods, the signing of a check, the endorsement of the check, the shipment of goods under a bill of Lading, and so on. However, the UCC presupposes that each of these transactions is a facet of one single transaction: the sale of and payment for goods. The Code deals with phases of this transaction from start to finish. These phases are organized according to the following "articles":

- *Sales* (Article 2)
- *Commercial Paper* (Article 3)
- *Bank Deposits and Collections* (Article 4)
- *Letters of Credit* (Article 5)
- *Bulk Transfers* (Article 6)

- *Warehouse Receipts, Bills of Lading, and Other Documents of Title* (Article 7)
- *Investment Securities* (Article 8)
- *Secured Transactions; Sales of Accounts and Chattel Paper* (Article 9)

We now turn our attention to the sale—the first facet, and the cornerstone, of the commercial transaction. Sales law is a special type of contract law in that Article 2 applies only to the sale of goods, defined (Section 2-105) in part as "all things . . . which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid. . . ." The only contracts and agreements covered by Article 2 are those relating to the present or future sale of goods.

In certain cases, the courts have difficulty in determining the nature of the object of a sales contract. The problem: How can goods and services be separated in contracts calling for the seller to deliver a combination of goods and services? This difficulty frequently arises in product liability cases in which the buyer sues the seller for breach of one of the UCC warranties. For example, you go to the hairdresser for a permanent and the shampoo gives you a severe scalp rash. May you recover damages on the grounds that either the hairdresser or the manufacturer breached an implied warranty in the sale of goods?

When the goods used are incidental to the service, the courts are split on whether the plaintiff should win. Compare *Epstein* v. *Giannattasio*, 197 A.2d 342 (Conn. 1963), in which the court held that no sale of goods had been made because the plaintiff received a treatment in which the cosmetics were only incidentally used, with *Newmark* v. *Gimbel's Inc.*, 258 A.2d 697 (N.J. 1969), in which the court said "[i]f the permanent wave lotion were sold ... for home consumption . . . unquestionably an implied warranty of fitness for that purpose would have been an integral incident of the sale." The New Jersey court rejected the defendant's argument that by actually applying the lotion to the patron's head the salon lessened the liability it otherwise would have had if it had simply sold her the lotion.

In two areas, state legislatures have taken the goods vs. services issue out of the courts' hands and resolved the issue through legislation. One area involves restaurant cases, in which typically the plaintiff charges that he became ill because of tainted food. UCC Section 2·314(1) states that any seller who is

regularly a merchant of the goods sold impliedly warrants their merchantability in a contract for their sale. This section explicitly declares that serving food or drink is a sale, whether they are to be consumed on or off the premises.

The second type of case involves blood transfusions, which can give a patient hepatitis, a serious and sometimes fatal disease. Hospitals and blood banks obviously face large potential liability under the UCC provision just referred to on implied warranty of merchantability. Because medical techniques cannot detect the hepatitis virus in any form of blood used, hospitals and blood banks would be in constant jeopardy, without being able to take effective action to minimize the danger. Most states have enacted legislation specifically providing that blood supplies to be used in transfusions are a service, not goods, thus relieving the suppliers and hospitals of an onerous burden.

Three Basic Contract Types: Sources of Law

With this brief description of the UCC, it should now be clear that the primary sources of law for the three basic types of contracts are:

- Real estate: common law;
- Services: common law;
- Sale of goods: UCC (as interpreted by the courts).

Common law and UCC rules are often similar. For example, both require good faith in the performance of a contract. However, there are two general differences worth noting between the common law of contracts and the UCC's rules governing the sales of goods. First, the UCC is more liberal than the common law in upholding the existence of a contract. For example, in a sales contract (covered by the UCC), "open" terms—that is, those the parties have not agreed upon—do not require a court to rule that no contract was made. However, open terms in a *nonsales* contract will frequently result in a ruling that there is no contract. Second, although the common law of contracts applies to every person equally, under the UCC "merchants" occasionally receive special treatment. By "merchants" the UCC means persons who have special knowledge or skill who deal in the goods involved in the transaction.

The Convention on Contracts for the International Sale of Goods

A **Convention on Contracts for the International Sale of Goods (CISG)** was approved in 1980 at a diplomatic conference in Vienna. (A convention is a preliminary agreement that serves as the basis for a formal treaty.) The Convention has been adopted by several countries, including the United States.

The Convention is significant for three reasons. First, the Convention is a uniform law governing the sale of goods—in effect, an international Uniform Commercial Code. The major goal of the drafters was to produce a uniform law acceptable to countries with different legal, social and economic systems. Second, although provisions in the Convention are generally consistent with the UCC, there are significant differences. For instance, under the Convention, consideration (discussed below) is not required to form a contract and there is no Statute of Frauds (a requirement that some contracts be evidenced by a writing to be enforceable—also discussed below). Finally, the Convention represents the first attempt by the US Senate to reform the private law of business through its treaty powers, for the Convention preempts the UCC if the parties to a contract elect to use the CISG.

Basic Contract Taxonomy

Contracts are not all cut from the same die. Some are written, some oral; some are explicit, some not. Because contracts can be formed, expressed, and enforced in a variety of ways, a taxonomy of contracts has developed that is useful in lumping together like legal consequences. In general, contracts are classified along these dimensions: explicitness, mutuality, enforceability, and degree of completion. **Explicitness** is concerned with the degree to which the agreement is manifest to those not party to it. **Mutuality** takes into account whether promises are exchanged by two parties or only one. **Enforceability** is the degree to which a given contract is binding. **Completion** considers whether the contract is yet to be performed or the obligations have been fully discharged by one or both parties. We will examine each of these concepts in turn.

Explicitness

Express Contract

An **express contract** is one in which the terms are spelled out directly; the parties to an express contract, whether written or oral, are conscious that they are making an enforceable agreement. For example, an agreement to purchase your neighbor's car for $500 and to take title next Monday is an express contract.

Implied Contract

An **implied contract** is one that is inferred from the actions of the parties. Although no discussion of terms took place, an implied contract exists if it is clear from the conduct of both parties that they intended there be one. A delicatessen patron who asks for a "turkey sandwich to go" has made a contract and is obligated to pay when the sandwich is made. By ordering the food, the patron is implicitly agreeing to the price, whether posted or not.

Contract Implied in Law: Quasi-contract

Both express and implied contracts embody an actual agreement of the parties. A **quasi-contract**, by contrast, is an obligation said to be "imposed by law" in order to avoid unjust enrichment of one person at the expense of another. In fact, a quasi-contract is not a contract at all; it is a fiction that the courts created to prevent injustice. Suppose, for example, that a carpenter mistakenly believes you have hired him to repair your porch; in fact, it is your neighbor who has hired him. One Saturday morning he arrives at your doorstep and begins to work. Rather than stop him, you let him proceed, pleased at the prospect of having your porch fixed for free (since you have never talked to the carpenter, you figure you need not pay his bill). Although it is true there is no contract, the law implies a contract for the value of the work.

Mutuality

The garden-variety contract is one in which the parties make mutual promises. Each is both promisor and promisee; that is, each pledges to do something and each is the recipient of such a pledge. This type of contract is called a **bilateral contract**. But mutual promises are not necessary to constitute a contract. **Unilateral contracts**, in which only one party makes a promise, are equally valid but depend upon performance of the promise to be binding. If Charles says to Fran, "I will pay you five dollars if you

wash my car," Charles is contractually bound to pay once Fran washes the car. Fran never makes a promise, but by actually performing she makes Charles liable to pay. A common example of a unilateral contract is the offer "$50 for the return of my lost dog." Frances never makes a promise to the offeror, but if she looks for the dog and finds it, she is entitled to the $50.

Enforceability

Not every agreement between two people is a binding contract. An agreement that is lacking one of the legal elements of a contract is said to be **void**—that is, not a contract at all. An agreement that is illegal—for example, a promise to commit a crime in return for a money payment—is void. Neither party to a void "contract" may enforce it.

By contrast, a **voidable contract** is one that is unenforceable by one party but enforceable by the other. For example, a minor (any person under eighteen, in most states) may "avoid" a contract with an adult; the adult may not enforce the contract against the minor, if the minor refuses to carry out the bargain. But the adult has no choice if the minor wishes the contract to be performed. (A contract may be voidable by both parties if both are minors.) Ordinarily, the parties to a voidable contract are entitled to be restored to their original condition. Suppose you agree to buy your seventeen-year-old neighbor's car. He delivers it to you in exchange for your agreement to pay him next week. He has the legal right to terminate the deal and recover the car, in which case you will of course have no obligation to pay him. If you have already paid him, he still may legally demand a return to the *status quo ante* (previous state of affairs). You must return the car to him; he must return the cash to you.

A voidable contract remains a valid contract until it is voided. Thus, a contract with a minor remains in force unless the minor decides he does not wish to be bound by it. When the minor reaches his majority, he may "ratify" the contract—that is, agree to be bound by it-in which case the contract will no longer be voidable and will thereafter be fully enforceable.

An **unenforceable contract** is one that some rule of law bars a court from enforcing. For example, Tom owes Pete money, but Pete has waited too long to collect it and the statute of limitations has run out. The contract for repayment is unenforceable and Pete is out of luck, unless Tom makes a new promise to pay

or actually pays part of the debt. (However, if Pete is holding collateral as security for the debt, he is entitled to keep it; not all rights are extinguished because a contract is unenforceable.)

Degree of Completion

In medieval England, contract—defined as set of promises—was not an intuitive concept. The courts gave relief to one who wanted to collect a debt, for in such a case the creditor presumably had already given the debtor something of value, and the failure of the debtor to pay up was seen as manifestly unjust. But the issue was less clear when neither promise had yet been fulfilled. Suppose John agrees to sell Humphrey a quantity of wheat in one month. On the appointed day, Humphrey refuses to take the wheat or to pay. The modem law of contracts holds that a valid contract exists and that Humphrey is required to pay John.

An agreement consisting of a set of promises is called an **executory contract** before either promise is carried out. Most executory contracts are enforceable. If one promise or set of terms has been fulfilled—if, for example, John had delivered the wheat to Humphrey—the contract is called **partially executed**. A contract that has been carried out fully by both parties is called an **executed contract**.

KEY TAKEAWAYS

Contract is the mechanism by which people in modern society make choices for themselves, as opposed to being born or placed into a status as is common in feudal societies. A contract is a legally enforceable promise. The law of contract is the common law (for contracts involving real estate and services), statutory law (the Uniform Commercial Code for contract involving the sale or leasing of goods), and treaty law (the Convention on the International Sale of Goods). Contracts may be described based on the degree of their explicitness, mutuality, enforceability, and degree of completion.

EXERCISES

1. What did Sir Henry Maine mean when he wrote of society's movement "from status to contract?
2. Are all promises "contracts"?
3. What is the source of law for contracts involving real estate? For contracts involving the sale of goods?
4. In contract taxonomy, what are the degrees of explicitness, mutuality, enforceability, and of completion?

---

[1] Sir Henry Maine, *Ancient Law* (1869), 180–82.

8.2 Contract Formation

LEARNING OBJECTIVES

1. Understand the elements of common-law contracts: mutuality of agreement (offer and acceptance), consideration, legality, and capacity.
2. Learn when a contract must be in writing—or evidenced by some writing—to be enforceable.

Although it has countless wrinkles and nuances, contract law asks two principal questions: did the parties create a valid, enforceable contract? What remedies are available when one party breaks the contract? The answer to the first question is not always obvious; the range of factors that must be taken into account can be large and their relationship subtle. Since people in business frequently conduct contract negotiations without the assistance of a lawyer, it is important to attend to the nuances to avoid legal trouble at the outset. Whether a valid enforceable contract has been formed depends in turn on whether:

1. The parties reached an agreement (offer and acceptance);
2. Consideration was present (some "price was paid for what was received in return);
3. The agreement was legal;
4. The parties entered into the contract with capacity to make a contract; and
5. The agreement is in the proper form (something in writing, if required).

The Agreement: Offer and Acceptance

The core of a legal contract is the agreement between the parties. That is not merely a matter of convenience; it is at the heart of our received philosophical and psychological beliefs. As the great student of contract law, Samuel Williston, put it:

> *It was a consequence of the emphasis laid on the ego and the individual will that the formation of a contract should seem impossible unless the wills of the parties concurred. Accordingly we find at the end of the eighteenth century, and the beginning of the nineteenth century, the prevalent idea that there must be a "meeting of the minds" (a new phrase) in order to form a contract. (1921, p. 365)*

Although agreements may take any form, including unspoken conduct between the parties (UCC Section 2-204(1)), they are usually structured in terms of an *offer* and an *acceptance*. Note, however, that not every agreement, in the broadest sense of the word, need consist of an offer and acceptance, and it is entirely possible, therefore, for two persons to reach agreement without forming a contract. For example, people may agree that the weather is pleasant or that it would be preferable to go out for Chinese food rather than seeing a foreign film; in neither case has a contract been formed. One of the major functions of the law of contracts is to sort out those agreements that are legally binding—those that are contracts—from those that are not.

In interpreting agreements, courts generally apply an **objective standard**. The *Restatement (Second) of Contracts* defines agreement as a "*manifestation* of mutual assent by two or more persons to one

another." (Section 3) The UCC defines agreement as "the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance." (Section 1-201(3)) The critical question is what the parties said or did, not what they thought they said or did.

The distinction between objective and subjective standards crops up occasionally when one person claims he spoke in jest. The vice president of a manufacturer of punchboards, used in gambling, testified to the Washington State Game Commission that he would pay $100,000 to anyone who found a "crooked board." Barnes, a bartender, who had purchased two that were crooked some time before, brought one to the company office, and demanded payment. The company refused, claiming that the statement was made in jest (the audience before the commission had laughed when the offer was made). The court disagreed, holding that it was reasonable to interpret the pledge of $100,000 as a means of promoting punchboards:

> *(I)f the jest is not apparent and a reasonable hearer would believe that an offer was being made, then the speaker risks the formation of a contract which was not intended. It is the objective manifestations of the offeror that count and not secret, unexpressed intentions. If a party's words or acts, judged by a reasonable standard, manifest an intention to agree in regard to the matter in question, that agreement is established, and it is immaterial what may be the real but unexpressed state of the party's mind on the subject.*[1]

An **offer** is a manifestation of willingness to enter into a bargain such that it would be reasonable for another individual to conclude that assent to the offer would complete the bargain. Offers must be communicated and must be definite; that is, they must spell out terms to which the offeree can assent.

To constitute an agreement, there must be an **acceptance** of the offer. The offeree must manifest his assent to the terms of the offer in a manner invited or required by the offer. Complications arise when an offer is accepted indirectly through correspondence. Although offers and revocations of offers are not effective until received, an acceptance is deemed accepted when sent if the offeree accepts in the manner specified by the offeror.

If the offeror specifies no particular mode, then acceptance is effective when transmitted as long as the offeree uses a reasonable method of acceptance. It is implied that the offeree can use the same means used by the offeror or a means of communication customary to the industry. For example, the use of the postal service was so customary that acceptances are considered effective when mailed, regardless of the method used to transmit the offer. Indeed, the so-called "mailbox rule" (the acceptance is effective upon dispatch) has an ancient lineage, tracing back nearly two hundred years to the English courts.[2]

Consideration

Consideration, is the quid pro quo (something given or received for something else) between the contracting parties in the absence of which the law will not enforce the promise or promises made. Consider the following three "contracts":

1. Betty offers to give a book to Lou. Lou accepts.
2. Betty offers Lou the book in exchange for Lou's promise to pay $15. Lou accepts.
3. Betty offers to give Lou the book if Lou promises to pick it up at Betty's house. Lou accepts.

The question is which, if any, is a binding contract? In American law, only situation 2 is a binding contract, because only that contract contains a set of mutual promises in which each party pledges to give up something to the benefit of the other.

The question of what constitutes a binding contract has been answered differently throughout history and in other cultures. For example, under Roman law, any contract that was reduced to writing was binding, whether or not there was consideration in our sense. Moreover, in later Roman times, certain promises of gifts were made binding, whether written or oral; these would not be binding in the United States. And in the Anglo-American tradition, the presence of a seal was once sufficient to make a contract binding without any other consideration. In most states, the seal is no longer a substitute for consideration, although in some states it creates a presumption of consideration. The Uniform Commercial Code has abolished the seal on contracts for the sale of goods.

The existence of consideration is determined by examining whether the person against whom a promise is to be enforced (the **promisor**) received something in return from the person to whom he made the promise (the **promisee**). That may seem a simple enough question. But as with much in the law, the complicating situations are never very far away. The "something" that is promised or delivered cannot just be anything: a feeling of pride, warmth, amusement, friendship; it must be something known as a **legal detriment**—an act, a forbearance, or a promise of such from the promisee. The detriment need not be an actual detriment; it may in fact be a benefit to the promisee, or at least not a loss. At the same time, the "detriment" to the promisee need not confer a tangible benefit on the promisor; the promisee can agree to forego something without that something being given to the promisor. Whether consideration is legally sufficient has nothing to do with whether it is morally or economically adequate to make the bargain a fair one. Moreover, legal consideration need not even be certain; it can be a promise contingent on an event that may never happen. Consideration is a *legal* concept, and it centers on the giving up of a *legal* right or benefit.

Consideration has two elements. The first, as just outlined, is whether the promisee has incurred a legal detriment. (Some courts—although a minority—take the view that a bargained-for legal benefit to the promisor is sufficient consideration.) The second is whether the legal detriment was *bargained for*: did the promisor specifically intend the act, forbearance, or promise in return for his promise? Applying this two-pronged test to the three examples given at the outset of the chapter, we can easily see why only in the second is there legally sufficient consideration. In the first, Lou incurred no legal detriment; he made no pledge to act or to forbear from acting, nor did he in fact act or forbear from acting. In the third example, what might appear to be such a promise is not really so. Betty made a promise on a condition that Lou come to her house; the intent clearly is to make a gift. Betty was not seeking to induce Lou to come to her house by promising the book.

There is a widely recognized exception to the requirement of consideration. In cases of promissory estoppel, the courts will enforce promises without consideration. Simply stated, **promissory estoppel** means that the courts will stop the promisor from claiming that there was no consideration. The doctrine of promissory estoppel is invoked in the interests of justice when three

conditions are met: (1) the promise is one that the promisor should reasonably expect to induce the promisee to take action or forbear from taking action of a definite and substantial character; (2) the action or forbearance is taken; and (3) injustice can be avoided only by enforcing the promise.

Timko served on the board of trustees of a school. He recommended that the school purchase a building for a substantial sum of money, and to induce the trustees to vote for the purchase, he promised to help with the purchase and to pay at the end of five years the purchase price less the down payment. At the end of four years, Timko died. The school sued his estate, which defended on the ground that there was no consideration for the promise. Timko was promised or given nothing in return, and the purchase of the building was of no direct benefit to him (which would have made the promise enforceable as a unilateral contract). The court ruled that under the three-pronged promissory estoppel test, Timko's estate was liable.[3]

Illegality

In general, illegal contracts are unenforceable. The courts must grapple with two types of illegalities: (1) statutory violations (e.g., the practice of law by a non-lawyer is forbidden by statute), and (2) violations of public policy not expressly declared unlawful by statute, but so declared by the courts.

Capacity

A contract is a meeting of minds. If someone lacks mental **capacity** to understand what he is assenting to—or that he is assenting to anything—it is unreasonable to hold him to the consequences of his act.

The general rule is that persons younger than eighteen can avoid their contracts. Although the age of majority was lowered in most states during the 1970s to correspond to the Twenty-sixth Amendment (ratified in 1971, guaranteeing the right to vote at eighteen), some states still put the age of majority at twenty-one. Legal rights for those under twenty-one remain ambiguous, however. Although eighteen-year-olds may assent to binding contracts, not all creditors and landlords believe it, and they may require parents to cosign. For those under twenty-one, there are also legal impediments to holding certain kinds of jobs, signing certain kinds of contracts, marrying, leaving home, and drinking alcohol. There is as yet no uniform set of rules.

The exact day on which the disability of minority vanishes also varies. The old common law rule put it on the day before the twenty-first birthday. Many states have changed this rule so that majority commences on the day of the eighteenth (or twenty-first) birthday.

A minor's contract is voidable, not void. A child wishing to avoid the contract need do nothing positive to disaffirm; the defense of minority to a lawsuit is sufficient. Although the adult cannot enforce the contract, the child can (which is why it is said to be voidable, not void).

When the minor becomes an adult, he has two choices: he may ratify the contract or **disaffirm** it. She may ratify explicitly; no further consideration is necessary. She may also do so by implication—for instance, by continuing to make payments or retaining goods for an unreasonable period of time. (In some states, a court may ratify the contract before the child becomes an adult. In California, for example, a state statute permits a movie producer to seek court approval of a contract with a child actor in order to prevent the child from disaffirming it upon reaching majority and suing for additional wages. As quid pro quo, the court can order the producer to pay a percentage of the wages into a trust fund that the child's parents or guardians cannot invade.) If the child has not disaffirmed the contract while still a minor, she may do so within a reasonable time after reaching majority.

In most cases of disavowal, the only obligation is to return the goods (if he still has them) or repay the consideration (unless it has been dissipated). However, in two situations, a minor might incur greater liability: contracts for necessities and misrepresentation of age.

Contract for Necessities

At common law, a "necessity" was defined as an essential need of a human being: food, medicine, clothing, and shelter. In recent years, however, the courts have expanded the concept, so that in many states today necessities include property and services that will enable the minor to earn a living and to provide for those dependent on him. If the contract is executory, the minor can simply disaffirm. If the contract has been executed, however, the minor must face more onerous consequences. Although he will

not be required to perform under the contract, he will be liable under a theory of "quasi-contract" for the reasonable value of the necessity.

Misrepresentation of Age

In most states, a minor may misrepresent his age and disaffirm in accordance with the general rule, because that's what kids do, misrepresent their age. That the adult reasonably believed the minor was also an adult is of no consequence in a contract suit. But some states have enacted statutes that make the minor liable in certain situations. A Michigan statute, for instance, prohibits a minor from disaffirming if he has signed a "separate instrument containing only the statement of age, date of signing and the signature:" And some states "estop" him from claiming to be a minor if he falsely represented himself as an adult in making the ·contract. "Estoppel" is a refusal by the courts on equitable grounds to listen to an otherwise valid defense; unless the minor can return the consideration, the contract will be enforced.

Contracts made by an *insane* or *intoxicated* person are also said to have been made by a person lacking capacity. In general, such contracts are voidable by the person when capacity is regained (or by the person's legal representative if capacity is not regained).

Form

As a general rule, a contract need not be in writing to be enforceable. An oral agreement to pay a high-fashion model $1 million to pose for a photograph is as binding as if the language of the deal were printed on vellum and signed in the presence of twenty bishops. For centuries, however, a large exception has grown up around the **Statute of Frauds**, first enacted in England in 1677 under the formal name "An Act for the Prevention of Frauds and Perjuries." The purpose of the Statute of Frauds is to prevent the fraud that occurs when one party attempts to impose upon another a contract that did not in fact exist. The two sections dealing with contracts read as follows:

> *[Sect. 4] ...no action shall be brought whereby to charge any executor or administrator upon any special promise, to answer damages out of his own estate; (2) or whereby to charge the defendant upon any special promise to answer for the debt, default or miscarriages of another person; (3) or to charge any person upon any agreement made upon consideration of marriage;*

(4) or upon any contract or sale of lands, tenements or hereditaments, or any interest in or concerning them; (5) or upon any agreement that is not to be performed within the space of one year from the making thereof; (6) unless the agreement upon which such action shall be brought, or some memorandum or note thereof, shall be in writing, and signed by the party to be charged therewith, or some other person thereunto by him lawfully authorized.

[Sect. 17] ...no contract for the sale of any goods, wares and merchandizes, for the price of ten pounds sterling or upwards, shall be allowed to be good, except the buyer shall accept part of the goods so sold, and actually receive the same, or give something in earnest to bind the bargain, or in part of payment, or that some note or memorandum in writing of the said bargain be made and signed by the parties to be charged by such contract, or their agents thereunto lawfully authorized.

Again, as may be evident from the title of the act and its language, the general purpose of the law is to provide evidence, in areas of some complexity and importance, that a contract was actually made. To a lesser degree, the law serves to caution those about to enter a contract and "to create a climate in which parties often regard their agreements as tentative until there is a signed writing." *(Restatement (Second) of Contracts* Chapter 5, statutory note)

The Statute of Frauds has been enacted in form similar to the seventeenth century act in most states. However, in the twentieth century Section 7 was been replaced by a section Uniform Commercial Code. The UCC requires contracts for the sale of goods for $500 or more and for the sale of securities to be in writing.

KEY TAKEAWAYS

A contract requires mutuality—an offer and an acceptance of the offer; it requires consideration—a "price" paid for what is obtained; it requires that the parties to the contract have legal capacity to know what they are doing; it requires legality. Certain contracts—governed by the statute of frauds—are required to be evidenced by some writing, signed by the party to be bound. The purpose here is to avoid the fraud that occurs when one person attempts to impose upon another a contract that did not really exist.

EXERCISES

1. What are the required elements of a contract?
2. When was the Statute of Frauds first enacted, by whom, and why?
3. Basically, what does the Statute of Frauds require?

---

[1] *Barnes v. Treece*, 549 P.2d 1152 (Wash. App. 1976).

[2] *Adams v. Lindsell*, 1 Bamewall & Alderson 681 (K.B. 1818).

[3] *Estate of Timko v. Oral Roberts Evangelistic Assn.*, 215 N.W.2d 750 (Mich. App. 1974).

8.3 Remedies

LEARNING OBJECTIVES

1. Know the types of damages: compensatory and punitive.
2. Understand specific performance as a remedy.
3. Understand restitution as a remedy.
4. Recognize the interplay between contract and tort as a cause of action.

CC BY NC SA

Monetary awards (called “damages”), specific performance, and restitution are the three principle remedies.

In view of the importance given to the intention of the parties in forming and interpreting contracts, it may seem surprising that the remedy for every breach is not a judicial order that the obligor carry out his undertakings. But it is not. Of course, some duties cannot be performed after a breach: time and circumstances will have altered their purpose and rendered many worthless. Still, although there are numerous occasions on which it would be theoretically possible for courts to order the parties to carry out their contracts, the courts will not do it. In 1897, Justice Oliver Wendell Holmes, Jr., declared in a famous line that “the duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it.” By that he meant simply that the common law looks more toward compensating the promisee for his loss than toward compelling the promisor to perform—a person always has the power, though not the right, to breach a contract. Indeed, the law of remedies often provides the parties with an incentive to break the contract. In short, the promisor has a choice: to perform or pay. The purpose of contract remedies is, for the most part, to compensate the non-breaching party for the losses suffered—to put the non-breaching party in the position he, she, or it would have been in had there been no breach.

Compensatory Damages

One party has the right to **damages** (money) when the other party has breached the contract unless, of course, the contract itself or other circumstances suspend or discharge that right. **Compensatory damages** is the general category of damages awarded to make the non-breaching party whole.

Consequential Damages

A basic principle of contract law is that a person injured by breach of contract is not entitled to compensation unless the breaching party, at the time the contract was made, had reason to foresee the loss as a probable result of the breach. The leading case, perhaps the most studied case in all the common law, is *Hadley* v. *Baxendale*, decided in England in 1854. Joseph and Jonah Hadley were proprietors of a

flour mill in Gloucester. In May 1853, the shaft of the milling engine broke, stopping all milling. An employee went to Pickford and Company, a common carrier, and asked that the shaft be sent as quickly as possible to a Greenwich foundry that would use the shaft as a model to construct a new one. The carrier's agent promised delivery within two days. But through an error the shaft was shipped by canal rather than by rail and did not arrive in Greenwich for seven days. The Hadleys sued Joseph Baxendale, managing director of Pickford, for the profits they lost because of the delay. In ordering a new trial, the Court of Exchequer ruled that Baxendale was not liable because he had had no notice that the mill was stopped:

> *Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, i.e., according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it.*[1]

> *This rule, it has been argued, was a subtle change from the earlier rule that permitted damages for any consequences as long as the breach caused the injury and the plaintiff did not exacerbate it. But the change was evidently rationalized, at least in part, by the observation that in the "usual course of things," a mill would have on hand a spare shaft, so that its operations would not cease.*[2]

This sub-set of compensatory damages is called **consequential damages**—damages that flow as a foreseeable consequence of the breach. For example, if you hire a roofer to fix a leak in your roof, and he does a bad job so that the interior of your house suffers water damage, the roofer is liable not only for the poor roofing job, but also for the ruined drapes, damaged flooring and walls, and so on.

Nominal Damages

If the breach caused no loss, the plaintiff is nevertheless entitled to a minor sum, perhaps one dollar, called **nominal damages**. When, for example, a buyer could purchase the same commodity at the same

CC BY NC SA

price as that contracted for, without spending any extra time or money, there can be no real damages in the event of breach.

Incidental Damages

Suppose City College hires Prof. Blake on a two-year contract, after an extensive search. After one year the professor quits to take a job elsewhere, in breach of her contract. If City College has to pay $5000 more to find a replacement for year, Blake is liable for that amount—that's compensatory damages. But what if it costs City College $1200 to search for, bring to campus and interview a replacement? City College can claim that, too, as **incidental damages** which include additional costs incurred by the non-breaching party after the breach in a reasonable attempt to avoid further loss, even if the attempt is unsuccessful.

Punitive Damages

Punitive damages are those awarded for the purpose of punishing a defendant in a civil action, in which criminal sanctions may be unavailable. They are not part of the compensation for the loss suffered; they are proper in cases in which the defendant has acted willfully and maliciously and are thought to deter others from acting similarly. Since the purpose of contract law is compensation, not punishment, punitive damages have not traditionally been awarded, with one exception: when the breach of contract is also a tort for which punitive damages may be recovered. Punitive damages are permitted in the law of torts (in most states) when the behavior is malicious or willful (reckless conduct causing physical harm, deliberate defamation of one's character, a knowingly unlawful taking of someone's property), and some kinds of contract breach are also tortuous—for example, when a creditor holding collateral as security under a contract for a loan sells the collateral to a good-faith purchaser for value even though the debtor was not in default, he has breached the contract and committed the tort of **conversion**. Punitive damages may be awarded, assuming the behavior was willful and not merely mistaken.

Punitive damages are not fixed by law. The judge or jury may award at its discretion whatever sum is believed necessary to redress the wrong or deter like conduct in the future. This means that a richer person may be slapped with much heavier punitive damages than a poorer one in the appropriate case.

But the judge in all cases may **remit** (lower) some or all of a punitive damage award if he or she considers it excessive.

Punitive damage claims have been made in cases dealing with the refusal by insurance companies to honor their contracts. Many of these cases involve disability payments, and among the elements are charges of tortious conduct by the company's agents or employees. California has been the leader among the state courts in their growing willingness to uphold punitive damage awards despite insurer complaints that the concept of punitive damages is but a device to permit plaintiffs to extort settlements from hapless companies. Courts have also awarded punitive damages against other types of companies for breach of contract.

Specific Performance

Specific performance is a judicial order to the promisor that he undertake the performance to which he obligated himself in a contract. Specific performance is an alternative remedy to damages and may be issued at the discretion of the court, subject to a number of exceptions. (When the promisee is seeking enforcement of a contractual provision for forbearance—a promise that the promisor will refrain from doing something—an injunction, a judicial order not to act in a specified manner, may be the appropriate remedy.) Emily signs a contract to sell Charlotte a gold samovar, a Russian antique of great sentimental value because it once belonged to Charlotte's mother. Emily then repudiates the contract while still executory. A court may properly grant Charlotte an order of specific performance against Emily. Specific performance is an attractive but *limited* remedy: it is only available for breach of contract to sell a unique item (real estate is always unique).

Restitution

As the word implies, **restitution** is a restoring to one party of what he gave to the other. Therefore, only to the extent that the injured party conferred a benefit on the other party may the injured party be awarded restitution.

CC BY NC SA

If the claimant has given the other party a sum of money, there can be no dispute over the amount of the restitution interest. Tom gives Tim $100 to chop his tree into firewood. Tim repudiates. Tom's restitution interest is $100. But serious difficulties can arise when the benefit conferred was performance. The courts have considerable discretion to award either the cost of hiring someone else to do the work that the injured party performed (generally, the market price of the service) or the value that was added to the property of the party in breach by virtue of the claimant's performance. Mellors, a gardener, agrees to construct ten fences around Lady Chatterley's flower gardens at the market price of $2,500. After erecting three, Mellors has performed services that would cost $750, market value. Assume that he has increased the value of the Lady's grounds by $800. If the contract is repudiated, there are two measures of Mellors's restitution interest: $800, the value by which the property was enhanced; or $750, the amount it would have cost Lady Chatterley to hire someone else to do the work. Which measure to use depends on who repudiated the contract and for what reason.

Tort vs. Contract Remedies

Frequently a contract breach may also amount to tortious conduct. A physician warrants her treatment as perfectly safe but performs the operation negligently, scarring the patient for life. The patient could sue for malpractice (tort) or for breach of warranty (contract). The choice involves at least four considerations:

1. *Statute of limitations.* Most statutes of limitations prescribe longer periods for contract than for tort actions.
2. *Allowable damages.* Punitive damages are more often permitted in tort actions, and certain kinds of injuries are compensable in tort but not in contract suits—for example, pain and suffering.
3. *Expert testimony*. In most cases, the use of experts would be the same in either tort or contract suits, but in certain contract cases, the expert witness could be dispensed with, as, for example, in a contract case charging that the physician abandoned the patient.
4. *Insurance coverage.* Most policies do not cover intentional torts, so a contract theory that avoids the element of willfulness would provide the plaintiff with a surer chance of recovering money damages.

KEY TAKEAWAYS

The purpose of remedies in contract is, usually, to put the non-breaching party in the position he or she would have been in had there been no breach. The remedies are: compensatory damages (money paid to compensate the non-breaching party for the losses caused by the breach), which also include sub-categories of incidental and nominal damages; punitive damages (to punish the breaching party) are sometimes allowed where the breach is egregious and intentional.

EXERCISES

1. What are compensatory damages?
2. When is specific performance an appropriate remedy? Will it be used to require a person to perform a service (such as properly repair a leaky roof)?
3. When is restitution used?
4. How could a breach of contract also be a tort, and when is one cause of action chosen over the other?
5. What is the purpose of punitive damages?

---

[1] *Hadley v. Baxendale* (1854), 9 Ex. 341, 354, 156 Eng. Rep. 145, 151.

[2] R. J. Danzig, "Hadley v. Baxendale: A Study in the Industrialization of the Law," *Journal of Legal Studies* 4, no. 249 (1975): 249.

8.4 Cases

Objective Intention

Lucy v. Zehmer

84 S.E.2d 516 (Va. 1954)

CC BY NC SA

Buchanan, J.

This suit was instituted by W. O. Lucy and J. C. Lucy, complainants, against A. H. Zehmer and Ida S. Zehmer, his wife, defendants, to have specific performance of a contract by which it was alleged the Zehmers had sold to W. O. Lucy a tract of land owned by A. H. Zehmer in Dinwiddie county containing 471.6 acres, more or less, known as the Ferguson farm, for $50,000. J. C. Lucy, the other complainant, is a brother of W. O. Lucy, to whom W. O. Lucy transferred a half interest in his alleged purchase.

The instrument sought to be enforced was written by A. H. Zehmer on December 20, 1952, in these words: "We hereby agree to sell to W. O. Lucy the Ferguson farm complete for $50,000.00, title satisfactory to buyer," and signed by the defendants, A. H. Zehmer and Ida S. Zehmer.

The answer of A. H. Zehmer admitted that at the time mentioned W. O. Lucy offered him $50,000 cash for the farm, but that he, Zehmer, considered that the offer was made in jest; that so thinking, and both he and Lucy having had several drinks, he wrote out "the memorandum" quoted above and induced his wife to sign it; that he did not deliver the memorandum to Lucy, but that Lucy picked it up, read it, put it in his pocket, attempted to offer Zehmer $5 to bind the bargain, which Zehmer refused to accept, and realizing for the first time that Lucy was serious, Zehmer assured him that he had no intention of selling the farm and that the whole matter was a joke. Lucy left the premises insisting that he had purchased the farm....

In his testimony Zehmer claimed that he "was high as a Georgia pine," and that the transaction "was just a bunch of two doggoned drunks bluffing to see who could talk the biggest and say the most." That claim is inconsistent with his attempt to testify in great detail as to what was said and what was done....

If it be assumed, contrary to what we think the evidence shows, that Zehmer was jesting about selling his farm to Lucy and that the transaction was intended by him to be a joke, nevertheless the evidence shows that Lucy did not so understand it but considered it to be a serious business transaction and the contract to be binding on the Zehmers as well as on himself. The very next day he arranged with his brother to put up half the money and take a half interest in the land. The day after that he employed an attorney to

examine the title. The next night, Tuesday, he was back at Zehmer's place and there Zehmer told him for the first time, Lucy said, that he wasn't going to sell and he told Zehmer, "You know you sold that place fair and square." After receiving the report from his attorney that the title was good he wrote to Zehmer that he was ready to close the deal.

Not only did Lucy actually believe, but the evidence shows he was warranted in believing, that the contract represented a serious business transaction and a good faith sale and purchase of the farm.

In the field of contracts, as generally elsewhere, "We must look to the outward expression of a person as manifesting his intention rather than to his secret and unexpressed intention. The law imputes to a person an intention corresponding to the reasonable meaning of his words and acts."

At no time prior to the execution of the contract had Zehmer indicated to Lucy by word or act that he was not in earnest about selling the farm. They had argued about it and discussed its terms, as Zehmer admitted, for a long time. Lucy testified that if there was any jesting it was about paying $50,000 that night. The contract and the evidence show that he was not expected to pay the money that night. Zehmer said that after the writing was signed he laid it down on the counter in front of Lucy. Lucy said Zehmer handed it to him. In any event there had been what appeared to be a good faith offer and a good faith acceptance, followed by the execution and apparent delivery of a written contract. Both said that Lucy put the writing in his pocket and then offered Zehmer $5 to seal the bargain. Not until then, even under the defendants' evidence, was anything said or done to indicate that the matter was a joke. Both of the Zehmers testified that when Zehmer asked his wife to sign he whispered that it was a joke so Lucy wouldn't hear and that it was not intended that he should hear.

The mental assent of the parties is not requisite for the formation of a contract. If the words or other acts of one of the parties have but one reasonable meaning, his undisclosed intention is immaterial except when an unreasonable meaning which he attaches to his manifestations is known to the other party.

"* * * The law, therefore, judges of an agreement between two persons exclusively from those expressions of their intentions which are communicated between them. * * *." [Citation]

An agreement or mutual assent is of course essential to a valid contract but the law imputes to a person an intention corresponding to the reasonable meaning of his words and acts. If his words and acts, judged by a reasonable standard, manifest an intention to agree, it is immaterial what may be the real but unexpressed state of his mind.

So a person cannot set up that he was merely jesting when his conduct and words would warrant a reasonable person in believing that he intended a real agreement.

Whether the writing signed by the defendants and now sought to be enforced by the complainants was the result of a serious offer by Lucy and a serious acceptance by the defendants, or was a serious offer by Lucy and an acceptance in secret jest by the defendants, in either event it constituted a binding contract of sale between the parties....

Reversed and remanded.

CASE QUESTIONS

1. What objective evidence was there to support the defendants' contention that they were just kidding when they agreed to sell the farm?
2. Suppose the defendants really did think the whole thing was a kind of joke. Would that make any difference?
3. As a matter of public policy, why does the law use an objective standard to determine the seriousness of intention, instead of a subjective standard?
4. It's 85 degrees in July and 5:00 p.m., quitting time. The battery in Mary's car is out of juice, again. Mary says, "Arrgh! I will sell this stupid car for $50!" Jason, walking to his car nearby, whips out his checkbook

and says, “It’s a deal. Leave your car here. I’ll give you a ride home and pick up your car after you give me the title.” Do the parties have a contract?

Consideration: Preexisting Obligation

Denney v. Reppert

432 S.W.2d 647 (Ky. 1968)

R. L. Myre, Sr., Special Commissioner.

The sole question presented in this case is which of several claimants is entitled to an award for information leading to the apprehension and conviction of certain bank robbers....

On June 12th or 13th, 1963, three armed men entered the First State Bank, Eubank, Kentucky, and with a display of arms and threats robbed the bank of over $30,000 [about $208,000 in 2010 dollars]. Later in the day they were apprehended by State Policemen Garret Godby, Johnny Simms and Tilford Reppert, placed under arrest, and the entire loot was recovered. Later all of the prisoners were convicted and Garret Godby, Johnny Simms and Tilford Reppert appeared as witnesses at the trial.

The First State Bank of Eubank was a member of the Kentucky Bankers Association which provided and advertised a reward of $500.00 for the arrest and conviction of each bank robber. Hence the outstanding reward for the three bank robbers was $1,500.00 [about $11,000 in 2010 dollars]. Many became claimants for the reward and the Kentucky State Bankers Association being unable to determine the merits of the claims for the reward asked the circuit court to determine the merits of the various claims and to adjudge who was entitled to receive the reward or share in it. All of the claimants were made defendants in the action.

At the time of the robbery the claimants Murrell Denney, Joyce Buis, Rebecca McCollum and Jewell Snyder were employees of the First State Bank of Eubank and came out of the grueling situation with great credit and glory. Each one of them deserves approbation and an accolade. They were vigilant in

disclosing to the public and the peace officers the details of the crime, and in describing the culprits, and giving all the information that they possessed that would be useful in capturing the robbers. Undoubtedly, they performed a great service. It is in the evidence that the claimant Murrell Denney was conspicuous and energetic in his efforts to make known the robbery, to acquaint the officers as to the personal appearance of the criminals, and to give other pertinent facts.

The first question for determination is whether the employees of the robbed bank are eligible to receive or share in the reward. The great weight of authority answers in the negative. [Citation] states the rule thusly:

'To the general rule that, when a reward is offered to the general public for the performance of some specified act, such reward may be claimed by any person who performs such act, is the exception of agents, employees and public officials who are acting within the scope of their employment or official duties. * * *.'...

At the time of the robbery the claimants Murrell Denney, Joyce Buis, Rebecca McCollum, and Jewell Snyder were employees of the First State Bank of Eubank. They were under duty to protect and conserve the resources and moneys of the bank, and safeguard every interest of the institution furnishing them employment. Each of these employees exhibited great courage, and cool bravery, in a time of stress and danger. The community and the county have recompensed them in commendation, admiration and high praise, and the world looks on them as heroes. But in making known the robbery and assisting in acquainting the public and the officers with details of the crime and with identification of the robbers, they performed a duty to the bank and the public, for which they cannot claim a reward.

The claims of Corbin Reynolds, Julia Reynolds, Alvie Reynolds and Gene Reynolds also must fail. According to their statements they gave valuable information to the arresting officers. However, they did not follow the procedure as set forth in the offer of reward in that they never filed a claim with the Kentucky Bankers Association. It is well established that a claimant of a reward must comply with the terms and conditions of the offer of reward. [Citation]

State Policemen Garret Godby, Johnny Simms and Tilford Reppert made the arrest of the bank robbers and captured the stolen money. All participated in the prosecution. At the time of the arrest, it was the duty of the state policemen to apprehend the criminals. Under the law they cannot claim or share in the reward and they are interposing no claim to it.

This leaves the defendant, Tilford Reppert the sole eligible claimant. The record shows that at the time of the arrest he was a deputy sheriff in Rockcastle County, but the arrest and recovery of the stolen money took place in Pulaski County. He was out of his jurisdiction, and was thus under no legal duty to make the arrest, and is thus eligible to claim and receive the reward. In [Citation] it was said:
'It is * * * well established that a public officer with the authority of the law to make an arrest may accept an offer of reward or compensation for acts or services performed outside of his bailiwick or not within the scope of his official duties. * * *.'...

It is manifest from the record that Tilford Reppert is the only claimant qualified and eligible to receive the reward. Therefore, it is the judgment of the circuit court that he is entitled to receive payment of the $1,500.00 reward now deposited with the Clerk of this Court.

The judgment is affirmed.

CASE QUESTIONS

1. Why did the Bankers Association put the resolution of this matter into the court's hands?
2. Several claimants came forward for the reward; only one person got it. What was the difference between the person who got the reward and those who did not?

Consequential Damages

EBWS, LLC v. Britly Corp.

CC BY NC SA

928 A.2d 497 (Vt. 2007)

Reiber, C.J.

The Ransom family owns Rock Bottom Farm in Strafford, Vermont, where Earl Ransom owns a dairy herd and operates an organic dairy farm. In 2000, the Ransoms decided to build a creamery on-site to process their milk and formed EBWS, LLC to operate the dairy-processing plant and to market the plant's products. In July 2000, Earl Ransom, on behalf of EBWS, met with Britly's president to discuss building the creamery....In January 2001, EBWS and Britly entered into a contract requiring Britly to construct a creamery building for EBWS in exchange for $160,318....The creamery was substantially completed by April 15, 2001, and EBWS moved in soon afterward. On June 5, 2001, EBWS notified Britly of alleged defects in construction. [EBWS continued to use the creamery pending the necessity to vacate it for three weeks when repairs were commenced].

On September 12, 2001, EBWS filed suit against Britly for damages resulting from defective design and construction....

Following a three-day trial, the jury found Britly had breached the contract and its express warranty, and awarded EBWS: (1) $38,020 in direct damages, and (2) $35,711 in consequential damages....

...The jury's award to EBWS included compensation for both direct and consequential damages that EBWS claimed it would incur while the facility closed for repairs. Direct damages [i.e., compensatory damages] are for "losses that naturally and usually flow from the breach itself," and it is not necessary that the parties actually considered these damages. [Citation]. In comparison, special or consequential damages "must pass the tests of causation, certainty and foreseeability, and, in addition, be reasonably supposed to have been in the contemplation of both parties at the time they made the contract."

...The court ruled that EBWS could not recover for lost profits because it was not a going concern at the time the contract was entered into, and profits were too speculative. The court concluded, however, that

EBWS could submit evidence of other business losses, including future payment for unused milk and staff wages....

At trial, Huyffer, the CEO of EBWS, testified that during a repairs closure the creamery would be required to purchase milk from adjacent Rock Bottom Farm, even though it could not process this milk. She admitted that such a requirement was self-imposed as there was no written output contract between EBWS and the farm to buy milk. In addition, Huyffer testified that EBWS would pay its employees during the closure even though EBWS has no written contract to pay its employees when they are not working. The trial court allowed these elements of damages to be submitted to the jury, and the jury awarded EBWS consequential damages for unused milk and staff wages.

On appeal, Britly contends that because there is no contractual or legal obligation for EBWS to purchase milk or pay its employees, these are not foreseeable damages. EBWS counters that it is common knowledge that cows continue to produce milk, even if the processing plant is not working, and thus it is foreseeable that this loss would occur. We conclude that these damages are not the foreseeable result of Britly's breach of the construction contract and reverse the award....

[W]e conclude that...it is not reasonable to expect Britly to foresee that its failure to perform under the contract would result in this type of damages. While we are sympathetic to EBWS's contention that the cows continue to produce milk, even when the plant is closed down, this fact alone is not enough to demonstrate that buying and dumping milk is a foreseeable result of Britly's breach of the construction contract. Here, the milk was produced by a separate and distinct entity, Rock Bottom Farm, which sold the milk to EBWS....

Similarly, EBWS maintained no employment agreements with its employees obligating it to pay wages during periods of closure for repairs, dips in market demand, or for any other reason. Any losses EBWS might suffer in the future because it chooses to pay its employees during a plant closure for repairs would be a voluntary expense and not in Britly's contemplation at the time it entered the construction contract. It is not reasonable to expect Britly to foresee losses incurred as a result of agreements that are informal in

nature and carry no legal obligation on EBWS to perform. "[P]arties are not presumed to know the condition of each other's affairs nor to take into account contracts with a third party that is not communicated." [Citation] While it is true that EBWS may have business reasons to pay its employees even without a contractual obligation, for example, to ensure employee loyalty, no evidence was introduced at trial by EBWS to support a sound rationale for such considerations. Under these circumstances, this business decision is beyond the scope of what Britly could have reasonably foreseen as damages for its breach of contract....

In addition, the actual costs of the wages and milk are uncertain....[T]he the milk and wages here are future expenses, for which no legal obligation was assumed by EBWS, and which are separate from the terms of the parties' contract. We note that at the time of the construction contract EBWS had not yet begun to operate as a creamery and had no history of buying milk or paying employees. See [Citation] (explaining that profits for a new business are uncertain and speculative and not recoverable). Thus, both the cost of the milk and the number and amount of wages of future employees that EBWS might pay in the event of a plant closure for repairs are uncertain.

Award for consequential damages is reversed....

CASE QUESTIONS

1. Why, according to EBWS's CEO, would EBWS be required to purchase milk from adjacent Rock Bottom Farm, even though it could not process this milk?
2. Surely it is well known in Vermont dairy country that dairy farmers can't simply stop milking cows when no processing plant is available to take the milk—the cows will soon stop producing. Why was EBWS then not entitled to those damages which it will certainly suffer when the creamery is down for repairs?
3. Britly (the contractor) must have known EBWS had employees that would be idled when the creamery shut down for repairs. Why was it not liable for their lost wages?
4. What could EBWS have done at the time of contracting to protect itself against the damages it would incur in the event the creamery suffered downtime due to faulty construction?

8.5 Summary and Exercises

Summary

In this chapter we have seen that two fundamental sources of contract law are the common law as developed in the state courts and as summarized in the *Restatement (Second) of Contracts*, and the Uniform Commercial Code for the sale of goods.

Sales law is a special type of contract law, governed by Article 2 of the UCC. Article 2 governs the sale of goods only, defined as things movable at the time of identification to the contract for sale. When the goods are "sold" incidental to a service, the courts do not agree on whether Article 2 applies. For two categories of goods, legislation specifically answers the question: foodstuffs served by a restaurant are goods; blood supplied for transfusions is not.

Types of contracts can be distinguished along these axes: (1) express and implied, including quasi-contracts implied by law; (2) bilateral and unilateral; (3) enforceable and unenforceable; and (4) completed (executed) and uncompleted (executory). To understand contract law, it is necessary to master these distinctions and their nuances.

In order to determine whether a valid, enforceable contract exists, the following questions must be answered: (1) Did the parties reach an agreement? (2) Was consideration present? (3) Was the agreement legal? (4) Did the parties have capacity to make a contract? (5) Was the agreement in the proper form?

Remedies available against someone who breaches a contract include damages, specific performance, and restitution. Frequently the party who is not in breach must choose between tort and contract remedies.

EXERCISES

1. On November 26, Joe wrote to Kate offering to purchase a farm that she owned. Upon receiving the letter on November 28, Kate immediately sent Joe a letter of acceptance. However, shortly after mailing the letter, Kate had second thoughts and called Joe to advise him that she was rejecting his offer. The call was made before Joe received the letter of acceptance. Has a contract been formed? Why?
2. On a busy day just before April 15, Albert Accountant received a call from a local car dealer. The dealer said, "Hi, Mr. Accountant. Now, while you have income from doing clients' taxes, I have an excellent offer for you. You can buy a new Buick Century automobile completely loaded for $36,000. Al, I know you're busy. If I don't hear from you by the end of the day, I'll assume you want the car." Albert, distracted, did not respond immediately, and the dealer hung up. Then followed an exhausting day of working with anxiety-ridden tax clients. Albert forgot about the conversation. Two days later a statement arrived from the dealer, with instructions on how Albert should pick up the car at the dealership. Is there a contract? Explain.
3. Bert purchased Ernie's car. Before selling the car, Ernie had stated to Bert, "This car runs well and is reliable. Last week I drove the car all the way from Seattle to San Francisco to visit my mother and back again to Seattle." In fact, Ernie was not telling the truth: he had driven the car to San Francisco to visit his paramour, not his mother. Upon discovery of the truth, may Bert avoid the contract? Why?
4. Langstraat was seventeen when he purchased a motorcycle. When applying for insurance, he signed a "Notice of Rejection," declining to purchase uninsured motorist coverage. He was involved in an accident with an uninsured motorist and sought to disaffirm his rejection of the uninsured motorist coverage on the basis of infancy. May he do so?
5. Richard promised to have Darlene's deck awning constructed by July 10. On June 20, Darlene called him and asked if he could get the job done by July 3, in time for Independence Day. Richard said he could, but he failed to do so, and Darlene had to rent two canopies at some expense. Darlene claims that because Richard breached his promise, he is liable for the cost of awning rental. Is she correct—was his promise binding? Why?

6. After taking a business law class at State U, Elke entered into a contract to sell her business law book to a classmate, Matthew, for $45. As part of the same contract, she agreed to prepare a will for Matthew's mother for an additional $110. Elke prepared the will and sent the book to Matthew, but he refused to pay her. Is she entitled to any payment? Explain.
7. Sara Hohe, a fifteen-year-old junior at Mission Bay High School in San Diego, was injured during a campus hypnotism show sponsored by the PTSA as a fund-raiser for the senior class. Hypnotism shows had been held annually since 1980, and Sara had seen the previous year's show. She was selected at random from a group of many volunteers. Her participation in the "Magic of the Mind Show" was conditioned on signing two release forms. Hohe's father signed a form entitled "Mission Bay High School PTSA Presents Dr. Karl Santo." Hohe and her father both signed a form titled "Karl Santo Hypnotist," releasing Santo and the school district from all liability. During the course of the show, while apparently hypnotized, Hohe slid from her chair and also fell to the floor about six times and was injured. She, through her father, then sued the school district. The Hohes claimed the release was contrary to public policy; the trial court dismissed the suit on summary judgment. Was the release contrary to public policy? Decide.
8. Plaintiff Irma Kozlowski cohabited with Defendant Thaddeus Kozlowski for fifteen years without marriage. She repeatedly asked him specifically about her financial situation should he predecease her, and he assured her—she said—that he would arrange to provide for her for the rest of her life. She had provided the necessary household services and emotional support to permit him to successfully pursue his business career; she had performed housekeeping, cleaning, and shopping services and had run the household and raised the children, her own as well as his. When they separated and she was "literally forced out of the house," she was sixty-three years old and had no means or wherewithal for survival. When she sued, he raised the Statute of Frauds' one-year rule as a defense. Is the defense good?
9. Owner of an auto repair shop hires Contractor to remodel his shop but does not mention that two days after the scheduled completion date, Owner is to receive five small US Army personnel carrier trucks for service, with a three-week deadline to finish the job and turn the trucks over to the army. The contract between Owner and the army has a liquidated damages clause calling for $300 a day for every day trucks are not operable after the deadline. Contractor is five days late in finishing the remodel. Can Owner claim the $1,500 as damages against Contractor as a consequence of the latter's tardy completion of the contract? Explain.

10. Calvin, a promising young basketball and baseball player, signed a multiyear contract with a professional basketball team after graduating from college. After playing basketball for one year, he decided he would rather play baseball and breached his contract with the basketball team. What remedy could the team seek?

SELF-TEST QUESTIONS

1 An implied contract

a. must be in writing
b. is one in which the terms are spelled out
c. is one inferred from the actions of the parties
d. is imposed by law to avoid an unjust result
e. may be avoided by one party.

2 The Convention on Contracts for the International Sale of Goods is

a. an annual meeting of international commercial purchasing agents.
b. contract law used in overseas US federal territories
c. a customary format or template for drafting contracts
d. a kind of treaty setting out international contract law, to which the United States is a party
e. the organization that develops uniform international law.

3 Consideration

a. can consist of a written acknowledgment of some benefit received, even if in fact the benefit is not delivered
b. cannot be nominal in amount
c. is a bargained-for act, forbearance, or promise from the promisee
d. is all of the above

4 An example of valid consideration is a promise

a. by a seventeen-year-old to refrain from drinking alcohol
b. to refrain from going to court

c. to cook dinner if the promisor can get around to it

d. to repay a friend for the four years of free legal advice he had provided.

5 A contract to pay a lobbyist to influence a public official is generally illegal.

a. true

b. false

SELF-TEST ANSWERS

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

Chapter 9
Relationships between Principal and Agent

CC BY NC SA

LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. Why agency is important, what an agent is, and the types of agents
2. What an independent contractor is
3. The duties owed by the agent to the principal
4. The duties owed by the principal to the agent

9.1 Introduction to Agency and the Types of Agents

LEARNING OBJECTIVES

CC BY NC SA

1. Understand why agency law is important.
2. Recognize the recurring legal issues in agency law.
3. Know the types of agents.
4. Understand how the agency relationship is created.

Introduction to Agency Law

Why Is Agency Law Important, and What Is an Agent?

An agent is a person who acts in the name of and on behalf of another, having been given and assumed some degree of authority to do so. Most organized human activity—and virtually all commercial activity—is carried on through agency. No corporation would be possible, even in theory, without such a concept. We might say "General Motors is building cars in China," for example, but we can't shake hands with General Motors. "The General," as people say, exists and works through agents. Likewise, partnerships and other business organizations rely extensively on agents to conduct their business. Indeed, it is not an exaggeration to say that agency is the cornerstone of enterprise organization. In a partnership each partner is a general agent, while under corporation law the officers and all employees are agents of the corporation.

The existence of agents does not, however, require a whole new law of torts or contracts. A tort is no less harmful when committed by an agent; a contract is no less binding when negotiated by an agent. What does need to be taken into account, though, is the manner in which an agent acts on behalf of his principal and toward a third party.

Recurring Issues in Agency Law

Several problematic fact scenarios recur in agency, and law has developed in response.

John Alden

Consider John Alden (1599–1687), one of the most famous agents in American literature. He is said to have been the first person from the *Mayflower* to set foot on Plymouth Rock in 1620; he was a carpenter,

a cooper (barrel maker), and a diplomat. His agency task—of interest here—was celebrated in Henry Wadsworth Longfellow's "The Courtship of Miles Standish." He was to woo Priscilla Mullins (d. 1680), "the loveliest maiden of Plymouth," on behalf of Captain Miles Standish, a valiant soldier who was too shy to propose marriage. Standish turned to John Alden, his young and eloquent protégé, and beseeched Alden to speak on his behalf, unaware that Alden himself was in love with Priscilla. Alden accepted his captain's assignment, despite the knowledge that he would thus lose Priscilla for himself, and sought out the lady. But Alden was so tongue-tied that his vaunted eloquence fell short, turned Priscilla cold toward the object of Alden's mission, and eventually led her to turn the tables in one of the most famous lines in American literature and poetry: "Why don't you speak for yourself, John?" John eventually did: the two were married in 1623 in Plymouth.

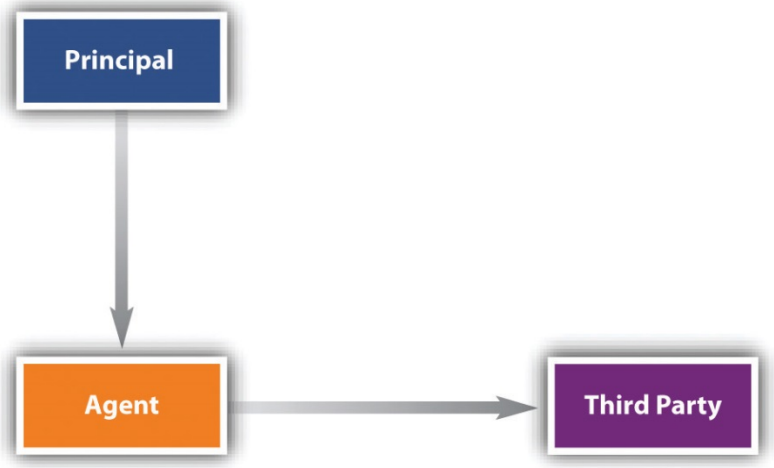
Recurring Issues in Agency

Let's analyze this sequence of events in legal terms—recognizing, of course, that this example is an analogy and that the law, even today, would not impose consequences on Alden for his failure to carry out Captain Standish's wishes. Alden was the captain's agent: he was specifically authorized to speak in his name in a manner agreed on, toward a specified end, and he accepted the assignment in consideration of the captain's friendship. He had, however, a conflict of interest. He attempted to carry out the assignment, but he did not perform according to expectations. Eventually, he wound up with the prize himself. Here are some questions to consider, the same questions that will recur throughout the discussion of agency:

- How extensive was John's authority? Could he have made promises to Priscilla on the captain's behalf—for example, that Standish would have built her a fine house?
- Could he, if he committed a tort, have imposed liability on his principal? Suppose, for example, that he had ridden at breakneck speed to reach Priscilla's side and while en route ran into and injured a pedestrian on the road. Could the pedestrian have sued Standish?
- Suppose Alden had injured himself on the journey. Would Standish be liable to Alden?
- Is Alden liable to Standish for stealing the heart of Priscilla—that is, for taking the "profits" of the enterprise for himself?

As these questions suggest, agency law often involves three parties—the principal, the agent, and a third party. It therefore deals with three different relationships: between principal and agent, between principal and third party, and between agent and third party. These relationships can be summed up in a simple diagram (see Figure 9.1 "Agency Relationships").

Figure 9.1 *Agency Relationships*



In this chapter, we will consider the principal-agent side of the triangle. In the next chapter we will turn to relationships involving third parties.

Types of Agents

There are five types of agents.

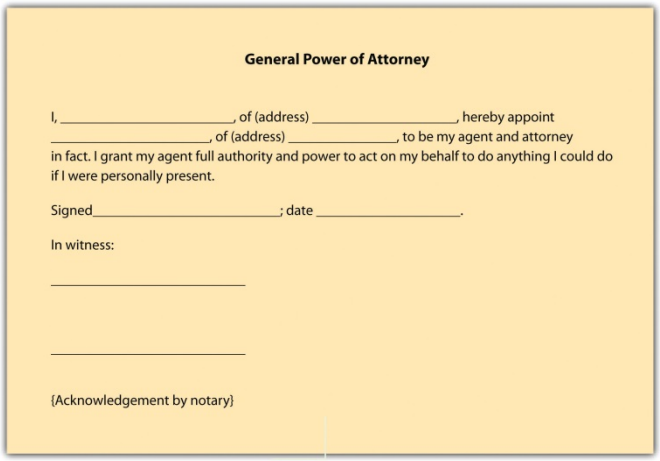
General Agent

The **general agent** possesses the authority to carry out a broad range of transactions in the name and on behalf of the principal. The general agent may be the manager of a business or may have a more limited but nevertheless ongoing role—for example, as a purchasing agent or as a life insurance agent authorized to sign up customers for the home office. In either case, the general agent has authority to alter the principal's legal relationships with third parties. One who is designated a general agent has the authority

to act in any way required by the principal's business. To restrict the general agent's authority, the principal must spell out the limitations explicitly, and even so the principal may be liable for any of the agent's acts in excess of his authority.

Normally, the general agent is a business agent, but there are circumstances under which an individual may appoint a general agent for personal purposes. One common form of a personal general agent is the person who holds another's power of attorney. This is a delegation of authority to another to act in his stead; it can be accomplished by executing a simple form, such as the one shown in Figure 9.2 "General Power of Attorney". Ordinarily, the power of attorney is used for a special purpose—for example, to sell real estate or securities in the absence of the owner. But a person facing a lengthy operation and recuperation in a hospital might give a general power of attorney to a trusted family member or friend.

Figure 9.2 *General Power of Attorney*



General Power of Attorney

I, _____, of (address) _____, hereby appoint _____, of (address) _____, to be my agent and attorney in fact. I grant my agent full authority and power to act on my behalf to do anything I could do if I were personally present.

Signed_____; date _____.

In witness:

_____

_____

{Acknowledgement by notary}

Special Agent

The **special agent** is one who has authority to act only in a specifically designated instance or in a specifically designated set of transactions. For example, a real estate broker is usually a special agent hired to find a buyer for the principal's land. Suppose Sam, the seller, appoints an agent Alberta to find a buyer for his property. Alberta's commission depends on the selling price, which, Sam states in a letter to her, "in any event may be no less than $150,000." If Alberta locates a buyer, Bob, who agrees to purchase the property for $160,000, her signature on the contract of sale will not bind Sam. As a special agent, Alberta had authority only to find a buyer; she had no authority to sign the contract.

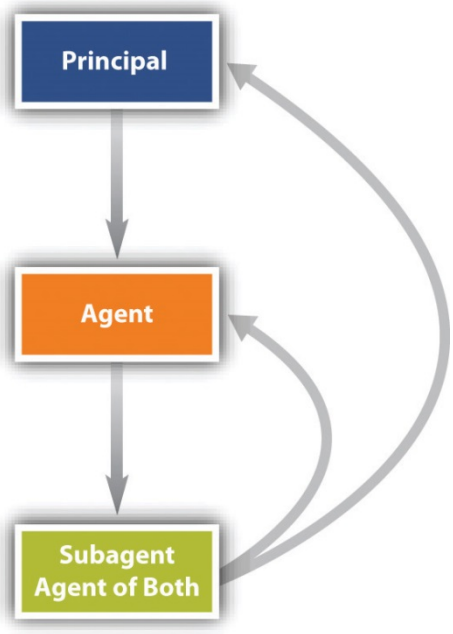
Agency Coupled with an Interest

An agent whose reimbursement depends on his continuing to have the authority to act as an agent is said to have an **agency coupled with an interest** if he has a property interest in the business. A literary or author's agent, for example, customarily agrees to sell a literary work to a publisher in return for a percentage of all monies the author earns from the sale of the work. The literary agent also acts as a collection agent to ensure that his commission will be paid. By agreeing with the principal that the agency is coupled with an interest, the agent can prevent his own rights in a particular literary work from being terminated to his detriment.

Subagent

To carry out her duties, an agent will often need to appoint her own agents. These appointments may or may not be authorized by the principal. An insurance company, for example, might name a general agent to open offices in cities throughout a certain state. The agent will necessarily conduct her business through agents of her own choosing. These agents are **subagents** of the principal if the general agent had the express or implied authority of the principal to hire them. For legal purposes, they are agents of both the principal and the principal's general agent, and both are liable for the subagent's conduct although normally the general agent agrees to be primarily liable (see Figure 9.3 "Subagent").

Figure 9.3 Subagent



Servant

The final category of agent is the **servant**. Until the early nineteenth century, any employee whose work duties were subject to an employer's control was called a servant; we would not use that term so broadly in modern English. The Restatement (Second) of Agency, Section 2, defines a servant as "an agent employed by a master [employer] to perform service in his affairs whose physical conduct in the performance of the service is controlled or is subject to the right to control by the master."

Independent Contractor

Not every contract for services necessarily creates a master-servant relationship. There is an important distinction made between the status of a servant and that of an **independent contractor**. According to the Restatement (Second) of Agency, Section 2, "an independent contractor is a person who contracts with another to do something for him but who is not controlled by the other nor subject to the other's right to control with respect to his physical conduct in the performance of the undertaking." As the name implies, the independent contractor is legally autonomous. A plumber salaried to a building contractor is an employee and agent of the contractor. But a plumber who hires himself out to repair pipes in people's homes is an independent contractor. If you hire a lawyer to settle a dispute, that person is not your employee or your servant; she is an independent contractor. The terms "agent" and "independent

contractor" are not necessarily mutually exclusive. In fact, by definition, "... an independent contractor is an agent in the broad sense of the term in undertaking, at the request of another, to do something for the other. As a general rule the line of demarcation between an independent contractor and a servant is not clearly drawn." [1]

This distinction between agent and independent contractor has important legal consequences for taxation, workers' compensation, and liability insurance. For example, employers are required to withhold income taxes from their employees' paychecks. But payment to an independent contractor, such as the plumber for hire, does not require such withholding. Deciding who is an independent contractor is not always easy; there is no single factor or mechanical answer. In *Robinson v. New York Commodities Corp.*, an injured salesman sought workers' compensation benefits, claiming to be an employee of the New York Commodities Corporation. [2] But the state workmen's compensation board ruled against him, citing a variety of factors. The claimant sold canned meats, making rounds in his car from his home. The company did not establish hours for him, did not control his movements in any way, and did not reimburse him for mileage or any other expenses or withhold taxes from its straight commission payments to him. He reported his taxes on a form for the self-employed and hired an accountant to prepare it for him. The court agreed with the compensation board that these facts established the salesman's status as an independent contractor.

The factual situation in each case determines whether a worker is an employee or an independent contractor. Neither the company nor the worker can establish the worker's status by agreement. As the North Dakota Workmen's Compensation Bureau put it in a bulletin to real estate brokers, "It has come to the Bureau's attention that many employers are requiring that those who work for them sign 'independent contractor' forms so that the employer does not have to pay workmen's compensation premiums for his employees. Such forms are meaningless if the worker is in fact an employee." *Vizcaino v. Microsoft Corporation*, discussed in Section 9.3.2 "Employee versus Independent Contractor", examines the distinction.

In addition to determining a worker's status for tax and compensation insurance purposes, it is sometimes critical for decisions involving personal liability insurance policies, which usually exclude from coverage accidents involving employees of the insureds. *General Accident Fire & Life Assurance Corp v. Pro Golf Association* [3] involved such a situation. The insurance policy in question covered members of the Professional Golfers Association. Gerald Hall, a golf pro employed by the local park department, was afforded coverage under the policy, which excluded "bodily injury to any employee of the insured arising out of and in the course of his employment by the insured." That is, no employee of Hall's would be covered (rather, any such person would have coverage under workers' compensation statutes). Bradley Martin, age thirteen, was at the golf course for junior league play. At Hall's request, he agreed to retrieve or "shag" golf balls to be hit during a lesson Hall was giving; he was—as Hall put it—to be compensated "either through golf instructions or money or hotdogs or whatever." During the course of the lesson, a golf ball hit by Hall hit young Martin in the eye. If Martin was an employee, the insurance company would be liable; if he was not an employee, the insurance company would not liable. The trial court determined he was not an employee. The evidence showed: sometimes the boys who "shagged" balls got paid, got golfing instructions, or got food, so the question of compensation was ambiguous. Martin was not directed in how to perform (the admittedly simple) task of retrieving golf balls, no control was exercised over him, and no equipment was required other than a bag to collect the balls: "We believe the evidence is susceptible of different inferences....We cannot say that the decision of the trial court is against the manifest weight of the evidence."

Creation of the Agency Relationship

The agency relationship can be created in two ways: by agreement (expressly) or by operation of law (constructively or impliedly).

Agency Created by Agreement

Most agencies are created by contract. Thus the general rules of contract law covered in Chapter 8 "Contracts" govern the law of agency. But agencies can also be created without contract, by agreement.

Therefore, three contract principles are especially important: the first is the requirement for consideration, the second for a writing, and the third concerns contractual capacity.

Consideration

Agencies created by consent—agreement—are not necessarily contractual. It is not uncommon for one person to act as an agent for another without consideration. For example, Abe asks Byron to run some errands for him: to buy some lumber on his account at the local lumberyard. Such a **gratuitous agency** gives rise to no different results than the more common contractual agency.

Formalities

Most oral agency contracts are legally binding; the law does not require that they be reduced to writing. In practice, many agency contracts are written to avoid problems of proof. And there are situations where an agency contract must be in writing: (1) if the agreed-on purpose of the agency cannot be fulfilled within one year or if the agency relationship is to last more than one year; (2) in many states, an agreement to pay a commission to a real estate broker; (3) in many states, authority given to an agent to sell real estate; and (4) in several states, contracts between companies and sales representatives.

Even when the agency contract is not required to be in writing, contracts that agents make with third parties often must be in writing. Thus Section 2-201 of the Uniform Commercial Code specifically requires contracts for the sale of goods for the price of five hundred dollars or more to be in writing and "signed by the party against whom enforcement is sought or by his authorized agent."

Capacity

A contract is void or voidable when one of the parties lacks capacity to make one. If both principal and agent lack capacity—for example, a minor appoints another minor to negotiate or sign an agreement—there can be no question of the contract's voidability. But suppose only one or the other lacks capacity. Generally, the law focuses on the principal. If the principal is a minor or otherwise lacks capacity, the

contract can be avoided even if the agent is fully competent. There are, however, a few situations in which the capacity of the agent is important. Thus a mentally incompetent agent cannot bind a principal.

Agency Created by Operation of Law

Most agencies are made by contract, but agency also may arise impliedly or apparently.

Implied Agency

In areas of social need, courts have declared an agency to exist in the absence of an agreement. The agency relationship then is said to have been implied "by operation of law." Children in most states may purchase necessary items—food or medical services—on the parent's account. Long-standing social policy deems it desirable for the head of a family to support his dependents, and the courts will put the expense on the family head in order to provide for the dependents' welfare. The courts achieve this result by supposing the dependent to be the family head's agent, thus allowing creditors to sue the family head for the debt.

Implied agencies also arise where one person behaves as an agent would and the "principal," knowing that the "agent" is behaving so, acquiesces, allowing the person to hold himself out as an agent. Such are the basic facts in *Weingart v. Directoire Restaurant, Inc.* in Section 9.3.1 "Creation of Agency: Liability of Parent for Contracts Made by "Agent" Child".

Apparent Agency

Suppose Arthur is Paul's agent, employed through October 31. On November 1, Arthur buys materials at Lumber Yard—as he has been doing since early spring—and charges them to Paul's account. Lumber Yard, not knowing that Arthur's employment terminated the day before, bills Paul. Will Paul have to pay? Yes, because the termination of the agency was not communicated to Lumber Yard. It *appeared* that Arthur was an authorized agent. This issue is discussed further in Chapter 10 "Liability of Principal and Agent; Termination of Agency".

KEY TAKEAWAY

An agent is one who acts on behalf of another. Many transactions are conducted by agents so acting. All corporate transactions, including those involving governmental organizations, are so conducted because corporations cannot themselves actually act; they are legal fictions. Agencies may be created expressly, impliedly, or apparently. Recurring issues in agency law include whether the "agent" really is such, the scope of the agent's authority, and the duties among the parties. The five types of agents include: general agent, special agent, subagent, agency coupled with an interest, and servant (or employee). The independent contractor is not an employee; her activities are not specifically controlled by her client, and the client is not liable for payroll taxes, Social Security, and the like. But it is not uncommon for an employer to claim workers are independent contractors when in fact they are employees, and the cases are often hard-fought on the facts.

EXERCISES

1. Why is agency law especially important in the business and government context?
2. What are the five types of agents?
3. What distinguishes an employee from an independent contractor?
4. Why do employers frequently try to pass off employees as independent contractors?

---

[1] 1. *Flick v. Crouch*, 434 P.2d 256, 260 (OK, 1967).

[2] *Robinson v. New York Commodities Corp.*, 396 N.Y.S.2d 725, App. Div. (1977).

[3] *General Accident Fire & Life Assurance Corp v. Pro Golf Association*, 352 N.E.2d 441 (Ill. App. 1976).

9.2 Duties between Agent and Principal

LEARNING OBJECTIVES

CC BY NC SA

1. Understand that the agent owes the principal two types of duties: a special duty—the fiduciary duty—and other general duties as recognized in agency law.
2. Recognize that the principal owes the agent duties: contract, tort, and workers' compensation.

Agent's Duty to Principal

The agent owes the principal duties in two categories: the fiduciary duty and a set of general duties imposed by agency law. But these general duties are not unique to agency law; they are duties owed by any employee to the employer.

Fiduciary Duty

In a nonagency contractual situation, the parties' responsibilities terminate at the border of the contract. There is no relationship beyond the agreement. This literalist approach is justified by the more general principle that we each should be free to act unless we commit ourselves to a particular course.

But the agency relationship is more than a contractual one, and the agent's responsibilities go beyond the border of the contract. Agency imposes a higher duty than simply to abide by the contract terms. It imposes a **fiduciary duty**. The law infiltrates the contract creating the agency relationship and reverses the general principle that the parties are free to act in the absence of agreement. As a fiduciary of the principal, the agent stands in a position of special trust. His responsibility is to subordinate his self-interest to that of his principal. The fiduciary responsibility is imposed by law. The absence of any clause in the contract detailing the agent's fiduciary duty does not relieve him of it. The duty contains several aspects.

Duty to Avoid Self-Dealing

A fiduciary may not lawfully profit from a conflict between his personal interest in a transaction and his principal's interest in that same transaction. A broker hired as a purchasing agent, for instance, may not sell to his principal through a company in which he or his family has a financial interest. The penalty for breach of fiduciary duty is loss of compensation and profit and possible damages for breach of trust.

Duty to Preserve Confidential Information

To further his objectives, a principal will usually need to reveal a number of secrets to his agent—how much he is willing to sell or pay for property, marketing strategies, and the like. Such information could easily be turned to the disadvantage of the principal if the agent were to compete with the principal or were to sell the information to those who do. The law therefore prohibits an agent from using for his own purposes or in ways that would injure the interests of the principal, information confidentially given or acquired. This prohibition extends to information gleaned from the principal though unrelated to the agent's assignment: "[A]n agent who is told by the principal of his plans, or who secretly examines books or memoranda of the employer, is not privileged to use such information at his principal's expense." [1] Nor may the agent use confidential information after resigning his agency. Though he is free, in the absence of contract, to compete with his former principal, he may not use information learned in the course of his agency, such as trade secrets and customer lists. Section 9.3.3 "Breach of Fiduciary Duty", *Bacon v. Volvo Service Center, Inc.*, deals with an agent's breach of the duty of confidentiality.

Other Duties

In addition to fiduciary responsibility (and whatever special duties may be contained in the specific contract) the law of agency imposes other duties on an agent. These duties are not necessarily unique to agents: a nonfiduciary employee could also be bound to these duties on the right facts.

Duty of Skill and Care

An agent is usually taken on because he has special knowledge or skills that the principal wishes to tap. The agent is under a legal duty to perform his work with the care and skill that is "standard in the locality for the kind of work which he is employed to perform" and to exercise any special skills, if these are greater or more refined than those prevalent among those normally employed in the community. In short, the agent may not lawfully do a sloppy job. [2]

Duty of Good Conduct

In the absence of an agreement, a principal may not ordinarily dictate how an agent must live his private life. An overly fastidious florist may not instruct her truck driver to steer clear of the local bar on his way home from delivering flowers at the end of the day. But there are some jobs on which the personal habits of the agent may have an effect. The agent is not at liberty to act with impropriety or notoriety, so as to bring disrepute on the business in which the principal is engaged. A lecturer at an antialcohol clinic may be directed to refrain from frequenting bars. A bank cashier who becomes known as a gambler may be fired.

Duty to Keep and Render Accounts

The agent must keep accurate financial records, take receipts, and otherwise act in conformity to standard business practices.

Duty to Act Only as Authorized

This duty states a truism but is one for which there are limits. A principal's wishes may have been stated ambiguously or may be broad enough to confer discretion on the agent. As long as the agent acts reasonably under the circumstances, he will not be liable for damages later if the principal ultimately repudiates what the agent has done: "Only conduct which is contrary to the principal's manifestations to him, interpreted in light of what he has reason to know at the time when he acts,...subjects the agent to liability to the principal."[3]

Duty Not to Attempt the Impossible or Impracticable

The principal says to the agent, "Keep working until the job is done." The agent is not obligated to go without food or sleep because the principal misapprehended how long it would take to complete the job. Nor should the agent continue to expend the principal's funds in a quixotic attempt to gain business, sign up customers, or produce inventory when it is reasonably clear that such efforts would be in vain.

Duty to Obey

As a general rule, the agent must obey reasonable directions concerning the manner of performance. What is reasonable depends on the customs of the industry or trade, prior dealings between agent and

principal, and the nature of the agreement creating the agency. A principal may prescribe uniforms for various classes of employees, for instance, and a manufacturing company may tell its sales force what sales pitch to use on customers. On the other hand, certain tasks entrusted to agents are not subject to the principal's control; for example, a lawyer may refuse to permit a client to dictate courtroom tactics.

Duty to Give Information

Because the principal cannot be every place at once—that is why agents are hired, after all—much that is vital to the principal's business first comes to the attention of agents. If the agent has actual notice or reason to know of information that is relevant to matters entrusted to him, he has a duty to inform the principal. This duty is especially critical because information in the hands of an agent is, under most circumstances, imputed to the principal, whose legal liabilities to third persons may hinge on receiving information in timely fashion. Service of process, for example, requires a defendant to answer within a certain number of days; an agent's failure to communicate to the principal that a summons has been served may bar the principal's right to defend a lawsuit. The imputation to the principal of knowledge possessed by the agent is strict: even where the agent is acting adversely to the principal's interests—for example, by trying to defraud his employer—a third party may still rely on notification to the agent, unless the third party knows the agent is acting adversely.

"Shop Rights" Doctrine

In *Grip Nut Co. v. Sharp*, Sharp made a deal with Grip Nut Company that in return for a salary and bonuses as company president, he would assign to the company any inventions he made.[4] When the five-year employment contract expired, Sharp continued to serve as chief executive officer, but no new contract was negotiated concerning either pay or rights to inventions. During the next ten years, Sharp invented a number of new products and developed new machinery to manufacture them; patent rights went to the company. However, he made one invention with two other employees and they assigned the patent to him. A third employee invented a safety device and also assigned the patent to Sharp. At one time, Sharp's son invented a leakproof bolt and a process to manufacture it; these, too, were assigned to Sharp. These inventions were developed in the company's plants at its expense.

When Sharp died, his family claimed the rights to the inventions on which Sharp held assignments and sued the company, which used the inventions, for patent infringement. The family reasoned that after the expiration of the employment contract, Sharp was employed only in a managerial capacity, not as an inventor. The court disagreed and invoked the **shop rights doctrine**, under which an invention "developed and perfected in [a company's] plant with its time, materials, and appliances, and wholly at its expense" may be used by the company without payment of royalties: "Because the servant uses his master's time, facilities and materials to attain a concrete result, the employer is entitled to use that which embodies his own property and to duplicate it as often as he may find occasion to employ similar appliances in his business." The company would have been given complete ownership of the patents had there been an express or implied (e.g., the employee is hired to make inventions) contract to this effect between Sharp and the company.

Principal's Duty to Agent

In this category, we may note that the principal owes the agent duties in contract, tort, and—statutorily—workers' compensation law.

Contract Duties

The fiduciary relationship of agent to principal does not run in reverse—that is, the principal is not the agent's fiduciary. Nevertheless, the principal has a number of contractually related obligations toward his agent.

General Contract Duties

These duties are analogues of many of the agent's duties that we have just examined. In brief, a principal has a duty "to refrain from unreasonably interfering with [an agent's] work."[5] The principal is allowed, however, to compete with the agent unless the agreement specifically prohibits it. The principal has a duty to inform his agent of risks of physical harm or pecuniary loss that inhere in the agent's performance of assigned tasks. Failure to warn an agent that travel in a particular neighborhood required by the job may be dangerous (a fact unknown to the agent but known to the principal) could under common law subject the principal to a suit for damages if the agent is injured while in the neighborhood performing her job. A

principal is obliged to render accounts of monies due to agents; a principal's obligation to do so depends on a variety of factors, including the degree of independence of the agent, the method of compensation, and the customs of the particular business. An agent's reputation is no less valuable than a principal's, and so an agent is under no obligation to continue working for one who sullies it.

Employment at Will

Under the traditional "employment-at-will" doctrine, an employee who is not hired for a specific period can be fired at any time, for any reason (except bad reasons: an employee cannot be fired, for example, for reporting that his employer's paper mill is illegally polluting groundwater). This doctrine has been much criticized.

Duty to Indemnify

Agents commonly spend money pursuing the principal's business. Unless the agreement explicitly provides otherwise, the principal has a duty to indemnify or reimburse the agent. A familiar form of indemnity is the employee expense account.

Tort and Workers' Compensation Duties

The employer owes the employee—any employee, not just agents—certain statutorily imposed tort and workers' compensation duties.

Background to Workers' Compensation

Andy, who works in a dynamite factory, negligently stores dynamite in the wrong shed. Andy warns his fellow employee Bill that he has done so. Bill lights up a cigarette near the shed anyway, a spark lands on the ground, the dynamite explodes, and Bill is injured. May Bill sue his employer to recover damages? At common law, the answer would be no—three times no. First, the "fellow-servant" rule would bar recovery because the employer was held not to be responsible for torts committed by one employee against another. Second, Bill's failure to heed Andy's warning and his decision to smoke near the dynamite amounted to contributory negligence. Hence even if the dynamite had been negligently stored by the employer rather than by a fellow employee, the claim would have been dismissed. Third, the courts might

have held that Bill had "assumed the risk": since he was aware of the dangers, it would not be fair to saddle the employer with the burden of Bill's actions.

The three common-law rules just mentioned ignited intense public fury by the turn of the twentieth century. In large numbers of cases, workers who were mutilated or killed on the job found themselves and their families without recompense. Union pressure and grass roots lobbying led to **workers' compensation** acts—statutory enactments that dramatically overhauled the law of torts as it affected employees.

The System in General

Workers' compensation is a no-fault system. The employee gives up the right to sue the employer (and, in some states, other employees) and receives in exchange predetermined compensation for a job-related injury, regardless of who caused it. This trade-off was felt to be equitable to employer and employee: the employee loses the right to seek damages for pain and suffering—which can be a sizable portion of any jury award—but in return he can avoid the time-consuming and uncertain judicial process and assure himself that his medical costs and a portion of his salary will be paid—and paid promptly. The employer must pay for all injuries, even those for which he is blameless, but in return he avoids the risk of losing a big lawsuit, can calculate his costs actuarially, and can spread the risks through insurance.

Most workers' compensation acts provide 100 percent of the cost of a worker's hospitalization and medical care necessary to cure the injury and relieve him from its effects. They also provide for payment of lost wages and death benefits. Even an employee who is able to work may be eligible to receive compensation for specific injuries. Part of the table of benefits for specific injuries under the Kansas statute is shown in Note 9.16 "Kansas Workers' Compensation Benefits for Specific Injuries".

Kansas Workers' Compensation Benefits for Specific Injuries

Article 5.—Workers' Compensation

44-510d. Compensation for certain permanent partial disabilities; schedule. If there is an award of permanent disability as a result of the injury there shall be a presumption that disability existed immediately after the injury and compensation is to be paid for not to exceed the number of weeks allowed in the following schedule:

(1) For loss of a thumb, 60 weeks.
(2) For the loss of a first finger, commonly called the index finger, 37 weeks.
(3) For the loss of a second finger, 30 weeks.
(4) For the loss of a third finger, 20 weeks.
(5) For the loss of a fourth finger, commonly called the little finger, 15 weeks.
(6) Loss of the first phalange of the thumb or of any finger shall be considered to be equal to the loss of 1/2 of such thumb or finger, and the compensation shall be 1/2 of the amount specified above. The loss of the first phalange and any part of the second phalange of any finger, which includes the loss of any part of the bone of such second phalange, shall be considered to be equal to the loss of 2/3 of such finger and the compensation shall be 2/3 of the amount specified above. The loss of the first phalange and any part of the second phalange of a thumb which includes the loss of any part of the bone of such second phalange, shall be considered to be equal to the loss of the entire thumb. The loss of the first and second phalanges and any part of the third proximal phalange of any finger, shall be considered as the loss of the entire finger. Amputation through the joint shall be considered a loss to the next higher schedule.
(7) For the loss of a great toe, 30 weeks.
(8) For the loss of any toe other than the great toe, 10 weeks.
(9) The loss of the first phalange of any toe shall be considered to be equal to the loss of 1/2 of such toe and the compensation shall be 1/2 of the amount above specified.
(10) The loss of more than one phalange of a toe shall be considered to be equal to the loss of the entire toe.
(11) For the loss of a hand, 150 weeks.
(12) For the loss of a forearm, 200 weeks.

(13) For the loss of an arm, excluding the shoulder joint, shoulder girdle, shoulder musculature or any other shoulder structures, 210 weeks, and for the loss of an arm, including the shoulder joint, shoulder girdle, shoulder musculature or any other shoulder structures, 225 weeks.

(14) For the loss of a foot, 125 weeks.

(15) For the loss of a lower leg, 190 weeks.

(16) For the loss of a leg, 200 weeks.

(17) For the loss of an eye, or the complete loss of the sight thereof, 120 weeks.

Source:http://www.kslegislature.org/li/statute/044_000_0000_chapter/044_005_0000_article/044_005_0010d_section/044_005_0010d_k/.

The injured worker is typically entitled to two-thirds his or her average pay, not to exceed some specified maximum, for two hundred weeks. If the loss is partial (like partial loss of sight), the recovery is decreased by the percentage still usable.

Coverage

Although workers' compensation laws are on the books of every state, in two states—New Jersey and Texas—they are not compulsory. In those states the employer may decline to participate, in which event the employee must seek redress in court. But in those states permitting an employer election, the old common-law defenses (fellow-servant rule, contributory negligence, and assumption of risk) have been statutorily eliminated, greatly enhancing an employee's chances of winning a suit. The incentive is therefore strong for employers to elect workers' compensation coverage.

Those frequently excluded are farm and domestic laborers and public employees; public employees, federal workers, and railroad and shipboard workers are covered under different but similar laws. The trend has been to include more and more classes of workers. Approximately half the states now provide coverage for household workers, although the threshold of coverage varies widely from state to state. Some use an earnings test; other states impose an hours threshold. People who fall within the domestic category include maids, baby-sitters, gardeners, and handymen but generally not plumbers, electricians, and other independent contractors.

Paying for Workers' Compensation

There are three general methods by which employers may comply with workers' compensation laws. First, they may purchase employer's liability and workers' compensation policies through private commercial insurance companies. These policies consist of two major provisions: payment by the insurer of all claims filed under workers' compensation and related laws (such as occupational disease benefits) and coverage of the costs of defending any suits filed against the employer, including any judgments awarded. Since workers' compensation statutes cut off the employee's right to sue, how can such a lawsuit be filed? The answer is that there are certain exceptions to the ban: for instance, a worker may sue if the employer deliberately injures an employee.

The second method of compliance with workers' compensation laws is to insure through a state fund established for the purpose. The third method is to self-insure. The laws specify conditions under which companies may resort to self-insurance, and generally only the largest corporations qualify to do so. In short, workers' compensation systems create a tax on employers with which they are required (again, in most states) to buy insurance. The amount the employer has to pay for the insurance depends on the number and seriousness of claims made—how dangerous the work is. For example, Washington State's 2011 proposed hourly rates for employers to purchase insurance include these items: for egg and poultry farms, $1.16 per hour; shake and shingle mills, $18.06 per hour; asphalt paving, $2.87 per hour; lawn care maintenance, $1.22 per hour; plastic products manufacturing, $0.87 per hour; freight handling, $1.81 per hour; supermarkets, $0.76; restaurants, $0.43; entertainers and dancers, $7.06; colleges and universities, $0.31.[6]

Recurring Legal Issues

There are a number of legal issues that recur in workers' compensation cases. The problem is, from the employer's point of view, that the cost of buying insurance is tied to the number of claims made. The employer therefore has reason to assert the injured employee is not eligible for compensation. Recurring legal issues include the following:

- Is the injury work related? As a general rule, on-the-job injuries are covered no matter what their relationship to the employee's specific duties. Although injuries resulting from drunkenness or fighting are not generally covered, there are circumstances under which they will be, as Section 9.3.2 "Employee versus Independent Contractor" shows.
- Is the injured person an employee? Courts are apt to be liberal in construing statutes to include those who might not seem to be employed. In*Betts v. Ann Arbor Public Schools*, a University of Michigan student majoring in physical education was a student teacher in a junior high school.[7] During a four-month period, he taught two physical education courses. On the last day of his student teaching, he walked into the locker room and thirty of his students grabbed him and tossed him into the swimming pool. This was traditional, but he "didn't feel like going in that morning" and put up a struggle that ended with a whistle on an elastic band hitting him in the eye, which he subsequently lost as a result of the injury. He filed a workers' compensation claim. The school board argued that he could not be classified as an employee because he received no pay. Since he was injured by students—not considered agents of the school—he would probably have been unsuccessful in filing a tort suit; hence the workers' compensation claim was his only chance of recompense. The state workers' compensation appeal board ruled against the school on the ground that payment in money was not required: "Plaintiff was paid in the form of training, college credits towards graduation, and meeting of the prerequisites of a state provisional certificate." The state supreme court affirmed the award.
- How palpable must the "injury" be? A difficult issue is whether a worker is entitled to compensation for psychological injury, including cumulative trauma. Until the 1970s, insurance companies and compensation boards required physical injury before making an award. Claims that job stresses led to nervous breakdowns or other mental disorders were rejected. But most courts have liberalized the definition of injury and now recognize that psychological trauma can be real and that job stress can bring it on, as shown by the discussion of *Wolfe v. Sibley, Lindsay & Curr Co.* in Section 9.3.4 "Workers' Compensation: What "Injuries" Are Compensable?".

KEY TAKEAWAY

The agent owes the principal two categories of duties: fiduciary and general. The fiduciary duty is the duty to act always in the interest of the principal; the duty here includes that to avoid self-dealing and to preserve confidential information. The general duty owed by the agent encompasses the sorts of obligations any employee might have: the duty of skill and care, of good conduct, to keep and render accounts, to not attempt the impossible or impracticable, to obey, and to give information. The shop rights doctrine provides that inventions made by an employee using the employer's resources and on the employer's time belong to the employer.

The principal owes the agent duties too. These may be categorized as contract and tort duties. The contract duties are to warn the agent of hazards associated with the job, to avoid interfering with the agent's performance of his job, to render accounts of money due the agent, and to indemnify the agent for business expenses according to their agreement. The tort duty owed by the principal to the agent—employee—is primarily the statutorily imposed duty to provide workers' compensation for injuries sustained on the job. In reaction to common-law defenses that often exonerated the employer from liability for workers' injuries, the early twentieth century saw the rise of workers' compensation statutes. These require the employer to provide no-fault insurance coverage for any injury sustained by the employee on the job. Because the employer's insurance costs are claims rated (i.e., the cost of insurance depends on how many claims are made), the employer scrutinizes claims. A number of recurring legal issues arise: Is the injury work related? Is the injured person an employee? What constitutes an "injury"?

EXERCISES

1. Judge Learned Hand, a famous early-twentieth-century jurist (1872–1961), said, "The fiduciary duty is not the ordinary morals of the marketplace." How does the fiduciary duty differ from "the ordinary morals of the marketplace"? Why does the law impose a fiduciary duty on the agent?
2. What are the nonfiduciary duties owed by the agent to the principal?
3. What contract duties are owed by the principal to the agent?
4. Why were workers' compensation statutes adopted in the early twentieth century?
5. How do workers' compensation statutes operate, and how are the costs paid for?

[1] Restatement (Second) of Agency, Section 395.

[2] Restatement (Second) of Agency, Section 379.

[3] Restatement (Second) of Agency, Section 383.

[4] *Grip Nut Co. v. Sharp*, 150 F.2d 192 (7th Cir. 1945).

[5] Restatement (Second) of Agency, Section 434.

[6] Washington State Department of Labor & Industries, *Rates for Workers' Compensation, Proposed 2011 Rates*,http://www.lni.wa.gov/ClaimsIns/Insurance/RatesRisk/Check/RatesHistory.

[7] *Betts v. Ann Arbor Public Schools*, 271 N.W.2d 498 (Mich. 1978).

9.3 Cases

Creation of Agency: Liability of Parent for Contracts Made by "Agent" Child

Weingart v. Directoire Restaurant, Inc.

333 N.Y.S.2d 806 (N.Y., 1972)

KASSEL, J.

The issue here is whether defendant restaurant by permitting an individual to park patrons' cars thereby held him out as its "employee" for such purposes. Admittedly, this individual, one Buster Douglas, is not its employee in the usual sense but with the knowledge of defendant, he did station himself in front of its restaurant, wore a doorman's uniform and had been parking its customers' autos. The parties stipulated that if he were held to be defendant's employee, this created a bailment between the parties [and the "employer" would have to rebut a presumption of negligence if the customer's property was not returned to the customer].

On April 20, 1968, at about 10 P.M., plaintiff drove his 1967 Cadillac Coupe de Ville to the door of the Directoire Restaurant at 160 East 48th Street in Manhattan. Standing in front of the door was Buster Douglas, dressed in a self-supplied uniform, comprised of a regular doorman's cap and matching jacket. Plaintiff gave the keys to his vehicle to Douglas and requested that he park the car. He gave Douglas a $1.00 tip and received a claim check. Plaintiff then entered defendant's restaurant, remained there for approximately 45 minutes and when he departed, Douglas was unable to locate the car which was never returned to plaintiff.

At the time of this occurrence, the restaurant had been open for only nine days, during which time plaintiff had patronized the restaurant on at least one prior occasion.

Defendant did not maintain any sign at its entrance or elsewhere that it would provide parking for its customers (nor, apparently, any sign warning to the contrary).

Buster Douglas parked cars for customers of defendant's restaurant and at least three or four other restaurants on the block. He stationed himself in front of each restaurant during the course of an evening and was so engaged during the evening of April 20, 1968. Defendant clearly knew of and did not object to Douglas' activities outside its restaurant. Defendant's witness testified at an examination before trial:

Q. Did anybody stand outside your restaurant in any capacity whatsoever?

A. There was a man out there parking cars for the block, but he was in no way connected with us or anything like that. He parked cars for the Tamburlaine and also for the Chateau Madrid, Nepentha and a few places around the block.

Q. Did you know that this gentleman was standing outside your restaurant?

A. Yes, I knew he was there.

Q. How did you know that he was standing outside your restaurant?

A. Well, I knew the man's face because I used to work in a club on 55th Street and he was there. When we first opened up here, we didn't know if we would have a doorman or have parking

facilities or what we were going to do at that time. We just let it hang and I told this Buster, Buster was his name, that you are a free agent and you do whatever you want to do. I am tending bar in the place and what you do in the street is up to you, I will not stop you, but we are not hiring you or anything like that, because at that time, we didn't know what we were going to use the parking lot or get a doorman and put on a uniform or what.

These facts establish to the court's satisfaction that, although Douglas was not an actual employee of the restaurant, defendant held him out as its authorized agent or "employee" for the purpose of parking its customers' cars, by expressly consenting to his standing, in uniform, in front of its door to receive customers, to park their cars and issue receipts therefor—which services were rendered without charge to the restaurant's customers, except for any gratuity paid to Douglas. Clearly, under these circumstances, apparent authority has been shown and Douglas acted within the scope of this authority.

Plaintiff was justified in assuming that Douglas represented the restaurant in providing his services and that the restaurant had placed him there for the convenience of its customers. A restaurateur knows that this is the impression created by allowing a uniformed attendant to so act. Facility in parking is often a critical consideration for a motorist in selecting a restaurant in midtown Manhattan, and the Directoire was keenly aware of this fact as evidenced by its testimony that the management was looking into various other possibilities for solving customers' parking problems.

There was no suitable disclaimer posted outside the restaurant that it had no parking facilities or that entrusting one's car to any person was at the driver's risk. It is doubtful that any prudent driver would entrust his car to a strange person on the street, if he thought that the individual had no authorization from the restaurant or club or had no connection with it, but was merely an independent operator with questionable financial responsibility.

The fact that Douglas received no compensation directly from defendant is not material. Each party derived a benefit from the arrangement: Douglas being willing to work for gratuities from customers, and the defendant, at no cost to itself, presenting the appearance of providing the convenience of free parking

and doorman services to its patrons. In any case, whatever private arrangements existed between the restaurant and Douglas were never disclosed to the customers.

Even if such person did perform these services for several restaurants, it does not automatically follow that he is a freelance entrepreneur, since a shared employee working for other small or moderately sized restaurants in the area would seem a reasonable arrangement, in no way negating the authority of the attendant to act as doorman and receive cars for any one of these places individually.

The case most analogous to the instant one is *Klotz v. El Morocco* [Citation, 1968], and plaintiff here relies on it. That case similarly involved the theft of a car parked by a uniformed individual standing in front of defendant's restaurant who, although not employed by it, parked vehicles for its patrons with the restaurant's knowledge and consent. Defendant here attempts to distinguish this case principally upon the ground that the parties in El Morocco *stipulated* that the 'doorman' was an agent or employee of the defendant acting within the scope of his authority. However, the judge made an express finding to that effect: '* * * there was sufficient evidence in plaintiff's case on which to find DiGiovanni, the man in the uniform, was acting within the scope of his authority as agent of defendant." Defendant here also points to the fact that in *Klotz* DiGiovanni placed patrons' car keys on a rack inside El Morocco; however, this is only one fact to be considered in finding a bailment and is, to me, more relevant to the issue of the degree of care exercised.

When defendant's agent failed to produce plaintiff's automobile, a presumption of negligence arose which now requires defendant to come forward with a sufficient explanation to rebut this presumption. [Citation] The matter should be set down for trial on the issues of due care and of damages.

CASE QUESTIONS

1. Buster Douglas was not the restaurant's employee. Why did the court determine his negligence could nevertheless be imputed to the restaurant?
2. The plaintiff in this case relied on *Klotz*, very similar in facts, in which the car-parking attendant *was* found to be an employee. The defendant, necessarily, needed to argue that the cases were not very similar. What argument did the defendant make? What did the court say about that argument?
3. The restaurant here is a bailee—it has rightful possession of the plaintiff's (bailor's) property, the car. If the car is not returned to the plaintiff a rebuttable presumption of negligence arises. What does that mean?

Employee versus Independent Contractor

Vizcaino v. Microsoft Corp.

97 F.3d 1187 (9th Cir. 1996)

Reinhardt, J.

Large corporations have increasingly adopted the practice of hiring temporary employees or independent contractors as a means of avoiding payment of employee benefits, and thereby increasing their profits. This practice has understandably led to a number of problems, legal and otherwise. One of the legal issues that sometimes arises is exemplified by this lawsuit. The named plaintiffs, who were classified by Microsoft as independent contractors, seek to strip that label of its protective covering and to obtain for themselves certain benefits that the company provided to all of its regular or permanent employees. After certifying the named plaintiffs as representatives of a class of "common-law employees," the district court granted summary judgment to Microsoft on all counts. The plaintiffs...now appeal as to two of their claims: a) the claim...that they are entitled to savings benefits under Microsoft's Savings Plus Plan (SPP); and b) that...they are entitled to stock-option benefits under Microsoft's Employee Stock Purchase Plan (ESPP). In both cases, the claims are based on their contention that they are common-law employees.

CC BY NC SA

Microsoft, one of the country's fastest growing and most successful corporations and the world's largest software company, produces and sells computer software internationally. It employs a core staff of permanent employees. It categorizes them as "regular employees" and offers them a wide variety of benefits, including paid vacations, sick leave, holidays, short-term disability, group health and life insurance, and pensions, as well as the two benefits involved in this appeal. Microsoft supplements its core staff of employees with a pool of individuals to whom it refuses to pay fringe benefits. It previously classified these individuals as "independent contractors" or "freelancers," but prior to the filing of the action began classifying them as "temporary agency employees." Freelancers were hired when Microsoft needed to expand its workforce to meet the demands of new product schedules. The company did not, of course, provide them with any of the employee benefits regular employees receive.

The plaintiffs...performed services as software testers, production editors, proofreaders, formatters and indexers. Microsoft fully integrated the plaintiffs into its workforce: they often worked on teams along with regular employees, sharing the same supervisors, performing identical functions, and working the same core hours. Because Microsoft required that they work on site, they received admittance card keys, office equipment and supplies from the company.

Freelancers and regular employees, however, were not without their obvious distinctions. Freelancers wore badges of a different color, had different electronic-mail addresses, and attended a less formal orientation than that provided to regular employees. They were not permitted to assign their work to others, invited to official company functions, or paid overtime wages. In addition, they were not paid through Microsoft's payroll department. Instead, they submitted invoices for their services, documenting their hours and the projects on which they worked, and were paid through the accounts receivable department.

The plaintiffs were told when they were hired that, as freelancers, they would not be eligible for benefits. None has contended that Microsoft ever promised them any benefits individually. All eight named plaintiffs signed [employment agreements] when first hired by Microsoft or soon thereafter. [One] included a provision that states that the undersigned "agrees to be responsible for all federal and state taxes, withholding, social security, insurance and other benefits." The [other one] states that "as an

Independent Contractor to Microsoft, you are self-employed and are responsible to pay all your own insurance and benefits." Eventually, the plaintiffs learned of the various benefits being provided to regular employees from speaking with them or reading various Microsoft publications concerning employee benefits.

In 1989 and 1990, the Internal Revenue Service (IRS)[,]...applying common-law principles defining the employer-employee relationship, concluded that Microsoft's freelancers were not independent contractors but employees for withholding and employment tax purposes, and that Microsoft would thereafter be required to pay withholding taxes and the employer's portion of Federal Insurance Contribution Act (FICA) tax. Microsoft agreed....

After learning of the IRS rulings, the plaintiffs sought various employee benefits, including those now at issue: the ESPP and SPP benefits. The SPP...is a cash or deferred salary arrangement under § 401k of the Internal Revenue Code that permits Microsoft's employees to save and invest up to fifteen percent of their income through tax-deferred payroll deductions....Microsoft matches fifty percent of the employee's contribution in any year, with [a maximum matching contribution]. The ESPP...permits employees to purchase company stock [with various rules].

Microsoft rejected the plaintiffs' claims for benefits, maintaining that they were independent contractors who were personally responsible for all their own benefits....

The plaintiffs brought this action, challenging the denial of benefits.

Microsoft contends that the extrinsic evidence, including the [employment agreements], demonstrates its intent not to provide freelancers or independent contractors with employee benefits[.]...We have no doubt that the company did not intend to provide freelancers or independent contractors with employee benefits, and that if the plaintiffs had in fact been freelancers or independent contractors, they would not be eligible under the plan. The plaintiffs, however, were not freelancers or independent contractors. They were common-law employees, and the question is what, if anything, Microsoft intended with respect to

persons who were actually common-law employees but were not known to Microsoft to be such. The fact that Microsoft did not intend to provide benefits to persons who it thought were freelancers or independent contractors sheds little or no light on that question....

Microsoft's argument, drawing a distinction between common-law employees on the basis of the manner in which they were paid, is subject to the same vice as its more general argument. Microsoft regarded the plaintiffs as independent contractors during the relevant period and learned of their common-law-employee status only after the IRS examination. They were paid through the accounts receivable department rather than the payroll department because of Microsoft's mistaken view as to their legal status. Accordingly, Microsoft cannot now contend that the fact that they were paid through the accounts receivable department demonstrates that the company intended to deny them the benefits received by all common-law employees regardless of their actual employment status. Indeed, Microsoft has pointed to no evidence suggesting that it ever denied eligibility to any employees, whom it *understood* to be common-law employees, by paying them through the accounts receivable department or otherwise.

We therefore construe the ambiguity in the plan against Microsoft and hold that the plaintiffs are eligible to participate under the terms of the SPP.

[Next, regarding the ESPP] we hold that the plaintiffs...are covered by the specific provisions of the ESPP. We apply the "objective manifestation theory of contracts," which requires us to "impute an intention corresponding to the reasonable meaning of a person's words and acts." [Citation] Through its incorporation of the tax code provision into the plan, Microsoft manifested an objective intent to make all common-law employees, and hence the plaintiffs, eligible for participation. The ESPP specifically provides:

> *It is the intention of the Company to have the Plan qualify as an "employee stock purchase plan" under Section 423 of the Internal Revenue Code of 1954. The provisions of the Plan shall, accordingly, be construed so as to extend and limit participation in a manner consistent with the requirements of that Section of the Code. (emphasis added)*

[T]he ESPP, when construed in a manner consistent with the requirements of § 423, extends participation to all common-law employees not covered by one of the express exceptions set forth in the plan. Accordingly, we find that the ESPP, through its incorporation of § 423, expressly extends eligibility for participation to the plaintiff class and affords them the same options to acquire stock in the corporation as all other employees.

Microsoft next contends that the [employment agreements] signed by the plaintiffs render them ineligible to participate in the ESPP. First, the label used in the instruments signed by the plaintiffs does not control their employment status. Second, the employment instruments, if construed to exclude the plaintiffs from receiving ESPP benefits, would conflict with the plan's express incorporation of § 423. Although Microsoft may have generally intended to exclude individuals who were in fact independent contractors, it could not, consistent with its express intention to extend participation in the ESPP to all common-law employees, have excluded the plaintiffs. Indeed, such an exclusion would defeat the purpose of including § 423 in the plan, because the exclusion of common-law employees not otherwise accepted would result in the loss of the plan's tax qualification.

Finally, Microsoft maintains that the plaintiffs are not entitled to ESPP benefits because the terms of the plan were never communicated to them and they were therefore unaware of its provisions when they performed their employment services....In any event, to the extent that knowledge of an offer of benefits is a prerequisite, it is probably sufficient that Microsoft publicly promulgated the plan. In [Citation], the plaintiff was unaware of the company's severance plan until shortly before his termination. The Oklahoma Supreme Court concluded nonetheless that publication of the plan was "the equivalent of constructive knowledge on the part of *all* employees not specifically excluded."

We are not required to rely, however, on the [this] analysis or even on Microsoft's own unwitting concession. There is a compelling reason, implicit in some of the preceding discussion, that requires us to reject the company's theory that the plaintiffs' entitlement to ESPP benefits is defeated by their previous lack of knowledge regarding their rights. It is "well established" that an optionor may not rely on an

optionee's failure to exercise an option when he has committed any act or failed to perform any duty "calculated to cause the optionee to delay in exercising the right." [Citation] "[T]he optionor may not make statements or representations calculated to cause delay, [or] fail to furnish [necessary] information...." Similarly, "[I]t is a principle of fundamental justice that if a promisor is himself the cause of the failure of performance, either of an obligation due him or of a condition upon which his own liability depends, he cannot take advantage of the failure." [Citation]...

Applying these principles, we agree with the magistrate judge, who concluded that Microsoft, which created a benefit to which the plaintiffs were entitled, could not defend itself by arguing that the plaintiffs were unaware of the benefit, when its own false representations precluded them from gaining that knowledge. Because Microsoft misrepresented both the plaintiffs' actual employment status and their eligibility to participate in the ESPP, it is responsible for their failure to know that they were covered by the terms of the offer. It may not now take advantage of that failure to defeat the plaintiffs' rights to ESPP benefits. Thus, we reject Microsoft's final argument.

Conclusion

For the reasons stated, the district court's grant of summary judgment in favor of Microsoft and denial of summary judgment in favor of the plaintiffs is REVERSED and the case REMANDED for the determination of any questions of individual eligibility for benefits that may remain following issuance of this opinion and for calculation of the damages or benefits due the various class members.

CASE QUESTIONS

1. In a 1993 *Wall Street Journal* article, James Bovard asserted that the IRS "is carrying out a sweeping campaign to slash the number of Americans permitted to be self-employed—and to punish the companies that contract with them…IRS officials indicate that more than half the nation's self-employed should no longer be able to work for themselves." Why did Microsoft want these employees to "be able to work for themselves"?
2. Why did the employees accept employment as independent contractors?

3. It seems unlikely that the purpose of the IRS's campaign was really to keep people from working for themselves, despite Mr. Bovard's assumption. What was the purpose of the campaign?
4. Why did the IRS and the court determine that these "independent contractors" were in fact employees?

Breach of Fiduciary Duty

Bacon v. Volvo Service Center, Inc.

597 S.E.2d 440 (Ga. App. 2004)

Smith, J.

[This appeal is] taken in an action that arose when two former employees left an existing business and began a new, competing business....Bacon and Johnson, two former employees of Volvo Service Center, Inc. (VSC), and the new company they formed, South Gwinnett Volvo Service, Ltd. (SGVS), appeal from the trial court's denial of their motion for judgment notwithstanding the jury's verdict in favor of VSC.... VSC filed suit against appellants, alleging a number of claims arising from the use by Bacon, who had been a service technician at VSC, of VSC's customer list, and his soliciting Johnson, a service writer, and another VSC employee to join SGVS. SGVS moved for a directed verdict on certain claims at the close of plaintiff's evidence and at the close of the case, which motions were denied. The jury was asked to respond to specific interrogatories, and it found for VSC and against all three appellants on VSC's claim for misappropriation of trade secrets. The jury also found for plaintiff against Bacon for breach of fiduciary duty,...tortious interference with business relations, employee piracy, and conversion of corporate assets. The jury awarded VSC attorney fees, costs, and exemplary damages stemming from the claim for misappropriation of trade secrets. Judgment was entered on the jury's verdict, and appellants' motion for j.n.o.v. was denied. This appeal ensued. We find that VSC did not meet its burden of proof as to the claims for misappropriation of trade secrets, breach of fiduciary duty, or employee piracy, and the trial court should have granted appellants' motion for j.n.o.v.

Construed to support the jury's verdict, the evidence of record shows that Bacon was a technician at VSC when he decided to leave and open a competing business. Before doing so, he printed a list of VSC's customers from one of VSC's two computers. Computer access was not password restricted, was easy to use, and was used by many employees from time to time.

About a year after he left VSC, Bacon gave Johnson and another VSC employee an offer of employment at his new Volvo repair shop, which was about to open. Bacon and Johnson advertised extensively, and the customer list was used to send flyers to some VSC customers who lived close to the new shop's location. These activities became the basis for VSC's action against Bacon, Johnson, and their new shop, SGVS....

1. The Georgia Trade Secrets Act of 1990, [Citation], defines a "trade secret" as

> *information, without regard to form, including, but not limited to,...a list of actual or potential customers or suppliers which is not commonly known by or available to the public and which information:*
>
> *(A) Derives economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use; and*
>
> *(B) Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.*

If an employer does not prove both prongs of this test, it is not entitled to protection under the Act. Our Supreme Court held in [Citation, 1991] for instance, that information was not a trade secret within the meaning of the Act because no evidence showed that the employer "made reasonable efforts under the circumstances...to maintain the confidentiality of the information it sought to protect."

While a client list may be subject to confidential treatment under the Georgia Trade Secrets Act, the information itself is not inherently confidential. Customers are not trade secrets. Confidentiality is afforded only where the customer list is not generally known or ascertainable from other sources and was the subject of reasonable efforts to maintain its secrecy....

Here, VSC took *no* precautions to maintain the confidentiality of its customer list. The information was on both computers, and it was not password-protected. Moreover, the same information was available to the technicians through the repair orders, which they were permitted to retain indefinitely while Bacon was employed there. Employees were not informed that the information was confidential. Neither Bacon nor Johnson was required to sign a confidentiality agreement as part of his employment.

Because no evidence was presented from which the jury could have concluded that VSC took any steps, much less reasonable ones, to protect the confidentiality of its customer list, a material requirement for trade secret status was not satisfied. The trial court should have granted appellants' motion for j.n.o.v.

2. To prove tortious interference with business relations, "a plaintiff must show defendant: (1) acted improperly and without privilege, (2) acted purposely and with malice with the intent to injure, (3) induced a third party or parties not to enter into or continue a business relationship with the plaintiff, and (4) caused plaintiff financial injury." [Citation] But "[f]air competition is always legal." [Citations] Unless an employee has executed a valid non-compete or non-solicit covenant, he is not barred from soliciting customers of his former employer on behalf of a new employer. [Citation]

No evidence was presented that Bacon acted "improperly," that any of VSC's former customers switched to SGVS because of any improper act by Bacon, or that these customers would have continued to patronize VSC but for Bacon's solicitations. Therefore, it was impossible for a jury to calculate VSC's financial damage, if any existed.

3. With regard to VSC's claim for breach of fiduciary duty, "[a]n employee breaches no fiduciary duty to the employer simply by making plans to enter a competing business while he is still employed. Even before the termination of his agency, he is entitled to make arrangements to compete and upon termination of employment immediately compete." [Citation] He cannot solicit customers for a rival business or do other, similar acts in direct competition with his employer's business before his employment ends. But here, no evidence was presented to rebut the evidence given by Bacon and Johnson that they engaged in no such practices before their employment with VSC ended. Even assuming, therefore, that a fiduciary relationship existed, no evidence was presented showing that it was breached.

4. The same is true for VSC's claim for employee piracy. The evidence simply does not show that any employees of VSC were solicited for SGVS before Bacon left VSC's employ....

Judgment reversed.

CASE QUESTIONS

1. Why was it determined that the defendants were not liable for any breach of trade secrecy?
2. What would have been necessary to show tortious interference with business relations?
3. The evidence was lacking that there was any breach of fiduciary duty. What would have been necessary to show that?
4. What is "employee piracy"? Why was it not proven?

Workers' Compensation: What "Injuries" Are Compensable?

Wolfe v. Sibley, Lindsay & Curr Co.

330 N.E.2d 603 (N.Y. 1975)

Wachtler, J.

This appeal involves a claim for workmen's compensation benefits for the period during which the claimant was incapacitated by severe depression caused by the discovery of her immediate supervisor's body after he had committed suicide.

The facts as adduced at a hearing before the Workmen's Compensation Board are uncontroverted. The claimant, Mrs. Diana Wolfe, began her employment with the respondent department store, Sibley, Lindsay & Curr Co. in February, 1968. After working for some time as an investigator in the security

department of the store she became secretary to Mr. John Gorman, the security director. It appears from the record that as head of security, Mr. Gorman was subjected to intense pressure, especially during the Christmas holidays. Mrs. Wolfe testified that throughout the several years she worked at Sibley's Mr. Gorman reacted to this holiday pressure by becoming extremely agitated and nervous. She noted, however, that this anxiety usually disappeared when the holiday season was over. Unfortunately, Mr. Gorman's nervous condition failed to abate after the 1970 holidays....
Despite the fact that he followed Mrs. Wolfe's advice to see a doctor, Mr. Gorman's mental condition continued to deteriorate. On one occasion he left work at her suggestion because he appeared to be so nervous. This condition persisted until the morning of June 9, 1971 when according to the claimant, Mr. Gorman looked much better and even smiled and 'tousled her hair' when she so remarked.

A short time later Mr. Gorman called her on the intercom and asked her to call the police to room 615. Mrs. Wolfe complied with this request and then tried unsuccessfully to reach Mr. Gorman on the intercom. She entered his office to find him lying in a pool of blood caused by a self-inflicted gunshot wound in the head. Mrs. Wolfe became extremely upset and was unable to continue working that day.

She returned to work for one week only to lock herself in her office to avoid the questions of her fellow workers. Her private physician perceiving that she was beset by feelings of guilt referred her to a psychiatrist and recommended that she leave work, which she did. While at home she ruminated about her guilt in failing to prevent the suicide and remained in bed for long periods of time staring at the ceiling. The result was that she became unresponsive to her husband and suffered a weight loss of 20 pounds. Her psychiatrist, Dr. Grinols diagnosed her condition as an acute depressive reaction.

After attempting to treat her in his office Dr. Grinols realized that the severity of her depression mandated hospitalization. Accordingly, the claimant was admitted to the hospital on July 9, 1971 where she remained for two months during which time she received psychotherapy and medication. After she was discharged, Dr. Grinols concluded that there had been no substantial remission in her depression and ruminative guilt and so had her readmitted for electroshock treatment. These treatments lasted for three

weeks and were instrumental in her recovery. She was again discharged and, in mid-January, 1972, resumed her employment with Sibley, Lindsay & Curr.

Mrs. Wolfe's claim for workmen's compensation was granted by the referee and affirmed by the Workmen's Compensation Board. On appeal the Appellate Division reversed citing its opinions in [Citations], [concluding]...that mental injury precipitated solely by psychic trauma is not compensable as a matter of law. We do not agree with this conclusion.

Workmen's compensation, as distinguished from tort liability which is essentially based on fault, is designed to shift the risk of loss of earning capacity caused by industrial accidents from the worker to industry and ultimately the consumer. In light of its beneficial and remedial character the Workmen's Compensation Law should be construed liberally in favor of the employee [Citation].

Liability under the act is predicated on accidental injury arising out of and in the course of employment....Applying these concepts to the case at bar we note that there is no issue raised concerning the causal relationship between the occurrence and the injury. The only testimony on this matter was given by Dr. Grinols who stated unequivocally that the discovery of her superior's body was the competent producing cause of her condition. Nor is there any question as to the absence of physical impact. Accordingly, the focus of our inquiry is whether or not there has been an accidental injury within the meaning of the Workmen's Compensation Law.

Since there is no statutory definition of this term we turn to the relevant decisions. These may be divided into three categories: (1) psychic trauma which produces physical injury, (2) physical impact which produces psychological injury, and (3) psychic trauma which produces psychological injury. As to the first class our court has consistently recognized the principle that an injury caused by emotional stress or shock may be accidental within the purview of the compensation law. [Citation] Cases falling into the second category have uniformly sustained awards to those incurring nervous or psychological disorders as a result of physical impact [Citation]. As to those cases in the third category the decisions are not as clear....

We hold today that psychological or nervous injury precipitated by psychic trauma is compensable to the same extent as physical injury. This determination is based on two considerations. First, as noted in the psychiatric testimony there is nothing in the nature of a stress or shock situation which ordains physical as opposed to psychological injury. The determinative factor is the particular vulnerability of an individual by virtue of his physical makeup. In a given situation one person may be susceptible to a heart attack while another may suffer a depressive reaction. In either case the result is the same—the individual is incapable of functioning properly because of an accident and should be compensated under the Workmen's Compensation Law.

Secondly, having recognized the reliability of identifying psychic trauma as a causative factor of injury in some cases and the reliability by identifying psychological injury as a resultant factor in other cases, we see no reason for limiting recovery in the latter instance to cases involving physical impact. There is nothing talismanic about physical impact.

We would note in passing that this analysis reflects the view of the majority of jurisdictions in this country and England. [Citations]...

Accordingly, the order appealed from should be reversed and the award to the claimant reinstated, with costs.

CASE QUESTIONS

1. Why did the appeals court deny workers' compensation benefits for Wolfe?
2. On what reasoning did the New York high court reverse?
3. There was a dissent in this case (not included here). Judge Breitel noted that the evidence was that Mrs. Wolfe had a psychological condition such that her trauma "could never have occurred unless she, to begin with, was extraordinarily vulnerable to severe shock at or away from her place of employment or one produced by accident or injury to those close to her in employment or in her private life." The judge worried that "one can easily call up a myriad of commonplace occupational pursuits where employees are

often exposed to the misfortunes of others which may in the mentally unstable evoke precisely the symptoms which this claimant suffered." He concluded, "In an era marked by examples of overburdening of socially desirable programs with resultant curtailment or destruction of such programs, a realistic assessment of impact of doctrine is imperative. An overburdening of the compensation system by injudicious and open-ended expansion of compensation benefits, especially for costly, prolonged, and often only ameliorative psychiatric care, cannot but threaten its soundness or that of the enterprises upon which it depends." What is the concern here?

9.4 Summary and Exercises

Summary

An agent is one who acts on behalf of another. The law recognizes several types of agents, including (1) the general agent, one who possesses authority to carry out a broad range of transactions in the name of and on behalf of the principal; (2) the special agent, one with authority to act only in a specifically designated instance or set of transactions; (3) the agent whose agency is coupled with an interest, one who has a property interest in addition to authority to act as an agent; (4) the subagent, one appointed by an agent with authority to do so; and (5) the servant ("employee" in modern English), one whose physical conduct is subject to control of the principal.

A servant should be distinguished from an independent contractor, whose work is not subject to the control of the principal. The difference is important for purposes of taxation, workers' compensation, and liability insurance.

The agency relationship is usually created by contract, and sometimes governed by the Statute of Frauds, but some agencies are created by operation of law.

An agent owes his principal the highest duty of loyalty, that of a fiduciary. The agent must avoid self-dealing, preserve confidential information, perform with skill and care, conduct his personal life so as not to bring disrepute on the business for which he acts as agent, keep and render accounts, and give appropriate information to the principal.

Although the principal is not the agent's fiduciary, the principal does have certain obligations toward the agent—for example, to refrain from interfering with the agent's work and to indemnify. The employer's common-law tort liability toward his employees has been replaced by the workers' compensation system, under which the employee gives up the right to sue for damages in return for prompt payment of medical and job-loss expenses. Injuries must have been work related and the injured person must have been an employee. Courts today allow awards for psychological trauma in the absence of physical injury.

EXERCISES

1. A woman was involved in an automobile accident that resulted in the death of a passenger in her car. After she was charged with manslaughter, her attorney agreed to work with her insurance company's claims adjuster in handling the case. As a result of the agreement, the woman gave a statement about the accident to the claims adjuster. When the prosecuting attorney demanded to see the statement, the woman's attorney refused on the grounds that the claims adjuster was his—the attorney's—agent, and therefore the statement was covered by the attorney-client privilege. Is the attorney correct? Why?
2. A local hotel operated under a franchise agreement with a major hotel chain. Several customers charged the banquet director of the local hotel with misconduct and harassment. They sued the hotel chain (the franchisor) for acts committed by the local hotel (the franchisee), claiming that the franchisee was the agent of the franchisor. Is an agency created under these circumstances? Why?
3. A principal hired a mortgage banking firm to obtain a loan commitment of $10,000,000 from an insurance company for the construction of a shopping center. The firm was promised a fee of $50,000 for obtaining the commitment. The firm was successful in arranging for the loan, and the insurance company, without the principal's knowledge, agreed to pay the firm a finder's fee. The principal then refused to pay the firm the promised $50,000, and the firm brought suit to recover the fee. May the firm recover the fee? Why?

4. Based on his experience working for the CIA, a former CIA agent published a book about certain CIA activities in South Vietnam. The CIA did not approve of the publication of the book although, as a condition of his employment, the agent had agreed not to publish any information relating to the CIA without specific approval of the agency. The government brought suit against the agent, claiming that all the agent's profits from publishing the book should go to the government. Assuming that the government suffered only nominal damages because the agent published no classified information, will the government prevail? Why?
5. Upon graduation from college, Edison was hired by a major chemical company. During the time when he was employed by the company, Edison discovered a synthetic oil that could be manufactured at a very low cost. What rights, if any, does Edison's employer have to the discovery? Why?
6. A US company hired MacDonald to serve as its resident agent in Bolivia. MacDonald entered into a contract to sell cars to Bolivia and personally guaranteed performance of the contract as required by Bolivian law. The cars delivered to Bolivia were defective, and Bolivia recovered a judgment of $83,000 from MacDonald. Must the US company reimburse MacDonald for this amount? Explain.
7. According to the late Professor William L. Prosser, "The theory underlying the workmen's compensation acts never has been stated better than in the old campaign slogan, 'The cost of the product should bear the blood of the workman.'" What is meant by this statement?
8. An employee in a Rhode Island foundry inserted two coins in a coin-operated coffee machine in the company cafeteria. One coin stuck in the machine, and the worker proceeded to "whack" the machine with his right arm. The arm struck a grate near the machine, rupturing the biceps muscle and causing a 10 percent loss in the use of the arm. Is the worker entitled to workers' compensation? Explain.
9. Paulson engaged Arthur to sell Paul's restored 1948 Packard convertible to Byers for $23,000. A few days later, Arthur saw an advertisement showing that Collector was willing to pay $30,000 for a 1948 Packard convertible in "restored" condition. Arthur sold the car to Byers, and subsequently Paulson learned of Collector's interest. What rights, if any, has Paulson against Arthur?

SELF-TEST QUESTIONS

CC BY NC SA

1 One who has authority to act only in a specifically designated instance or in a specifically designated set of transactions is called

a. a subagent
b. a general agent
c. a special agent
d. none of the above

2 An agency relationship may be created by

a. contract
b. operation of law
c. an oral agreement
d. all of the above

3 An agent's duty to the principal includes

a. the duty to indemnify
b. the duty to warn of special dangers
c. the duty to avoid self dealing
d. all of the above

4 A person whose work is not subject to the control of the principal, but who arranges to perform a job for him is called

a. a subagent
b. a servant
c. a special agent
d. an independent contractor

5 An employer's liability for employees' on-the-job injuries is generally governed by

a. tort law
b. the workers' compensation system
c. Social Security
d. none of the above

SELF-TEST ANSWERS

1. c

2. d

3. c

4. d

5. b

Chapter 10
Liability of Principal and Agent; Termination of Agency

LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The principal's liability in contract

CC BY NC SA

2. The principal's liability in tort
3. The principal's criminal liability
4. The agent's personal liability in tort and contract
5. How agency relationships are terminated

In Chapter 9 "Relationships between Principal and Agent" we considered the relationships between agent and principal. Now we turn to relationships between third parties and the principal or agent. When the agent makes a contract for his principal or commits a tort in the course of his work, is the principal liable? What is the responsibility of the agent for torts committed and contracts entered into on behalf of his principal? How may the relationship be terminated so that the principal or agent will no longer have responsibility toward or liability for the acts of the other? These are the questions addressed in this chapter.

10.1 Principal's Contract Liability

LEARNING OBJECTIVES

1. Understand that the principal's liability depends on whether the agent was authorized to make the contract.
2. Recognize how the agent's authority is acquired: expressly, impliedly, or apparently.

3. Know that the principal may also be liable—even if the agent had no authority—if the principal ratifies the agent's contract after the fact.

Principal's Contract Liability Requires That Agent Had Authority

The key to determining whether a principal is liable for contracts made by his agent is authority: was the agent authorized to negotiate the agreement and close the deal? Obviously, it would not be sensible to hold a contractor liable to pay for a whole load of lumber merely because a stranger wandered into the lumberyard saying, "I'm an agent for ABC Contractors; charge this to their account." To be liable, the principal must have authorized the agent in some manner to act in his behalf, and that authorization must be communicated to the third party by the principal.

Types of Authority

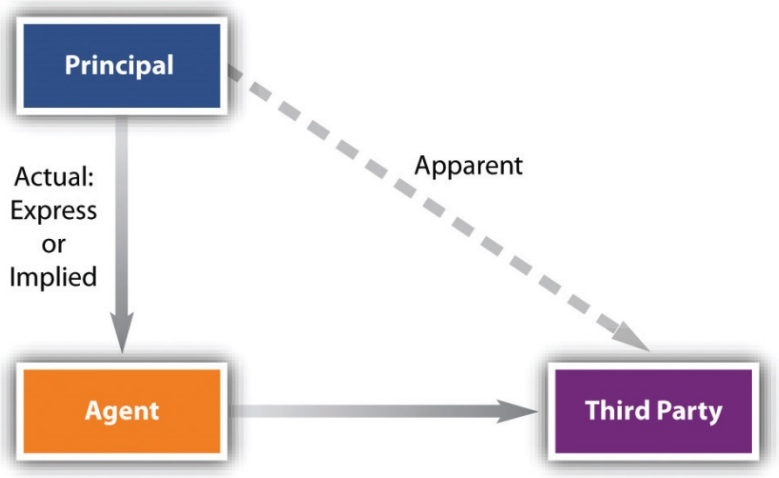
There are three types of authority: express, implied, and apparent (see Figure 10.1 "Types of Authority"). We will consider each in turn.

Express Authority

The strongest form of authority is that which is expressly granted, often in written form. The principal consents to the agent's actions, and the third party may then rely on the document attesting to the agent's authority to deal on behalf of the principal. One common form of **express authority** is the standard signature card on file with banks allowing corporate agents to write checks on the company's credit. The principal bears the risk of any wrongful action of his agent, as demonstrated in *Allen A. Funt Productions, Inc. v. Chemical Bank*.[1] Allen A. Funt submitted to his bank through his production company various certificates permitting his accountant to use the company's checking accounts.[2] In fact, for several years the accountant embezzled money from the company by writing checks to himself and depositing them in his own account. The company sued its bank, charging it with negligence, apparently for failing to monitor the amount of money taken by the accountant. But the court dismissed the negligence complaint, citing a state statute based on the common-law agency principle that a third party is entitled to rely on the express authorization given to an agent; in this case, the accountant drew checks on the account within the

monetary limits contained in the signature cards on file with the bank. Letters of introduction and work orders are other types of express authority.

Figure 10.1 Types of Authority



Implied Authority

Not every detail of an agent's work can be spelled out. It is impossible to delineate step-by-step the duties of a general agent; at best, a principal can set forth only the general nature of the duties that the agent is to perform. Even a special agent's duties are difficult to describe in such detail as to leave him without discretion. If express authority were the only valid kind, there would be no efficient way to use an agent, both because the effort to describe the duties would be too great and because the third party would be reluctant to deal with him.

But the law permits authority to be "implied" by the relationship of the parties, the nature and customs of the business, the circumstances surrounding the act in question, the wording of the agency contract, and the knowledge that the agent has of facts relevant to the assignment. The general rule is that the agent has implied or "incidental" authority to perform acts incidental to or reasonably necessary to carrying out the transaction. Thus if a principal instructs her agent to "deposit a check in the bank today," the agent has authority to drive to the bank unless the principal specifically prohibits the agent from doing so.

The theory of **implied authority** is especially important to business in the realm of the business manager, who may be charged with running the entire business operation or only a small part of it. In either event, the business manager has a relatively large domain of implied authority. He can buy goods and services; hire, supervise, and fire employees; sell or junk inventory; take in receipts and pay debts; and in general, direct the ordinary operations of the business. The full extent of the manager's authority depends on the circumstances—what is customary in the particular industry, in the particular business, and among the individuals directly concerned.

On the other hand, a manager does not have implicit authority to undertake unusual or extraordinary actions on behalf of his principal. In the absence of express permission, an agent may not sell part of the business, start a new business, change the nature of the business, incur debt (unless borrowing is integral to the business, as in banking, for example), or move the business premises. For example, the owner of a hotel appoints Andy manager; Andy decides to rename the hotel and commissions an artist to prepare a new logo for the hotel's stationery. Andy has no implied authority to change the name or to commission the artist, though he does have implied authority to engage a printer to replenish the stationery supply—and possibly to make some design changes in the letterhead.

Even when there is no implied authority, in an emergency the agent may act in ways that would in the normal course require specific permission from the principal. If unforeseen circumstances arise and it is impracticable to communicate with the principal to find out what his wishes would be, the agent may do what is reasonably necessary in order to prevent substantial loss to his principal. During World War II, Eastern Wine Corporation marketed champagne in a bottle with a diagonal red stripe that infringed the trademark of a French producer. The French company had granted licenses to an American importer to market its champagne in the United States. The contract between producer and importer required the latter to notify the French company whenever a competitor appeared to be infringing its rights and to recommend steps by which the company could stop the infringement. The authority to institute suit was not expressly conferred, and ordinarily the right to do so would not be inferred. Because France was under German occupation, however, the importer was unable to communicate with the producer, its principal. The court held that the importer could file suit to enjoin Eastern Wine from continuing to display the

infringing red diagonal stripe, since legal action was "essential to the preservation of the principal's property." [3]

The rule that a person's position can carry with it implied authority is fundamental to American business practice. But outside the United States this rule is not applicable, and the business executive traveling abroad should be aware that in civil-law countries it is customary to present proof of authority to transact corporate business—usually in the form of a power of attorney. This is not always an easy task. Not only must the power of the traveling executive be shown but the right of the corporate officer back in the United States to delegate authority must also be proven.

Apparent Authority

In the agency relationship, the agent's actions in dealing with third parties will affect the legal rights of the principal. What the third party knows about the agency agreement is irrelevant to the agent's legal authority to act. That authority runs from principal to agent. As long as an agent has authorization, either express or implied, she may bind the principal legally. Thus the seller of a house may be ignorant of the buyer's true identity; the person he supposes to be the prospective purchaser might be the agent of an undisclosed principal. Nevertheless, if the agent is authorized to make the purchase, the seller's ignorance is not a ground for either seller or principal to void the deal.

But if a person has no authority to act as an agent, or an agent has no authority to act in a particular way, is the principal free from all consequences? The answer depends on whether or not the agent has **apparent authority**—that is, on whether or not the third person reasonably believes from the principal's words, written or spoken, or from his conduct that he has in fact consented to the agent's actions. Apparent authority is a manifestation of authority communicated to the third person; it runs from principal to third party, not to the agent.

Apparent authority is sometimes said to be based on the principle of estoppel. Estoppel is the doctrine that a person will not now be allowed to deny a promise or assertion she previously made where there has been detrimental reliance on that promise or assertion. Estoppel is commonly used to avoid injustice. It may be a substitute for the requirement of consideration in contract (making the promise of a gift

enforceable where the donee has relied upon the promise), and it is sometimes available to circumvent the requirement of a writing under the Statute of Frauds.

Apparent authority can arise from prior business transactions. On July 10, Meggs sold to Buyer his business, the right to use the trade name Rose City Sheet Metal Works, and a list of suppliers he had used. Three days later, Buyer began ordering supplies from Central Supply Company, which was on Meggs's list but with which Meggs had last dealt four years before. On September 3, Central received a letter from Meggs notifying it of Meggs's sale of the business to Buyer. Buyer failed to pay Central, which sued Meggs. The court held that Rose City Sheet Metal Works had apparent authority to buy on Meggs's credit; Meggs was liable for supplies purchased between July 10 and September 3.[4] In such cases, and in cases involving the firing of a general manager, actual notice should be given promptly to all customers. See the discussion of *Kanavos v. Hancock Bank & Trust Company* in Section 10.4.1 "Implied Authority".

Ratification

Even if the agent possessed no actual authority and there was no apparent authority on which the third person could rely, the principal may still be liable if he ratifies or adopts the agent's acts before the third person withdraws from the contract. Ratification usually relates back to the time of the undertaking, creating authority after the fact as though it had been established initially. Ratification is a voluntary act by the principal. Faced with the results of action purportedly done on his behalf but without authorization and through no fault of his own, he may affirm or disavow them as he chooses. To ratify, the principal may tell the parties concerned or by his conduct manifest that he is willing to accept the results as though the act were authorized. Or by his silence he may find under certain circumstances that he has ratified. Note that ratification does not require the usual consideration of contract law. The principal need be promised nothing extra for his decision to affirm to be binding on him. Nor does ratification depend on the position of the third party; for example, a loss stemming from his reliance on the agent's representations is not required. In most situations, ratification leaves the parties where they expected to be, correcting the agent's errors harmlessly and giving each party what was expected.

KEY TAKEAWAY

The principal is liable on an agent's contract only if the agent was authorized by the principal to make the contract. Such authority is express, implied, or apparent. *Express* means made in words, orally or in writing; *implied* means the agent has authority to perform acts incidental to or reasonably necessary to carrying out the transaction for which she has express authority. *Apparent authority* arises where the principal gives the third party reason to believe that the agent had authority. The reasonableness of the third party's belief is based on all the circumstances—all the facts. Even if the agent has no authority, the principal may, after the fact, ratify the contract made by the agent.

EXERCISES

1. Could express authority be established by silence on the part of the principal?
2. Why is the concept of implied authority very important in business situations?
3. What is the rationale for the doctrine of apparent authority—that is, why would the law impose a contract on a "principal" when in fact there was no principal-agent relationship with the "agent" at all?

---

[1] *Allen A. Funt Productions, Inc. v. Chemical Bank*, 405 N.Y.S.2d 94 (1978).

[2] Allen Funt (1914–99) was an American television producer, director, and writer, best known as the creator and host of *Candid Camera* from the 1940s to 1980s, which was broadcast as either a regular show or a series of specials. Its most notable run was from 1960 to 1967 on CBS.

[3] *G. H. Mumm Champagne v. Eastern Wine Corp.*, 52 F. Supp. 167 (S.D.N.Y. 1943).

[4] *Meggs v. Central Supply Co.*, 307 N.E.2d 288 (Ind. App. 1974).

10.2 Principal's Tort and Criminal Liability

LEARNING OBJECTIVES

1. Understand in what circumstances a principal will be vicariously liable for torts committed by employees.
2. Recognize the difference between agents whose tort and criminal liability may be imputed to the employer and those whose liability will not be so imputed.
3. Know when the principal will be vicariously liable for intentional torts committed by the agent.
4. Explain what is meant by "the scope of employment," within which the agent's actions may be attributed to the principal and without which they will not.
5. Name special cases of vicarious liability.
6. Describe the principal's liability for crimes committed by the agent.

Principal's Tort Liability

The Distinction between Direct and Vicarious Liability

When is the principal liable for injuries that the agent causes another to suffer?

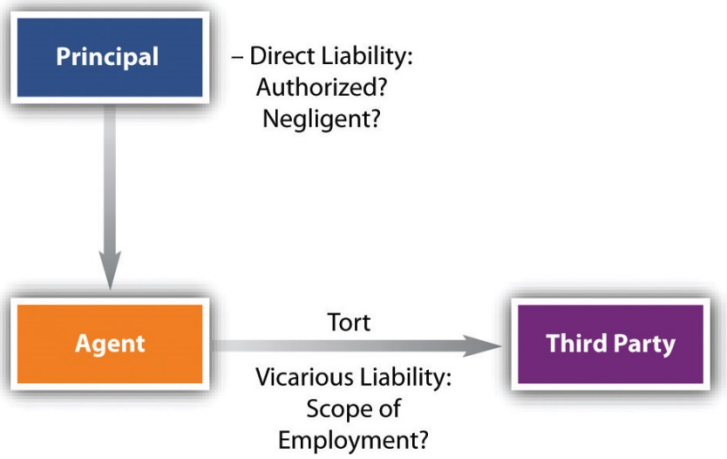
Direct Liability

There is a distinction between torts prompted by the principal himself and torts of which the principal was innocent. If the principal directed the agent to commit a tort or knew that the consequences of the agent's carrying out his instructions would bring harm to someone, the principal is liable. This is an application of the general common-law principle that one cannot escape liability by delegating an unlawful act to another. The syndicate that hires a hitman is as culpable of murder as the man who pulls the trigger. Similarly, a principal who is negligent in his use of agents will be held liable for their negligence. This rule comes into play when the principal fails to supervise employees adequately, gives faulty directions, or hires incompetent or unsuitable people for a particular job. Imposing liability on the principal in these cases is readily justifiable since it is the principal's own conduct that is the underlying fault; the principal here is directly liable.

Vicarious Liability

But the principle of liability for one's agent is much broader, extending to acts of which the principal had no knowledge, that he had no intention to commit nor involvement in, and that he may in fact have expressly prohibited the agent from engaging in. This is the principle of **respondeat superior** ("let the master answer") or the **master-servant doctrine**, which imposes on the principal **vicarious liability** (*vicarious* means "indirectly, as, by, or through a substitute") under which the principal is responsible for acts committed by the agent within the scope of the employment (see Figure 10.2 "Principal's Tort Liability").

Figure 10.2 *Principal's Tort Liability*



The modern basis for vicarious liability is sometimes termed the "deep pocket" theory: the principal (usually a corporation) has deeper pockets than the agent, meaning that it has the wherewithal to pay for the injuries traceable one way or another to events it set in motion. A million-dollar industrial accident is within the means of a company or its insurer; it is usually not within the means of the agent—employee—who caused it.

The "deep pocket" of the defendant-company is not always very deep, however. For many small businesses, in fact, the principle of respondeat superior is one of life or death. One example was the

closing in San Francisco of the much-beloved Larraburu Brothers Bakery—at the time, the world's second largest sourdough bread maker. The bakery was held liable for $2 million in damages after one of its delivery trucks injured a six-year-old boy. The bakery's insurance policy had a limit of $1.25 million, and the bakery could not absorb the excess. The Larraburus had no choice but to cease operations. (Seehttp://www.outsidelands.org/larraburu.php.)

Respondeat superior raises three difficult questions: (1) What type of agents can create tort liability for the principal? (2) Is the principal liable for the agent's intentional torts? (3) Was the agent acting within the scope of his employment? We will consider these questions in turn.

Agents for Whom Principals Are Vicariously Liable

In general, the broadest liability is imposed on the master in the case of tortious physical conduct by a servant, as discussed in Chapter 9 "Relationships between Principal and Agent". If the servant acted within the scope of his employment—that is, if the servant's wrongful conduct occurred while performing his job—the master will be liable to the victim for damages unless, as we have seen, the victim was another employee, in which event the workers' compensation system will be invoked. Vicarious tort liability is primarily a function of the employment relationship and not agency status.

Ordinarily, an individual or a company is not vicariously liable for the tortious acts of independent contractors. The plumber who rushes to a client's house to repair a leak and causes a traffic accident does not subject the homeowner to liability. But there are exceptions to the rule. Generally, these exceptions fall into a category of duties that the law deems nondelegable. In some situations, one person is obligated to provide protection to or care for another. The failure to do so results in liability whether or not the harm befell the other because of an independent contractor's wrongdoing. Thus a homeowner has a duty to ensure that physical conditions in and around the home are not unreasonably dangerous. If the owner hires an independent contracting firm to dig a sewer line and the contractor negligently fails to guard passersby against the danger of falling into an open trench, the homeowner is liable because the duty of

care in this instance cannot be delegated. (The contractor is, of course, liable to the homeowner for any damages paid to an injured passerby.)

Liability for Agent's Intentional Torts

In the nineteenth century, a principal was rarely held liable for intentional wrongdoing by the agent if the principal did not command the act complained of. The thought was that one could never infer authority to commit a willfully wrongful act. Today, liability for intentional torts is imputed to the principal if the agent is acting to further the principal's business. See the very disturbing *Lyon v. Carey* in Section 10.4.2 "Employer's Liability for Employee's Intentional Torts: Scope of Employment".

Deviations from Employment

The general rule is that a principal is liable for torts only if the servant committed them "in the scope of employment." But determining what this means is not easy.

The "Scope of Employment" Problem

It may be clear that the person causing an injury is the agent of another. But a principal cannot be responsible for every act of an agent. If an employee is following the letter of his instructions, it will be easy to determine liability. But suppose an agent deviates in some way from his job. The classic test of liability was set forth in an 1833 English case, *Joel v. Morrison*.[1] The plaintiff was run over on a highway by a speeding cart and horse. The driver was the employee of another, and inside was a fellow employee. There was no question that the driver had acted carelessly, but what he and his fellow employee were doing on the road where the plaintiff was injured was disputed. For weeks before and after the accident, the cart had never been driven in the vicinity in which the plaintiff was walking, nor did it have any business there. The suggestion was that the employees might have gone out of their way for their own purposes. As the great English jurist Baron Parke put it, "If the servants, being on their master's business, took a detour to call upon a friend, the master will be responsible....But if he was going on a frolic of his own, without being at all on his master's business, the master will not be liable." In applying this test, the court held the employer liable.

The test is thus one of degree, and it is not always easy to decide when a detour has become so great as to be transformed into a frolic. For a time, a rather mechanical rule was invoked to aid in making the decision. The courts looked to the servant's purposes in "detouring." If the servant's mind was fixed on accomplishing his own purposes, then the detour was held to be outside the scope of employment; hence the tort was not imputed to the master. But if the servant also intended to accomplish his master's purposes during his departure from the letter of his assignment, or if he committed the wrong while returning to his master's task after the completion of his frolic, then the tort was held to be within the scope of employment.

This test is not always easy to apply. If a hungry deliveryman stops at a restaurant outside the normal lunch hour, intending to continue to his next delivery after eating, he is within the scope of employment. But suppose he decides to take the truck home that evening, in violation of rules, in order to get an early start the next morning. Suppose he decides to stop by the beach, which is far away from his route. Does it make a difference if the employer knows that his deliverymen do this?

The Zone of Risk Test

Court decisions in the last forty years have moved toward a different standard, one that looks to the foreseeability of the agent's conduct. By this standard, an employer may be held liable for his employee's conduct even when devoted entirely to the employee's own purposes, as long as it was foreseeable that the agent might act as he did. This is the "zone of risk" test. The employer will be within the zone of risk for vicarious liability if the employee is where she is supposed to be, doing—more or less—what she is supposed to be doing, and the incident arose from the employee's pursuit of the employer's interest (again, more or less). That is, the employer is within the zone of risk if the servant is in the place within which, if the master were to send out a search party to find a missing employee, it would be reasonable to look. See Section 4, *Cockrell v. Pearl River Valley Water Supply Dist.*

Special Cases of Vicarious Liability

Vicarious liability is not limited to harm caused in the course of an agency relationship. It may also be imposed in other areas, including torts of family members, and other torts governed by statute or regulation. We will examine each in turn.

Use of Automobiles

A problem commonly arises when an automobile owner lends his vehicle to a personal friend, someone who is not an agent, and the borrower injures a third person. Is the owner liable? In many states, the owner is not liable; in other states, however, two approaches impose liability on the owner.

The first approach is legislative: **owner's consent statutes** make the owner liable when the automobile is being driven with his consent or knowledge. The second approach to placing liability on the owner is judicial and known as the **family purpose doctrine**. Under this doctrine, a family member who negligently injures someone with the car subjects the owner to liability if the family member was furthering family purposes. These are loosely defined to include virtually every use to which a child, for example, might put a car. In a Georgia case, *Dixon v. Phillips*, the father allowed his minor son to drive the car but expressly forbade him from letting anyone else do so.[2] Nevertheless, the son gave the wheel to a friend and a collision occurred while both were in the car. The court held the father liable because he made the car available for the pleasure and convenience of his son and other family members.

Torts of Family Members

At common law, the husband was liable for the torts of his wife, not because she was considered an agent but because she was considered to be an extension of him. "Husband and wife were only one person in law,"[3] says Holmes, and any act of the wife was supposed to have been done at the husband's direction (to which Mr. Dickens's Mr. Bumble responded, in the memorable line, "If the law supposes that, the law is a ass—a idiot"[4]). This ancient view has been abrogated by statute or by court ruling in all the states, so that now a wife is solely responsible for her own torts unless she in fact serves as her husband's agent.

Unlike wives, children are not presumed at common law to be agents or extensions of the father so that normally parents are not vicariously liable for their children's torts. However, they can be held liable for failing to control children known to be dangerous.

Most states have statutorily changed the common-law rule, making parents responsible for willful or malicious tortious acts of their children whether or not they are known to be mischief-makers. Thus the

Illinois Parental Responsibility Law provides the following: "The parent or legal guardian of an unemancipated minor who resides with such parent or legal guardian is liable for actual damages for the willful or malicious acts of such minor which cause injury to a person or property." [5] Several other states impose a monetary limit on such liability.

Other Torts Governed by Statute or Regulation

There are certain types of conduct that statutes or regulation attempt to control by placing the burden of liability on those presumably in a position to prevent the unwanted conduct. An example is the "Dramshop Act," which in many states subjects the owner of a bar to liability if the bar continues to serve an intoxicated patron who later is involved in an accident while intoxicated. Another example involves the sale of adulterated or short-weight foodstuffs: the employer of one who sells such may be liable, even if the employer did not know of the sales.

Principal's Criminal Liability

As a general proposition, a principal will not be held liable for an agent's unauthorized criminal acts if the crimes are those requiring specific intent. Thus a department store proprietor who tells his chief buyer to get the "best deal possible" on next fall's fashions is not liable if the buyer steals clothes from the manufacturer. A principal will, however, be liable if the principal directed, approved, or participated in the crime. Cases here involve, for example, a corporate principal's liability for agents' activity in antitrust violations—price-fixing is one such violation.

There is a narrow exception to the broad policy of immunity. Courts have ruled that under certain regulatory statutes and regulations, an agent's criminality may be imputed to the principal, just as civil liability is imputed under Dramshop Acts. These include pure food and drug acts, speeding ordinances, building regulations, child labor rules, and minimum wage and maximum hour legislation. Misdemeanor criminal liability may be imposed upon corporations and individual employees for the sale or shipment of adulterated food in interstate commerce, notwithstanding the fact that the defendant may have had no actual knowledge that the food was adulterated at the time the sale or shipment was made.

KEY TAKEAWAY

The principal will be liable for the employee's torts in two circumstances: first, if the principal was directly responsible, as in hiring a person the principal knew or should have known was incompetent or dangerous; second, if the employee committed the tort in the scope of business for the principal. This is the master-servant doctrine or respondeat superior. It imposes vicarious liability on the employer: the master (employer) will be liable if the employee was in the zone of activity creating a risk for the employer ("zone of risk" test), that is—generally—if the employee was where he was supposed to be, when he was supposed to be there, and the incident arose out of the employee's interest (however perverted) in promoting the employer's business.

Special cases of vicarious liability arise in several circumstances. For example, the owner of an automobile may be liable for torts committed by one who borrows it, or if it is—even if indirectly—used for family purposes. Parents are, by statute in many states, liable for their children's torts. Similarly by statute, the sellers and employers of sellers of alcohol or adulterated or short-weight foodstuffs may be liable. The employer of one who commits a crime is not usually liable unless the employer put the employee up to the crime or knew that a crime was being committed. But some prophylactic statutes impose liability on the employer for the employee's crime—even if the employee had no intention to commit it—as a means to force the employer to prevent such actions.

EXERCISES

1. What is the difference between direct and vicarious employer tort liability?
2. What is meant by the "zone of risk" test?
3. Under what circumstances will an employer be liable for intentional torts of the employee?
4. When will the employer be liable for an employee's criminal acts?

[1] *Joel v. Morrison*, 6 Carrington & Payne 501.

[2] *Dixon v. Phillips*, 217 S.E.2d 331 (Ga. 1975).

[3] O.W. Holmes, *Agency*, 4 Harvard Law Rev. 353 (1890–91).

[4] Charles Dickens, *Oliver Twist*, (London: 1838), chap 51.

[5] Ill. Rev. Stat. (2005), chapter 70, paragraph 51.http://law.justia.com/illinois/codes/2005/chapter57/2045.html.

10.3 Agent's Personal Liability for Torts and Contracts; Termination of Agency

LEARNING OBJECTIVES

1. Understand the agent's personal liability for tort.
2. Understand the agent's personal liability for contract.
3. Recognize the ways the agency relationship is terminated.

Agent's Personal Liability for Torts and Contracts

Tort Liability

That a principal is held vicariously liable and must pay damages to an injured third person does not excuse the agent who actually committed the tortious acts. A person is always liable for his or her own torts (unless the person is insane, involuntarily intoxicated, or acting under extreme duress). The agent is personally liable for his wrongful acts and must reimburse the principal for any damages the principal was forced to pay, as long as the principal did not authorize the wrongful conduct. The agent directed to commit a tort remains liable for his own conduct but is not obliged to repay the principal. Liability as an agent can be burdensome, sometimes perhaps more burdensome than as a principal. The latter normally purchases insurance to cover against wrongful acts of agents, but liability insurance policies frequently do not cover the employee's personal liability if the employee is named in a lawsuit individually. Thus doctors' and hospitals' malpractice policies protect a doctor from both her own mistakes and those of

nurses and others that the doctor would be responsible for; nurses, however, might need their own coverage. In the absence of insurance, an agent is at serious risk in this lawsuit-conscious age. The risk is not total. The agent is not liable for torts of other agents unless he is personally at fault—for example, by negligently supervising a junior or by giving faulty instructions. For example, an agent, the general manager for a principal, hires Brown as a subordinate. Brown is competent to do the job but by failing to exercise proper control over a machine negligently injures Ted, a visitor to the premises. The principal and Brown are liable to Ted, but the agent is not.

Contract Liability

It makes sense that an agent should be liable for her own torts; it would be a bad social policy indeed if a person could escape tort liability based on her own fault merely because she acted in an agency capacity. It also makes sense that—as is the general rule—an agent is not liable on contracts she makes on the principal's behalf; the agent is not a party to a contract made by the agent on behalf of the principal. No public policy would be served by imposing liability, and in many cases it would not make sense. Suppose an agent contracts to buy $25 million of rolled aluminum for a principal, an airplane manufacturer. The agent personally could not reasonably perform such contract, and it is not intended by the parties that she should be liable. (Although the rule is different in England, where an agent residing outside the country is liable even if it is clear that he is signing in an agency capacity.) But there are three exceptions to this rule: (1) if the agent is undisclosed or partially disclosed, (2) if the agent lacks authority or exceeds it, or (3) if the agent entered into the contract in a personal capacity. We consider each situation.

Agent for Undisclosed or Partially Disclosed Principal

An agent need not, and frequently will not, inform the person with whom he is negotiating that he is acting on behalf of a principal. The secret principal is usually called an "undisclosed principal." Or the agent may tell the other person that he is acting as an agent but not disclose the principal's name, in which event the principal is "partially disclosed." To understand the difficulties that may occur, consider the following hypothetical but common example. A real estate developer known for building amusement parks wants to acquire several parcels of land to construct a new park. He wants to keep his identity secret to hold down the land cost. If the landowners realized that a major building project was about to be

launched, their asking price would be quite high. So the developer obtains two options to purchase land by using two secret agents—Betty and Clem.

Betty does not mention to sellers that she is an agent; therefore, to those sellers the developer is an undisclosed principal. Clem tells those with whom he is dealing that he is an agent but refuses to divulge the developer's name or his business interest in the land. Thus the developer is, to the latter sellers, a partially disclosed principal. Suppose the sellers get wind of the impending construction and want to back out of the deal. Who may enforce the contracts against them?

The developer and the agents may sue to compel transfer of title. The undisclosed or partially disclosed principal may act to enforce his rights unless the contract specifically prohibits it or there is a representation that the signatories are not signing for an undisclosed principal. The agents may also bring suit to enforce the principal's contract rights because, as agents for an undisclosed or partially disclosed principal, they are considered parties to their contracts.

Now suppose the developer attempts to call off the deal. Whom may the sellers sue? Both the developer and the agents are liable. That the sellers had no knowledge of the developer's identity—or even that there was a developer—does not invalidate the contract. If the sellers first sue agent Betty (or Clem), they may still recover the purchase price from the developer as long as they had no knowledge of his identity prior to winning the first lawsuit. The developer is discharged from liability if, knowing his identity, the plaintiffs persist in a suit against the agents and recover a judgment against them anyway. Similarly, if the seller sues the principal and recovers a judgment, the agents are relieved of liability. The seller thus has a "right of election" to sue either the agent or the undisclosed principal, a right that in many states may be exercised any time before the seller collects on the judgment.

Lack of Authority in Agent

An agent who purports to make a contract on behalf of a principal, but who in fact has no authority to do so, is liable to the other party. The theory is that the agent has warranted to the third party that he has the

requisite authority. The principal is not liable in the absence of apparent authority or ratification. But the agent does not warrant that the principal has capacity. Thus an agent for a minor is not liable on a contract that the minor later disavows unless the agent expressly warranted that the principal had attained his majority. In short, the implied warranty is that the agent has authority to make a deal, not that the principal will necessarily comply with the contract once the deal is made.

Agent Acting on Own Account

An agent will be liable on contracts made in a personal capacity—for instance, when the agent personally guarantees repayment of a debt. The agent's intention to be personally liable is often difficult to determine on the basis of his signature on a contract. Generally, a person signing a contract can avoid personal liability only by showing that he was in fact signing as an agent. If the contract is signed "Jones, Agent," Jones can introduce evidence to show that there was never an intention to hold him personally liable. But if he signed "Jones" and neither his agency nor the principal's name is included, he will be personally liable. This can be troublesome to agents who routinely indorse checks and notes. There are special rules governing these situations, which are discussed in Chapter 22 "Liability and Discharge" dealing with commercial paper.

Termination of Agency

The agency relationship is not permanent. Either by action of the parties or by law, the relationship will eventually terminate.

By Act of the Parties

Certainly the parties to an agency contract can terminate the agreement. As with the creation of the relationship, the agreement may be terminated either expressly or implicitly.

Express Termination

Many agreements contain specified circumstances whose occurrence signals the end of the agency. The most obvious of these circumstances is the expiration of a fixed period of time ("agency to terminate at the end of three months" or "on midnight, December 31"). An agreement may also terminate on the

accomplishment of a specified act ("on the sale of the house") or following a specific event ("at the conclusion of the last horse race").

Mutual consent between the parties will end the agency. Moreover, the principal may revoke the agency or the agent may renounce it; such a **revocation** or **renunciation of agency** would be an express termination. Even a contract that states the agreement is irrevocable will not be binding, although it can be the basis for a damage suit against the one who breached the agreement by revoking or renouncing it. As with any contract, a person has the *power* to breach, even in absence of the *right* to do so. If the agency is coupled with an interest, however, so that the authority to act is given to secure an interest that the agent has in the subject matter of the agency, then the principal lacks the power to revoke the agreement.

Implied Termination

There are a number of other circumstances that will spell the end of the relationship by implication. Unspecified events or changes in business conditions or the value of the subject matter of the agency might lead to a reasonable inference that the agency should be terminated or suspended; for example, the principal desires the agent to buy silver but the silver market unexpectedly rises and silver doubles in price overnight. Other circumstances that end the agency include disloyalty of the agent (e.g., he accepts an appointment that is adverse to his first principal or embezzles from the principal), bankruptcy of the agent or of the principal, the outbreak of war (if it is reasonable to infer that the principal, knowing of the war, would not want the agent to continue to exercise authority), and a change in the law that makes a continued carrying out of the task illegal or seriously interferes with it.

By Operation of Law

Aside from the express termination (by agreement of both or upon the insistence of one), or the necessary or reasonable inferences that can be drawn from their agreements, the law voids agencies under certain circumstances. The most frequent termination by operation of law is the death of a principal or an agent. The death of an agent also terminates the authority of subagents he has appointed, unless the principal has expressly consented to the continuing validity of their appointment. Similarly, if the agent or principal

loses capacity to enter into an agency relationship, it is suspended or terminated. The agency terminates if its purpose becomes illegal.

Even though authority has terminated, whether by action of the parties or operation of law, the principal may still be subject to liability. Apparent authority in many instances will still exist; this is called **lingering authority**. It is imperative for a principal on termination of authority to notify all those who may still be in a position to deal with the agent. The only exceptions to this requirement are when termination is effected by death, loss of the principal's capacity, or an event that would make it impossible to carry out the object of the agency.

KEY TAKEAWAY

A person is always liable for her own torts, so an agent who commits a tort is liable; if the tort was in the scope of employment the principal is liable too. Unless the principal put the agent up to committing the tort, the agent will have to reimburse the principal. An agent is not generally liable for contracts made; the principal is liable. But the agent will be liable if he is undisclosed or partially disclosed, if the agent lacks authority or exceeds it, or, of course, if the agent entered into the contract in a personal capacity.

Agencies terminate expressly or impliedly or by operation of law. An agency terminates expressly by the terms of the agreement or mutual consent, or by the principal's revocation or the agent's renunciation. An agency terminates impliedly by any number of circumstances in which it is reasonable to assume one or both of the parties would not want the relationship to continue. An agency will terminate by operation of law when one or the other party dies or becomes incompetent, or if the object of the agency becomes illegal. However, an agent may have apparent lingering authority, so the principal, upon termination of the agency, should notify those who might deal with the agent that the relationship is severed.

EXERCISES

1. Pauline, the owner of a large bakery business, wishes to expand her facilities by purchasing the adjacent property. She engages Alice as an agent to negotiate the deal with the property owner but instructs her not to tell the property owner that she—Alice—is acting as an agent because Pauline is concerned that the property owner would demand a high price. A reasonable contract is made. When the economy sours, Pauline decides not to expand and cancels the plan. Who is liable for the breach?
2. Peter, the principal, instructs his agent, Alice, to tour England and purchase antique dining room furniture for Peter's store. Alice buys an antique bed set. Who is liable, Peter or Alice? Suppose the seller did not know of the limit on Alice's authority and sells the bed set to Alice in good faith. What happens when Peter discovers he owes the seller for the set?
3. Under what circumstances will the agency terminate expressly?
4. Agent is hired by Principal to sell a new drug, Phobbot. Six months later, as it becomes apparent that Phobbot has nasty side effects (including death), the Food and Drug Administration orders the drug pulled from the shelves. Agent's agency is terminated; what terminology is appropriate to describe how?
5. Principal engages Agent to buy lumber, and in that capacity Agent deals with several large timber owners. Agent's contract ends on July 31; on August 1, Agent buys $150,000 worth of lumber from a seller with whom he had dealt previously on Principal's behalf. Who is liable and why?

10.4 Cases

Implied Authority

Kanavos v. Hancock Bank & Trust Company

439 N.E.2d 311 (Mass. 1982)

KASS, J.

CC BY NC SA

At the close of the plaintiff's evidence, the defendant moved for a directed verdict, which the trial judge allowed. The judge's reason for so doing was that the plaintiff, in his contract action, failed to introduce sufficient evidence tending to prove that the bank officer who made the agreement with which the plaintiff sought to charge the bank had any authority to make it. Upon review of the record we are of opinion that there was evidence which, if believed, warranted a finding that the bank officer had the requisite authority or that the bank officer had apparent authority to make the agreement in controversy. We therefore reverse the judgment.

For approximately ten years prior to 1975, Harold Kanavos and his brother borrowed money on at least twenty occasions from the Hancock Bank & Trust Company (the Bank), and, during that period, the loan officer with whom Kanavos always dealt was James M. Brown. The aggregate loans made by the Bank to Kanavos at any given time went as high as $800,000.

Over that same decade, Brown's responsibilities at the Bank grew, and he had become executive vice-president. Brown was also the chief loan officer for the Bank, which had fourteen or fifteen branches in addition to its head office. Physically, Brown's office was at the head office, toward the rear of the main banking floor, opposite the office of the president—whose name was Kelley. Often Brown would tell Kanavos that he had to check an aspect of a loan transaction with Kelley, but Kelley always backed Brown up on those occasions.

...

[The plaintiff, Harold Kanavos, entered into an agreement with the defendant Bank whereby stock owned by the Kanavos brothers was sold to the Bank and the plaintiff was given an option to repurchase the stock. Kanavos' suit against the Bank was based on an amendment to the agreement offered by Brown.]

Kanavos was never permitted to introduce in evidence the terms of the offer Brown made. That offer was contained in a writing, dated July 16, 1976, on bank letterhead, which read as follows: "This letter is to confirm our conversation regarding your option to re-purchase the subject property. In lieu of your not exercising your option, we agree to pay you $40,000 representing a commission upon our sale of the subject property, and in addition, will give you the option to match the price of sale of said property to

extend for a 60 day period from the time our offer is received." Brown signed the letter as executive vice-president. The basis of exclusion was that the plaintiff had not established the authority of Brown to make with Kanavos the arrangement memorialized in the July 16, 1976, letter.

Whether Brown's job description impliedly authorized the right of last refusal or cash payment modification is a question of how, in the circumstances, a person in Brown's position could reasonably interpret his authority. Whether Brown had apparent authority to make the July 16, 1976, modification is a question of how, in the circumstances, a third person, e.g., a customer of the Bank such as Kanavos, would reasonably interpret Brown's authority in light of the manifestations of his principal, the Bank.

Titles of office generally do not establish apparent authority. Brown's status as executive vice-president was not, therefore, a badge of apparent authority to modify agreements to which the Bank was a party.

Trappings of office, e.g., office and furnishing, private secretary, while they may have some tendency to suggest executive responsibility, do not without other evidence provide a basis for finding apparent authority. Apparent authority is drawn from a variety of circumstances. Thus in *Federal Nat. Bank v. O'Connell*...(1940), it was held apparent authority could be found because an officer who was a director, vice-president and treasurer took an active part in directing the affairs of the bank in question and was seen by third parties talking with customers and negotiating with them. In *Costonis v. Medford Housing Authy*....(1961), the executive director of a public housing authority was held to have apparent authority to vary specifications on the basis of the cumulative effect of what he had done and what the authority appeared to permit him to do.

In the instant case there was evidence of the following variety of circumstances: Brown's title of executive vice-president; the location of his office opposite the president; his frequent communications with the president; the long course of dealing and negotiations; the encouragement of Kanavos by the president to deal with Brown; the earlier amendment of the agreement by Brown on behalf of the Bank on material points, namely the price to be paid by the Bank for the shares and the repurchase price; the size of the Bank (fourteen or fifteen branches in addition to the main office); the secondary, rather than

fundamental, nature of the change in the terms of the agreement now repudiated by the Bank, measured against the context of the overall transaction; and Brown's broad operating authority...all these added together would support a finding of apparent authority. When a corporate officer, as here, is allowed to exercise general executive responsibilities, the "public expectation is that the corporation should be bound to engagements made on its behalf by those who presume to have, and convincingly appear to have, the power to agree." [Citation] This principle does not apply, of course, where in the business context, the requirement of specific authority is presumed, e.g., the sale of a major asset by a corporation or a transaction which by its nature commits the corporation to an obligation outside the scope of its usual activity. The modification agreement signed by Brown and dated July 16, 1976, should have been admitted in evidence, and a verdict should not have been directed.

Judgment reversed.

CASE QUESTIONS

1. Why are "titles of office" insufficient to establish apparent authority?
2. Why are "trappings of office" insufficient to establish apparent authority?
3. What is the relationship between apparent authority and estoppel? Who is estopped to do what, and why?

Employer's Liability for Employee's Intentional Torts: Scope of Employment

Lyon v. Carey

533 F.2d 649 (Cir. Ct. App. DC 1976)

McMillan, J.:

CC BY NC SA

Corene Antoinette Lyon, plaintiff, recovered a $33,000.00 verdict [about $142,000 in 2010 dollars] in the United States District Court for the District of Columbia before Judge Barrington T. Parker and a jury, against the corporate defendants, George's Radio and Television Company, Inc., and Pep Line Trucking Company, Inc. The suit for damages arose out of an assault, including rape, committed with a knife and other weapons upon the plaintiff on May 9, 1972, by Michael Carey, a nineteen-year-old deliveryman for Pep Line Trucking Company, Inc. Three months after the trial, Judge Parker set aside the verdict and rendered judgment for both defendants notwithstanding the verdict. Plaintiff appealed....

Although the assault was perhaps at the outer bounds of respondeat superior, the case was properly one for the jury. Whether the assault in this case was the outgrowth of a job-related controversy or simply a personal adventure of the deliveryman, was a question for the jury. This was the import of the trial judge's instructions. The verdict as to Pep Line should not have been disturbed.

Irene Lyon bought a mattress and springs for her bed from the defendant George's Radio and Television Company, Inc. The merchandise was to be delivered on May 9, 1972. Irene Lyon had to be at work and the plaintiff [Irene's sister] Corene Lyon, had agreed to wait in her sister's apartment to receive the delivery.

A C.O.D. balance of $13.24 was due on the merchandise, and Irene Lyon had left a check for $13.24 to cover that balance. Plaintiff had been requested by her sister to "wait until the mattress and the springs came and to check and make sure they were okay."

Plaintiff, fully clothed, answered the door. Her description of what happened is sufficiently brief and unqualified that it will bear repeating in full. She testified, without objection, as follows:

> *I went to the door, and I looked in the peephole, and I asked who was there. The young man told me he was a delivery man from George's. He showed me a receipt, and it said, 'George's.' He said he [needed cash on delivery—COD], so I let him in, and I told him to bring the mattress upstairs and he said, 'No,' that he wasn't going to lug them upstairs, and he wanted the COD first, and I told him I wanted to see the mattress and box springs to make sure they were okay, and he said no, he wasn't going to lug them upstairs [until he got the check].*

So this went back and forwards and so he was getting angry, and I told him to wait right here while I go get the COD. I went to the bedroom to get the check, and I picked it up, and I turned around and he was right there.

And then I was giving him the check and then he told me that his boss told him not to accept a check, that he wanted cash money, and that if I didn't give him cash money, he was going to take it on my ass, and he told me that he was no delivery man, he was a rapist and then he threw me on the bed.

[The Court] Talk louder, young lady, the jury can't hear you.

[The witness] And then he threw me on the bed, and he had a knife to my throat.

[Plaintiff's attorney] Then what happened?

And then he raped me.

Plaintiff's pre-trial deposition was a part of the record on appeal, and it shows that Carey raped plaintiff at knife point; that then he chased her all over the apartment with a knife and scissors and cut plaintiff in numerous places on her face and body, beat and otherwise attacked her. All of the physical injury other than the rape occurred after rather than before the rape had been accomplished....

[Carey was convicted of rape and sent to prison. The court determined that George's was properly dismissed because Pep Line, Carey's employer, was an independent contractor over which George's had no control.]

The principal question, therefore, is whether the evidence discloses any other basis upon which a jury could reasonably find Pep Line, the employer of Carey, liable for the assault.

Michael Carey was in the employment of the defendant Pep Line as a deliveryman. He was authorized to make the delivery of the mattress and springs plaintiff's sister had bought. He gained access to the apartment only upon a showing of the delivery receipt for the merchandise. His employment contemplated that he visit and enter that particular apartment. Though the apartment was not owned by nor in the control of his employer, it was nevertheless a place he was expected by his employer to enter.

After Carey entered, under the credentials of his employment and the delivery receipt, a dispute arose naturally and immediately between him and the plaintiff about two items of great significance in connection with his job. These items were the request of the plaintiff, the customer's agent, to inspect the mattress and springs before payment (which would require their being brought upstairs before the payment was made), and Carey's insistence on getting cash rather than a check.

The dispute arose out of the very transaction which had brought Carey to the premises, and, according to the plaintiff's evidence, out of the employer's instructions to get cash only before delivery.

On the face of things, Pep Line Trucking Company, Inc. is liable, under two previous decisions of the Court of Appeals for the District of Columbia Circuit. [Citation (1953)] held a taxi owner liable for damages (including a broken leg) sustained by a customer who had been run over by the taxi in pursuit of a dispute between the driver and the customer about a fare. [Citation (1939)], held a restaurant owner liable to a restaurant patron who was beaten with a stick by a restaurant employee, after a disagreement over the service. The theory was that:

> *It is well established that an employer may be held responsible in tort for assaults committed by an employee while he is acting within the scope of his employment, even though he may act wantonly and contrary to his employer's instructions. [Citations] "...having placed [the employee] in charge and committed the management of the business to his care, defendants may not escape liability either on the ground of his infirmity of temperament or because, under the*

CC BY NC SA

influence of passion aroused by plaintiff's threat to report the circumstances, he went beyond the ordinary line of duty and inflicted the injury shown in this case. [Citations]"

Munick v. City of Durham ([Citation], Supreme Court of North Carolina, 1921), though not a binding precedent, is informative and does show that the theory of liability advanced by the plaintiff is by no means recent in origin. The plaintiff, Munick, a Russian born Jew, testified that he went to the Durham, North Carolina city water company office on April 17, 1919, and offered to pay his bill with "three paper dollars, one silver dollar, and fifty cents in pennies." The pennies were in a roll "like the bank fixes them." The clerk gave a receipt and the plaintiff prepared to leave the office. The office manager came into the room, saw the clerk counting the pennies, became enraged at the situation, shoved the pennies onto the floor and ordered Munick to pick them up. Bolton, the manager, "locked the front door and took me by the jacket and called me 'God damned Jew,' and said, 'I want only bills.' I did not say anything and he hit me in the face. I did not resist, and the door was locked and I could not get out...." With the door locked, Bolton then repeatedly choked and beat the plaintiff, finally extracted a bill in place of the pennies, and ordered him off the premises with injuries including finger marks on his neck that could be seen for eight or ten days. Bolton was convicted of unlawful assault [but the case against the water company was dismissed].

The North Carolina Supreme Court (Clark, C. J.) reversed the trial court's dismissal and held that the case should have gone to the jury. The court...said [Citation]:

*"'It is now fully established that corporations may be held liable for negligent and malicious torts, and that responsibility will be imputed whenever such wrongs are committed by their employees and agents in the course of their employment and within its scope * * * in many of the cases, and in reliable textbooks * * * 'course of employment' is stated and considered as sufficiently inclusive; but, whether the one or the other descriptive term is used, they have the same significance in importing liability on the part of the principal when the agent is engaged in the work that its principal has employed or directed him to do and * * * in the effort to accomplish it. When such conduct comes within the description that constitutes an actionable wrong, the corporation*

principal, as in other cases of principal and agent, is liable not only for 'the act itself, but for the ways and means employed in the performance thereof.'

"In 1 Thompson, Negligence, s 554, it is pointed out that, unless the above principle is maintained:

"'It will always be more safe and profitable for a man to conduct his business vicariously than in his own person. He would escape liability for the consequences of many acts connected with his business, springing from the imperfections of human nature, because done by another, for which he would be responsible if done by himself. Meanwhile, the public, obliged to deal or come in contact with his agent, for injuries done by them must be left wholly without redress. He might delegate to persons pecuniarily irresponsible the care of large factories, of extensive mines, of ships at sea, or of railroad trains on land, and these persons, by the use of the extensive power thus committed to them, might inflict wanton and malicious injuries on third persons, without other restraint than that which springs from the imperfect execution of the criminal laws. A doctrine so fruitful of mischief could not long stand unshaken in an enlightened jurisprudence.' This court has often held the master liable, even if the agent was willful, provided it was committed in the course of his employment. [Citation]"

"The act of a servant done to effect some independent purpose of his own and not with reference to the service in which he is employed, or while he is acting as his own master for the time being, is not within the scope of his employment so as to render the master liable therefor. In these circumstances the servant alone is liable for the injury inflicted." [Citation]...."The general idea is that the employee at the time of doing the wrongful act, in order to fix liability on the employer, must have been acting in behalf of the latter and not on his own account [Citation]."

The principal physical (as opposed to psychic) damage to the plaintiff is a number of disfiguring knife wounds on her head, face, arms, breasts and body. If the instrumentalities of assault had not included rape, the case would provoke no particular curiosity nor interest because it comes within all the classic requirements for recovery against the master. The verdict is not attacked as excessive, and could not be excessive in light of the physical injuries inflicted.

It may be suggested that [some of the cases discussed] are distinguishable because in each of those cases the plaintiff was a business visitor on the defendant's "premises."...Home delivery customers are usually in their homes, sometimes alone; and deliveries of merchandise may expose householders to one-on-one confrontations with deliverymen. It would be a strange rule indeed which, while allowing recovery for assaults committed in "the store," would deny a master's liability for an assault committed on a lone woman in her own home, by a deliveryman required by his job to enter the home....

If, as in [one case discussed], the assault was not motivated or triggered off by anything in the employment activity but was the result of only propinquity and lust, there should be no liability. However, if the assault, sexual or otherwise, was triggered off or motivated or occasioned by a dispute over the conduct then and there of the employer's business, then the employer should be liable.

It is, then, a question of fact for the trier of fact, rather than a question of law for the court, whether the assault stemmed from purely and solely personal sources or arose out of the conduct of the employer's business; and the trial judge so instructed the jury.

It follows that, under existing decisions of the District of Columbia Circuit, plaintiff has made out a case for the jury against Pep Line Trucking, Inc. unless the sexual character of one phase of the assault bars her from recovery for damages from all phases of the assault.

We face, then, this question: Should the entire case be taken from the jury because, instead of a rod of wood (as in [one case]), in addition to weapons of steel (as in [one case, a knife]); and in addition to his hands (as in [the third case, regarding the dispute about the pennies]), Carey also employed a sexual weapon, a rod of flesh and blood in the pursuit of a job-related controversy?
The answer is, No. It is a jury's job to decide how much of plaintiff's story to believe, and how much if any of the damages were caused by actions, including sexual assault, which stemmed from job-related sources rather than from purely personal origins....

The judgment is affirmed as to the defendant George's and reversed as to the defendant Pep Line Trucking Company, Inc.

CASE QUESTIONS

1. What triggered the dispute here?
2. The court observes, "On the face of things, Pep Line Trucking Company, Inc. is liable." But there are two issues that give the court cause for more explanation. (1) Why does the court discuss the point that the assault did not occur on the employer's premises? (2) Why does the court mention that the knife assault happened *after* the rape?
3. It is difficult to imagine that a sexual assault could be anything other than some "purely and solely personal" gratification, unrelated to the employer's business. How did the court address this?
4. What is the controlling rule of law as to the employer's liability for intentional torts here?
5. What does the court mean when it says, "the assault was perhaps at the outer bounds of respondeat superior"?
6. Would the jury think about who had the "deep pocket" here? Who did have it?

Employer's Liability for Employee's Intentional Torts: Scope of Employment

Cockrell v. Pearl River Valley Water Supply Dist.

865 So.2d 357 (Miss. 2004)

The Pearl River Valley Water Supply District ("District") was granted summary judgment pursuant to the Mississippi Tort Claims Act (MTCA) dismissing with prejudice all claims asserted against it by Sandra Cockrell. Cockrell appeals the ruling of the circuit court citing numerous errors. Finding the motion for summary judgment was properly granted in favor of the District, this Court affirms the final judgment entered by the Circuit Court of Rankin County.

Facts and Proceedings in the Trial Court

On June 28, 1998, Sandra Cockrell was arrested for suspicion of driving under the influence of alcohol by Officer Joey James who was employed as a security patrol officer with the Reservoir Patrol of the Pearl River Valley Water Supply District. Officer James then transported Cockrell to the Reservoir Patrol office and administered an intoxilyzer test. The results of the test are not before us; however, we do know that after the test was administered, Officer James apologized to Cockrell for arresting her, and he assured her that he would prepare her paperwork so that she would not have to spend much time in jail. As they were leaving the Reservoir Patrol office, Officer James began asking Cockrell personal questions such as where she lived, whether she was dating anyone and if she had a boyfriend. Officer James then asked Cockrell for her cell phone number so that he could call and check on her. As they were approaching his patrol car for the trip to the Rankin County jail, Officer James informed Cockrell that she should be wearing handcuffs; however, he did not handcuff Cockrell, and he allowed her to ride in the front seat of the patrol car with him. In route to the jail, Cockrell became emotional and started crying. As she was fixing her makeup using the mirror on the sun visor, Officer James pulled his patrol car into a church parking lot and parked the car. He then pulled Cockrell towards him in an embrace and began stroking her back and hair telling her that things would be fine. Cockrell told Officer James to release her, but he continued to embrace her for approximately five minutes before continuing on to the jail.

On June 30, 1998, Cockrell returned to the Reservoir Patrol office to retrieve her driver's license. Officer James called Cockrell into his office and discussed her DUI charge with her. As she was leaving, Officer James grabbed her from behind, turned her around, pinned both of her arms behind her and pulled her to his chest. When Officer James bent down to kiss her, she ducked her head, thus causing Officer James to instead kiss her forehead. When Officer James finally released Cockrell, she ran out of the door and drove away. [Subsequently, Cockrell's attorney threatened civil suit against Patrol; James was fired in October 1998.]

On September 22, 1999, Cockrell filed a complaint for damages against the District alleging that on the nights of June 28 and June 30, 1998, Officer James was acting within the course and scope of his employment with the District and that he acted with reckless disregard for her emotional well-being and safety....On April 2, 2002, the District filed its motion for summary judgment alleging that there was no

genuine issue of material fact regarding Cockrell's claim of liability. The motion alleged that the conduct described by Cockrell was outside the course and scope of Officer James's public employment as he was intending to satisfy his lustful urges. Cockrell responded to the motion arguing that the misconduct did occur in the course and scope of Officer James's employment with the District and also that the misconduct did not reach the level of a criminal offense such that the District could be found not liable under the MTCA.

The trial court entered a final judgment granting the District's motion for summary judgment and dismissing the complaint with prejudice. The trial court found that the District could not be held liable under the MTCA for the conduct of Officer James which was both criminal and outside the course and scope of his employment. Cockrell...appeal[ed].

Discussion

Summary judgment is granted in cases where there is "no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law."...

Cockrell contends there is a genuine issue of material of fact regarding whether Officer James was acting in the course and scope of his employment with the District during the incidents which occurred on the nights of June 28 and June 30, 1998. Cockrell argues Officer James's conduct, although inappropriate, did not rise to the level of criminal conduct. Cockrell contends Officer James's action of hugging Cockrell was similar to an officer consoling a victim of a crime. Cockrell does admit that Officer James's action of kissing her is more difficult to view as within the course and scope of his employment...

The District argues that although Officer James acted within the course and scope of his duties when he arrested Cockrell, his later conduct, which was intended to satisfy his lustful desires, was outside the scope of his employment with it....

"Mississippi law provides that an activity must be in furtherance of the employer's business to be within the scope and course of employment." [Citation] To be within the course and scope of employment, an

activity must carry out the employer's purpose of the employment or be in furtherance of the employer's business. [Citations] Therefore, if an employee steps outside his employer's business for some reason which is not related to his employment, the relationship between the employee and the employer "is temporarily suspended and this is so 'no matter how short the time and the [employer] is not liable for [the employee's] acts during such time.'" "An employee's personal unsanctioned recreational endeavors are beyond the course and scope of his employment." [Citation]

[In one case cited,] Officer Kerry Collins, a Jackson Police officer, was on duty when he came upon the parked car of L.T., a minor, and her boyfriend, who were about to engage in sexual activity. [Citation] Officer Collins instructed L.T. to take her boyfriend home, and he would follow her to make sure she followed his orders. After L.T. dropped off her boyfriend, Officer Collins continued to follow her until he pulled L.T. over. Officer Collins then instructed L.T. to follow him to his apartment or else he would inform L.T.'s parents of her activities. L.T. followed Officer Collins to his apartment where they engaged in sexual activity. Upon returning home, L.T. told her parents everything that had happened. L.T. and her parents filed suit against Officer Collins, the City of Jackson and the Westwood Apartments, where Officer Collins lived rent free in return for his services as a security guard....The district court granted summary judgment in favor of the City finding that Officer Collins acted outside the course and scope of his employment with the Jackson Police Department. [Citation]
In [Citation] the plaintiff sued the Archdiocese of New Orleans for damages that allegedly resulted from his sexual molestation by a Catholic priest. The Fifth Circuit found that the priest was not acting within the course and scope of his employment. The Fifth Circuit held that "smoking marijuana and engaging in sexual acts with minor boys" in no way furthered the interests of his employer.

The Southern District of Mississippi and the Fifth Circuit, applying Mississippi law, have held that sexual misconduct falls outside the course and scope of employment. There is no question that Officer James was within the course and scope of his employment when he first stopped Cockrell for suspicion of driving under the influence of alcohol. However, when Officer James diverted from his employment for personal reasons, he was no longer acting in the furtherance of his employer's interests...Therefore, the District

cannot be held liable...for the misconduct of Officer James which occurred outside the course and scope of his employment.

Affirmed.

CASE QUESTIONS

1. How can this case and *Lyon v. Carey* (Section 10.4.2 "Employer's Liability for Employee's Intentional Torts: Scope of Employment") be reconciled? Both involve an agent's unacceptable behavior—assault—but in *Lyon* the agent's actions were imputed to the principal, and in *Cockrell* the agent's actions were not imputed to the principal.
2. What is the controlling rule of law governing the principal's liability for the agent's actions?
3. The law governing the liability of principals for acts of their agents is well settled. Thus the cases turn on the facts. Who decides what the facts are in a lawsuit?

10.5 Summary and Exercises

Summary

A contract made by an agent on behalf of the principal legally binds the principal. Three types of authority may bind the principal: (1) express authority—that which is actually given and spelled out, (2) implied authority—that which may fairly be inferred from the parties' relationship and which is incidental to the agent's express authority, and (3) apparent authority—that which reasonably appears to a third party under the circumstances to have been given by the principal. Even in the absence of authority, a principal may ratify the agent's acts.

The principal may be liable for tortious acts of the agent but except under certain regulatory statutes may not be held criminally liable for criminal acts of agents not prompted by the principal. Under the doctrine of respondeat superior, a principal is generally liable for acts by a servant within the scope of employment. A principal usually will not be held liable for acts of nonservant agents that cause physical damage, although he will be held liable for nonphysical torts, such as misrepresentation. The principal will not be held liable for tortious acts of independent contractors, although the principal may be liable for injuries resulting from his failure to act in situations in which he was not legally permitted to delegate a duty to act. Whenever an agent is acting to further the principal's business interests, the principal will be held vicariously liable for the agent's intentional torts. What constitutes scope of employment is not easy to determine; the modern trend is to hold a principal liable for the conduct of an agent if it was foreseeable that the agent might act as he did.

Most states have special rules of vicarious liability for special situations; for example, liability of an automobile owner for use by another. Spouses are not vicariously liable for each other, nor are parents for children, except for failing to control children known to be dangerous.

In general, an agent is not personally liable on contracts he has signed on behalf of a principal. This general rule has several exceptions recognized in most states: (1) when the agent is serving an undisclosed or partially disclosed principal, (2) when the agent lacks authority or exceeds his authority, and (3) if the agent entered into the contract in a personal capacity.

The agency relationship may be terminated by mutual consent, by express agreement of the parties that the agency will end at a certain time or on the occurrence of a certain event, or by an implied agreement arising out of the circumstances in each case. The agency may also be unilaterally revoked by the principal—unless the agency is coupled with an interest—or renounced by the agent. Finally, the agency will terminate by operation of law under certain circumstances, such as death of the principal or agent.

EXERCISES

1. Parke-Bernet Galleries, acting as agent for an undisclosed principal, sold a painting to Weisz. Weisz later discovered that the painting was a forgery and sued Parke-Bernet for breach of contract. In defense, Parke-Bernet argued that as a general rule, agents are not liable on contracts made for principals. Is this a good defense? Explain.
2. Lynch was the loan officer at First Bank. Patterson applied to borrow $25,000. Bank policy required that Lynch obtain a loan guaranty from Patterson's employer, a milk company. The manager of the milk company visited the bank and signed a guaranty on behalf of the company. The last paragraph of the guaranty stated, "This guaranty is signed by an officer having legal right to bind the company through authorization of the Board of Directors." Should Lynch be satisfied with this guaranty? Would he be satisfied if the president of the milk company, who was also a director, affirmed that the manager had authority to sign the guaranty? Explain.
3. Ralph owned a retail meat market. Ralph's agent Sam, without authority but purporting to act on Ralph's behalf, borrowed $7,500 from Ted. Although he never received the money, Ralph repaid $700 of the alleged loan and promised to repay the rest. If Sam had no authority to make the loan, is Ralph liable? Why?
4. A guest arrived early one morning at the Hotel Ohio. Clemens, a person in the hotel office who appeared to be in charge, walked behind the counter, registered the guest, gave him a key, and took him to his room. The guest also checked valuables (a diamond pin and money) with Clemens, who signed a receipt on behalf of the hotel. Clemens in fact was a roomer at the hotel, not an employee, and had no authority to act on behalf of the hotel. When Clemens absconded with the valuables, the guest sued the hotel. Is the hotel liable? Why?
5. A professional basketball player punched an opposing player in the face during the course of a game. The opponent, who was seriously injured, sued the owner of the team for damages. A jury awarded the player $222,000 [about $800,000 in 2010 dollars] for medical expenses, $200,000 [$700,000] for physical pain, $275,000 [$963,000] for mental anguish, $1,000,000 [$3.5 million] for lost earnings, and $1,500,000 [$5.2 million] in punitive damages (which was $500,000 more than requested by the player). The jury also awarded $50,000 [$150,000] to the player's wife for loss of companionship. If we assume that the player who threw the punch acted out of personal anger and had no intention to further the business, how could the damage award against his principal be legally justified?

6. A doctor in a University of Chicago hospital seriously assaulted a patient in an examining room. The patient sued the hospital on the theory that the doctor was an agent or employee of the hospital and the assault occurred within the hospital. Is the hospital liable for the acts of its agent? Why?
7. Hector was employed by a machine shop. One day he made a delivery for his employer and proceeded back to the shop. When he was four miles from the shop and on the road where it was located, he turned left onto another road to visit a friend. The friend lived five miles off the turnoff. On the way to the friend's house, Hector caused an accident. The injured person sued Hector's employer. Is the employer liable? Discuss.
8. A fourteen-year-old boy, who had no driver's license, took his parents' car without permission and caused an automobile accident. A person injured in the accident sued the boy's parents under the relevant state's Parental Responsibility Law (mentioned in Section 10.2.1 "Principal's Tort Liability"). Are the parents liable? Discuss.
9. In the past decades the Catholic Church has paid out hundreds of millions of dollars in damage awards to people—mostly men—who claimed that when they were boys and teenagers they were sexually abused by their local parish priests, often on Church premises. That is, the men claimed they had been victims of child rape. Obviously, such behavior is antithetical to any reasonable standard of clergy behavior: the priests could not have been in the scope of employment. How is the Church liable?

SELF-TEST QUESTIONS

1 Authority that legally may bind the principal includes

a. implied authority
b. express authority
c. apparent authority
d. all of the above

2 As a general rule, a principal is not

a. liable for tortious acts of an agent, even when the principal is negligent
b. liable for acts of a servant within the scope of employment
c. criminally liable for acts of the agent

d. liable for nondelegable duties performed by independent contractors

3 An agent may be held personally liable on contracts signed on behalf of a principal when

a. the agent is serving an undisclosed or partially disclosed principal

b. the agent exceeds his authority

c. the agent entered into the contract in a personal capacity

d. all of the above are true

4 An agency relationship may be terminated by

a. an implied agreement arising out of the circumstances

b. mutual consent of parties

c. death of the principal or agent

d. all of the above

5 The principal's liability for the agent's acts of which the principal had no knowledge or intention to commit is called

a. contract liability

b. implied liability

c. respondeat superior

d. all of the above

SELF-TEST ANSWERS

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

CC BY NC SA

Chapter 11
Partnerships: General Characteristics and Formation

LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The importance of partnership and the present status of partnership law
2. The extent to which a partnership is an entity
3. The tests that determine whether a partnership exists
4. Partnership by estoppel
5. Partnership formation

11.1 Introduction to Partnerships and Entity Theory

CC BY NC SA

LEARNING OBJECTIVES

1. Describe the importance of partnership.
2. Understand partnership history.
3. Identify the entity characteristics of partnerships.

Importance of Partnership Law

It would be difficult to conceive of a complex society that did not operate its businesses through organizations. In this chapter we study partnerships, limited partnerships, and limited liability companies, and we touch on joint ventures and business trusts.

When two or more people form their own business or professional practice, they usually consider becoming partners. Partnership law defines a **partnership** as "the association of two or more persons to carry on as co-owners a business for profit...whether or not the persons intend to form a partnership."[1] In 2011, there were more than three million business firms in the United States as partnerships (see Table 11.1 "Selected Data: Number of US Partnerships, Limited Partnerships, and Limited Liability Companies", showing data to 2006), and partnerships are a common form of organization among accountants, lawyers, doctors, and other professionals. When we use the word *partnership*, we are referring to the *general business partnership*. There are also limited partnerships and limited liability partnerships, which are discussed in Chapter 13 "Hybrid Business Forms".

Table 11.1 Selected Data: Number of US Partnerships, Limited Partnerships, and Limited Liability Companies

	2003	2004	2005	2006
Total number of active partnerships	2,375,375	2,546,877	2,763,625	2,947,116
Number of partners	14,108,458	15,556,553	16,211,908	16,727,803
Number of limited partnerships	378,921	402,238	413,712	432,550
Number of partners	6,262,103	7,023,921	6,946,986	6,738,737

	2003	2004	2005	2006
Number of limited liability companies	1,091,502	1,270,236	1,465,223	1,630,161
Number of partners	4,226,099	4,949,808	5,640,146	6,361,958

Source: IRS, http://www.irs.gov/pub/irs-soi/09sprbul.pdf.

Partnerships are also popular as investment vehicles. Partnership law and tax law permit an investor to put capital into a limited partnership and realize tax benefits without liability for the acts of the general partners.

Even if you do not plan to work within a partnership, it can be important to understand the law that governs it. Why? Because it is possible to become someone's partner without intending to or even realizing that a partnership has been created. Knowledge of the law can help you avoid partnership liability.

History of Partnership Law

Through the Twentieth Century

Partnership is an ancient form of business enterprise, and special laws governing partnerships date as far back as 2300 BC, when the Code of Hammurabi explicitly regulated the relations between partners. Partnership was an important part of Roman law, and it played a significant role in the law merchant, the international commercial law of the Middle Ages.

In the nineteenth century, in both England and the United States, partnership was a popular vehicle for business enterprise. But the law governing it was jumbled. Common-law principles were mixed with equitable standards, and the result was considerable confusion. Parliament moved to reduce the uncertainty by adopting the Partnership Act of 1890, but codification took longer in the United States. The Commissioners on Uniform State Laws undertook the task at the turn of the twentieth century. The Uniform Partnership Act (UPA), completed in 1914, and the Uniform Limited Partnership Act (ULPA), completed in 1916, were the basis of partnership law for many decades. UPA and ULPA were adopted by all states except Louisiana.

The Current State of Partnership Law

Despite its name, UPA was not enacted uniformly among the states; moreover, it had some shortcomings. So the states tinkered with it, and by the 1980s, the National Conference of Commissioners on Uniform Laws (NCCUL) determined that a revised version was in order. An amended UPA appeared in 1992, and further amendments were promulgated in 1993, 1994, 1996, and 1997. The NCCUL reports that thirty-nine states have adopted some version of the revised act. This chapter will discuss the Revised Uniform Partnership Act (RUPA) as promulgated in 1997, but because not all jurisdictions have not adopted it, where RUPA makes significant changes, the original 1914 UPA will also be considered.[2] The NCCUL observes in its "prefatory note" to the 1997 act: "The Revised Act is largely a series of 'default rules' that govern the relations among partners in situations they have not addressed in a partnership agreement. The primary focus of RUPA is the small, often informal, partnership. Larger partnerships generally have a partnership agreement addressing, and often modifying, many of the provisions of the partnership act."[3]

Entity Theory

Meaning of "Legal Entity"

A significant difference between a partnership and most other kinds of business organization relates to whether, and the extent to which, the business is a legal entity. A legal entity is a person or group that the law recognizes as having legal rights, such as the right to own and dispose of property, to sue and be sued, and to enter into contracts; the **entity theory** is the concept of a business firm as a legal person, with existence and accountability separate from its owners. When individuals carry out a common enterprise as partners, a threshold legal question is whether the partnership is a legal entity. The common law said no. In other words, under the common-law theory, a partnership was but a convenient name for an aggregate of individuals, and the rights and duties recognized and imposed by law are those of the individual partners. By contrast, the mercantile theory of the law merchant held that a partnership is a legal entity that can have rights and duties independent of those of its members.

During the drafting of the 1914 UPA, a debate raged over which theory to adopt. The drafters resolved the debate through a compromise. In Section 6(1), UPA provides a neutral definition of partnership ("an

association of two or more persons to carry on as co-owners a business for profit") and retained the common-law theory that a partnership is an aggregation of individuals—the **aggregate theory**.

RUPA moved more toward making partnerships entities. According to the NCCUL, "The Revised Act enhances the entity treatment of partnerships to achieve simplicity for state law purposes, particularly in matters concerning title to partnership property. RUPA does not, however, relentlessly apply the entity approach. The aggregate approach is retained for some purposes, such as partners' joint and several liability." [4] Section 201(a) provides, "A partnership is an entity distinct from its partners." [5]

Entity Characteristics of a Partnership

Under RUPA, then, a partnership has entity characteristics, but the partners remain guarantors of partnership obligations, as always—that is the partners' joint and several liability noted in the previous paragraph (and discussed further in Chapter 12 "Partnership Operation and Termination"). This is a very important point and a primary weakness of the partnership form: all partners are, and each one of them is, ultimately personally liable for the obligations of the partnership, without limit, which includes personal and unlimited liability. This personal liability is very distasteful, and it has been abolished, subject to some exceptions, with limited partnerships and limited liability companies, as discussed in Chapter 13 "Hybrid Business Forms". And, of course, the owners of corporations are also not generally liable for the corporation's obligations, which is a major reason for the corporate form's popularity.

For Accounting Purposes

Under both versions of the law, the partnership may keep business records as if it were a separate entity, and its accountants may treat it as such for purposes of preparing income statements and balance sheets.

For Purposes of Taxation

Under both versions of the law, partnerships are *not* taxable entities, so they do not pay income taxes. Instead, each partner's distributive share, which includes income or other gain, loss, deductions, and credits, must be included in the partner's personal income tax return, whether or not the share is actually distributed.

For Purposes of Litigation

In litigation, the aggregate theory causes some inconvenience in naming and serving partnership defendants: under UPA, lawsuits to enforce a partnership contract or some other right must be filed in the name of all the partners. Similarly, to sue a partnership, the plaintiff must name and sue each of the partners. This cumbersome procedure was modified in many states, which enacted special statutes expressly permitting suits by and against partnerships in the firm name. In suits on a claim in federal court, a partnership may sue and be sued in its common name. The move by RUPA to make partnerships entities changed very little. Certainly it provides that "a partnership may sue and be sued in the name of the partnership"—that's handy where the plaintiff hopes for a judgment against the partnership, without recourse to the individual partners' personal assets.[6] But a plaintiff must still name the partnership and the partners individually to have access to both estates, the partnership and the individuals': "A judgment against a partnership is not by itself a judgment against a partner. A judgment against a partnership may not be satisfied from a partner's assets unless there is also a judgment against the partner."[7]

For Purposes of Owning Real Estate

Aggregate theory concepts bedeviled property co-ownership issues, so UPA finessed the issue by stating that partnership property, real or personal, could be held in the name of the partners as "tenants in partnership"—a type of co-ownership—or it could be held in the name of the partnership.[8] Under RUPA, "property acquired by the partnership is property of the partnership and not of the partners."[9] But RUPA is no different from UPA in practical effect. The latter provides that "property originally brought into the partnership stock or subsequently acquired by purchase...on account of the partnership, is partnership property."[10] Under either law, a partner may bring onto the partnership premises her own property, not acquired in the name of the partnership or with its credit, and it remains her separate property. Under neither law can a partner unilaterally dispose of partnership property, however labeled, for the obvious reason that one cannot dispose of another's property or property rights without permission.[11] And keep in mind that partnership law is the default: partners are free to make up partnership agreements as they like, subject to some limitations. They are free to set up property ownership rules as they like.

For Purposes of Bankruptcy

Under federal bankruptcy law—state partnership law is preempted—a partnership is an entity that may voluntarily seek the haven of a bankruptcy court or that may involuntarily be thrust into a bankruptcy proceeding by its creditors. The partnership cannot discharge its debts in a liquidation proceeding under Chapter 7 of the bankruptcy law, but it can be rehabilitated under Chapter 11 (see Chapter 27 "Bankruptcy").

KEY TAKEAWAY

Partnership law is very important because it is the way most small businesses are organized and because it is possible for a person to become a partner without intending to. Partnership law goes back a long way, but in the United States, most states—but not all—have adopted the Revised Uniform Partnership Act (RUPA, 1997) over the previous Uniform Partnership Act, originally promulgated in 1914. One salient change made by RUPA is to directly announce that a partnership is an entity: it is like a person for purposes of accounting, litigation, bankruptcy, and owning real estate. Partnerships do not pay taxes; the individual partners do. But in practical terms, what RUPA does is codify already-existing state law on these matters, and partners are free to organize their relationship as they like in the partnership agreement.

EXERCISES

1. When was UPA set out for states to adopt? When was RUPA promulgated for state adoption?
2. What does it mean to say that the partnership act is the “default position”? For what types of partnership is UPA (or RUPA) likely to be of most importance?
3. What is the aggregate theory of partnership? The entity theory?

---

[1] Revised Uniform Partnership Act, Section 202(a).

[2] NCCUSL, Uniform Law Commission, “Acts: Partnership Act,” http://www.nccusl.org/Act.aspx?title=Partnership%20Act. The following states *have* adopted the RUPA: Alabama,

Alaska, Arizona, Arkansas, California, Colorado, Delaware, District of Columbia, Florida, Hawaii, Idaho, Illinois, Iowa, Kansas, Kentucky, Maine, Maryland, Minnesota, Mississippi, Montana, Nebraska, Nevada, New Jersey, New Mexico, North Dakota, Oklahoma, Oregon, Puerto Rico, South Dakota (substantially similar), Tennessee, Texas (substantially similar), US Virgin Islands, Vermont, Virginia, and Washington. Connecticut, West Virginia, and Wyoming adopted the 1992 or 1994 version. Here are the states that have *not* adopted RUPA (Louisiana never adopted UPA at all): Georgia, Indiana, Massachusetts, Michigan, Mississippi, New Hampshire, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, and Wisconsin.

[3] University of Pennsylvania Law School, Biddle Law Library, "Uniform Partnership Act (1997)," NCCUSL Archives,http://www.law.upenn.edu/bll/archives/ulc/fnact99/1990s/upa97fa.pdf.

[4] University of Pennsylvania Law School, Biddle Law Library, "Uniform Partnership Act (1997)," NCCUSL Archives,http://www.law.upenn.edu/bll/archives/ulc/fnact99/1990s/upa97fa.pdf.

[5] RUPA, Section 201(a).

[6] RUPA, Section 307(a).

[7] RUPA, Section 307(c).

[8] Uniform Partnership Act, Section 25(1); UPA, Section 8(3).

[9] RUPA, Section 203.

[10] UPA, Section 8(1).

[11] UPA, Sections 9(3)(a) and 25; RUPA, Section 302.

11.2 Partnership Formation

LEARNING OBJECTIVES

1. Describe the creation of an express partnership.
2. Describe the creation of an implied partnership.
3. Identify tests of partnership existence.
4. Understand partnership by estoppel.

Creation of an Express Partnership

Creation in General

The most common way of forming a partnership is expressly—that is, in words, orally or in writing. Such a partnership is called an **express partnership**. If parties have an express partnership with no partnership agreement, the relevant law—the Uniform Partnership Act (UPA) or the Revised Uniform Partnership Act (RUPA)—applies the governing rules.

Assume that three persons have decided to form a partnership to run a car dealership. Able contributes $250,000. Baker contributes the building and space in which the business will operate. Carr contributes his services; he will manage the dealership.

The first question is whether Able, Baker, and Carr must have a partnership agreement. As should be clear from the foregoing discussion, no agreement is necessary as long as the tests of partnership are met. However, they *ought* to have an agreement in order to spell out their rights and duties among themselves.

The agreement itself is a contract and should follow the principles and rules spelled out in Chapter 8 "Contracts" of this book. Because it is intended to govern the relations of the partners toward themselves and their business, every partnership contract should set forth clearly the following terms: (1) the name under which the partners will do business; (2) the names of the partners; (3) the nature, scope, and location of the business; (4) the capital contributions of each partner; (5) how profits and losses are to be divided; (6) how salaries, if any, are to be determined; (7) the responsibilities of each partner for managing the business; (8) limitations on the power of each partner to bind the firm; (9) the method by which a given partner may withdraw from the partnership; (10) continuation of the firm in the event of a partner's death and the formula for paying a partnership interest to his heirs; and (11) method of dissolution.

Specific Issues of Concern

In forming a partnership, three of these items merit special attention. And note again that if the parties do not provide for these in their agreement, RUPA will do it for them as the default.

Who Can Be a Partner?

As discussed earlier in this chapter, a partnership is not limited to a direct association between human beings but may also include an association between other entities, such as corporations or even partnerships themselves.[1] Family members can be partners, and partnerships between parents and minor children are lawful, although a partner who is a minor may disaffirm the agreement.

Written versus Oral Agreements

If the business cannot be performed within one year from the time that the agreement is entered into, the partnership agreement should be in writing to avoid invalidation under the Statute of Frauds. Most partnerships have no fixed term, however, and are partnerships "at will" and therefore not covered by the Statute of Frauds.

Validity of the Partnership Name

Able, Baker, and Carr decide that it makes good business sense to choose an imposing, catchy, and well-known name for their dealership—General Motors Corporation. There are two reasons why they cannot do so. First, their business is a partnership, not a corporation, and should not be described as one. Second, the name is deceptive because it is the name of an existing business. Furthermore, if not registered, the name would violate the assumed or fictitious name statutes of most states. These require that anyone doing business under a name other than his real name register the name, together with the names and addresses of the proprietors, in some public office. (Often, the statutes require the proprietors to publish this information in the newspapers when the business is started.) As *Loomis v. Whitehead* in Section 11.3.2 "Creation of a Partnership: Registering the Name" shows, if a business fails to comply with the statute, it could find that it will be unable to file suit to enforce its contracts.

Creation of Implied Partnership

An **implied partnership** exists when in fact there are two or more persons carrying on a business as co-owners for profit. For example, Carlos decides to paint houses during his summer break. He gathers some materials and gets several jobs. He hires Wally as a helper. Wally is very good, and pretty soon both of them are deciding what jobs to do and how much to charge, and they are splitting the profits. They have an implied partnership, without intending to create a partnership at all.

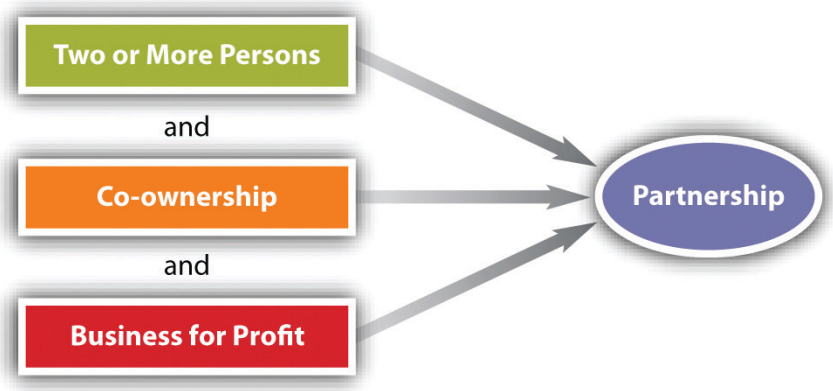
Tests of Partnership Existence

But how do we know whether an implied partnership *has* been created? Obviously, we know if there is an express agreement. But partnerships can come into existence quite informally, indeed, without any formality—they can be created accidentally. In contrast to the corporation, which is the creature of statute, partnership is a catchall term for a large variety of working relationships, and frequently, uncertainties arise about whether or not a particular relationship is that of partnership. The law can reduce the uncertainty in advance only at the price of severely restricting the flexibility of people to associate. As the chief drafter of the Uniform Partnership Act (UPA, 1914) explained,

> *All other business associations are statutory in origin. They are formed by the happening of an event designated in a statute as necessary to their formation. In corporations this act may be the issuing of a charter by the proper officer of the state; in limited partnerships, the filing by the associates of a specified document in a public office. On the other hand, an infinite number of combinations of circumstances may result in co-ownership of a business. Partnership is the residuum, including all forms of co-ownership, of a business except those business associations organized under a specific statute.*[2]

Figure 11.1 Partnership Tests

CC BY NC SA



Because it is frequently important to know whether a partnership exists (as when a creditor has dealt with only one party but wishes to also hold others liable by claiming they were partners, see Section 11.3.1 "Tests of Partnership Existence", *Chaiken v. Employment Security Commission*), a number of tests have been established that are clues to the existence of a partnership (see Figure 11.1 "Partnership Tests"). We return to the definition of a partnership: "the association of two or more persons to carry on as co-owners a business for profit[.]" The three elements are (1) the association of persons, (2) as co-owners, (3) for profit.

Association of Persons

This element is pretty obvious. A partnership is a contractual agreement among persons, so the persons involved need to have *capacity* to contract. But RUPA does not provide that only *natural* persons can be partners; it defines *person* as follows: "'Person' means an individual, corporation, business trust, estate, trust, partnership, association, joint venture, government, governmental subdivision, agency, or instrumentality, or any other legal or commercial entity."[3] Thus unless state law precludes it, a corporation can be a partner in a partnership. The same is true under UPA.

Co-owners of a Business

If what two or more people own is clearly a business—including capital assets, contracts with employees or agents, an income stream, and debts incurred on behalf of the operation—a partnership exists. A tougher question arises when two or more persons co-own property. Do they automatically become

partners? The answer can be important: if one of the owners while doing business pertinent to the property injures a stranger, the latter could sue the other owners if there is a partnership.

Co-ownership comes in many guises. The four most common are joint tenancy, tenancy in common, tenancy by the entireties, and community property. In joint tenancy, the owners hold the property under a single instrument, such as a deed, and if one dies, the others automatically become owners of the deceased's share, which does not descend to his heirs. Tenancy in common has the reverse rule: the survivor tenants do not take the deceased's share. Each tenant in common has a distinct estate in the property. The tenancy by the entirety and community property (in community-property states) forms of ownership are limited to spouses, and their effects are similar to that of joint tenancy.

Suppose a husband and wife who own their home as tenants by the entirety (or community property) decide to spend the summer at the seashore and rent their home for three months. Is their co-ownership sufficient to establish that they are partners? The answer is no. By UPA Section 7(2) and RUPA Section 202(b)(1), the various forms of joint ownership by themselves do not establish partnership, whether or not the co-owners share profits made by the use of the property. To establish a partnership, the ownership must be of a business, not merely of property.

Sharing of Profits

There are two aspects to consider with regard to profits: first, whether the business is for-profit, and second, whether there is a sharing of the profit.

Business for Profit

Unincorporated nonprofit organizations (UNAs) cannot be partnerships. The paucity of coherent law governing these organizations gave rise in 2005 to the National Conference of Commissioners of Uniform Laws' promulgation of the Revised Uniform Unincorporated Nonprofit Association Act (RUUNAA). The prefatory note to this act says, "RUUNAA was drafted with small informal associations in mind. These informal organizations are likely to have no legal advice and so fail to consider legal and organizational questions, including whether to incorporate. The act provides better answers than the common law for a

limited number of legal problems...There are probably hundreds of thousands of UNAs in the United States including unincorporated nonprofit philanthropic, educational, scientific and literary clubs, sporting organizations, unions, trade associations, political organizations, churches, hospitals, and condominium and neighborhood associations." [4] At least twelve states have adopted RUUNAA or its predecessor.

Sharing the Profit

While co-ownership does not establish a partnership unless there is a business, a business by itself is not a partnership unless co-ownership is present. Of the tests used by courts to determine co-ownership, perhaps the most important is sharing of profits. Section 202(c) of RUPA provides that "a person who receives a share of the profits of a business is presumed to be a partner in the business," but this presumption can be rebutted by showing that the share of the profits paid out was (1) to repay a debt; (2) wages or compensation to an independent contractor; (3) rent; (4) an annuity, retirement, or health benefit to a representative of a deceased or retired partner; (5) interest on a loan, or rights to income, proceeds, or increase in value from collateral; or (5) for the sale of the goodwill of a business or other property. Section 7(4) of UPA is to the same effect.

Other Factors

Courts are not limited to the profit-sharing test; they also look at these factors, among others: the right to participate in decision making, the duty to share liabilities, and the manner in which the business is operated. Section 11.3.1 "Tests of Partnership Existence", *Chaiken v. Employment Security Commission*, illustrates how these factors are weighed in court.

Creation of Partnership by Estoppel

Ordinarily, if two people are not legally partners, then third parties cannot so regard them. For example, Mr. Tot and Mr. Tut own equal shares of a house that they rent but do not regard it as a business and are not in fact partners. They do have a loose "understanding" that since Mr. Tot is mechanically adept, he will make necessary repairs whenever the tenants call. On his way to the house one day to fix its boiler,

CC BY NC SA

Mr. Tot injures a pedestrian, who sues both Mr. Tot and Mr. Tut. Since they are not partners, the pedestrian cannot sue them as if they were; hence Mr. Tut has no partnership liability.

Suppose that Mr. Tot and Mr. Tut happened to go to a lumberyard together to purchase materials that Mr. Tot intended to use to add a room to the house. Short of cash, Mr. Tot looks around and espies Mr. Tat, who greets his two friends heartily by saying within earshot of the salesman who is debating whether to extend credit, "Well, how are my two partners this morning?" Messrs. Tot and Tut say nothing but smile faintly at the salesman, who mistakenly but reasonably believes that the two are acknowledging the partnership. The salesman knows Mr. Tat well and assumes that since Mr. Tat is rich, extending credit to the "partnership" is a "sure thing." Messrs. Tot and Tut fail to pay. The lumberyard is entitled to collect from Mr. Tat, even though he may have forgotten completely about the incident by the time suit is filed. Under Uniform Partnership Act Section 16(1), Mr. Tat would be liable for the debt as being part of a **partnership by estoppel**. The Revised Uniform Partnership Act is to the same effect:

> *Section 308. Liability of Purported Partner.*
>
> *(a) If a person, by words or conduct, purports to be a partner, or consents to being represented by another as a partner, in a partnership or with one or more persons not partners, the purported partner is liable to a person to whom the representation is made, if that person, relying on the representation, enters into a transaction with the actual or purported partnership.*

Partnership by estoppel has two elements: (1) a representation to a third party that there is in fact a partnership and (2) reliance by the third party on the representation. See Section 11.3.3 "Partnership by Estoppel", *Chavers v. Epsco, Inc.*, for an example of partnership by estoppel.

KEY TAKEAWAY

A partnership is any two or more persons—including corporate persons—carrying on a business as co-owners for profit. A primary test of whether a partnership exists is whether there is a sharing of profits, though other

factors such as sharing decision making, sharing liabilities, and how the business is operated are also examined.

Most partnerships are expressly created. Several factors become important in the partnership agreement, whether written or oral. These include the name of the business, the capital contributions of each partner, profit sharing, and decision making. But a partnership can also arise by implication or by estoppel, where one has held herself as a partner and another has relied on that representation.

EXERCISES

1. Why is it necessary—or at least useful—to have tests to determine whether a partnership exists?
2. What elements of the business organization are examined to make this determination?
3. Jacob rents farmland from Davis and pays Davis a part of the profits from the crop in rent. Is Davis a partner? What if Davis offers suggestions on what to plant and when? Now is he a partner?
4. What elements should be included in a written partnership agreement?
5. What is an implied partnership?
6. What is a partnership by estoppel, and why are its "partners" estopped to deny its existence?

---

[1] A **joint venture**—sometimes known as a joint adventure, coadventure, joint enterprise, joint undertaking, syndicate, group, or pool—is an association of persons to carry on a particular task until completed. In essence, a joint venture is a "temporary partnership." In the United States, the use of joint ventures began with the railroads in the late 1800s. Throughout the middle part of the twentieth century joint ventures were common in the manufacturing sector. By the late 1980s, they increasingly appeared in both manufacturing and service industries as businesses looked for new, competitive strategies. They are aggressively promoted on the Internet: "Joint Ventures are in, and if you're not utilizing this strategic weapon, chances are your competition is, or will soon be, using this to their advantage….possibly against you!" (Scott Allen, "Joint Venturing 101," About.com Entrepreneurs,http://entrepreneurs.about.com/od/beyondstartup/a/jointventures.htm).As a risk-avoiding device, the joint venture allows two or more firms to pool their differing expertise so that neither needs to "learn the

ropes" from the beginning; neither needs the entire capital to start the enterprise. Partnership rules generally apply, although the relationship of the joint venturers is closer to that of special than general agency as discussed in Chapter 9 "Relationships between Principal and Agent". Joint venturers are fiduciaries toward one another. Although no formality is necessary, the associates will usually sign an agreement. The joint venture need have no group name, though it may have one. Property may be owned jointly. Profits and losses will be shared, as in a partnership, and each associate has the right to participate in management. Liability is unlimited. Sometimes two or more businesses will form a joint venture to carry out a specific task—prospecting for oil, building a nuclear reactor, doing basic scientific research—and will incorporate the joint venture. In that case, the resulting business—known as a "joint venture corporation"—is governed by corporation law, not the law of partnership, and is not a joint venture in the sense described here. Increasingly, companies are forming joint ventures to do business abroad; foreign investors or governments own significant interests in these joint ventures. For example, in 1984 General Motors entered into a joint venture with Toyota to revive GM's shuttered Fremont, California, assembly plant to create New United Motor Manufacturing, Inc. (NUMMI). For GM the joint venture was an opportunity to learn about lean manufacturing from the Japanese company, while Toyota gained its first manufacturing base in North America and a chance to test its production system in an American labor environment. Until May 2010, when the copartnership ended and the plant closed, NUMMI built an average of six thousand vehicles a week, or nearly eight million cars and trucks. These vehicles were the Chevrolet Nova (1984–88), the Geo Prizm (1989–97), the Chevrolet Prizm (1998–2002), and the Hilux (1991–95, predecessor of the Tacoma), as well as the Toyota Voltz, the Japanese right-hand-drive version of the Pontiac Vibe. The latter two were based on the Toyota Matrix. Paul Stenquist, "GM and Toyota's Joint Venture Ends in California," *New York Times*, April 2, 2010, http://wheels.blogs.nytimes.com/2010/04/02/g-m-and-toyotas-joint-venture-ends-in-california.

[2] W. D. Lewis, "The Uniform Partnership Act," *Yale Law Journal* 24 (1915): 617, 622.

[3] RUPA, Section 101(10).

[4] Revised Uniform Unincorporated Nonprofit Associations Act,http://www.abanet.org/intlaw/leadership/policy/RUUNAA_Final_08.pdf.

11.3 Cases

Tests of Partnership Existence

Chaiken v. Employment Security Commission

274 A.2d 707 (Del. 1971)

STOREY, J.

The Employment Security Commission, hereinafter referred to as the Commission, levied an involuntary assessment against Richard K. Chaiken, complainant, hereinafter referred to as Chaiken, for not filing his unemployment security assessment report. Pursuant to the same statutory section, a hearing was held and a determination made by the Commission that Chaiken was the employer of two barbers in his barber shop and that he should be assessed as an employer for his share of unemployment compensation contributions. Chaiken appealed the Commission's decision....

Both in the administrative hearing and in his appeal brief Chaiken argues that he had entered into partnership agreements with each of his barbers and, therefore, was and is not subject to unemployment compensation assessment. The burden is upon the individual assessed to show that he is outside the ambit of the statutory sections requiring assessment. If Chaiken's partnership argument fails he has no secondary position and he fails to meet his burden.

Chaiken contends that he and his "partners":

1. properly registered the partnership name and names of partners in the prothonotary's office, in accordance with [the relevant statute],[1]
2. properly filed federal partnership information returns and paid federal taxes quarterly on an estimated basis, and
3. duly executed partnership agreements.

Of the three factors, the last is most important. Agreements of "partnership" were executed between Chaiken and Mr. Strazella, a barber in the shop, and between Chaiken and Mr. Spitzer, similarly situated.

The agreements were nearly identical. The first paragraph declared the creation of a partnership and the location of business. The second provided that Chaiken would provide barber chair, supplies, and licenses, while the other partner would provide tools of the trade. The paragraph also declared that upon dissolution of the partnership, ownership of items would revert to the party providing them. The third paragraph declared that the income of the partnership would be divided 30% for Chaiken, 70% for Strazella; 20% for Chaiken and 80% for Spitzer. The fourth paragraph declared that all partnership policy would be decided by Chaiken, whose decision was final. The fifth paragraph forbade assignment of the agreement without permission of Chaiken. The sixth paragraph required Chaiken to hold and distribute all receipts. The final paragraph stated hours of work for Strazella and Spitzer and holidays.

The mere existence of an agreement labeled "partnership" agreement and the characterization of signatories as "partners" docs not conclusively prove the existence of a partnership. Rather, the intention of the parties, as explained by the wording of the agreement, is paramount.

A partnership is defined as an association of two or more persons to carry on as co-owners a business for profit. As co-owners of a business, partners have an equal right in the decision making process. But this right may be abrogated by agreement of the parties without destroying the partnership concept, provided other partnership elements are present.

Thus, while paragraph four reserves for Chaiken all right to determine partnership policy, it is not standing alone, fatal to the partnership concept. Co-owners should also contribute valuable consideration for the creation of the business. Under paragraph two, however, Chaiken provides the barber chair (and implicitly the barber shop itself), mirror, licenses and linen, while the other partners merely provide their tools and labor—nothing more than any barber-employee would furnish. Standing alone, however, mere contribution of work and skill can be valuable consideration for a partnership agreement.

Partnership interests may be assignable, although it is not a violation of partnership law to prohibit assignment in a partnership agreement. Therefore, paragraph five on assignment of partnership interests does not violate the partnership concept. On the other hand, distribution of partnership assets to the

partners upon dissolution is only allowed after all partnership liabilities are satisfied. But paragraph two of the agreement, in stating the ground rules for dissolution, makes no declaration that the partnership assets will be utilized to pay partnership expenses before reversion to their original owners. This deficiency militates against a finding in favor of partnership intent since it is assumed Chaiken would have inserted such provision had he thought his lesser partners would accept such liability. Partners do accept such liability, employees do not.

Most importantly, co-owners carry on "a business for profit." The phrase has been interpreted to mean that partners share in the profits and the losses of the business. The intent to divide the profits is an indispensable requisite of partnership. Paragraph three of the agreement declares that each partner shall share in the income of the business. There is no sharing of the profits, and as the agreement is drafted, there are no profits. Merely sharing the gross returns does not establish a partnership. Nor is the sharing of profits prima facie evidence of a partnership where the profits received are in payment of wages.

The failure to share profits, therefore, is fatal to the partnership concept here.

Evaluating Chaiken's agreement in light of the elements implicit in a partnership, no partnership intent can be found. The absence of the important right of decision making or the important duty to share liabilities upon dissolution individually may not be fatal to a partnership. But when both are absent, coupled with the absence of profit sharing, they become strong factors in discrediting the partnership argument. Such weighing of the elements against a partnership finding compares favorably with *Fenwick v. Unemployment Compensation Commission*, which decided against the partnership theory on similar facts, including the filing of partnership income tax forms.

In addition, the total circumstances of the case taken together indicate the employer-employee relationship between Chaiken and his barbers. The agreement set forth the hours of work and days off—unusual subjects for partnership agreements. The barbers brought into the relationship only the equipment required of all barber shop operators. And each barber had his own individual "partnership" with Chaiken. Furthermore, Chaiken conducted all transactions with suppliers, and purchased licenses,

insurance, and the lease for the business property in his own name. Finally, the name "Richard's Barber Shop" continued to be used after the execution of the so-called partnership agreements. [The Commission's decision is affirmed.]

CASE QUESTIONS

1. Why did the unemployment board sue Chaiken?
2. Why did Chaiken set up this "partnership"?
3. What factors did the court examine to determine whether there was a partnership here? Which one was the most important?
4. Why would it be unusual in a partnership agreement to set forth the hours of work and days off?

Creation of a Partnership: Registering the Name

Loomis v. Whitehead

183 P.3d 890 (Nev. 2008)

Per Curiam.

In this appeal, we address whether [Nevada Revised Statute] NRS 602.070 bars the partners of an unregistered fictitious name partnership from bringing an action arising out of a business agreement that was not made under the fictitious name. [The statute] prohibits persons who fail to file an assumed or fictitious name certificate from suing on any contract or agreement made under the assumed or fictitious name. We conclude that it does not bar the partners from bringing the action so long as the partners did not conduct the business or enter into an agreement under the fictitious name or otherwise mislead the other party into thinking that he was doing business with some entity other than the partners themselves.

Background Facts

Appellants Leroy Loomis and David R. Shanahan raised and sold cattle in Elko County, Nevada. Each of the appellants had certain responsibilities relating to the cattle business. Loomis supplied the livestock

and paid expenses, while Shanahan managed the day-to-day care of the cattle. Once the cattle were readied for market and sold, Loomis and Shanahan would share the profits equally. While Loomis and Shanahan often called themselves the 52 Cattle Company, they had no formal partnership agreement and did not file an assumed or fictitious name certificate in that name. Loomis and Shanahan bring this appeal after an agreement entered into with respondent Jerry Carr Whitehead failed.

In the fall of 2003, Shanahan entered into a verbal agreement with Whitehead, a rancher, through Whitehead's ranch foreman to have their cattle wintered at Whitehead's ranch. Neither Loomis nor Whitehead was present when the ranch foreman made the deal with Shanahan, but the parties agree that there was no mention of the 52 Cattle Company at the time they entered into the agreement or anytime during the course of business thereafter. Shanahan and Loomis subsequently alleged that their cattle were malnourished and that a number of their cattle died from starvation that winter at Whitehead's ranch. Whitehead denied these allegations.

Suit against Whitehead

The following summer, Shanahan and Loomis sued Whitehead, claiming negligence and breach of contract. Later, well into discovery, Whitehead was made aware of the existence of the 52 Cattle Company when Shanahan stated in his deposition that he did not actually own any of the cattle on Whitehead's ranch. In his deposition, he described the partnership arrangement. At about the same time, Whitehead learned that the name "52 Cattle Company" was not registered with the Elko County Clerk.

Whitehead then filed a motion for partial summary judgment, asserting that, pursuant to NRS 602.070, Loomis and Shanahan's failure to register their fictitiously named partnership with the county clerk barred them from bringing a legal action. The district court agreed with Whitehead, granted the motion, and dismissed Loomis and Shanahan's claims. Loomis and Shanahan timely appealed.

Discussion

The district court found that Loomis and Shanahan conducted business under a fictitious name without filing a fictitious name certificate with the Elko County Clerk as required by NRS 602.010.[2] The district

court therefore concluded that, pursuant to NRS 602.070, they were barred from bringing an action against Whitehead because they did not file a fictitious name certificate for the 52 Cattle Company.[3]

Loomis and Shanahan contend that the district court erred in granting partial summary judgment because they did not enter into a contract with Whitehead under the name of the 52 Cattle Company, and they did not conduct business with Whitehead under that name. Loomis and Shanahan argue that NRS 602.070 is not applicable to their action against Whitehead because they did not mislead Whitehead into thinking that he was doing business with anyone other than them. We agree....

When looking at a statute's language, this court is bound to follow the statute's plain meaning, unless the plain meaning was clearly not intended. Here, in using the phrase "under the assumed or fictitious name," the statute clearly bars bringing an action when the claims arise from a contract, transaction, or business conducted beneath the banner of an unregistered fictitious name. However, NRS 602.070 does not apply to individual partners whose transactions or business with another party were not performed under the fictitious name.

Here, Whitehead knew that Shanahan entered into the oral contract under his own name. He initially thought that Shanahan owned the cattle and Loomis had "some type of interest." Shanahan did not enter into the contract under the fictitious "52 Cattle Company" name. Moreover, Whitehead does not allege that he was misled by either Loomis or Shanahan in any way that would cause him to think he was doing business with the 52 Cattle Company. In fact, Whitehead did not know of the 52 Cattle Company until Shanahan mentioned it in his deposition. Under these circumstances, when there simply was no indication that Loomis and Shanahan represented that they were conducting business as the 52 Cattle Company and no reliance by Whitehead that he was doing business with the 52 Cattle Company, NRS 602.070 does not bar the suit against Whitehead.

We therefore reverse the district court's partial summary judgment in this instance and remand for trial because, while the lawsuit between Loomis and Whitehead involved partnership business, the transaction

at issue was not conducted and the subsequent suit was not maintained under the aegis of the fictitiously named partnership.

CASE QUESTIONS

1. The purpose of the fictitious name statute might well be, as the court here describes it, "to prevent fraud and to give the public information about those entities with which they conduct business." But that's not what the statute says; it says nobody can sue on a cause of action arising out of business conducted under a fictitious name if the name is not registered. The legislature determined the consequence of failure to register. Should the court disregard the statute's plain, unambiguous meaning?
2. That was one of two arguments by the dissent in this case. The second one was based on this problem: Shanahan and Loomis agreed that the cattle at issue were partnership cattle bearing the "52" brand. That is, the cows were *not* Shanahan's; they were the partnership's. When Whitehead moved to dismiss Shanahan's claim—again, because the cows weren't Shanahan's—Shanahan conceded that but for the existence of the partnership he would have no claim against Whitehead. If there is no claim against the defendant except insofar as he harmed the partnership business (the cattle), how could the majority assert that claims against Whitehead did not arise out of "the business" conducted under 52 Cattle Company? Who has the better argument, the majority or the dissent?
3. Here is another problem along the same lines but with a different set of facts and a Uniform Partnership Act (UPA) jurisdiction (i.e., pre–Revised Uniform Partnership Act [RUPA]). Suppose the plaintiffs had a partnership (as they did here), but the claim by one was that the other partner had stolen several head of cattle, and UPA was in effect so that the partnership property was owned as "tenant in partnership"—the cattle would be owned by the partners as a whole. A person who steals his own property cannot be criminally liable; therefore, a partner cannot be guilty of stealing (or misappropriating) firm property. Thus under UPA there arise anomalous cases, for example, in *People v. Zinke*, 555 N.E.2d 263 (N.Y. 1990), which is a criminal case, Zinke embezzled over a million dollars from his own investment firm but the prosecutor's case against him was dismissed because, the New York court said, "partners cannot be prosecuted for stealing firm property." If the partnership is a legal entity, as under RUPA, how is this result changed?

Partnership by Estoppel

Chavers v. Epsco, Inc.

98 S.W.3d 421 (Ark. 2003)

Hannah, J.

Appellants Reggie Chavers and Mark Chavers appeal a judgment entered against them by the Craighead County Circuit Court. Reggie and Mark argue that the trial court erred in holding them liable for a company debt based upon partnership by estoppel because the proof was vague and insufficient and there was no detrimental reliance on the part of a creditor. We hold that the trial court was not clearly erroneous in finding liability based upon partnership by estoppel. Accordingly, we affirm.

Facts

Gary Chavers operated Chavers Welding and Construction ("CWC"), a construction and welding business, in Jonesboro. Gary's sons Reggie Chavers and Mark Chavers joined their father in the business after graduating from high school. Gary, Mark, and Reggie maintain that CWC was a sole proprietorship owned by Gary, and that Reggie and Mark served only as CWC employees, not as CWC partners.

In February 1999, CWC entered into an agreement with Epsco, Inc. ("Epsco"), a staffing service, to provide payroll and employee services for CWC. Initially, Epsco collected payments for its services on a weekly basis, but later, Epsco extended credit to CWC. Melton Clegg, President of Epsco, stated that his decision to extend credit to CWC was based, in part, on his belief that CWC was a partnership.

CWC's account with Epsco became delinquent, and Epsco filed a complaint against Gary, Reggie, and Mark, individually, and doing business as CWC, to recover payment for the past due account. Gary discharged a portion of his obligation to Epsco due to his filing for bankruptcy. Epsco sought to recover CWC's remaining debt from Reggie and Mark. After a hearing on March 7, 2002, the trial court issued a letter opinion, finding that Reggie and Mark "represented themselves to [Epsco] as partners in an existing partnership and operated in such a fashion to give creditors in general, and Epsco in particular, the

impression that such creditors/potential creditors were doing business with a partnership....” On May 21, 2002, the trial court entered an order stating that Reggie and Mark were partners by estoppel as relates to Epsco. The trial court found that Reggie and Mark were jointly and severally liable for the debt of CWC in the amount of $80,360.92. In addition, the trial court awarded Epsco pre-judgment interest at the rate of six percent, post-judgment interest at the rate of ten percent, and attorney's fees in the amount of $8,036.92.

[The relevant Arkansas statute provides]:

> *(1) When a person, by words spoken or written or by conduct, represents himself, or consents to another representing him to any one, as a partner in an existing partnership or with one (1) or more persons not actual partners, he is liable to any person to whom such representation has been made, who has, on the faith of such representation, given credit to the actual or apparent partnership, and if he has made such representation or consented to its being made in a public manner, he is liable to that person, whether the representation has or has not been made or communicated to that person so giving credit by or with the knowledge of the apparent partner making the representation or consenting to it being made.*
>
> *(a) When a partnership liability results, he is liable as though he were an actual member of the partnership.*

We have long recognized the doctrine of partnership by estoppel. [Citation, 1840], the court stated that

> *they who hold themselves out to the world as partners in business or trade, are to be so regarded as to creditors and third persons; and the partnership may be established by any evidence showing that they so hold themselves out to the public, and were so regarded by the trading community.*

Further, we have stated that "[p]artnerships may be proved by circumstantial evidence; and evidence will sometimes fix a joint liability, where persons are charged as partners, in a suit by a third person, when they are not, in fact, partners as between themselves." [Citation, 1843.]

In [Citation, 1906], the court noted that

> *[a] person who holds himself out as a partner of a firm is estopped to deny such representation, not only as to those as to whom the representation was directly made, but as to all others who had knowledge of such holding out and in reliance thereon sold goods to the firm….*

In addition, "if the party himself puts out the report that he is a partner, he will be liable to all those selling goods to the firm on the faith and credit of such report." [Citation] When a person holds himself out as a member of partnership, any one dealing with the firm on the faith of such representation is entitled to assume the relation continues until notice of some kind is given of its discontinuance. [Citations]

In [Citation, 1944], the court wrote:

> *It is a thoroughly well-settled rule that persons who are not as between themselves partners, or as between whom there is in fact no legal partnership, may nevertheless become subject to the liabilities of partners, either by holding themselves out as partners to the public and the world generally or to particular individuals, or by knowingly or negligently permitting another person to do so. All persons who hold themselves out, or knowingly permit others to hold them out, to the public as partners, although they are not in partnership, become bound as partners to all who deal with them in their apparent relation.*
>
> *The liability as a partner of a person who holds himself out as a partner, or permits others to do so, is predicated on the doctrine of estoppel and on the policy of the law seeking to prevent frauds on those who lend their money on the apparent credit of those who are held out as partners. One*

holding himself out as a partner or knowingly permitting himself to be so held out is estopped from denying liability as a partner to one who has extended credit in reliance thereon, although no partnership has in fact existed.

In the present case, the trial court cited specific examples of representations made by Reggie and Mark indicating that they were partners of CWC, including correspondence to Epsco, checks written to Epsco, business cards distributed to the public, and credit applications. We will discuss each in turn.

The Faxed Credit References

Epsco argues that Plaintiff's Exhibit # 1, a faxed list of credit references, clearly indicates that Gary was the owner and that Reggie and Mark were partners in the business. The fax lists four credit references, and it includes CWC's contact information. The contact information lists CWC's telephone number, fax number, and federal tax number. The last two lines of the contact information state: "Gary Chavers Owner" and "Reggie Chavers and Mark Chavers Partners."

Gary testified that he did not know that the list of credit references was faxed to Epsco. In addition, he testified that his signature was not at the bottom of the fax. He testified that his former secretary might have signed his name to the fax; however, he stated that he did not authorize his secretary to sign or fax a list of credit references to Epsco. Moreover, Gary testified that the first time he saw the list of credit references was at the bench trial.

This court gives deference to the superior position of the trial judge to determine the credibility of the witnesses and the weight to be accorded their testimony. [Citations] Though there was a dispute concerning whether Gary faxed the list to Epsco, the trial court found that Epsco received the faxed credit references from CWC and relied on CWC's statement that Reggie and Mark were partners. The trial court's finding is not clearly erroneous.

The Fax Cover Sheet

At trial, Epsco introduced Plaintiff's Exhibit # 2, a fax cover sheet from "Chavers Construction" to Epsco. The fax cover sheet was dated July 19, 2000. The fax cover sheet contained the address, telephone number, and fax number of the business. Listed under this information was "Gary, Reggie, or Mark Chavers." Epsco argues that Gary, Reggie, and Mark are all listed on the fax cover sheet, and that this indicates that they were holding themselves out to the public as partners of the business. The trial court's finding that the fax cover sheet indicated that Reggie and Mark were holding themselves out as partners of CWC is not clearly erroneous.

The Epsco Personnel Credit Application

Epsco introduced Plaintiff's Exhibit # 9, a personnel credit application, which was received from CWC. Adams testified that the exhibit represented a completed credit application that she received from CWC. The type of business checked on the credit application is "partnership." Adams testified that the application showed the company to be a partnership, and that this information was relied upon in extending credit. Clegg testified that he viewed the credit application which indicated that CWC was a partnership, and that his decision to extend credit to CWC was based, in part, on his belief that CWC was a partnership. Gary denied filling out the credit application form.

It was within the trial court's discretion to find Adams's and Clegg's testimony more credible than Gary's testimony and to determine that Epsco relied on the statement of partnership on the credit application before extending credit to CWC. The trial court's finding concerning the credit application is not clearly erroneous.

The Checks to Epsco

Epsco argues that Plaintiff's Exhibit # 3 and Plaintiff's Exhibit # 11, checks written to Epsco showing the CWC account to be in the name of "Gary A. or Reggie J. Chavers," indicates that Reggie was holding himself out to be a partner of CWC. Plaintiff's Exhibit # 3 was signed by Gary, and Plaintiff's Exhibit # 11 was signed by Reggie. The checks are evidence that Reggie was holding himself out to the public as a

partner of CWC, and Epsco could have detrimentally relied on the checks before extending credit to CWC. The trial court was not clearly erroneous in finding that the checks supported a finding of partnership by estoppel.

The Business Card

Epsco introduced Plaintiff's Exhibit # 4, a business card that states "Chavers Welding, Construction & Crane Service." Listed on the card as "owners" are Gary Chavers and Reggie Chavers. Gary testified that the business cards were printed incorrectly, and that Reggie's name should not have been included as an owner. He also testified that some of the cards might have been handed out, and that it was possible that he might have given one of the cards to a business listed as one of CWC's credit references on Plaintiff's Exhibit # 1.

The business card listing Reggie as an owner indicates that Reggie was holding himself out as a partner. As we stated in [Citation] when a person holds himself out as a member of partnership, any one dealing with the firm on the faith of such representation is entitled to assume the relation continues until notice of some kind is given of its discontinuance. There is no indication that Reggie ever informed any person who received a business card that the business relationship listed on the card was incorrect or had been discontinued. The trial court's finding concerning the business card is not clearly erroneous.

The Dealership Application

Epsco introduced Plaintiff's Exhibit # 5, an application form from "Chavers Welding," signed by Reggie, seeking a dealership from Sukup Manufacturing. The application, dated January 23, 1997, lists "Gary & Reggie Chavers" as owners of "Chavers Welding." The application is signed by Reggie. Reggie admits that he signed the dealership application and represented that he was an owner of "Chavers Welding," but he dismisses his statement of ownership as mere "puffery" on his part. Epsco argues that instead, the application shows that Reggie was holding himself out to the public as being a partner. The trial court's determination that Reggie's dealership application supports a finding of partnership by estoppel is not clearly erroneous.

In sum, the trial court was not clearly erroneous in finding that Reggie and Mark held themselves out as partners of CWC and that Epsco detrimentally relied on the existence of the partnership before extending credit to CWC. The appellants argue that even if we find Reggie liable based upon partnership by estoppel, there was scant proof of Mark being liable based upon partnership by estoppel. We disagree. We are aware that some examples of holding out cited in the trial court's order pertain only to Reggie. However, the representations attributed to both Reggie and Mark are sufficient proof to support the trial court's finding that both Reggie and Mark are estopped from denying liability to Epsco.

Affirmed.

CASE QUESTIONS

1. What is the rationale for the doctrine of partnership by estoppel?
2. Gary and Reggie claimed the evidence brought forth to show the existence of a partnership was unconvincing. How credible were their claims?

---

[1] The word *prothonotary* means first notary of the court. The prothonotary is the keeper of the civil records for the court system. The office is responsible for the creation, maintenance, and certification of matters pending or determined by the court. The office is also responsible for certain reporting and collection duties to state agencies.

[2] NRS 602.010(1): "Every person doing business in this state under an assumed or fictitious name that is in any way different from the legal name of each person who owns an interest in the business must file with the county clerk of each county in which the business is being conducted a certificate containing the information required by NRS 602.020."

[3] NRS 602.070: "No action may be commenced or maintained by any person…upon or on account of any contract made or transaction had under the assumed or fictitious name, or upon or on account of any cause of action arising or growing out of the business conducted under that name, unless before the commencement of the action the certificate required by NRS 602.010 has been filed."

11.4 Summary and Exercises

Summary

The basic law of partnership is found in the Uniform Partnership Act and Revised Uniform Partnership Act. The latter has been adopted by thirty-five states. At common law, a partnership was not a legal entity and could not sue or be sued in the partnership name. Partnership law defines a partnership as "an association of two or more persons to carry on as co-owners a business for profit." The Uniform Partnership Act (UPA) assumes that a partnership is an aggregation of individuals, but it also applies a number of rules characteristic of the legal entity theory. The Revised Uniform Partnership Act (RUPA) assumes a partnership is an entity, but it applies one crucial rule characteristic of the aggregate theory: the partners are ultimately liable for the partnership's obligations. Thus a partnership may keep business records as if it were a legal entity, may hold real estate in the partnership name, and may sue and be sued in federal court and in many state courts in the partnership name.

Partnerships may be created informally. Among the clues to the existence of a partnership are (1) co-ownership of a business, (2) sharing of profits, (3) right to participate in decision making, (4) duty to share liabilities, and (5) manner in which the business is operated. A partnership may also be formed by implication; it may be formed by estoppel when a third party reasonably relies on a representation that a partnership in fact exists.

No special rules govern the partnership agreement. As a practical matter, it should sufficiently spell out who the partners are, under what name they will conduct their business, the nature and scope of the business, capital contributions of each partner, how profits are to be divided, and similar pertinent provisions. An oral agreement to form a partnership is valid unless the business cannot be performed wholly within one year from the time that the agreement is made. However, most partnerships have no fixed terms and hence are "at-will" partnerships not subject to the Statute of Frauds.

EXERCISES

1. Able, Baker, and Carr own, as partners, a warehouse. The income from the warehouse during the current year is $300,000, two-thirds of which goes to Able. Who must file a tax return listing this as income, the partnership or Able? Who pays the tax, the partnership or Able?
2. The Havana Club operated in Salt Lake City under a lease running to defendant Dale Bowen, who owned the equipment, furnishings, and inventory. He did not himself work in operating the club. He made an oral agreement with Frances Cutler, who had been working for him as a bartender, that she take over the management of the club. She was to have the authority and the responsibility for the entire active management and operation: to purchase the supplies, pay the bills, keep the books, hire and fire employees, and do whatever else was necessary to run the business. As compensation, the arrangement was for a down-the-middle split; each was to receive $300 per week plus one half of the net profits. This went on for four years until the city took over the building for a redevelopment project. The city offered Bowen $30,000 as compensation for loss of business while a new location was found for the club. Failing to find a suitable location, the parties decided to terminate the business. Bowen then contended he was entitled to the entire $30,000 as the owner, Cutler being an employee only. She sued to recover half as a partner. What was the result? Decide and discuss.
3. Raul, a business student, decided to lease and operate an ice cream stand during his summer vacation. Because he could not afford rent payments, his lessor agreed to take 30 percent of the profits as rent and provide the stand and the parcel of real estate on which it stood. Are the two partners?
4. Able, Baker, and Carr formed the ABC Partnership in 2001. In 2002 Able gave her three sons, Duncan, Eldon, and Frederick, a gift of her 41 percent interest in the partnership to provide money to pay for their college expenses. The sons reported income from the partnership on their individual tax returns, and the partnership reported the payment to them on its information return. The sons were listed as partners on unaudited balance sheets in 2003, and the 2004 income statement listed them as partners. The sons never requested information about the management of the firm, never attended any meetings or voted, and never attempted to withdraw the firm's money or even speak with the other partners about the firm. Two of the sons didn't know where the firm was located, but they all once received "management fees" totaling $3,000, without any showing of what the "fees" were for. In 2005, the partnership incurred liability for pension-fund contributions to an employee, and a trustee for the fund asserted that Able's sons were

personally liable under federal law for the money owing because they were partners. The sons moved for summary judgment denying liability. How should the court rule?

5. The Volkmans wanted to build a house and contacted David McNamee for construction advice. He told them that he was doing business with Phillip Carroll. Later the Volkmans got a letter from McNamee on stationery that read "DP Associates," which they assumed was derived from the first names of David and Phillip. At the DP Associates office McNamee introduced Mr. Volkman to Carroll, who said to Volkman, "I hope we'll be working together." At one point during the signing process a question arose and McNamee said, "I will ask Phil." He returned with the answer to the question. After the contract was signed but before construction began, Mr. Volkman visited the DP Associates office where the two men chatted; Carroll said to him, "I am happy that we will be working with you." The Volkmans never saw Carroll on the construction site and knew of no other construction supervised by Carroll. They understood they were purchasing Carroll's services and construction expertise through DP Associates. During construction, Mr. Volkman visited the DP offices several times and saw Carroll there. During one visit, Mr. Volkman expressed concerns about delays and expressed the same to Carroll, who replied, "Don't worry. David will take care of it." But David did not, and the Volkmans sued DP Associates, McNamee, and Carroll. Carroll asserted he could not be liable because he and McNamee were not partners. The trial court dismissed Carroll on summary judgment; the Volkmans appealed. How should the court rule on appeal?
6. Wilson and VanBeek want to form a partnership. Wilson is seventeen and VanBeek is twenty-two. May they form a partnership? Explain.
7. Diane and Rachel operate a restaurant at the county fair every year to raise money for the local 4-H Club. They decide together what to serve, what hours to operate, and generally how to run the business. Do they have a partnership?

SELF-TEST QUESTIONS

1 The basic law of partnership is currently found in

a. common law

b. constitutional law

c. statutory law

CC BY NC SA

d. none of the above

2 Existence of a partnership may be established by

a. co-ownership of a business for profit

b. estoppel

c. a formal agreement

d. all of the above

3 Which is false?

a. An oral agreement to form a partnership is valid.

b. Most partnerships have no fixed terms and are thus not subject to the Statute of Frauds.

c. Strict statutory rules govern partnership agreements.

d. A partnership may be formed by estoppel.

4 Partnerships

a. are not taxable entities

b. may buy, sell, or hold real property in the partnership name

c. may file for bankruptcy

d. have all of the above characteristics

5 Partnerships

a. are free to select any name not used by another partnership

b. must include the partners' names in the partnership name

c. can be formed by two corporations

d. cannot be formed by two partnerships

SELF-TEST ANSWERS

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

CC BY NC SA

5. c

Chapter 12
Partnership Operation and Termination

LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The operation of a partnership, including the relations among partners and relations between partners and third parties
2. The dissolution and winding up of a partnership

12.1 Operation: Relations among Partners

LEARNING OBJECTIVES

CC BY NC SA

1. Recognize the duties partners owe each other: duties of service, loyalty, care, obedience, information, and accounting.
2. Identify the rights that partners have, including the rights to distributions of money, to management, to choice of copartners, to property of the partnership, to assign partnership interest, and to enforce duties and rights.

Most of the rules discussed in this section apply unless otherwise agreed, and they are really intended for the small firm.[1] The Uniform Partnership Act (UPA) and the Revised Uniform Partnership Act (RUPA) do not dictate what the relations among partners must be; the acts supply rules in the event that the partners have not done so for themselves. In this area, it is especially important for the partners to elaborate their agreement in writing. If the partners should happen to continue their business beyond the term fixed for it in their agreement, the terms of the agreement continue to apply.

Duties Partners Owe Each Other

Among the duties partners owe each other, six may be called out here: (1) the duty to serve, (2) the duty of loyalty, (3) the duty of care, (4) the duty of obedience, (5) the duty to inform copartners, and (6) the duty to account to the partnership. These are all very similar to the duty owed by an agent to the principal, as partnership law is based on agency concepts.[2]

Duty to Serve

Unless otherwise agreed, expressly or impliedly, a partner is expected to work for the firm. The partnership, after all, is a profit-making co-venture, and it would not do for one to loaf about and still expect to get paid. For example, suppose Joan takes her two-week vacation from the horse-stable partnership she operates with Sarah and Sandra. Then she does not return for four months because she has gone horseback riding in the Southwest. She might end up having to pay if the partnership hired a substitute to do her work.

Duty of Loyalty

In general, this requires partners to put the firm's interests ahead of their own. Partners are *fiduciaries* as to each other and as to the partnership, and as such, they owe a **fiduciary duty** to each other and the partnership. Judge Benjamin Cardozo, in an often-quoted phrase, called the fiduciary duty "something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior." [3] Breach of the fiduciary duty gives rise to a claim for compensatory, consequential, and incidental damages; recoupment of compensation; and—rarely—punitive damages. See Section 12.4.1 "Breach of Partnership Fiduciary Duty", *Gilroy v. Conway*, for an example of breach of fiduciary duty.

Application of the Fiduciary Standard to Partnership Law

Under UPA, all partners are fiduciaries of each other—they are all principals and agents of each other—though the word *fiduciary* was not used except in the *heading* to Section 21. The section reads, "Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property."

Section 404 of RUPA specifically provides that a partner has a fiduciary duty to the partnership and other partners. It imposes the fiduciary standard on the duty of loyalty in three circumstances:

> *(1) to account to the partnership and hold as trustee for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or derived from a use by the partner of partnership property, including the appropriation of a partnership opportunity;*
>
> *(2) to refrain from dealing with the partnership in the conduct or winding up of the partnership business as or on behalf of a party having an interest adverse to the partnership; and*

(3) to refrain from competing with the partnership in the conduct of the partnership business before the dissolution of the partnership.

Limits on the Reach of the Fiduciary Duty

This sets out a fairly limited scope for application of the fiduciary standard, which is reasonable because partners do not delegate open-ended control to their copartners. Further, there are some specific limits on how far the fiduciary duty reaches (which means parties are held to the lower standard of "good faith"). Here are two examples. First, RUPA—unlike UPA—does not extend to the *formation* of the partnership; Comment 2 to RUPA Section 404 says that would be inappropriate because then the parties are "really dealing at arm's length." Second, fiduciary duty doesn't apply to a dissociated partner (one who leaves the firm—discussed in Section 12 "Dissociation") who can immediately begin competing without the others' consent; and it doesn't apply if a partner violates the standard "merely because the partner's conduct furthers the partner's own interest."[4] Moreover, the partnership agreement may eliminate the duty of loyalty so long as that is not "manifestly unreasonable."[5]

Activities Affected by the Duty of Loyalty

The duty of loyalty means, again, that partners must put the firm's interest above their own. Thus it is held that a partner

- may not compete with the partnership,
- may not make a secret profit while doing partnership business,
- must maintain the confidentiality of partnership information.

This is certainly not a comprehensive list, and courts will determine on a case-by-case basis whether the duty of loyalty has been breached.

Duty of Care

Stemming from its roots in agency law, partnership law also imposes a duty of care on partners. Partners are to faithfully serve to the best of their ability. Section 404 of RUPA imposes the fiduciary standard on the duty of care, but rather confusingly: how does the "punctilio of an honor the most sensitive"—as Judge

Cardozo described that standard—apply when under RUPA Section 404(c) the "the duty of care...is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law"? Recognize that a person can attend to business both loyally and negligently. For example, Alice Able, a partner in a law firm who is not very familiar with the firm's computerized bookkeeping system, attempts to trace a missing check and in so doing erases a month's worth of records. She has not breached her duty of care: maybe she was negligent, but not grossly negligent under RUPA Section 404(c). The partnership agreement may reduce the duty of care so long as it is not "unreasonably reduce[d]"; it may increase the standard too.[6]

Duty of Obedience

The partnership is a contractual relationship among the partners; they are all agents and principals of each other. Expressly or impliedly that means no partner can disobey the partnership agreement or fail to follow any properly made partnership decision. This includes the duty to act within the authority expressly or impliedly given in the partnership agreement, and a partner is responsible to the other partners for damages or losses arising from unauthorized activities.

Duty to Inform Copartners

As in the agency relationship, a partner is expected to inform copartners of notices and matters coming to her attention that would be of interest to the partnership.

Duty to Account

The partnership—and necessarily the partners—have a duty to allow copartners and their agents access to the partnership's books and records and to provide "any information concerning the partnership's business and affairs reasonably required for the proper exercise of the partner's rights and duties under the partnership agreement [or this Act]."[7] The fiduciary standard is imposed upon the duty to account for "it any property, profit, or benefit derived by [a] partner," as noted in RUPA Section 404.[8]

The Rights That Partners Have in a Partnership

CC BY NC SA

Necessarily, for every duty owed there is a correlative right. So, for example, if a partner has a duty to account, the other partners and the partnership have a right to an accounting. Beyond that, partners have recognized rights affecting the operation of the partnership.

Here we may call out the following salient rights: (1) to distributions of money, (2) to management, (3) to choose copartners, (4) to property of the partnership, (5) to assign partnership interest, and (6) to enforce duties and rights.

Rights to Distributions

The purpose of a partnership is ultimately to distribute "money or other property from a partnership to a partner in the partner's capacity."[9] There are, however, various types of money distributions, including profits (and losses), indemnification, capital, and compensation.

Right to Profits (and Losses)

Profits and losses may be shared according to any formula on which the partners agree. For example, the partnership agreement may provide that two senior partners are entitled to 35 percent each of the profit from the year and the two junior partners are entitled to 15 percent each. The next year the percentages will be adjusted based on such things as number of new clients garnered, number of billable hours, or amount of income generated. Eventually, the senior partners might retire and each be entitled to 2 percent of the firm's income, and the previous junior partners become senior, with new junior partners admitted.

If no provision is stated, then under RUPA Section 401(b), "each partner is entitled to an equal share of the partnership profits and is chargeable with a share of the partnership losses in proportion to the partner's share of the profits." Section 18(a) of the Uniform Partnership Act is to the same effect. The right to share in the profits is the reason people want to "make partner": a partner will reap the benefits of other partners' successes (and pay for their failures too). A person working for the firm who is not a partner is an associate and usually only gets only a salary.

Right to Indemnification

A partner who incurs liabilities in the normal course of business or to preserve its business or property is entitled to indemnification (UPA Section 18(b), RUPA Section 401(c)). The liability is a loan owing to the partner by the firm.

Right to Return of Capital Contribution

When a partner joins a partnership, she is expected to make a capital contribution to the firm; this may be deducted from her share of the distributed profit and banked by the firm in its capital account. The law provides that "the partnership must reimburse a partner for an advance of funds beyond the amount of the partner's agreed capital contribution, thereby treating the advance as a loan."[10] A partner may get a return of capital under UPA after creditors are paid off if the business is wound down and terminated.[11]

Right to Compensation

Section 401(d) of RUPA provides that "a partner is not entitled to remuneration for services performed for the partnership, except for reasonable compensation for services rendered in winding up the business of the partnership"; UPA Section 18(f) is to the same effect. A partner gets his money from the firm by sharing the profits, *not* by a salary or wages.

Right to Management

All partners are entitled to share equally in the management and conduct of the business, unless the partnership agreement provides otherwise.[12] The partnership agreement could be structured to delegate more decision-making power to one class of partners (senior partners) than to others (junior partners), or it may give more voting weight to certain individuals. For example, perhaps those with the most experience will, for the first four years after a new partner is admitted, have more voting weight than the new partner.

Right to Choose Partners

A business partnership is often analogized to a marriage partnership. In both there is a relationship of trust and confidence between (or among) the parties; in both the poor judgment, negligence, or dishonesty of one can create liabilities on the other(s). In a good marriage or good partnership, the partners are friends, whatever else the legal relationship imposes. Thus no one is compelled to accept a

partner against his or her will. Section 401(i) of RUPA provides, "A person may become a partner only with the consent of all of the partners." UPA Section 18(g) is to the same effect; the doctrine is called **delectus personae**. The freedom to select new partners, however, is not absolute. In 1984, the Supreme Court held that Title VII of the Civil Rights Act of 1964—which prohibits discrimination in employment based on race, religion, national origin, or sex—applies to partnerships.[13]

Right to Property of the Partnership

Partners are the owners of the partnership, which might not include any physical property; that is, one partner could contribute the building, furnishings, and equipment and rent those to the partnership (or those could count as her partnership capital contribution and become the partnership's). But partnership property consists of all property originally advanced or contributed to the partnership or subsequently acquired by purchase or contribution. Unless a contrary intention can be shown, property acquired with partnership funds is partnership property, not an individual partner's: "Property acquired by a partnership is property of the partnership and not of the partners individually."[14]

Rights in Specific Partnership Property: UPA Approach

Suppose that Able, who contributed the building and grounds on which the partnership business is conducted, suddenly dies. Who is entitled to her share of the specific property, such as inventory, the building, and the money in the cash register—her husband and children, or the other partners, Baker and Carr? Section 25(1) of UPA declares that the partners hold the partnership property as **tenants in partnership**. As spelled out in Section 25(2), the specific property interest of a tenant in partnership vests in the surviving partners, not in the heirs. But the heirs are entitled to the deceased partner's interest in the partnership itself, so that while Baker and Carr may use the partnership property for the benefit of the partnership without consulting Able's heirs, they must account to her heirs for her proper share of the partnership's profits.

Rights in Specific Property: RUPA Approach

Section 501 of RUPA provides, "A partner is not a co-owner of partnership property and has no interest in partnership property which can be transferred, either voluntarily or involuntarily." Partnership property is owned by the entity; UPA's concept of tenants in partnership is abolished in favor of adoption of the entity theory. The result, however, is not different.

Right to Assign Partnership Interest

One of the hallmarks of the capitalistic system is that people should be able to dispose of their property interests more or less as they see fit. Partnership interests may be assigned to some extent.

Voluntary Assignment

At common law, assignment of a partner's interest in the business—for example, as a mortgage in return for a loan—would result in a legal dissolution of the partnership. Thus in the absence of UPA, which changed the law, Baker's decision to mortgage his interest in the car dealership in return for a $20,000 loan from his bank would mean that the three—Able, Baker, and Carr—were no longer partners. Section 27 of UPA declares that assignment of an interest in the partnership neither dissolves the partnership nor entitles the assignee "to interfere in the management or administration of the partnership business or affairs, or to require any information or account of partnership transactions, or to inspect the partnership books." The assignment merely entitles the assignee to receive whatever profits the assignor would have received—this is the assignor's transferable interest.[15] Under UPA, this interest is assignable.[16]

Under RUPA, the same distinction is made between a partner's interest in the partnership and a partner's transferable interest. The Official Comment to Section 101 reads as follows: "'Partnership interest' or 'partner's interest in the partnership' is defined to mean all of a partner's interests in the partnership, including the partner's transferable interest and all management and other rights. A partner's 'transferable interest' is a more limited concept and means only his share of the profits and losses and right to receive distributions, that is, the partner's economic interests."[17]

This transferable interest is assignable under RUPA 503 (unless the partners agree to restrict transfers, Section 103(a)). It does not, by itself, cause the dissolution of the partnership; it does not entitle the

transferee to access to firm information, to participate in running the firm, or to inspect or copy the books. The transferee is entitled to whatever distributions the transferor partner would have been entitled to, including, upon dissolution of the firm, the net amounts the transferor would have received had there been no assignment.

RUPA Section 101(b)(3) confers standing on a transferee to seek a judicial dissolution and winding up of the partnership business as provided in Section 801(6), thus continuing the rule of UPA Section 32(2). But under RUPA 601(4)(ii), the other partners may by unanimous vote expel a partner who has made "a transfer of all or substantially all of that partner's transferable interest in the partnership, other than a transfer for security purposes [as for a loan]." Upon a creditor *foreclosure* of the security interest, though, the partner may be expelled.

Involuntary Assignment

It may be a misnomer to describe an involuntary assignment as a "right"; it might better be thought of as a consequence of the right to own property. In any event, if a partner is sued in his personal capacity and a judgment is rendered against him, the question arises: may the judgment creditor seize partnership property? Section 28 of UPA and RUPA Section 504 permit a judgment creditor to obtain a **charging order**, which charges the partner's interest in the partnership with obligation to satisfy the judgment. The court may appoint a receiver to ensure that partnership proceeds are paid to the judgment creditor. But the creditor is not entitled to specific partnership property. The partner may always pay off the debt and redeem his interest in the partnership. If the partner does not pay off the debt, the holder of the charging order may acquire legal ownership of the partner's interest. That confers upon the judgment creditor an important power: he may, if the partnership is one at will, dissolve the partnership and claim the partner's share of the assets. For that reason, the copartners might wish to redeem the interest—pay off the creditor—in order to preserve the partnership. As with the voluntary assignment, the assignee of an involuntary assignment does not become a partner. See Figure 12.1 "Property Rights".

Figure 12.1 Property Rights

	Specific Property	Interest
1. At Death	To Surviving Partners	To Estate
2. Assignment by One Partner?	No	Yes
3. Claims by a Partner's Creditors?	No	Yes

Right to Enforce Partnership Rights

The rights and duties imposed by partnership law are, of course, valueless unless they can be enforced. Partners and partnerships have mechanisms under the law to enforce them.

Right to Information and Inspection of Books

We noted in Section 12.1.1 "Duties Partners Owe Each Other" of this chapter that partners have a duty to account; the corollary right is the right to access books and records, which is usually very important in determining partnership rights. Section 403(b) of RUPA provides, "A partnership shall provide partners and their agents and attorneys access to its books and records. It shall provide former partners and their agents and attorneys access to books and records pertaining to the period during which they were partners. The right of access provides the opportunity to inspect and copy books and records during ordinary business hours. A partnership may impose a reasonable charge, covering the costs of labor and material, for copies of documents furnished."[18]

Section 19 of UPA is basically in accord. This means that without demand—and for any purpose—the partnership must provide any information concerning its business and affairs reasonably required for the proper exercise of the partner's rights and duties under the partnership agreement or the act; and on demand, it must provide any other information concerning the partnership's business and affairs, unless the demand is unreasonable or improper.[19] Generally, the partnership agreement cannot deny the right to inspection.

The duty to account mentioned in Section 12.1.1 "Duties Partners Owe Each Other" of this chapter normally means that the partners and the partnership should keep reasonable records so everyone can tell what is going on. A formal accounting under UPA is different.

Under UPA Section 22, any partner is entitled to a formal account (or accounting) of the partnership affairs under the following conditions:

1. If he is wrongfully excluded from the partnership business or possession of its property by his copartners;
2. If the right exists under the terms of any agreement;
3. If a partner profits in violation of his fiduciary duty (as per UPA 22); and
4. Whenever it is otherwise just and reasonable.

At common law, partners could not obtain an accounting except in the event of dissolution. But from an early date, equity courts would appoint a referee, auditor, or special master to investigate the books of a business when one of the partners had grounds to complain, and UPA broadened considerably the right to an accounting. The court has plenary power to investigate all facets of the business, evaluate claims, declare legal rights among the parties, and order money judgments against any partner in the wrong.

Under RUPA Section 405, this "accounting" business is somewhat modified. Reflecting the entity theory, the *partnership* can sue a partner for wrongdoing, which is not allowed under UPA. Moreover, to quote from the Official Comment, RUPA "provides that, during the term of the partnership, partners may maintain a variety of legal or equitable actions, including an action for an accounting, as well as a final action for an accounting upon dissolution and winding up. It reflects a new policy choice that partners should have access to the courts during the term of the partnership to resolve claims against the partnership and the other partners, leaving broad judicial discretion to fashion appropriate remedies[, and] an accounting is not a prerequisite to the availability of the other remedies a partner may have against the partnership or the other partners." [20]

KEY TAKEAWAY

Partners have important duties in a partnership, including (1) the duty to serve—that is, to devote herself to the work of the partnership; (2) the duty of loyalty, which is informed by the fiduciary standard: the obligation to act always in the best interest of the partnership and not in one's own best interest; (3) the duty of care—that is, to act as a reasonably prudent partner would; (4) the duty of obedience not to breach any aspect of the agreement or act without authority; (5) the duty to inform copartners; and (6) the duty to account to the partnership.

Partners also have rights. These include the rights (1) to distributions of money, including profits (and losses), indemnification, and return of capital contribution (but not a right to compensation); (2) to management; (3) to choose copartners; (4) to property of the partnership, and no partner has any rights to specific property; (5) to assign (voluntarily or involuntarily) the partnership interest; and (6) to enforce duties and rights by suits in law or equity. (Under RUPA, a formal accounting is not first required.)

EXERCISES

1. What is the "fiduciary duty," and why is it imposed on some partners' actions with the partnership?
2. Distinguish between ownership of partnership property under UPA as opposed to under RUPA.
3. Carlos obtained a judgment against Pauline, a partner in a partnership, for negligently crashing her car into Carlos's while she was not in the scope of partnership business. Carlos wants to satisfy the judgment from her employer. How can Carlos do that?
4. What is the difference between the duty to account and a formal partnership accounting?
5. What does it mean to say a partnership interest has been involuntarily assigned?

---

[1] "The basic mission of RUPA is to serve the small firm. Large partnerships can fend for themselves by drafting partnership agreements that suit their special needs." Donald J. Weidner, "RUPA and Fiduciary Duty: The Texture of Relationship," *Law and Contemporary Problems* 58, no. 2 (1995): 81, 83.

[2] Revised Uniform Partnership Act, Section 404, Comment 3: "Indeed, the law of partnership reflects the broader law of principal and agent, under which every agent is a fiduciary."

[3] *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928).

[4] RUPA, Section 503(b)(2); RUPA, Section 404 (e).

[5] RUPA, Section 103(2)(c).

[6] RUPA, Section 103(2)(d); RUPA, Section 103.

[7] UPA, Sections 19 and 20; RUPA, Section 403.

[8] RUPA, Section 404(1).

[9] RUPA, Section 101(3).

[10] UPA, Section 18(c); RUPA, Section 401(d).

[11] UPA, Section 40(b); RUPA, Section 807(b).

[12] UPA, Section 18(e); RUPA, Section 401(f).

[13] *Hishon v. King & Spalding*, 467 U.S. 69 (1984).

[14] RUPA, Section 203; UPA, Sections 8(1) and 25.

[15] UPA, Section 26.

[16] UPA, Section 27.

[17] RUPA, Official Comment to Section 101.

[18] RUPA Section 403(b).

[19] RUPA, Section 403(c)(1); RUPA, Section 403(c)(2).

[20] RUPA Official Comment 2, Section 405(b).

12.2 Operation: The Partnership and Third Parties

LEARNING OBJECTIVES

1. Understand the partners' and partnership's contract liability.
2. Understand the partners' and partnership's tort and criminal liability.
3. Describe the partners' and partnership's tax liability.

By express terms, the law of agency applies to partnership law. Every partner is an agent of the partnership for the purpose of its business. Consequently, the following discussion will be a review of agency law, covered in Chapter 11 "Partnerships: General Characteristics and Formation" as it applies to partnerships. The Revised Uniform Partnership Act (RUPA) adds a few new wrinkles to the liability issue.

Contract Liability

Liability of the Partnership

Recall that an agent can make contracts on behalf of a principal under three types of authority: express, implied, and apparent. *Express authority* is that explicitly delegated to the agent, *implied authority* is that necessary to the carrying out of the express authority, and *apparent authority* is that which a third party is led to believe has been conferred by the principal on the agent, even though in fact it was not or it was revoked. When a partner has authority, the partnership is bound by contracts the partner makes on its behalf. Section 12.4.2 "Partnership Authority, Express or Apparent", *Hodge v. Garrett*, discusses all three types of authority.

The General Rule

Section 305 of RUPA restates agency law: "A partnership is liable for loss or injury, or for a penalty incurred, as a result of a wrongful act or omission, or other actionable conduct, of a partner acting in the ordinary course"[1] of partnership business or with its authority. The ability of a partner to bind the partnership to contract liability is problematic, especially where the authority is apparent: the firm denies liability, lawsuits ensue, and unhappiness generally follows.

But the firm is not liable for an act not apparently in the ordinary course of business, unless the act was authorized by the others.[2] Section 401(j) of RUPA requires the unanimous consent of the partners for a grant of authority outside the ordinary course of business, unless the partnership agreement provides otherwise.

Under the Uniform Partnership Act (UPA) Section 9(3), the firm is not liable for five actions that no single partner has implied or apparent authority to do, because they are not "in the ordinary course of partnership." These actions are: (1) assignment of partnership property for the benefit of creditors, (2) disposing of the firm's goodwill (selling the right to do business with the firm's clients to another business), (3) actions that make it impossible to carry on the business, (4) confessing a judgment against the partnership, and (5) submitting a partnership claim or liability. RUPA omits that section, leaving it to the courts to decide the outer limits of the agency power of a partner. In any event, unauthorized actions by a partner may be ratified by the partnership.

Partnership "Statements"

New under RUPA is the ability of partnerships, partners, or even nonpartners to issue and file "statements" that announce to the world the establishment or denial of authority. The goal here is to control the reach of apparent authority. There are several kinds of statements authorized.

A **statement of partnership authority** is allowed by RUPA Section 303. It specifies the names of the partners authorized, or not authorized, to enter into transactions on behalf of the partnership and any other matters. The most important goal of the statement of authority is to facilitate the transfer of real property held in the name of the partnership. A statement must specify the names of the partners authorized to execute an instrument transferring that property.

A **statement of denial**, RUPA Section 304, operates to allow partners (and persons named as partners) an opportunity to deny any fact asserted in a statement of partnership authority.

A **statement of dissociation**, RUPA Section 704, may be filed by a partnership or a dissociated partner, informing the world that the person is no longer a partner. This tells the world that the named person is no longer in the partnership.

There are three other statements authorized: a *statement of qualification* establishes that the partnership has satisfied all conditions precedent to the qualification of the partnership as a limited liability partnership; a *statement of foreign qualification* means a limited liability partnership is qualified and

registered to do business in a state other than that in which it is originally registered; and a *statement of amendment or cancellation* of any of the foregoing.[3] Limited liability partnerships are taken up in Chapter 13 "Hybrid Business Forms".

Generally, RUPA Section 105 allows partnerships to file these statements with the state secretary of state's office; those affecting real estate need to be filed with (or also with) the local county land recorder's office. The notices bind those who know about them right away, and they are constructive notice to the world after ninety days as to authority to transfer real property in the partnership's name, as to dissociation, and as to dissolution. However, as to other grants or limitations of authority, "only a third party who knows or has received a notification of a partner's lack of authority in an ordinary course transaction is bound."[4]

Since RUPA is mostly intended to provide the rules for the small, unsophisticated partnership, it is questionable whether these arcane "statements" are very often employed.

Personal Liability of Partners, in General

It is clear that the *partnership* is liable for contracts by authorized partners, as discussed in the preceding paragraphs. The bad thing about the partnership as a form of business organization is that it imposes liability on the partners *personally and without limit*. Section 306 of RUPA provides that "all partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed by the claimant or provided by law."[5] Section 13 of UPA is in accord.

Liability of Existing Partners

Contract liability is joint and several: that is, all partners are liable ("joint") and each is "several." (We usually do not use *several* in modern English to mean "each"; it's an archaic usage.) But—and here's the intrusion of entity theory—generally RUPA requires the judgment creditor to exhaust the partnership's assets before going after the separate assets of a partner. Thus under RUPA the partners are *guarantors* of the partnership's liabilities.[6]

Under UPA, contract liability is joint only, not also several. This means the partners must be sued in a joint action brought against them all. A partner who is not named cannot later be sued by a creditor in a separate proceeding, though the ones who were named could see a proportionate contribution from the ones who were not.

Liability of Incoming Partners

Under RUPA Section 306(b), a new partner has no personal liability to existing creditors of the partnership, and only her capital investment in the firm is at risk for the satisfaction of existing partnership debts. Sections 17 and 41(7) of UPA are in accord. But, again, under either statute a new partner's personal assets are at risk with respect to partnership liabilities incurred after her admission as a partner. This is a daunting prospect, and it is the reason for the invention of hybrid forms of business organization: limited partnerships, limited liability companies, and limited liability partnerships. The corporate form, of course, also (usually) obviates the owners' personal liability.

Tort and Criminal Liability

Partnership Liability for Torts

The rules affecting partners' tort liability (discussed in Section 12.2.1 "Contract Liability") and those affecting contract liability are the same. Section 13 of UPA says the partnership is liable for "any wrongful act or omission of any partner acting in the ordinary course of the business of the partnership or with the authority of his co-partners."[7] A civil "wrongful act" is necessarily either a tort or a breach of contract, so no distinction is made between them. (Section 305 of RUPA changed the phraseology slightly by adding after *any wrongful act or omission* the words *or other actionable conduct*; this makes the partnership liable for its partner's no-fault torts.) That the principal should be liable for its agents' wrongdoings is of course basic agency law. RUPA does expand liability by allowing a partner to sue during the term of the partnership without first having to get out of it, as is required under UPA.

For tortious acts, the partners are said to be jointly and severally liable under both UPA and RUPA, and the plaintiff may separately sue one or more partners. Even after winning a judgment, the plaintiff may sue other partners unnamed in the original action. Each and every partner is separately liable for the

entire amount of the debt, although the plaintiff is not entitled to recover more than the total of his damages. The practical effect of the rules making partners personally liable for partnership contracts and torts can be huge. In his classic textbook *Economics*, Professor Paul Samuelson observed that unlimited liability "reveals why partnerships tend to be confined to small, personal enterprises....When it becomes a question of placing their personal fortunes in jeopardy, people are reluctant to put their capital into complex ventures over which they can exercise little control....In the field of investment banking, concerns like JPMorgan Chase used to advertise proudly 'not incorporated' so that their creditors could have extra assurance. But even these concerns have converted themselves into corporate entities."[8]

Partners' Personal Liability for Torts

Of course, a person is always liable for his own torts. All partners are also liable for any partner's tort committed in the scope of partnership business under agency law, and this liability is—again—personal and unlimited, subject to RUPA's requirement that the judgment creditor exhaust the partnership's assets before going after the separate assets of the partners. The partner who commits a tort or breach of trust must indemnify the partnership for losses paid to the third party.[9]

Liability for Crimes

Criminal liability is generally personal to the miscreant. Nonparticipating copartners are ordinarily not liable for crimes if guilty intent is an element. When guilty intent is not an element, as in certain regulatory offenses, all partners may be guilty of an act committed by a partner in the course of the business.

Liability for Taxes

Corporate income gets taxed twice under federal law: once to the corporation and again to the shareholders who receive income as dividends. However, the partnership's income "passes through" the partnership and is distributed to the partners under the **conduit theory**. When partners get income from the firm they have to pay tax on it, but the partnership pays no tax (it files an information return). This is perceived to be a significant advantage of the partnership form.

KEY TAKEAWAY

CC BY NC SA

The partnership is generally liable for any contract made by a partner with authority express, implied, or apparent. Under RUPA the firm, partners, or even nonpartners may to some extent limit their liability by filing "statements" with the appropriate state registrar; such statements only affect those who know of them, except that a notice affecting the right of a partner to sell real estate or regarding dissociation or dissolution is effective against the world after ninety days.

All partners are liable for contracts entered into and torts committed by any partner acting in or apparently in the normal course of business. This liability is personal and unlimited, joint and several (although under UPA contract liability it is only joint). Incoming partners are not liable, in contract or in tort, for activities predating their arrival, but their capital contribution is at risk. Criminal liability is generally personal unless the crime requires no intention.

EXERCISES

1. What is the partnership's liability for contracts entered into by its partners?
2. What is the personal liability of partners for breach of a contract made by one of the partnership's members?
3. Why would people feel more comfortable knowing that JPMorgan Bank—Morgan was at one time the richest man in the United States—was a partnership and not a corporation?
4. What is the point of RUPA's "statements"? How can they be of use to a partner who has, for example, retired and is no longer involved in the firm?
5. Under what circumstances is the partnership liable for crimes committed by its partners?
6. How is a partnership taxed more favorably than a corporation?

[1] RUPA Section 305.

[2] RUPA, Section 301(2); UPA, Section 9(2).

[3] RUPA, Section 1001(d); RUPA, Section 1102.

[4] RUPA, Section 303, Comment 3.

[5] RUPA, Section 306.

[6] RUPA Section 306.

[7] UPA, Section 13.

[8] Paul A. Samuelson, *Economics* (New York: McGraw-Hill, 1973), 106.

[9] RUPA, Section 405(a).

12.3 Dissolution and Winding Up

LEARNING OBJECTIVES

1. Understand the dissolution of general partnerships under the Uniform Partnership Act (UPA).
2. Understand the dissociation and dissolution of general partnerships under the Revised Uniform Partnership Act (RUPA).
3. Explain the winding up of partnerships under UPA and RUPA.

It is said that a partnership is like a marriage, and that extends to its ending too. It's easier to get into a partnership than it is to get out of it because legal entanglements continue after a person is no longer a partner. The rules governing "getting out" of a partnership are different under the Revised Uniform Partnership Act (RUPA) than under the Uniform Partnership Act (UPA). We take up UPA first.

Dissolution of Partnerships under UPA

Dissolution, in the most general sense, means a separation into component parts.

Meaning of Dissolution under UPA

People in business are sometimes confused about the meaning of **dissolution**. It does not mean the termination of a business. It has a precise legal definition, given in UPA Section 29: "The dissolution of a partnership is the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business." The partnership is not necessarily terminated on dissolution; rather, it continues until the winding up of partnership affairs is completed, and the remaining partners may choose to continue on as a new partnership if they want.[1] But, again, under UPA the partnership dissolves upon the withdrawal of any partner.

Causes of Dissolution

Partnerships can dissolve for a number of reasons.[2]

In Accordance with the Agreement

The term of the partnership agreement may have expired or the partnership may be at will and one of the partners desires to leave it. All the partners may decide that it is preferable to dissolve rather than to continue. One of the partners may have been expelled in accordance with a provision in the agreement. In none of these circumstances is the agreement violated, though its spirit surely might have been. Professor Samuelson calls to mind the example of William Dean Howells's Silas Lapham, who forces his partner to sell out by offering him an ultimatum: "You may buy me out or I'll buy you out." The ultimatum was given at a time when the partner could not afford to buy Lapham out, so the partner had no choice.

In Violation of the Agreement

Dissolution may also result from violation of the agreement, as when the partners decide to discharge a partner though no provision permits them to do so, or as when a partner decides to quit in violation of a term agreement. In the former case, the remaining partners are liable for damages for wrongful dissolution, and in the latter case, the withdrawing partner is liable to the remaining partners the same way.

By Operation of Law

A third reason for dissolution is the occurrence of some event, such as enactment of a statute, that makes it unlawful to continue the business. Or a partner may die or one or more partners or the entire partnership may become bankrupt. Dissolution under these circumstances is said to be by operation of law.[3]

By Court Order

Finally, dissolution may be by court order. Courts are empowered to dissolve partnerships when "on application by or for a partner" a partner is shown to be a lunatic, of unsound mind, incapable of performing his part of the agreement, "guilty of such conduct as tends to affect prejudicially the carrying on of the business," or otherwise behaves in such a way that "it is not reasonably practicable to carry on the business in partnership with him." A court may also order dissolution if the business can only be carried on at a loss or whenever equitable. In some circumstances, a court will order dissolution upon the application of a purchaser of a partner's interest.[4]

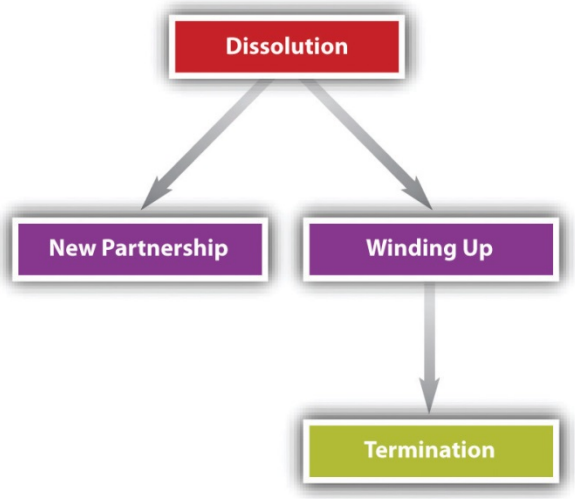
Effect of Dissolution on Authority

For the most part, dissolution terminates the authority of the partners to act for the partnership. The only significant exceptions are for acts necessary to wind up partnership affairs or to complete transactions begun but not finished at the time of dissolution.[5] Notwithstanding the latter exception, no partner can bind the partnership if it has dissolved because it has become unlawful to carry on the business or if the partner seeking to exercise authority has become bankrupt.

After Dissolution

After a partnership has dissolved, it can follow one of two paths. It can carry on business as a new partnership, or it can wind up the business and cease operating (see Figure 12.2 "Alternatives Following UPA Dissolution").

Figure 12.2 Alternatives Following UPA Dissolution



Forming a New Partnership

In order to carry on the business as a new partnership, there must be an agreement—preferably as part of the original partnership agreement but maybe only after dissolution (and maybe oral)—that upon dissolution (e.g., if a partner dies, retires, or quits) the others will regroup and carry on.

Under UPA the remaining partners have the right to carry on when (1) the dissolution was in contravention of the agreement, (2) a partner was expelled according to the partnership agreement, or (3) all partners agree to carry on.[6]

Whether the former partner dies or otherwise quits the firm, the noncontinuing one or his, her, or its legal representative is entitled to an accounting and to be paid the value of the partnership interest, less damages for wrongful dissolution.[7] The firm may need to borrow money to pay the former partner or her estate; or, in the case of a deceased partner, the money to pay the former partner is obtained through a life insurance buyout policy.

Partnerships routinely insure the lives of the partners, who have no ownership interests in the insurance policies. The policies should bear a face amount equal to each partner's interest in the partnership and should be adjusted as the fortunes of the partnership change. Proceeds of the insurance policy are used on death to pay the purchase price of the interest inherited by the deceased's estate. If the insurance policy

pays out more than the interest at stake, the partnership retains the difference. If the policy pays out less, the partnership agrees to pay the difference in installments.

Another set of issues arises when the partnership changes because an old partner departs and a new one joins. Suppose that Baker leaves the car dealership business and his interest is purchased by Alice, who is then admitted to the partnership. Assume that when Baker left, the business owed Mogul Parts Company $5,000 and Laid Back Upholsterers $4,000. After Baker left and Alice joined, Mogul sells another $5,000 worth of parts to the firm on credit, and Sizzling Radiator Repair, a new creditor, advances $3,000 worth of radiator repair parts. These circumstances pose four questions.

First, do creditors of the old partnership remain creditors of the new partnership? Yes.[8]

Second, does Baker, the old partner, remain liable to the creditors of the old partnership? Yes.[9] That could pose uncomfortable problems for Baker, who may have left the business because he lost interest in it and wished to put his money elsewhere. The last thing he wants is the threat of liability hanging over his head when he can no longer profit from the firm's operations. That is all the more true if he had a falling out with his partners and does not trust them. The solution is given in UPA Section 36(2), which says that an old partner is discharged from liability if the creditors and the new partnership agree to discharge him.

Third, is Alice, the new partner, liable to creditors of the old partnership? Yes, but only to the extent of her capital contribution.[10]

Fourth, is Baker, the old partner, liable for debts incurred after his withdrawal from the partnership? Surprisingly, yes, unless Baker takes certain action toward old and new creditors. He must provide actual notice that he has withdrawn to anyone who has extended credit in the past. Once he has done so, he has no liability to these creditors for credit extended to the partnership thereafter. Of course, it would be difficult to provide notice to future creditors, since at the time of withdrawal they would not have had a relationship with the partnership. To avoid liability to new creditors who knew of the partnership, the

solution required under UPA Section 35(l)(b)(II) is to advertise Baker's departure in a general circulation newspaper in the place where the partnership business was regularly carried on.

Winding Up and Termination

Because the differences between UPA's and RUPA's provisions for winding up and termination are not as significant as those between their provisions for dissolution, the discussion for winding up and termination will cover both acts at once, following the discussion of dissociation and dissolution under RUPA.

Dissociation and Dissolution of Partnerships under RUPA

Comment 1 to RUPA Section 601 is a good lead-in to this section. According to the comment, RUPA dramatically changes the law governing partnership breakups and dissolution. An entirely new concept, "dissociation," is used in lieu of UPA term "dissolution" to denote the change in the relationship caused by a partner's ceasing to be associated in the carrying on of the business. "Dissolution" is retained but with a different meaning. The entity theory of partnership provides a conceptual basis for continuing the firm itself despite a partner's withdrawal from the firm.

Under UPA, the partnership is an aggregate, a collection of individuals; upon the withdrawal of any member from the collection, the aggregate dissolves. But because RUPA conforms the partnership as an entity, there is no conceptual reason for it to dissolve upon a member's withdrawal. "Dissociation" occurs when any partner ceases to be involved in the business of the firm, and "dissolution" happens when RUPA requires the partnership to wind up and terminate; dissociation does not necessarily cause dissolution.

Dissociation

Dissociation, as noted in the previous paragraph, is the change in relations caused by a partner's withdrawal from the firm's business.

Causes of Dissociation

Dissociation is caused in ten possible ways: (1) a partner says she wants out; (2) an event triggers dissociation as per the partnership agreement; (3) a partner is expelled as per the agreement; (4) a partner is expelled by unanimous vote of the others because it is unlawful to carry on with that partner, because that partner has transferred to a transferee all interest in the partnership (except for security purposes), or because a corporate partner's or partnership partner's existence is effectively terminated; (5) by a court order upon request by the partnership or another partner because the one expelled has been determined to have misbehaved (engaged in serious wrongful conduct, persists in abusing the agreement, acts in ways making continuing the business impracticable); (6) the partner has declared bankruptcy; (7) the partner has died or had a guardian appointed, or has been adjudicated as incompetent; (8) the partner is a trust whose assets are exhausted; (9) the partner is an estate and the estate's interest in the partnership has been entirely transferred; (10) the partner dies or, if the partner is another partnership or a corporation trust or estate, that entity's existence is terminated.[11]

Effect of Dissociation

After a partner dissociates, the partner's right to participate in management terminates. (However, if the dissociation goes on to dissolution and winding up, partners who have not wrongfully caused the dissociation may participate in winding-up activities.)[12] The dissociated partner's duty of loyalty and care terminates; the former partner may compete with the firm, except for matters arising before the dissociation.[13]

When partners come and go, as they do, problems may arise. What power does the dissociated partner have to bind the partnership? What power does the partnership have to impose liability on the dissociated one? RUPA provides that the dissociated partner loses any actual authority upon dissociation, and his or her apparent authority lingers for not longer than two years if the dissociated one acts in a way that would have bound the partnership before dissociation, provided the other party (1) reasonably believed the dissociated one was a partner, (2) did not have notice of the dissociation, and (3) is not deemed to have constructive notice from a filed "statement of dissociation."[14] The dissociated partner, of course, is liable for damages to the partnership if third parties had cause to think she was still a partner and the partnership became liable because of that; she is liable to the firm as an unauthorized agent.[15]

A partner's dissociation does nothing to change that partner's liability for predissociation obligations.[16] For postdissociation liability, exposure is for two years if at the time of entering into the transaction the other party (1) reasonably believed the dissociated one was a partner, (2) didn't have notice of the dissociation, and (3) is not deemed to have constructive notice from a filed "statement of dissociation." For example, Baker withdraws from the firm of Able, Baker, and Carr. Able contracts with HydroLift for a new hydraulic car lift that costs $25,000 installed. HydroLift is not aware at the time of contracting that Baker is disassociated and believes she is still a partner. A year later, the firm not having been paid, HydroLift sues Able, Baker, and Carr and the partnership. Baker has potential liability. Baker could have protected herself by filing a "statement of dissociation," or—better—the partnership agreement should provide that the firm would file such statements upon the dissociation of any partner (and if it does not, it would be liable to her for the consequences).

Dissolution

Dissociation does not necessarily cause dissolution (see the discussion later in this section of how the firm continues after a dissociation); dissolution and winding up happen only for the causes stated in RUPA Section 801, discussed in the following paragraphs.

Causes of Dissolution

There are three causes of dissolution: (1) by act of the partners—some dissociations do trigger dissolution; (2) by operation of law; or (3) by court order. The partnership agreement may change or eliminate the dissolution trigger as to (1); dissolution by the latter two means cannot be tinkered with.[17]

(1) Dissolution by *act of the partners* may occur as follows:

- Any member of an **at-will partnership** can dissociate at any time, triggering dissolution and liquidation. The partners who wish to continue the business of a **term partnership**, though, cannot be forced to liquidate the business by a partner who withdraws prematurely in violation of the partnership agreement. In any event, common agreement formats for dissolution will provide for

built-in dispute resolution, and enlightened partners often agree to such mechanisms in advance to avoid the kinds of problems listed here.

- Any partnership will dissolve upon the happening of an event the partners specified would cause dissolution in their agreement. They may change their minds, of course, agree to continue, and amend the partnership agreement accordingly.
- A term partnership may be dissolved before its term expires in three ways. First, if a partner dissociated by death, declaring bankruptcy, becoming incapacitated, or wrongfully dissociates, the partnership will dissolve if within ninety days of that triggering dissociation at least half the remaining partners express their will to wind it up. Second, the partnership may be dissolved if the term expires. Third, it may be dissolved if all the partners agree to amend the partnership agreement by expressly agreeing to dissolve.

(2) Dissolution will happen in some cases by *operation of law* if it becomes illegal to continue the business, or substantially all of it. For example, if the firm's business was the manufacture and distribution of trans fats and it became illegal to do that, the firm would dissolve.[18] This cause of dissolution is not subject to partnership agreement.

(3) *Dissolution by court order* can occur on application by a partner. A court may declare that it is, for various reasons specified in RUPA Section 801(5), no longer reasonably practicable to continue operation. Also, a court may order dissolution upon application by a transferee of a partner's transferable interest or by a purchaser at a foreclosure of a charging order if the court determines it is equitable. For example, if Creditor gets a charging order against Paul Partner and the obligation cannot reasonably be paid by the firm, a court could order dissolution so Creditor would get paid from the liquidated assets of the firm.

Effect of Dissolution

A partnership continues after dissolution only for the purpose of winding up its business. The partnership is terminated when the winding up of its business is completed.[19] However, before winding up is completed, the partners—except any wrongfully dissociating—may agree to carry on the partnership, in which case it resumes business as if dissolution never happened.[20]

Continuing after Dissociation

Dissociation, again, does not necessarily cause dissolution. In an at-will partnership, the death (including termination of an entity partner), bankruptcy, incapacity, or expulsion of a partner will not cause dissolution.[21] In a term partnership, the firm continues if, within ninety days of an event triggering dissociation, fewer than half the partners express their will to wind up. The partnership agreement may provide that RUPA's dissolution-triggering events, including dissociation, will not trigger dissolution. However, the agreement cannot change the rules that dissolution is caused by the business becoming illegal or by court order. Creditors of the partnership remain as before, and the dissociated partner is liable for partnership obligations arising before dissociation.

Section 701 of RUPA provides that if the firm continues in business after a partner dissociates, without winding up, then the partnership must purchase the dissociated partner's interest; RUPA Section 701(b) explains how to determine the buyout price. It is the amount that would have been distributed to the dissociated partner if, on the date of dissociation, the firm's assets were sold "at a price equal to the greater of the liquidation value or the value based on a sale of the entire business as a going concern," minus damages for wrongful dissociation. A wrongful dissociater may have to wait a while to get paid in full, unless a court determines that immediate payment "will not cause an undue hardship to the partnership," but the longest nonwrongful dissociaters need to wait is 120 days.[22] A dissociated partner can sue the firm to determine the buyout price and the court may assess attorney's, appraiser's, and expert's fees against a party the court finds "acted arbitrarily, vexatiously, or in bad faith."[23]

Winding Up the Partnership under UPA and RUPA

If the partners decide not to continue the business upon dissolution, they are obliged to wind up the business. The partnership continues after dissolution only for the purpose of winding up its business, after which it is terminated.[24] **Winding up** entails concluding all unfinished business pending at the date of dissolution and payment of all debts. The partners must then settle accounts among themselves in order to distribute the remaining assets. At any time after dissolution and before winding up is completed, the partners (except a wrongfully dissociated one) can stop the process and carry on the business.

UPA and RUPA are not significantly different as to winding up, so they will be discussed together. Two issues are discussed here: who can participate in winding up and how the assets of the firm are distributed on liquidation.

Who Can Participate in Winding Up

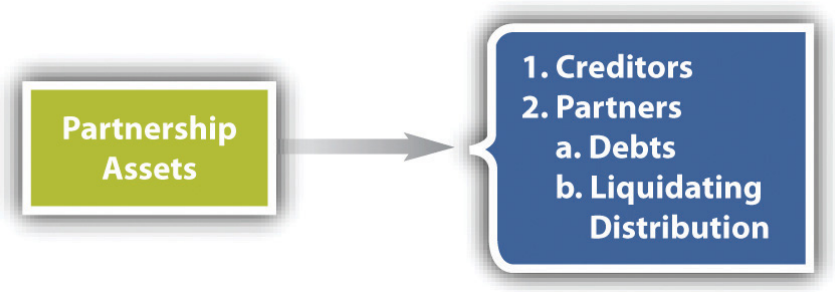
The partners who have not wrongfully dissociated may participate in winding up the partnership business. On application of any partner, a court may for good cause judicially supervise the winding up.[25]

Settlement of Accounts among Partners

Determining the priority of liabilities can be problematic. For instance, debts might be incurred to both outside creditors and partners, who might have lent money to pay off certain accounts or for working capital.

An agreement can spell out the order in which liabilities are to be paid, but if it does not, UPA Section 40(a) and RUPA Section 807(1) rank them in this order: (1) to creditors other than partners, (2) to partners for liabilities other than for capital and profits, (3) to partners for capital contributions, and finally (4) to partners for their share of profits (see Figure 12.3 "Priority Partnership Liabilities under RUPA"). However, RUPA eliminates the distinction between capital and profits when the firm pays partners what is owed to them; RUPA Section 807(b) speaks simply of the right of a partner to a liquidating distribution.

Figure 12.3 Priority Partnership Liabilities under RUPA



Partners are entitled to share equally in the profits and surplus remaining after all liabilities, including those owed to partners, are paid off, although the partnership agreement can state a different share—for example, in proportion to capital contribution. If after winding up there is a net loss, whether capital or otherwise, each partner must contribute toward it in accordance with his share in the profits, had there been any, unless the agreement states otherwise. If any of the partners is insolvent or refuses to contribute and cannot be sued, the others must contribute their own share to pay off the liabilities and in addition must contribute, in proportion to their share of the profits, the additional amount necessary to pay the liabilities of their defaulting partners.

In the event of insolvency, a court may take possession of both partnership property and individual assets of the partners; this again is a big disadvantage to the partnership form.

The estate of a deceased partner is credited or liable as that partner would have been if she were living at the time of the distribution.

KEY TAKEAWAY

Under UPA, the withdrawal of any partner from the partnership causes dissolution; the withdrawal may be caused in accordance with the agreement, in violation of the agreement, by operation of law, or by court order. Dissolution terminates the partners' authority to act for the partnership, except for winding up, but remaining partners may decide to carry on as a new partnership or may decide to terminate the firm. If they continue, the old creditors remain as creditors of the new firm, the former partner remains liable for

obligations incurred while she was a partner (she may be liable for debts arising after she left, unless proper notice is given to creditors), and the former partner or her estate is entitled to an accounting and payment for the partnership interest. If the partners move to terminate the firm, winding up begins.

Under RUPA, a partner who ceases to be involved in the business is dissociated, but dissociation does not necessarily cause dissolution. Dissociation happens when a partner quits, voluntarily or involuntarily; when a partner dies or becomes incompetent; or on request by the firm or a partner upon court order for a partner's wrongful conduct, among other reasons. The dissociated partner loses actual authority to bind the firm but remains liable for predissociation obligations and may have lingering authority or lingering liability for two years provided the other party thought the dissociated one was still a partner; a notice of dissociation will, after ninety days, be good against the world as to dissociation and dissolution. If the firm proceeds to termination (though partners can stop the process before its end), the next step is dissolution, which occurs by acts of partners, by operation of law, or by court order upon application by a partner if continuing the business has become untenable. After dissolution, the only business undertaken is to wind up affairs. However, the firm may continue after dissociation; it must buy out the dissociated one's interest, minus damages if the dissociation was wrongful.

If the firm is to be terminated, winding up entails finishing the business at hand, paying off creditors, and splitting the remaining surplus or liabilities according the parties' agreement or, absent any, according to the relevant act (UPA or RUPA).

EXERCISES

1. Under UPA, what is the effect on the partnership of a partner's ceasing to be involved in the business?
2. Can a person no longer a partner be held liable for partnership obligations after her withdrawal? Can such a person incur liability to the partnership?
3. What obligation does a partnership or its partners owe to a partner who wrongfully terminates the partnership agreement?
4. What bearing does RUPA's use of the term *dissociate* have on the entity theory that informs the revised act?

5. When a partnership is wound up, who gets paid first from its assets? If the firm winds up toward termination and has inadequate assets to pay its creditors, what recourse, if any, do the creditors have?

---

[1] UPA, Section 30.

[2] UPA, Section 31.

[3] UPA, Section 31.

[4] UPA, Section 32.

[5] UPA, Section 33.

[6] UPA, Sections 37 and 38.

[7] UPA, Section 38.

[8] UPA, Section 41(1).

[9] UPA, Section 36(1).

[10] UPA, Section 17.

[11] RUPA, Section 601.

[12] RUPA. Sections 603(b) and 804(a).

[13] RUPA, Section 603(b)(3).

[14] RUPA, Section 603(b)(1).

[15] RUPA, Section 702.

[16] RUPA, Section 703(a).

[17] RUPA, Section 103.

[18] Trans fats are hydrogenated vegetable oils; the process of hydrogenation essentially turns the oils into semisolids, giving them a higher melting point and extending their shelf life but, unfortunately, also clogging consumers' arteries and causing heart disease. California banned their sale effective January 1, 2010; other jurisdictions have followed suit.

[19] RUPA, Section 802.

[20] RUPA, Section 802(b).

[21] RUPA, Sections 601 and 801.

[22] RUPA, Section 701(e).

[23] RUPA, Section 701(h)(4)(i).

[24] UPA, Section 30; RUPA, Section 802(a).

[25] UPA, Section 37; RUPA, Section 803(a).

12.4 Cases

Breach of Partnership Fiduciary Duty

Gilroy v. Conway

391 N.W. 2d 419 (Mich. App. 1986)

PETERSON, J.

Defendant cheated his partner and appeals from the trial court's judgment granting that partner a remedy.

Plaintiff was an established commercial photographer in Kalamazoo who also had a partnership interest in another photography business, Colonial Studios, in Coldwater. In 1974, defendant became plaintiff's partner in Colonial Studios, the name of which was changed to Skylight Studios. Under the partnership agreement, defendant was to be the operating manager of the partnership, in return for which he would have a guaranteed draw. Except for the guaranteed draw, the partnership was equal in ownership and the sharing of profits.

Prior to defendant's becoming a partner, the business had acquired a small contractual clientele of schools for which the business provided student portrait photographs. The partners agreed to concentrate on this type of business, and both partners solicited schools with success. Gross sales, which were $40,000 in 1974, increased every year and amounted to $209,085 in 1980 [about $537,000 in 2011 dollars].

In the spring of 1981, defendant offered to buy out plaintiff and some negotiations followed. On June 25, 1981, however, plaintiff was notified by the defendant that the partnership was dissolved as of July 1,

1981. Plaintiff discovered that defendant: had closed up the partnership's place of business and opened up his own business; had purchased equipment and supplies in preparation for commencing his own business and charged them to the partnership; and had taken with him the partnership employees and most of its equipment.

Defendant had also stolen the partnership's business. He had personally taken over the business of some customers by telling them that the partnership was being dissolved; in other cases he simply took over partnership contracts without telling the customers that he was then operating on his own. Plaintiff also learned that defendant's deceit had included the withdrawal, without plaintiff's knowledge, of partnership funds for defendant's personal use in 1978 in an amount exceeding $11,000 [about $36,000 in 2011 dollars].

The trial judge characterized the case as a "classic study of greed" and found that defendant had in effect appropriated the business enterprise, holding that defendant had "knowingly and willfully violated his fiduciary relationship as a partner by converting partnership assets to his use and, in doing so, literally destroying the partnership." He also found that the partnership could have been sold as a going business on June 30, 1981, and that after a full accounting, it had a value on that date of $94,596 less accounts payable of $17,378.85, or a net value of $77,217.15. The division thereof after adjustments for plaintiff's positive equity or capital resulted in an award to plaintiff for his interest in the business of $53,779.46 [about $126,000 in 2011 dollars]....

Plaintiff also sought exemplary [punitive] damages. Count II of the complaint alleged that defendant's conduct constituted a breach of defendant's fiduciary duty to his partner under §§ 19-22 of the Uniform Partnership Act, and Count III alleged conversion of partnership property. Each count contained allegations that defendant's conduct was willful, wanton and in reckless disregard of plaintiff's rights and that such conduct had caused injury to plaintiff's feelings, including humiliation, indignity and a sense of moral outrage. The prayer for relief sought exemplary damages therefore.

Plaintiff's testimony on the point was brief. He said:

The effect of really the whole situation, and I think it was most apparent when I walked into the empty building, was extreme disappointment and really total outrage at the fact that something that I had given the utmost of my talent and creativity, energy, and whatever time was necessary to build, was totally destroyed and there was just nothing of any value that was left....My business had been stolen and there wasn't a thing that I could do about it. And to me, that was very humiliating that one day I had something that I had worked 10 years on, and the next day I had absolutely nothing of any value.

As noted above, the trial judge found that defendant had literally destroyed the partnership by knowingly and willfully converting partnership assets in violation of his fiduciary duty as a partner. He also found that plaintiff had suffered a sense of outrage, indignity and humiliation and awarded him $10,000 [$23,000 in 2011 dollars] as exemplary damages.

Defendant appeals from that award, asserting that plaintiff's cause of action arises from a breach of the partnership contract and that exemplary damages may not be awarded for breach of that contract....

If it were to be assumed that a partner's breach of his fiduciary duty or appropriation of partnership equipment and business contract to his own use and profit are torts, it is clear that the duty breached arises from the partnership contract. One acquires the property interest of a co-tenant in partnership only by the contractual creation of a partnership; one becomes a fiduciary in partnership only by the contractual undertaking to become a partner. There is no tortious conduct here existing independent of the breach of the partnership contract.

Neither do we see anything in the Uniform Partnership Act to suggest that an aggrieved partner is entitled to any remedy other than to be made whole economically. The act defines identically the partnership fiduciary duty and the remedy for its breach, i.e., to account:

Sec. 21. (1) Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction

connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property.

So, the cases involving a partner's breach of the fiduciary duty to their partners have been concerned solely with placing the wronged partners in the economic position that they would have enjoyed but for the breach.

[Judgment for plaintiff affirmed, as modified with regard to damages.]

CASE QUESTIONS

1. For what did the court award the plaintiff $53,000?
2. The court characterizes the defendant as having "cheated his partner"—that is, Conway committed fraud. (Gilroy said his business had been "stolen.") Fraud is a tort. Punitive damages may be awarded against a tortfeasor, even in a jurisdiction that generally disallows punitive damages in contract. In fact, punitive damages are sometimes awarded for breach of the partnership fiduciary duty. In *Cadwalader, Wickersham & Taft v. Beasley*, 728 So.2d 253 (Florida Ct. App., 1998), a New York law firm was found to have wrongfully expelled a partner lawyer, Beasley, from membership in its Palm Beach, Florida, offices. New York law controlled. The trial court awarded Beasley $500,000 in punitive damages. The appeals court, construing the same UPA as the court construed in *Gilroy*, said:

Under New York law, the nature of the conduct which justifies an award of punitive damages is conduct having a high degree of moral culpability, or, in other words, conduct which shows a "conscious disregard of the rights of others or conduct so reckless as to amount to such disregard."…[S]ince the purpose of punitive damages is to both punish the wrongdoer and deter others from such wrongful behavior, as a matter of policy, courts have the discretion to award punitive damages[.]…[The defendant] was participating in a clandestine plan to wrongfully expel some partners for the financial gain of other partners. Such activity cannot be said to be honorable, much less to comport with the "punctilio of an honor." Because these findings establish that [the defendant] consciously disregarded the rights of Beasley, we affirm the award of punitive damages.

As a matter of social policy, which is the better ruling, the Michigan court's in *Gilroy* or the Florida court's in *Cadwalader*?

Partnership Authority, Express or Apparent

Hodge v Garrett

614 P.2d 420 (Idaho 1980)

Bistline, J.

[Plaintiff] Hodge and defendant-appellant Rex E. Voeller, the managing partner of the Pay-Ont Drive-In Theatre, signed a contract for the sale of a small parcel of land belonging to the partnership. That parcel, although adjacent to the theater, was not used in theater operations except insofar as the east 20 feet were necessary for the operation of the theater's driveway. The agreement for the sale of land stated that it was between Hodge and the Pay-Ont Drive-In Theatre, a partnership. Voeller signed the agreement for the partnership, and written changes as to the footage and price were initialed by Voeller. (The trial court found that Hodge and Voeller had orally agreed that this 20 foot strip would be encumbered by an easement for ingress and egress to the partnership lands.)

Voeller testified that he had told Hodge prior to signing that Hodge would have to present him with a plat plan which would have to be approved by the partners before the property could be sold. Hodge denied that a plat plan had ever been mentioned to him, and he testified that Voeller did not tell him that the approval of the other partners was needed until after the contract was signed. Hodge also testified that he offered to pay Voeller the full purchase price when he signed the contract, but Voeller told him that that was not necessary.

The trial court found that Voeller had actual and apparent authority to execute the contract on behalf of the partnership, and that the contract should be specifically enforced. The partners of the Pay-Ont Drive-

In Theatre appeal, arguing that Voeller did not have authority to sell the property and that Hodge knew that he did not have that authority.

At common law one partner could not, "without the concurrence of his copartners, convey away the real estate of the partnership, bind his partners by a deed, or transfer the title and interest of his copartners in the firm real estate." [Citation] This rule was changed by the adoption of the Uniform Partnership Act....[citing the statute].

The meaning of these provisions was stated in one text as follows:

> *"If record title is in the partnership and a partner conveys in the partnership name, legal title passes. But the partnership may recover the property (except from a bona fide purchaser from the grantee) if it can show (A) that the conveying partner was not apparently carrying on business in the usual way or (B) that he had in fact no authority and the grantee had knowledge of that fact. The burden of proof with respect to authority is thus on the partnership." [Citation]*

Thus this contract is enforceable if Voeller had the actual authority to sell the property, or, even if Voeller did not have such authority, the contract is still enforceable if the sale was in the usual way of carrying on the business and Hodge did not know that Voeller did not have this authority.

As to the question of actual authority, such authority must affirmatively appear, "for the authority of one partner to make and acknowledge a deed for the firm will not be presumed...." [Citation] Although such authority may be implied from the nature of the business, or from similar past transactions [Citation], nothing in the record in this case indicates that Voeller had express or implied authority to sell real property belonging to the partnership. There is no evidence that Voeller had sold property belonging to the partnership in the past, and obviously the partnership was not engaged in the business of buying and selling real estate.

The next question, since actual authority has not been shown, is whether Voeller was conducting the partnership business in the usual way in selling this parcel of land such that the contract is binding under [the relevant section of the statute] i.e., whether Voeller had apparent authority. Here the evidence showed, and the trial court found:

1. "That the defendant, Rex E. Voeller, was one of the original partners of the Pay-Ont Drive In Theatre; that the other defendants obtained their partnership interest by inheritance upon the death of other original partners; that upon the death of a partner the partnership affairs were not wound up, but instead, the partnership merely continued as before, with the heirs of the deceased partner owning their proportionate share of the partnership interest.
2. "That at the inception of the partnership, and at all times thereafter, Rex E. Voeller was the exclusive, managing partner of the partnership and had the full authority to make all decisions pertaining to the partnership affairs, including paying the bills, preparing profit and loss statements, income tax returns and the ordering of any goods or services necessary to the operation of the business."

The court made no finding that it was customary for Voeller to sell real property, or even personal property, belonging to the partnership. Nor was there any evidence to this effect. Nor did the court discuss whether it was in the usual course of business for the managing partner of a theater to sell real property. Yet the trial court found that Voeller had apparent authority to sell the property. From this it must be inferred that the trial court believed it to be in the usual course of business for a partner who has exclusive control of the partnership business to sell real property belonging to the partnership, where that property is not being used in the partnership business. We cannot agree with this conclusion. For a theater, "carrying on in the usual way the business of the partnership," [Citation to relevant section of the statute] means running the operations of the theater; it does not mean selling a parcel of property adjacent to the theater. Here the contract of sale stated that the land belonged to the partnership, and, even if Hodge believed that Voeller as the exclusive manager had authority to transact all business for the firm, Voeller still could not bind the partnership through a unilateral act which was not in the usual business of the partnership. We therefore hold that the trial court erred in holding that this contract was binding on the partnership.

Judgment reversed. Costs to appellant.

CASE QUESTIONS

1. What was the argument that Voeller had actual authority? What did the court on appeal say about that argument?
2. What was the argument that Voeller had apparent authority? What did the court on appeal say about that argument? To rephrase the question, what facts would have been necessary to confer on Voeller apparent authority?

Partnership Bound by Contracts Made by a Partner on Its Behalf; Partners' Duties to Each Other; Winding Up

Long v. Lopez

115 S.W.3d 221 (Texas App. 2003)

Holman, J.

Wayne A. Long [plaintiff at the trial court] sued Appellee Sergio Lopez to recover from him, jointly and severally, his portion of a partnership debt that Long had paid. After a bench trial, the trial court ruled that Long take nothing from Appellee. We reverse and render, and remand for calculation of attorney's fees in this suit and pre- and post-judgment interest.

Long testified that in September 1996, Long, Lopez, and Don Bannister entered into an oral partnership agreement in which they agreed to be partners in Wood Relo ("the partnership"), a trucking business located in Gainesville, Texas. Wood Relo located loads for and dispatched approximately twenty trucks it leased from owner-operators....

The trial court found that Long, Lopez, and Bannister formed a partnership, Wood Relo, without a written partnership agreement. Lopez does not contest these findings.

Long testified that to properly conduct the partnership's business, he entered into an office equipment lease with IKON Capital Corporation ("IKON") on behalf of the partnership. The lease was a thirty-month contract under which the partnership leased a telephone system, fax machine, and photocopier at a rate of $577.91 per month. The lease agreement was between IKON and Wood Relo; the "authorized signer" was listed as Wayne Long, who also signed as personal guarantor.

Long stated that all three partners were authorized to buy equipment for use by the partnership. He testified that the partners had agreed that it was necessary for the partnership to lease the equipment and that on the day the equipment was delivered to Wood Relo's office, Long was the only partner at the office; therefore, Long was the only one available to sign the lease and personal guaranty that IKON required. [The partnership disintegrated when Bannister left and he later filed for bankruptcy.]...Long testified that when Bannister left Wood Relo, the partnership still had "quite a few" debts to pay, including the IKON lease....

Eventually, IKON did repossess all the leased equipment. Long testified that he received a demand letter from IKON, requesting payment by Wood Relo of overdue lease payments and accelerating payment of the remaining balance of the lease. IKON sought recovery of past due payments in the amount of $2,889.55 and accelerated future lease payments in the amount of $11,558.20, for a total of $14,447.75, plus interest, costs, and attorney's fees, with the total exceeding $16,000. Long testified that he advised Lopez that he had received the demand letter from IKON.

Ultimately, IKON filed a lawsuit against Long individually and d/b/a Wood Relo, but did not name Lopez or Bannister as parties to the suit. Through his counsel, Long negotiated a settlement with IKON for a total of $9,000. An agreed judgment was entered in conjunction with the settlement agreement providing that if Long did not pay the settlement, Wood Relo and Long would owe IKON $12,000.

After settling the IKON lawsuit, Long's counsel sent a letter to Lopez and Bannister regarding the settlement agreement, advising them that they were jointly and severally liable for the $9,000 that extinguished the partnership's debt to IKON, plus attorney's fees....

The trial court determined that Long was not entitled to reimbursement from Lopez because Long was not acting for the partnership when he settled IKON's claim against the partnership. The court based its conclusion on the fact that Long had no "apparent authority with respect to lawsuits" and had not notified Lopez of the IKON lawsuit.

Analysis

To the extent that a partnership agreement does not otherwise specify, the provisions of the Texas Revised Partnership Act govern the relations of the partners and between the partners and the partnership. [Citations] Under the Act, each partner has equal rights in the management and conduct of the business of a partnership. With certain inapplicable exceptions, all partners are liable jointly and severally for all debts and obligations of the partnership unless otherwise agreed by the claimant or provided by law. A partnership may be sued and may defend itself in its partnership name. Each partner is an agent of the partnership for the purpose of its business; unless the partner does not have authority to act for the partnership in a particular matter and the person with whom the partner is dealing knows that the partner lacks authority, an act of a partner, including the execution of an instrument in the partnership name, binds the partnership if "the act is for apparently carrying on in the ordinary course: (1) the partnership business." [Citation] If the act of a partner is not apparently for carrying on the partnership business, an act of a partner binds the partnership only if authorized by the other partners. [Citation]

The extent of authority of a partner is determined essentially by the same principles as those measuring the scope of the authority of an agent. [Citation] As a general rule, each partner is an agent of the partnership and is empowered to bind the partnership in the normal conduct of its business. [Citation] Generally, an agent's authority is presumed to be coextensive with the business entrusted to his care. [Citations] An agent is limited in his authority to such contracts and acts as are incident to the management of the particular business with which he is entrusted. [Citation]

Winding Up the Partnership

A partner's duty of care to the partnership and the other partners is to act in the conduct and winding up of the partnership business with the care an ordinarily prudent person would exercise in similar circumstances. [Citation] During the winding up of a partnership's business, a partner's fiduciary duty to the other partners and the partnership is limited to matters relating to the winding up of the partnership's affairs. [Citation]

Long testified that he entered into the settlement agreement with IKON to save the partnership a substantial amount of money. IKON's petition sought over $16,000 from the partnership, and the settlement agreement was for $9,000; therefore, Long settled IKON's claim for 43% less than the amount for which IKON sued the partnership.

Both Long and Lopez testified that the partnership "fell apart," "virtually was dead," and had to move elsewhere....The inability of the partnership to continue its trucking business was an event requiring the partners to wind up the affairs of the partnership. See [Citation]...

The Act provides that a partner winding up a partnership's business is authorized, to the extent appropriate for winding up, to perform the following in the name of and for and on behalf of the partnership:

> *(1) prosecute and defend civil, criminal, or administrative suits;*
>
> *(2) settle and close the partnership's business;*
>
> *(3) dispose of and convey the partnership's property;*
>
> *(4) satisfy or provide for the satisfaction of the partnership's liabilities;*
>
> *(5) distribute to the partners any remaining property of the partnership; and*
>
> *(6) perform any other necessary act. [Citation]*

Long accrued the IKON debt on behalf of the partnership when he secured the office equipment for partnership operations, and he testified that he entered into the settlement with IKON when the

partnership was in its final stages and the partners were going their separate ways. Accordingly, Long was authorized by the Act to settle the IKON lawsuit on behalf of the partnership....

Lopez's Liability for the IKON Debt

If a partner reasonably incurs a liability in excess of the amount he agreed to contribute in properly conducting the business of the partnership or for preserving the partnership's business or property, he is entitled to be repaid by the partnership for that excess amount. [Citation] A partner may sue another partner for reimbursement if the partner has made such an excessive payment. [Citation]

With two exceptions not applicable to the facts of this case, all partners are liable jointly and severally for all debts and obligations of the partnership unless otherwise agreed by the claimant or provided by law. Because Wood Relo was sued for a partnership debt made in the proper conduct of the partnership business, and Long settled this claim in the course of winding up the partnership, he could maintain an action against Lopez for reimbursement of Long's disproportionate payment. [Citations]

Attorneys' Fees

Long sought to recover the attorney's fees expended in defending the IKON claim, and attorney's fees expended in the instant suit against Lopez. Testimony established that it was necessary for Long to employ an attorney to defend the action brought against the partnership by IKON; therefore, the attorney's fees related to defending the IKON lawsuit on behalf of Wood Relo are a partnership debt for which Lopez is jointly and severally liable. As such, Long is entitled to recover from Lopez one-half of the attorney's fees attributable to the IKON lawsuit. The evidence established that reasonable and necessary attorney's fees to defend the IKON lawsuit were $1725. Therefore, Long is entitled to recover from Lopez $862.50.

Long also seeks to recover the attorney's fees expended pursuing the instant lawsuit. See [Texas statute citation] (authorizing recovery of attorney's fees in successful suit under an oral contract); see also [Citation] (holding attorney's fees are recoverable by partner under because action against other partner was founded on partnership agreement, which was a contract). We agree that Long is entitled to recover

reasonable and necessary attorney's fees incurred in bringing the instant lawsuit. Because we are remanding this case so the trial court can determine the amount of pre- and post-judgment interest to be awarded to Long, we also remand to the trial court the issue of the amount of attorney's fees due to Long in pursuing this lawsuit against Lopez for collection of the amount paid to IKON on behalf of the partnership.

Conclusion

We hold the trial court erred in determining that Long did not have authority to act for Wood Relo in defending, settling, and paying the partnership debt owed by Wood Relo to IKON. Lopez is jointly and severally liable to IKON for $9,000, which represents the amount Long paid IKON to defend and extinguish the partnership debt. We hold that Lopez is jointly and severally liable to Long for $1725, which represents the amount of attorney's fees Long paid to defend against the IKON claim. We further hold that Long is entitled to recover from Lopez reasonable and necessary attorney's fees in pursuing the instant lawsuit.

We reverse the judgment of the trial court. We render judgment that Lopez owes Long $5362.50 (one-half of the partnership debt to IKON plus one-half of the corresponding attorney's fees). We remand the case to the trial court for calculation of the amount of attorney's fees owed by Lopez to Long in the instant lawsuit, and calculation of pre- and post-judgment interest.

CASE QUESTIONS

1. Why did the trial court determine that Lopez owed Long nothing?
2. Absent a written partnership agreement, what rules control the operation and winding up of the partnership?
3. Why did the appeals court determine that Long did have authority to settle the lawsuit with IKON?
4. Lopez was not named by IKON when it sued Long and the partnership. Why did the court determine that did not matter, that Lopez was still liable for one-half the costs of settling that case?

5. Why was Long awarded compensation for the attorneys' fees expended in dealing with the IKON matter and in bringing this case?

Dissolution under RUPA

Horizon/CMS Healthcare Corp. v. Southern Oaks Health Care, Inc.

732 So.2d 1156 (Fla. App. 1999)

Goshorn, J.

Horizon is a large, publicly traded provider of both nursing home facilities and management for nursing home facilities. It wanted to expand into Osceola County in 1993. Southern Oaks was already operating in Osceola County[.]...Horizon and Southern Oaks decided to form a partnership to own the proposed [new] facility, which was ultimately named Royal Oaks, and agreed that Horizon would manage both the Southern Oaks facility and the new Royal Oaks facility. To that end, Southern Oaks and Horizon entered into several partnership and management contracts in 1993.

In 1996, Southern Oaks filed suit alleging numerous defaults and breaches of the twenty-year agreements....[T]he trial court found largely in favor of Southern Oaks, concluding that Horizon breached its obligations under two different partnership agreements [and that] Horizon had breached several management contracts. Thereafter, the court ordered that the partnerships be dissolved, finding that "the parties to the various agreements which are the subject of this lawsuit are now incapable of continuing to operate in business together" and that because it was dissolving the partnerships, "there is no entitlement to future damages...." In its cross appeal, Southern Oaks asserts that because Horizon unilaterally and wrongfully sought dissolution of the partnerships, Southern Oaks should receive a damage award for the loss of the partnerships' seventeen remaining years' worth of future profits. We reject its argument.

Southern Oaks argues Horizon wrongfully caused the dissolution because the basis for dissolution cited by the court is not one of the grounds for which the parties contracted. The pertinent contracts provided in section 7.3 "Causes of Dissolution": "In addition to the causes for dissolution set forth in Section 7.2(c),

the Partnership shall be dissolved in the event that:...(d) upon thirty (30) days prior written notice to the other Partner, either Partner elects to dissolve the Partnership on account of an Irreconcilable Difference which arises and cannot, after good faith efforts, be resolved...."

Southern Oaks argues that what Horizon relied on at trial as showing irreconcilable differences—the decisions of how profits were to be determined and divided—were not "good faith differences of opinion," nor did they have "a material and adverse impact on the conduct of the Partnerships' Business." Horizon's refusal to pay Southern Oaks according to the terms of the contracts was not an "irreconcilable difference" as defined by the contract, Southern Oaks asserts, pointing out that Horizon's acts were held to be breaches of the contracts. Because there was no contract basis for dissolution, Horizon's assertion of dissolution was wrongful, Southern Oaks concludes.

Southern Oaks contends further that not only were there no contractual grounds for dissolution, dissolution was also wrongful under the Florida Statutes. Southern Oaks argues that pursuant to section [of that statute] Horizon had the power to dissociate from the partnership, but, in the absence of contract grounds for the dissociation, Horizon wrongfully dissociated. It asserts that it is entitled to lost future profits under Florida's partnership law....

We find Southern Oaks' argument without merit. First, the trial court's finding that the parties are incapable of continuing to operate in business together *is* a finding of "irreconcilable differences," a permissible reason for dissolving the partnerships under the express terms of the partnership agreements. Thus, dissolution was not "wrongful," assuming there can be "wrongful" dissolutions, and Southern Oaks was not entitled to damages for lost future profits. Additionally, the partnership contracts also permit dissolution by "judicial decree." Although neither party cites this provision, it appears that pursuant thereto, the parties agreed that dissolution would be proper if done by a trial court for whatever reason the court found sufficient to warrant dissolution.

Second, even assuming the partnership was dissolved for a reason not provided for in the partnership agreements, damages were properly denied. Under RUPA, it is clear that wrongful *dissociation* triggers

liability for lost future profits. *See* [RUPA:] "A partner who wrongfully dissociates is liable to the partnership and to the other partners for damages caused by the dissociation. The liability is in addition to any other obligation of the partner to the partnership or to the other partners." However, RUPA does *not* contain a similar provision for dissolution; RUPA does not refer to the dissolutions as rightful or wrongful. [RUPA sets out] "Events causing dissolution and winding up of partnership business," [and] outlines the events causing dissolution without any provision for liability for damages....[RUPA] recognizes judicial dissolution:

> *A partnership is dissolved, and its business must be wound up, only upon the occurrence of any of the following events:...*
>
> *(5) On application by a partner, a judicial determination that:*
> *(a) The economic purpose of the partnership is likely to be unreasonably frustrated;*
> *(b) Another partner has engaged in conduct relating to the partnership business which makes it not reasonably practicable to carry on the business in partnership with such partner; or*
> *(c) It is not otherwise reasonably practicable to carry on the partnership business in conformity with the partnership agreement[.]...*

Paragraph (5)(c) provides the basis for the trial court's dissolution in this case. While "reasonably practicable" is not defined in RUPA, the term is broad enough to encompass the inability of partners to continue working together, which is what the court found.

Certainly the law predating RUPA allowed for recovery of lost profits upon the wrongful dissolution of a partnership. *See e.g.*, [Citation]: "A partner who assumes to dissolve the partnership before the end of the term agreed on in the partnership articles is liable, in an action at law against him by his co-partner for the breach of the agreement, to respond in damages for the value of the profits which the plaintiff would otherwise have received."

CC BY NC SA

However, RUPA brought significant changes to partnership law, among which was the adoption of the term "dissociation." Although the term is undefined in RUPA, dissociation appears to have taken the place of "dissolution" as that word was used pre-RUPA. "Dissolution" under RUPA has a different meaning, although the term is undefined in RUPA. It follows that the pre-RUPA cases providing for future damages upon wrongful dissolution are no longer applicable to a partnership dissolution. In other words a "wrongful dissolution" referred to in the pre-RUPA case law is now, under RUPA, known as "wrongful dissociation." Simply stated, under [RUPA], only when a partner *dissociates* and the dissociation is wrongful can the remaining partners sue for damages. When a partnership is *dissolved*, RUPA...provides the parameters of liability of the partners upon dissolution....

[Citation]: "Dissociation is not a condition precedent to dissolution....Most dissolution events are dissociations. On the other hand, it is not necessary to have a dissociation to cause a dissolution and winding up."

Southern Oaks' attempt to bring the instant dissolution under the statute applicable to dissociation is rejected. The trial court ordered dissolution of the partnership, not the dissociation of Horizon for wrongful conduct. There no longer appears to be "wrongful" dissolution—either dissolution is provided for by contract or statute or the dissolution was improper and the dissolution order should be reversed. In the instant case, because the dissolution either came within the terms of the partnership agreements or [RUPA] (judicial dissolution where it is not reasonably practicable to carry on the partnership business), Southern Oaks' claim for lost future profits is without merit. Affirmed.

CASE QUESTIONS

1. Under RUPA, what is a dissociation? What is a dissolution?
2. Why did Southern Oaks claim there was no contractual basis for dissolution, notwithstanding the determination that Horizon had breached the partnership agreement and the management contract?

3. Given those findings, what did Southern Oaks *not* get at the lower-court trial that it wanted on this appeal?
4. Why didn't Southern Oaks get what it wanted on this appeal?

12.5 Summary and Exercises

Summary

Most of the Uniform Partnership Act (UPA) and Revised Uniform Partnership Act (RUPA) rules apply only in the absence of agreement among the partners. Under both, unless the agreement states otherwise, partners have certain duties: (1) the duty to serve—that is, to devote themselves to the work of the partnership; (2) the duty of loyalty, which is informed by the fiduciary standard: the obligation to act always in the best interest of the partnership and not in one's own best interest; (3) the duty of care—that is, to act as a reasonably prudent partner would; (4) the duty of obedience not to breach any aspect of the agreement or act without authority; (5) the duty to inform copartners; and (6) the duty to account to the partnership. Ordinarily, partners operate through majority vote, but no act that contravenes the partnership agreement itself can be undertaken without unanimous consent.

Partners' rights include rights (1) to distributions of money, including profits (and losses) as per the agreement or equally, indemnification, and return of capital contribution (but not a right to compensation); (2) to management as per the agreement or equally; (3) to choose copartners; (4) to property of the partnership, but no partner has any rights to specific property (under UPA the partners own property as tenants in partnership; under RUPA the partnership as entity owns property, but it will be distributed upon liquidation); (5) to assign (voluntarily or involuntarily) the partnership interest; the assignee does not become a partner or have any management rights, but a judgment creditor may obtain a charging order against the partnership; and (6) to enforce duties and rights by suits in law or equity (under RUPA a formal accounting is not required).

Under UPA, a change in the relation of the partners dissolves the partnership but does not necessarily wind up the business. Dissolution may be voluntary, by violation of the agreement, by operation of law, or by court order. Dissolution terminates the authority of the partners to act for the partnership. After dissolution, a new partnership may be formed.

Under RUPA, a change in the relation of the partners is a dissociation, leaving the remaining partners with two options: continue on; or wind up, dissolve, and terminate. In most cases, a partnership may buy out the interest of a partner who leaves without dissolving the partnership. A term partnership also will not dissolve so long as at least one-half of the partners choose to remain. When a partner's dissociation triggers dissolution, partners are allowed to vote subsequently to continue the partnership.

When a dissolved partnership is carried on as a new one, creditors of the old partnership remain creditors of the new one. A former partner remains liable to the creditors of the former partnership. A new partner is liable to the creditors of the former partnership, bur only to the extent of the new partner's capital contribution. A former partner remains liable for debts incurred after his withdrawal unless he gives proper notice of his withdrawal; his actual authority terminates upon dissociation and apparent authority after two years.

If the firm is to be terminated, it is wound up. The assets of the partnership include all required contributions of partners, and from the assets liabilities are paid off (1) to creditors and (2) to partners on their accounts. Under RUPA, nonpartnership creditors share equally with unsatisfied partnership creditors in the personal assets of their debtor-partners.

EXERCISES

1. Anne and Barbara form a partnership. Their agreement specifies that Anne will receive two-thirds of the profit and Barbara will get one-third. The firm suffers a loss of $3,000 the first year. How are the losses divided?

2. Two lawyers, Glenwood and Higgins, formed a partnership. Glenwood failed to file Client's paperwork on time in a case, with adverse financial consequences to Client. Is Higgins liable for Glenwood's malpractice?
3. When Client in Exercise 2 visited the firm's offices to demand compensation from Glenwood, the two got into an argument. Glenwood became very agitated; in an apparent state of rage, he threw a law book at Client, breaking her nose. Is Higgins liable?
4. Assume Glenwood from Exercise 2 entered into a contract on behalf of the firm to buy five computer games. Is Higgins liable?
5. Grosberg and Goldman operated the Chatham Fox Hills Shopping Center as partners. They agreed that Goldman would deposit the tenants' rental checks in an account in Grosberg's name at First Bank. Without Grosberg's knowledge or permission, Goldman opened an account in both their names at Second Bank, into which Goldman deposited checks payable to the firm or the partners. He indorsed each check by signing the name of the partnership or the partners. Subsequently, Goldman embezzled over $100,000 of the funds. Second Bank did not know Grosberg and Goldman were partners. Grosberg then sued Second Bank for converting the funds by accepting checks on which Grosberg's or the partnership's indorsement was forged. Is Second Bank liable? Discuss.
6. Pearson Collings, a partner in a criminal defense consulting firm, used the firm's phones and computers to operate a side business cleaning carpets. The partnership received no compensation for the use of its equipment. What claim would the other partners have against Collings?
7. Follis, Graham, and Hawthorne have a general partnership, each agreeing to split losses 20 percent, 20 percent, and 60 percent, respectively. While on partnership business, Follis negligently crashes into a victim, causing $100,000 in damages. Follis declares bankruptcy, and the firm's assets are inadequate to pay the damages. Graham says she is liable for only $20,000 of the obligation, as per the agreement. Is she correct?
8. Ingersoll and Jackson are partners; Kelly, after much negotiation, agreed to join the firm effective February 1. But on January 15, Kelly changed his mind. Meanwhile, however, the other two had already arranged for the local newspaper to run a notice that Kelly was joining the firm. The notice ran on February 1. Kelly did nothing in response. On February 2, Creditor, having seen the newspaper notice, extended credit to the firm. When the firm did not pay, Creditor sought to have Kelly held liable as a partner. Is Kelly liable?

SELF-TEST QUESTIONS

1 Under UPA, a partner is generally entitled to a formal accounting of partnership affairs

a. whenever it is just and reasonable

b. if a partner is wrongfully excluded from the business by copartners

c. if the right exists in the partnership agreement

d. all of the above

2 Donners, Inc., a partner in CDE Partnership, applies to Bank to secure a loan and assigns to Bank its partnership interest. After the assignment, which is true?

a. Bank steps into Donners's shoes as a partner.

b. Bank does not become a partner but has the right to participate in the management of the firm to protect its security interest until the loan is paid.

c. Bank is entitled to Donners's share of the firm's profits.

d. Bank is liable for Donners's share of the firm's losses.

e. None of these is true.

3 Which of these requires unanimous consent of the partners in a general partnership?

a. the assignment of a partnership interest

b. the acquisition of a partnership debt

c. agreement to be responsible for the tort of one copartner

d. admission of a new partner

e. agreement that the partnership should stand as a surety for a third party's obligation

4 Paul Partner (1) bought a computer and charged it to the partnership's account; (2) cashed a firm check and used the money to buy a computer in his own name; (3) brought from home a computer and used it at the office. In which scenario does the computer become partnership property?

a. 1 only

b. 1 and 2

c. 1, 2, and 3

5 That partnerships are entities under RUPA means they have to pay federal income tax in their own name.

a. true

b. false

6 That partnerships are entities under RUPA means the partners are not personally liable for the firm's debts beyond their capital contributions.

a. true

b. false

SELF-TEST ANSWERS

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

Chapter 13
Hybrid Business Forms

LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The limited partnership
2. The limited liability company
3. Other hybrid business forms: the sub-S corporation, limited liability partnerships, and limited liability limited partnerships

CC BY NC SA

This chapter provides a bridge between the partnership and the corporate form. It explores several types of associations that are hybrid forms—that is, they share some aspects of partnerships and some of corporations. Corporations afford the inestimable benefit of limited liability, partnerships the inestimable benefit of limited taxation. Businesspeople always seek to limit their risk and their taxation.

At base, whether to allow businesspeople and investors to grasp the holy grail of limited liability is a political issue. When we say a person is "irresponsible," it means he (or she, or it) does not take responsibility for his harmful actions; the loss is borne by others. Politically speaking, there is an incentive to allow businesspeople insulation from liability: it encourages them to take risks and invest, thus stimulating economic activity and forestalling unemployment. So the political trade-off with allowing various inventive forms of business organization is between providing business actors with the security that they will lose only their calculable investment, thus stimulating the economy, versus the "moral hazard" of allowing them to emerge mostly unscathed from their own harmful or foolish activities, thus externalizing resulting losses upon others. Some people feel that during the run-up to the "Great Recession" of 2007–09, the economic system allowed too much risk taking. When the risky investments collapsed, though, instead of forcing the risk takers to suffer loss, the government intervened—it "bailed them out," as they say, putting the consequences of the failed risks on the taxpayer.

The risk-averseness and inventiveness of businesspeople is seemingly unlimited, as is investors' urge to make profits through others' efforts with as little risk as possible. The rationale for the invention of these hybrid business forms, then, is (1) risk reduction and (2) tax reduction. Here we take up the most common hybrid types first: limited partnerships and limited liability companies. Then we cover them in the approximate chronological order of their invention: sub-S corporations, limited liability partnerships, and limited liability limited partnerships. All these forms are entities.

13.1 Limited Partnerships

LEARNING OBJECTIVES

Understand the following aspects of the limited partnership:

1. Governing law and definition
2. Creation and capitalization
3. Control and compensation
4. Liabilities
5. Taxation
6. Termination

Governing Law and Definition

The limited partnership is attractive because of its treatment of taxation and its imposition of limited liability on its limited partners.

Governing Law

The original source of limited partnership law is the Uniform Limited Partnership Act (ULPA), which was drafted in 1916. A revised version, the Revised Uniform Limited Partnership Act (RULPA), was adopted by the National Conference of Commissioners on Uniform Laws in 1976 and further amended in 1985 and in 2001.

The 2001 act was

> *drafted for a world in which limited liability partnerships and limited liability companies can meet many of the needs formerly met by limited partnerships. This Act therefore targets two types of enterprises that seem largely beyond the scope of LLPs and LLCs: (i) sophisticated, manager-entrenched commercial deals whose participants commit for the long term, and (ii) estate planning arrangements (family limited partnerships). The Act accordingly assumes that, more often than not, people utilizing it will want (1) strong centralized management, strongly*

CC BY NC SA

entrenched, and (2) passive investors with little control over or right to exit the entity. The Act's rules, and particularly its default rules, have been designed to reflect these assumptions.[1]

All states except Louisiana adopted the 1976 or 1985 act—most opting for the 1985 version—and sixteen states have adopted the 2001 version. The acts may be properly referred to with a hyphen: "ULPA-1985," or "ULPA-2001"; the word *revised* has been dropped. Here, we mainly discuss ULPA-1985. The Uniform Partnership Act (UPA) or the Revised Uniform Partnership Act (RUPA) also applies to limited partnerships except where it is inconsistent with the limited partnership statutes. The ULPA-2001 is not so much related to UPA or RUPA as previous versions were.

Definition

A **limited partnership** (LP) is defined as "a partnership formed by two or more persons under the laws of a State and having one or more general partners and one or more limited partners."[2] The form tends to be attractive in business situations that focus on a single or limited-term project, such as making a movie or developing real estate; it is also widely used by private equity firms.

Creation and Capitalization

Unlike a general partnership, a limited partnership is created in accordance with the state statute authorizing it. There are two categories of partners: limited and general. The limited partners capitalize the business and the general partners run it.

Creation

The act requires that the firm's promoters file a **certificate of limited partnership** with the secretary of state; if they do not, or if the certificate is substantially defective, a general partnership is created. The certificate must be signed by all general partners. It must include the name of the limited partnership (which must include the words *limited partnership* so the world knows there are owners of the firm who are not liable beyond their contribution) and the names and business addresses of the general partners. If there are any changes in the general partners, the certificate must be amended. The general partner may be, and often is, a corporation. Having a general partner be a corporation achieves the goal of limited

liability for everyone, but it is somewhat of a "clunky" arrangement. That problem is obviated in the limited liability company, discussed in Section 13.2 "Limited Liability Companies". Here is an example of a limited partnership operating agreement:http://www.wyopa.com/Articles%20of%20limited%20partnership.htm.

Any natural person, partnership, limited partnership (domestic or foreign), trust, estate, association, or corporation may become a partner of a limited partnership.

Capitalization

The money to capitalize the business typically comes mostly from the **limited partners**, who may themselves be partnerships or corporations. That is, the limited partners use the business as an investment device: they hope the managers of the firm (the general partners) will take their contributions and give them a positive return on it. The contributions may be money, services, or property, or promises to make such contributions in the future.

Control and Compensation

Control

Control is *not* generally shared by both classes of partners.

General Partners

The control of the limited partnership is in the hands of the general partners, which may—as noted—be partnerships or corporations.

Limited Partners

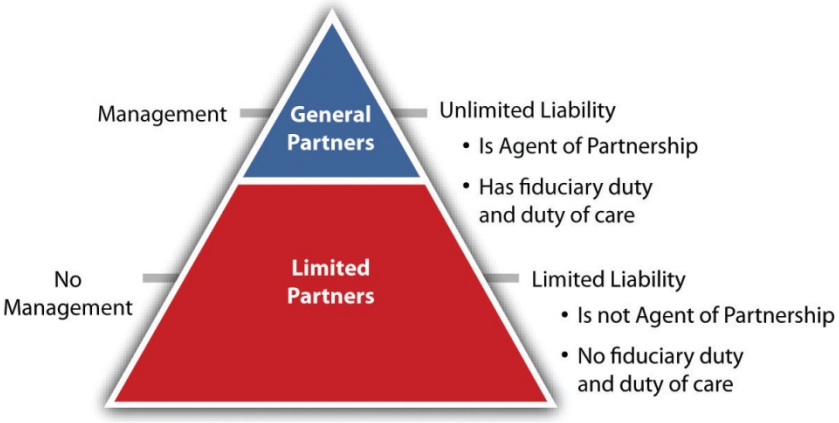
Under ULPA-1985 and its predecessors, a limited partner who exercised any significant control would incur liability like a general partner as to third parties who believed she was one (the "control rule"). However, among the things a limited partner could do that would *not* risk the loss of insulation from personal liability were these "safe harbors":

- Acting as an agent, employee, or contractor for the firm; or being an officer, director, or shareholder of a corporate general partner
- Consulting with the general partner of the firm
- Requesting or attending a meeting of partners
- Being a surety for the firm
- Voting on amendments to the agreement, on dissolution or winding up the partnership, on loans to the partnership, on a change in its nature of business, on removing or admitting a general or limited partner

However, see Section 13.3.3 "Limited Liability Limited Partnerships" for how this "control rule" has been abolished under ULPA-2001.

General partners owe fiduciary duties to other general partners, the firm, and the limited partners; limited partners who do not exercise control do not owe fiduciary duties. See Figure 13.1 "The Limited Partnership under ULPA-1985".

Figure 13.1 *The Limited Partnership under ULPA-1985*



The partnership agreement may specify which general or limited partners have the right to vote on any matter, but if the agreement grants limited partners voting rights beyond the "safe harbor," a court may abolish that partner's limited liability.

Assignment of Partnership Rights

Limited partnership interests may be assigned in whole or in part; if in whole, the assignor ceases to be a partner unless otherwise agreed. An assignment is usually made as security for a loan. The assignee becomes a new limited partner only if all the others consent or if provided for in the certificate; the assignment does not cause dissolution. The happy ease with which a limited partner can divest himself of the partnership interest makes the investment in the firm here more like that in a corporation than in a general partnership.

Inspection of Books

Limited partners have the right to inspect the firm's books and records, they may own competing interests, they may be creditors of the firm, and they may bring derivative suits on the firm's behalf. They may not withdraw their capital contribution if that would impair creditors' rights.

Addition of New Partners

Unless the partnership agreement provides otherwise (it usually does), the admission of additional limited partners requires the written consent of all. A general partner may withdraw at any time with written notice; if withdrawal is a violation of the agreement, the limited partnership has a right to claim of damages. A limited partner can withdraw any time after six months' notice to each general partner, and the withdrawing partner is entitled to any distribution as per the agreement or, if none, to the fair value of the interest based on the right to share in distributions.

Compensation

We noted in discussing partnerships that the partners are not entitled to "compensation," that is, payment for their work; they are entitled to a share of the profits. For limited partnerships, the rule is a bit different.

General Partners

Often, general partners are paid for their management work on a sliding scale, receiving a greater share of each dollar of cash flow as the limited partners' cash distributions rise, thus giving the general partner an incentive to increase limited-partner distributions.

Limited Partners

Profits or losses are shared as agreed in the certificate or, if there is no agreement, in accordance with the percentages of capital contributions made.

Liabilities

Liability is not shared.

General Partners

The general partners are liable as in a general partnership, and they have the same fiduciary duty and duty of care as partners in a general partnership. However, see the discussion in Section 13.3.3 "Limited Liability Limited Partnerships" of the newest type of LP, the limited liability limited partnership (triple LP), where the general partner is also afforded limited liability under ULPA-2001.

Limited Partners

The limited partners are only liable up to the amount of their capital contribution, provided the surname of the limited partner does not appear in the partnership name (unless his name is coincidentally the same as that of one of the general partners whose name does appear) and provided the limited partner does not participate in control of the firm. See Section 13.4.1 "Limited Partnerships: Limited Partners' Liability for Managing Limited Partnership" for a case that highlights liability issues for partners.

We have been discussing ULPA-1985 here. But in a world of limited liability companies, limited liability partnerships, and limited liability limited partnerships, "the control rule has become an anachronism"; ULPA-2001 "provides a full, status-based liability shield for each limited partner, 'even if the limited partner participates in the management and control of the limited partnership.' [3] The section thus eliminates the so-called control rule with respect to personal liability for entity obligations and brings

limited partners into parity with LLC members, LLP partners and corporate shareholders."[4] And as will be noted in Section 13.3.3 "Limited Liability Limited Partnerships" under ULPA-2001 the *general* partner is also shielded from liability.

Taxation

Assuming the limited partnership meets a minimum number of criteria related to limited liability, centralized management, duration, and transferability of ownership, it can enjoy the benefits of pass-through taxation; otherwise it will be taxed as a corporation. Pass-through ("conduit") taxation is usually very important to partners.

Termination

The limited partnership's termination involves the same three steps as in a general partnership: (1) dissolution, (2) winding up, and (3) termination.

Dissolution

Dissolution of a limited partnership is the first step toward termination (but termination does not necessarily follow dissolution). The limited partners have no power to dissolve the firm except on court order, and the death or bankruptcy of a limited partner does not dissolve the firm. The following events may cause dissolution: (1) termination of the partnership as per the certificate's provisions; (2) termination upon an event specified in the partnership agreement; (3) the unanimous written consent of the partners; (4) the withdrawal of a general partner, unless at least one remains and the agreement says one is enough, or if within ninety days all partners agree to continue; (5) an event that causes the business to be illegal; and (6) judicial decree of dissolution when it is not reasonable to carry on. If the agreement has no term, its dissolution is not triggered by some agreed-to event, and none of the other things listed cause dissolution.

Dissolution requires the filing of a certificate of cancellation with the state if winding up commences.

Winding Up

General partners who have not wrongfully dissolved the partnership may wind it up, and so may the limited partners if all the general partners have wrongfully dissolved the firm. Any partner or that person's legal representative can petition a court for winding up, with cause.

Upon winding up, the assets are distributed (1) to creditors, including creditor-partners, not including liabilities for distributions of profit; (2) to partners and ex-partners to pay off unpaid distributions; (3) to partners as return of capital contributions, unless otherwise agreed; and (4) to partners for partnership interests in proportion as they share in distributions, unless otherwise agreed. No distinction is made between general and limited partners—they share equally, unless otherwise agreed. When winding up is completed, the firm is terminated.

It is worth reiterating the part about "unless otherwise agreed": people who form any kind of a business organization—partnership, a hybrid form, or corporations—can to a large extent choose to structure their relationship as they see fit. Any aspect of the company's formation, operation, or ending that is not included in an agreement flops into the default provisions of the relevant law.

KEY TAKEAWAY

A limited partnership is a creature of statute: it requires filing a certificate with the state because it confers on some of its members the marvel of limited liability. It is an investment device composed of one or more general partners and one or more limited partners; limited partners may leave with six months' notice and are entitled to an appropriate payout. The general partner is liable as a partner is a general partnership; the limited partners' liability is limited to the loss of their investment, unless they exercise so much control of the firm as to become general partners. The general partner is paid, and the general and limited partners split profit as per the agreement or, if none, in the proportion as they made capital contributions. The firm is usually taxed like a general partnership: it is a conduit for the partners' income. The firm is dissolved upon the end of its term, upon an event specified in the agreement, or in several other circumstances, but it may have indefinite existence.

EXERCISES

1. Why does the fact that the limited liability company provides limited liability for some of its members mean that a state certificate must be filed?
2. What liability has the general partner? The limited partner?
3. How easy is it for the limited partner to dispose of (sell) her partnership interest?

---

[1] "Uniform Limited Partnership Act (2001), Prefatory Note," NCCUSL Archives,http://www.law.upenn.edu/bll/archives/ulc/ulpa/final2001.pdf.

[2] ULPA, Section 102(11).

[3] ULPA-2001, Section 303.

[4] Official Comment to Uniform Limited Partnership Act 2001, Section 303.

13.2 Limited Liability Companies

LEARNING OBJECTIVES

1. Understand the history and law governing limited liability companies (LLCs).
2. Identify the creation and capitalization of an LLC.
3. Understand control and compensation of a firm.
4. Recognize liabilities in the LLC form.
5. Explain the taxation of an LLC.
6. Identify how LLCs are terminated.

History and Law Governing Limited Liability Companies

History of the Limited Liability Company

The **limited liability company** (LLC) gained sweeping popularity in the late twentieth century because it combines the best aspects of partnership and the best aspects of corporations: it allows all its owners (members) insulation from personal liability and pass-through (conduit) taxation. The first efforts to form LLCs were thwarted by IRS rulings that the business form was too much like a corporation to escape corporate tax complications. Tinkering by promoters of the LLC concept and flexibility by the IRS solved those problems in interesting and creative ways.

Corporations have six characteristics: (1) associates, (2) an objective to carry on a business and divide the gains, (3) continuity of life, (4) centralized management, (5) limited liability, and (6) free transferability of interests. Partnerships also, necessarily, have the first two corporate characteristics; under IRS rulings, if the LLC is *not* to be considered a corporation for tax purposes, it must lack at least one-half of the remaining four characteristics of a corporation: the LLC, then, must lack two of these corporate characteristics (otherwise it will be considered a corporation): (1) limited liability, (2) centralized management, (3) continuity of life, or (4) free transferability of interests. But limited liability is essential and centralized management is necessary for passive investors who don't want to be involved in decision making, so pass-through taxation usually hinges on whether an LLC has continuity of life and free transferability of accounts. Thus it is extremely important that the LLC promoters avoid the corporate characteristics of continuity of life and free transferability of interests.

We will see how the LLC can finesse these issues.

Governing Law

All states have statutes allowing the creation of LLCs, and while a Uniform Limited Liability Company Act has been promulgated, only eight states have adopted it as of January 2011. That said, the LLC has become the entity of choice for many businesses.

Creation and Capitalization

Creation of the LLC

An LLC is created according to the statute of the state in which it is formed. It is required that the LLC members file a "certificate of organization" with the secretary of state, and the name must indicate that it

is a limited liability company. Partnerships and limited partnerships may convert to LLCs; the partners' previous liability under the other organizational forms is not affected, but going forward, limited liability is provided. The members' operating agreement spells out how the business will be run; it is subordinate to state and federal law. Unless otherwise agreed, the operating agreement can be amended only by unanimous vote. The LLC is an entity. Foreign LLCs must register with the secretary of state before doing business in a "foreign" state, or they cannot sue in state courts.

As compared with corporations, the LLC is not a good form if the owners expect to have multiple investors or to raise money from the public. The typical LLC has relatively few members (six or seven at most), all of whom usually are engaged in running the firm.

Most early LLC statutes, at least, prohibited their use by professionals. That is, practitioners who need professional licenses, such as certified public accountants, lawyers, doctors, architects, chiropractors, and the like, could not use this form because of concern about what would happen to the standards of practice if such people could avoid legitimate malpractice claims. For that reason, the limited liability partnership was invented.

Capitalization

Capitalization is like a partnership: members contribute capital to the firm according to their agreement. As in a partnership, the LLC property is not specific to any member, but each has a personal property interest in general. Contributions may be in the form of cash, property or services rendered, or a promise to render them in the future.

Control and Compensation

Control

The LLC operating agreement may provide for either a member-managed LLC or a manager-managed (centralized) LLC. If the former, all members have actual and apparent authority to bind the LLC to contracts on its behalf, as in a partnership, and all members' votes have equal weight unless otherwise agreed. Member-managers have duty of care and a fiduciary duty, though the parameters of those duties

vary from state to state. If the firm is manager managed, only managers have authority to bind the firm; the managers have the duty of care and fiduciary duty, but the nonmanager members usually do not. Some states' statutes provide that voting is based on the financial interests of the members. Most statutes provide that any extraordinary firm decisions be voted on by all members (e.g., amend the agreement, admit new members, sell all the assets prior to dissolution, merge with another entity). Members can make their own rules without the structural requirements (e.g., voting rights, notice, quorum, approval of major decisions) imposed under state corporate law.

If the firm has a centralized manager system, it gets a check in its "corporate-like" box, so it will need to make sure there are enough noncorporate-like attributes to make up for this one. If it looks too much like a corporation, it will be taxed like one.

One of the real benefits of the LLC as compared with the corporation is that no annual meetings are required, and no minutes need to be kept. Often, owners of small corporations ignore these formalities to their peril, but with the LLC there are no worries about such record keeping.

Compensation

Distributions are allocated among members of an LLC according to the operating agreement; managing partners may be paid for their services. Absent an agreement, distributions are allocated among members in proportion to the values of contributions made by them or required to be made by them. Upon a member's dissociation that does not cause dissolution, a dissociating member has the right to distribution as provided in the agreement, or—if no agreement—the right to receive the fair value of the member's interest within a reasonable time after dissociation. No distributions are allowed if making them would cause the LLC to become insolvent.

Liability

The great accomplishment of the LLC is, again, to achieve limited liability for all its members: no general partner hangs out with liability exposure.

Liability to Outsiders

Members are not liable to third parties for contracts made by the firm or for torts committed in the scope of business (but of course a person is always liable for her own torts), regardless of the owner's level of participation—unlike a limited partnership, where the general partner is liable. Third parties' only recourse is as against the firm's property. See *Puleo v. Topel*, (see Section 13.4.2 "Liability Issues in LLCs"), for an analysis of owner liability in an LLC.

Internal Liabilities

Unless the operating agreement provides otherwise, members and managers of the LLC are generally not liable to the firm or its members except for acts or omissions constituting gross negligence, intentional misconduct, or knowing violations of the law. Members and managers, though, must account to the firm for any personal profit or benefit derived from activities not consented to by a majority of disinterested members or managers from the conduct of the firm's business or member's or managers use of firm property—which is the same as in partnership law.

Taxation

Assuming the LLC is properly formed so that it is not too much like a corporation, it will—upon its members' election—be treated like a partnership for tax purposes.

Termination

Termination, loosely speaking, refers either to how the entity's life as a business ends (continuity of life) or to how a member's interest in the firm ends—that is, how freely the interest is transferable.

Continuity of Life

The first step in the termination of the LLC is dissolution, though dissolution is not necessarily followed by termination.

Dissolution and Winding Up

The IRS has determined that continuity of life does *not* exist "if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause a dissolution of the organization,"[1] and that if one of these events occurs, the entity may continue only with the members' unanimous consent. Dissolution may occur even if the business is continued by the remaining members.

The typical LLC statute provides that an LLC will dissolve upon (1) expiration of the LLC's term as per its agreement; (2) events specified in the agreement; (3) written consent of all members; (4) an "event of dissociation" of a member, unless within ninety days of the event all remaining members agree to continue, or the right to continue is stated in the LLC; (5) the entry of a judicial decree of dissolution; (6) a change in membership that results in there being fewer than two members; or (7) the expiration of two years after the effective date of administrative dissolution.

And an "event of dissociation" is typically defined as (1) a member's voluntary withdrawal, (2) her assignment of the entire LLC interest, (3) her expulsion, (4) her bankruptcy, (5) her becoming incompetent, (6) dissolution of an entity member (as an LLC, limited partnership, or corporation), or (7) any other event specified in the agreement.

Thus under most statutes' default position, if a member dies, becomes insane or bankrupt, retires, resigns, or is expelled, the LLC will dissolve *unless* within ninety days the rest of the members unanimously agree to continue. And by this means the firm does *not* have continuity of life. Some states provide opportunities for even more flexibility regarding the "unanimous" part. In the mid-1990s, the IRS issued revenue rulings (as opposed to regulations) that it would be enough if a "majority in interest" of remaining partners agreed to continue the business, and the "flexible" statute states adopted this possibility (the ones that did not are called "bulletproof" statutes). "Majority in interests" means a majority of profits and capital.

If the firm does dissolve, some states require public filings to that effect. If dissolution leads to winding up, things progress as in a general partnership: the business at hand is finished, accounts are rendered, bills paid, assets liquidated, and remaining assets are distributed to creditors (including member and

manager creditors, but not for their shares in profits); to members and past members for unpaid distributions; to members for capital contributions; and to members as agreed or in proportion to contributions made. Upon dissolution, actual authority of members or managers terminates except as needed to wind up; members may have apparent authority, though, unless the third party had notice of the dissolution.

Free Transferability of Interest

Again, the problem here is that if a member's interest in the LLC is as freely transferable as a shareholder's interest in a corporation (an owner can transfer all attributes of his interest without the others' consent), the LLC will probably be said to have a check mark in the "corporate-like" box: too many of those and the firm will not be allowed pass-through taxation. Thus the trick for the LLC promoters is to limit free transferability enough to pass the test of not being a corporation, but not limit so much as to make it really difficult to divest oneself of the interest (then it's not a very liquid or desirable investment).

Some states' LLC statutes have as the default rule that the remaining members must unanimously consent to allow an assignee or a transferee of a membership interest to participate in managing the LLC. Since this prevents a member from transferring *all* attributes of the interest (the right to participate in management isn't transferred or assigned), the LLC formed under the default provision will not have "free transferability of interest." But if the LLC agreement allows *majority* consent for the transfer of all attributes, that also would satisfy the requirement that there not be free transferability of interests. Then we get into the question of how to define "majority": by number of members or by value of their membership? And what if only the managing partners need to consent? Or if there are two classes of membership and the transfer of interests in one class requires the consent of the other? The point is that people keep pushing the boundaries to see how close their LLC can come to corporation-like status without being called a corporation.

Statutes for LLCs allow other business entities to convert to this form upon application.

KEY TAKEAWAY

The limited liability company has become the entity of choice for many businesspeople. It is created by state authority that, upon application, issues the "certificate of organization." It is controlled either by managers or by members, it affords its members limited liability, and it is taxed like a partnership. But these happy results are obtained only if the firm lacks enough corporate attributes to escape being labeled as a corporation. To avoid too much "corporateness," the firm's certificate usually limits its continuity of life and the free transferability of interest. The ongoing game is to finesse these limits: to make them as nonconstraining as possible, to get right up to the line to preserve continuity, and to make the interest as freely transferable as possible.

EXERCISES

1. What are the six attributes of a corporation? Which are automatically relevant to the LLC? Which two corporate attributes are usually dropped in an LLC?
2. Why does the LLC not want to be treated like a corporation?
3. Why does the name of the LLC have to include an indication that it is an LLC?
4. How did LLCs finesse the requirement that they not allow too-free transferability of the interest?

---

[1] Treasury Regulation, § 301.7701-2(b)(1).

13.3 Other Forms

LEARNING OBJECTIVE

1. Recognize other business forms: sub-S corporations, limited liability partnerships, and limited liability limited partnerships.

Sub-S Corporation

History

The sub-S corporation or the **S corporation** gets its name from the IRS Code, Chapter 1, Subchapter S. It was authorized by Congress in 1958 to help small corporations and to stem the economic and cultural influence of the relatively few, but increasingly powerful, huge multinational corporations. According to the website of an S corporation champion, "a half century later, S corporations are the most popular corporate structure in America. The IRS estimates that there were 4.5 million S corporation owners in the United States in 2007—about twice the number of C [standard] corporations." [1]

Creation and Capitalization

The S corporation is a regular corporation created upon application to the appropriate secretary of state's office and operated according to its bylaws and shareholders' agreements. There are, however, some limits on how the business is set up, among them the following:

- It must be incorporated in the United States.
- It cannot have more than one hundred shareholders (a married couple counts as one shareholder).
- The only shareholders are individuals, estates, certain exempt organizations, or certain trusts.
- Only US citizens and resident aliens may be shareholders.
- The corporation has only one class of stock.
- With some exceptions, it cannot be a bank, thrift institution, or insurance company.

- All shareholders must consent to the S corporation election.
- It is capitalized as is a regular corporation.

Liability

The owners of the S corporation have limited liability.

Taxation

Taxation is the crux of the matter. The S corporation pays no corporate income tax (unless it has a lot of passive income). The S corporation's shareholders include on their personal income statements, and pay tax on, their share of the corporation's separately stated items of income, deduction, and loss. That is, the S corporation avoids the dreaded double taxation of corporate income.

Transferability of Ownership

S corporations' shares can be bought or sold via share purchase agreements, and all changes in the ownership are reflected in the share ledger in the corporate minute book.

Limited Liability Partnerships

Background

In 1991, Texas enacted the first **limited liability partnership** (LLP) statute, largely in response to the liability that had been imposed on partners in partnerships sued by government agencies in relation to massive savings and loan failures in the 1980s.[2] (Here we see an example of the legislature allowing business owners to externalize the risks of business operation.) More broadly, the success of the limited liability company attracted the attention of professionals like accountants, lawyers, and doctors who sought insulation from personal liability for the mistakes or malpractice of their partners. Their wish was granted with the adoption in all states of statutes authorizing the creation of the limited liability partnership in the early 1990s. Most partnership law under the Revised Uniform Partnership Act applies to LLPs.

Creation

Members of a partnership (only a majority is required) who want to form an LLP must file with the secretary of state; the name of the firm must include "limited liability partnership" or "LLP" to notify the public that its members will not stand personally for the firm's liabilities.

Liability

As noted, the purpose of the LLP form of business is to afford insulation from liability for its members. A typical statute provides as follows: "Any obligation of a partnership incurred while the partnership is a limited liability partnership, whether arising in contract, tort or otherwise, is solely the obligation of the partnership. A partner is not personally liable, directly or indirectly, by way of indemnification, contribution, assessment or otherwise, for such an obligation solely by reason of being or so acting as a partner." [3]

However, the statutes vary. The early ones only allowed limited liability for negligent acts and retained unlimited liability for other acts, such as malpractice, misconduct, or wrongful acts by partners, employees, or agents. The second wave eliminated all these as grounds for unlimited liability, leaving only breaches of ordinary contract obligation. These two types of legislation are called *partial shield* statutes. The third wave of LLP legislation offered *full shield* protection—no unlimited liability at all. Needless to say, the full-shield type has been most popular and most widely adopted. Still, however, many statutes require specified amounts of professional malpractice insurance, and partners remain fully liable for their own negligence or for wrongful acts of those in the LLP whom they supervise.

In other respects, the LLP is like a partnership.

Limited Liability Limited Partnerships

The progress toward achieving limited liability continues. A

limited liability limited partnership (LLLP, or triple LP) is the latest invention. It is a limited partnership that has invoked the LLLP provisions of its state partnership law by filing with a specified public official the appropriate documentation to become an LLLP. This form completely eliminates the

automatic personal liability of the general partner for partnership obligations and, under most statutes, also eliminates the "control rule" liability exposure for all limited partners. It is noteworthy that California law does not allow for an LLLP to be formed in California; however, it does recognize LLLPs formed in other states. A "foreign" LLLP doing business in California must register with the secretary of state. As of February 2011, twenty-one states allow the formation of LLLPs.

The 2001 revision of the Uniform Limited Partnership Act (ULPA) provides this definition of an LLLP: "'Limited liability limited partnership'...means a limited partnership whose certificate of limited partnership states that the limited partnership is a limited liability limited partnership." [4] Section 404(c) gets to the point: "An obligation of a limited partnership incurred while the limited partnership is a limited liability limited partnership, whether arising in contract, tort, or otherwise, is solely the obligation of the limited partnership. A general partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for such an obligation solely by reason of being or acting as a general partner. This subsection applies despite anything inconsistent in the partnership agreement that existed immediately before the consent required to become a limited liability limited partnership[.]" [5]

In the discussion of limited partnerships, we noted that ULPA-2001 eliminates the "control rule" so that limited partners who exercise day-to-day control are *not* thereby liable as general partners. Now, in the section quoted in the previous paragraph, the *general partner's* liability for partnership obligations is vaporized too. (Of course, the general partner is liable for its, his, or her own torts.) The preface to ULPA-2001 explains, "In a limited liability limited partnership ('LLLP'), no partner—whether general or limited—is liable on account of partner status for the limited partnership's obligations. Both general and limited partners benefit from a full, status-based liability shield that is equivalent to the shield enjoyed by corporate shareholders, LLC members, and partners in an LLP."

Presumably, most existing limited partnerships will switch over to LLLPs. The ULPA-2001 provides that "the Act makes LLLP status available through a simple statement in the certificate of limited partnership."

Ethical Concerns

There was a reason that partnership law imposed personal liability on the partners: people tend to be more careful when they are personally liable for their own mistakes and bad judgment. Many government programs reflect peoples' interest in adverting risk: federal deposit insurance, Social Security, and bankruptcy, to name three. And of course corporate limited liability has existed for two hundred years.[6] Whether the movement to allow almost anybody the right to a business organization that affords limited liability will encourage entrepreneurship and business activity or whether it will usher in a new era of **moral hazard**—people being allowed to escape the consequences of their own irresponsibility—is yet to be seen.

KEY TAKEAWAY

Businesspeople always prefer to reduce their risks. The partnership form imposes serious potential risk: unlimited personal liability. The corporate form eliminates that risk but imposes some onerous formalities and double taxation. Early on, then, the limited partnership form was born, but it still imposed unlimited liability on the general partner and on the limited partner if she became too actively involved. Congress was induced in the mid-1950s to allow certain small US corporations the right to single taxation, but the sub-S corporation still suffered from various limitations on its structure. In the 1980s, the limited liability company was invented; it has become the entity of choice for many businesspeople, but its availability for professionals was limited. In the late 1980s, the limited liability partnership form gained favor, and in the early 2000s, the limited liability limited partnership finished off unlimited liability for limited partnerships.

EXERCISES

1. The principal disadvantage of the general partnership is that it imposes unlimited personal liability on the partners. What is the disadvantage of the corporate form?
2. Why isn't the limited partnership an entirely satisfactory solution to the liability problem of the partnership?
3. Explain the issue of "moral hazard" and the business organization form.

[1] "The History and Challenges of America's Dominant Business Structure," *S Corp: Defending America's Small and Family-Owned Businesses*, http://www.s-corp.org/our-history.

[2] Christine M. Przybysz, "Shielded Beyond State Limits: Examining Conflict-Of-Law Issues In Limited Liability Partnerships," *Case Western Reserve Law Review* 54, no. 2 (2003): 605.

[3] Revised Code of Washington (RCW), Section 25.05.130.

[4] "Uniform Limited Partnership Act (2001)," NCCUSL Archives,http://www.law.upenn.edu/bll/archives/ulc/ulpa/final2001.htm; ULPA Section, 102(9).

[5] ULPA Section, 404(c).

[6] See, for example, David A. Moss, "Risk, Responsibility, and the Role of Government," *Drake Law Review* 56, no. 2 (2008): 541.

13.4 Cases

Limited Partnerships: Limited Partners' Liability for Managing Limited Partnership

Frigidaire Sales Corp. v. Union Properties, Inc.

562 P.2d 244 (Wash. 1977)

Plaintiff [Frigidaire] entered into a contract with Commercial Investors (Commercial), a limited partnership. Defendants, Leonard Mannon and Raleigh Baxter, were limited partners of Commercial. Defendants were also officers, directors, and shareholders of Union Properties, Inc., the only general partner of Commercial. Defendants controlled Union Properties, and through their control of Union

Properties they exercised the day-to-day control and management of Commercial. Commercial breached the contract, and Plaintiff brought suit against Union Properties and Defendants. The trial court concluded that Defendants did not incur general liability for Commercial's obligations by reason of their control of Commercial, and the Court of Appeals affirmed.

[Plaintiff] does not contend that Defendants acted improperly by setting up the limited partnership with a corporation as the sole general partner. Limited partnerships are a statutory form of business organization, and parties creating a limited partnership must follow the statutory requirements. In Washington, parties may form a limited partnership with a corporation as the sole general partner. [Citations]

Plaintiff's sole contention is that Defendants should incur general liability for the limited partnership's obligations under RCW 25.08.070, because they exercised the day-to-day control and management of Commercial. Defendants, on the other hand, argue that Commercial was controlled by Union Properties, a separate legal entity, and not by Defendants in their individual capacities. [RCW 25.08.070 then read: "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as limited partner, he takes part in the control of the business."]

...The pattern of operation of Union Properties was to investigate and conceive of real estate investment opportunities and, when it found such opportunities, to cause the creation of limited partnerships with Union Properties acting as the general partner. Commercial was only one of several limited partnerships so conceived and created. Defendants did not form Union Properties for the sole purpose of operating Commercial. Hence, their acts on behalf of Union Properties were not performed merely for the benefit of Commercial....

[P]etitioner was never led to believe that Defendants were acting in any capacity other than in their corporate capacities. The parties stipulated at the trial that Defendants never acted in any direct, personal capacity. When the shareholders of a corporation, who are also the corporation's officers and directors, conscientiously keep the affairs of the corporation separate from their personal affairs, and no fraud or

manifest injustice is perpetrated upon third persons who deal with the corporation, the corporation's separate entity should be respected. [Citations]

For us to find that Defendants incurred general liability for the limited partnership's obligations under RCW 25.08.070 would require us to apply a literal interpretation of the statute and totally ignore the corporate entity of Union Properties, when Plaintiff knew it was dealing with that corporate entity. There can be no doubt that Defendants, in fact, controlled the corporation. However, they did so only in their capacities as agents for their principal, the corporate general partner. Although the corporation was a separate entity, it could act only through its board of directors, officers, and agents. [Citations] Plaintiff entered into the contract with Commercial. Defendants signed the contract in their capacities as president and secretary-treasurer of Union Properties, the general partner of Commercial. In the eyes of the law it was Union Properties, as a separate corporate entity, which entered into the contract with Plaintiff and controlled the limited partnership.

Further, because Defendants scrupulously separated their actions on behalf of the corporation from their personal actions, Plaintiff never mistakenly assumed that Defendants were general partners with general liability. [Citations] Plaintiff knew Union Properties was the sole general partner and did not rely on Defendants' control by assuming that they were also general partners. If Plaintiff had not wished to rely on the solvency of Union Properties as the only general partner, it could have insisted that Defendants personally guarantee contractual performance. Because Plaintiff entered into the contract knowing that Union Properties was the only party with general liability, and because in the eyes of the law it was Union Properties, a separate entity, which controlled the limited partnership, there is no reason for us to find that Defendants incurred general liability for their acts done as officers of the corporate general partner.

The decision of the Court of Appeals is affirmed.

CASE QUESTIONS

1. Frigidaire entered into a contract with Commercial Investors, a limited partnership. The general partner in the limited partnership was Union Properties, Inc., a corporation. Who were the limited partners in the limited partnership? Who were the controlling principals of the corporate general partner?
2. Why is it common for the general partner in a limited partnership to be a corporation?
3. Why does the court reiterate that the plaintiff knew it was dealing with a limited partnership that had a corporate general partner?
4. What could the plaintiff have done in this case to protect itself?
5. The court ruled in favor of the defendants, but is this setup kind of a scam? What is the "moral hazard" problem lurking in this case?

Liability Issues in LLCs

Puleo v. Topel

856 N.E.2d 1152 (Ill. App. 2006)

Plaintiffs Philip Puleo [and others]...appeal the order of the circuit court dismissing their claims against defendant Michael Topel.

The record shows that effective May 30, 2002, Thinktank, a limited liability company (LLC) primarily involved in web design and web marketing, was involuntarily dissolved by the Illinois Secretary of State...due to Thinktank's failure to file its 2001 annual report as required by the Illinois Limited Liability Company Act (the Act) [Citation].

[In December 2002], plaintiffs, independent contractors hired by Topel, filed a complaint against Topel and Thinktank in which they alleged breach of contract, unjust enrichment, and claims under the account stated theory. Those claims stemmed from plaintiffs' contention that Topel, who plaintiffs alleged was the sole manager and owner of Thinktank, knew or should have known of Thinktank's involuntary

dissolution, but nonetheless continued to conduct business as Thinktank from May 30, 2002, through the end of August 2002. They further contended that on or about August 30, 2002, Topel informed Thinktank employees and independent contractors, including plaintiffs, that the company was ceasing operations and that their services were no longer needed. Thinktank then failed to pay plaintiffs for work they had performed....

On September 2, 2003, the circuit granted plaintiffs' motion for judgment on the pleadings against Thinktank. Thereafter, on October 16, 2003, plaintiffs filed a separate motion for summary judgment against Topel [personally]. Relying on [Citation], plaintiffs contended that Topel, as a principal of Thinktank, an LLC, had a legal status similar to a shareholder or director of a corporation, who courts have found liable for a dissolved corporation's debts. Thus, plaintiffs argued that Topel was personally liable for Thinktank's debts....

...The circuit court denied plaintiffs' motion for summary judgment against Topel....In doing so, the circuit court acknowledged that Topel continued to do business as Thinktank after its dissolution and that the contractual obligations at issue were incurred after the dissolution.

However...the court entered a final order dismissing all of plaintiffs' claims against Topel with prejudice....The court stated in pertinent part:

> *Based upon the Court's...finding that the Illinois Legislature did not intend to hold a member of a Limited Liability Company liable for debts incurred after the Limited Liability Company had been involuntarily dissolved, the Court finds that all of Plaintiffs' claims against Defendant Topel within the Complaint fail as a matter of law, as they are premised upon Defendant Topel's alleged personal liability for obligations incurred in the name of Thinktank LLC after it had been involuntarily dissolved by the Illinois Secretary of State.*

Plaintiffs now appeal that order...[contending] that...the circuit court erred in dismissing their claims against Topel. In making that argument, plaintiffs acknowledge that the issue as to whether a member or manager of an LLC may be held personally liable for obligations incurred by an involuntarily dissolved

LLC appears to be one of first impression under the Act. That said, plaintiffs assert that it has long been the law in Illinois that an officer or director of a dissolved corporation has no authority to exercise corporate powers and thus is personally liable for any debts he incurs on behalf of the corporation after its dissolution. [Citations] Plaintiffs reason that Topel, as managing member of Thinktank, similarly should be held liable for debts the company incurred after its dissolution.

We first look to the provisions of the Act as they provided the trial court its basis for its ruling....

> *(a) Except as otherwise provided in subsection (d) of this Section, the debts, obligations, and liabilities of a limited liability company, whether arising in contract, tort, or otherwise, are solely the debts, obligations, and liabilities of the company. A member or manager is not personally liable for a debt, obligation, or liability of the company solely by reason of being or acting as a member or manager....*
>
> *(c) The failure of a limited liability company to observe the usual company formalities or requirements relating to the exercise of its company powers or management of its business is not a ground for imposing personal liability on the members or managers for liabilities of the company.*
>
> *(d) All or specified members of a limited liability company are liable in their capacity as members for all or specified debts, obligations, or liabilities of the company if:*
> *(1) a provision to that effect is contained in the articles of organization; and*
> *(2) a member so liable has consented in writing to the adoption of the provision or to be bound by the provision.*
>
> *[Another relevant section provides]:*
>
> *(a) A limited liability company is bound by a member or manager's act after dissolution that:*
> *(1) is appropriate for winding up the company's business; or*

CC BY NC SA

(2) would have bound the company before dissolution, if the other party to the transaction did not have notice of the dissolution.

(b) A member or manager who, with knowledge of the dissolution, subjects a limited liability company to liability by an act that is not appropriate for winding up the company's business is liable to the company for any damage caused to the company arising from the liability.

[The statute] clearly indicates that a member or manager of an LLC is not personally liable for debts the company incurs unless each of the provisions in subsection (d) is met. In this case, plaintiffs cannot establish either of the provisions in subsection (d). They have not provided this court with Thinktank's articles of organization, much less a provision establishing Topel's personal liability, nor have they provided this court with Topel's written adoption of such a provision. As such, under the express language of the Act, plaintiffs cannot establish Topel's personal liability for debts that Thinktank incurred after its dissolution....

In 1998...the legislature amended [the LLC statute]...and in doing so removed...language which explicitly provided that a member or manager of an LLC could be held personally liable for his or her own actions or for the actions of the LLC to the same extent as a shareholder or director of a corporation could be held personally liable [which would include post-dissolution acts undertaken without authority]. As we have not found any legislative commentary regarding that amendment, we presume that by removing the noted statutory language, the legislature meant to shield a member or manager of an LLC from personal liability. [Citation] "When a statute is amended, it is presumed that the legislature intended to change the law as it formerly existed."

Nonetheless, plaintiffs ask this court to disregard the 1998 amendment and to imply a provision into the Act similar to...the Business Corporation Act. We cannot do so....When the legislature amended section [the relevant section] it clearly removed the provision that allowed a member or manager of an LLC to be held personally liable in the same manner as provided in section 3.20 of the Business Corporation Act. Thus, the Act does not provide for a member or manager's personal liability to a third party for an LLC's

debts and liabilities, and no rule of construction authorizes this court to declare that the legislature did not mean what the plain language of the statute imports.

We, therefore, find that the circuit court did not err in concluding that the Act did not permit it to find Topel personally liable to plaintiffs for Thinktank's debts and liabilities. We agree with plaintiff that the circuit court's ruling does not provide an equitable result. However, the circuit court, like this court, was bound by the statutory language.

Accordingly, we affirm the judgment of the circuit court of Cook County.

CASE QUESTIONS

1. Is it possible the defendant did not know his LLC had been involuntarily dissolved because it failed to file its required annual report? Should he have known it was dissolved?
2. If Topel's business had been a corporation, he would not have had insulation from liability for postdissolution contracts—he would have been liable. Is the result here equitable? Is it fraud?
3. Seven months after the LLC's existence was terminated by the state, the defendant hired a number of employees, did not pay them, and then avoided liability under the LLC shield. How else could the court have ruled here? It is possible that the legislature's intent was simply to eliminate compulsory piercing (see Chapter 14 "Corporation: General Characteristics and Formation" under corporate law principles and leave the question of LLC piercing to the courts. If so was the court's decision was correct? The current LLC act language is similar to the Model Business Corporation Act, which surely permits piercing (see Chapter 14 "Corporation: General Characteristics and Formation").

Defective Registration as a Limited Liability Partnership

Campbell v. Lichtenfels

2007 WL 447919 (Conn. Super. 2007)

This case concerns the aftermath of the dissolution of the parties' law practice. Following a hearing on January 2 and 3, 2007, this court issued a memorandum of decision on January 5, 2007 granting the plaintiff a prejudgment remedy in the amount of $15,782.01. The plaintiff has now moved for reargument, contending that the court improperly considered as a setoff one-half of a malpractice settlement paid personally by the defendant, which sum the court found to be a debt of a partnership. [The defendant was sued for malpractice by a third party; he paid the entire claim personally and when the law firm dissolved, the plaintiff's share from the liquidated assets was reduced by one-half to account for the amount the defendant had paid.]

In support of his motion to reargue, the plaintiff relies on General Statutes Sec. 34-427(c) and, in that motion, italicizes those portions which he believes apply to his request for reargument. That section states (with emphasis as supplied in the plaintiff's motion) that:

> *a partner in a registered limited liability partnership is not liable directly or indirectly, including by way of indemnification, contribution or otherwise, for any debts, obligations and liabilities of or chargeable to the partnership or another partner or partners, whether arising in contract, tort, or otherwise, arising in the course of the partnership business while the partnership is a registered limited liability partnership. (emphasis in original)*

While italicizing the phases that appear to suit his purposes, the plaintiff completely ignores the most important phrase: "a partner in a registered limited liability partnership." At the hearing, neither party presented any evidence at the hearing that tended to prove that the nature of the business relationship between the parties was that of a "registered limited liability partnership." To the contrary, the testimony presented at the hearing revealed that the parties had a general partnership in which they had orally agreed to share profits and losses equally and that they never signed a partnership agreement. There was certainly no testimony or tangible evidence to the effect that the partnership had filed "a certificate of limited liability partnership with the Secretary of the State, stating the name of the partnership, which shall conform to the requirements of [the statute]; the address of its principal office;...a brief statement of the business in which the partnership engages; any other matters the partnership may determine to

include; and that the partnership therefore applies for status as a registered limited liability partnership." [Citation]

It is true that certain of the exhibits, such as copies of checks and letters written on the law firm letterhead, refer to the firm as "Campbell and Lichtenfels, LLP." These exhibits, however, were not offered for the purpose of establishing the partnership's character, and merely putting the initials "LLP" on checks and letterhead is not, in and of itself, proof of having met the statutory requirements for registration as a limited liability partnership. The key to establishing entitlement to the protections offered by [the limited liability partnership statute] is proof that the partnership has filed "a certificate of limited liability partnership with the Secretary of the State," and the plaintiff presented no such evidence to the court.

Because the evidence presented at the hearing does not support a claim that the nature of the relationship between the parties to this case was that of partners in a registered limited liability partnership, the provisions of [the limited liability partnership statute] do not apply. Rather, this partnership is governed by the provisions of [the Uniform Partnership Act] which states: "Except as otherwise provided...all partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed by the claimant or provided by law." Because there has been no evidence that this partnership falls within [any exceptions] the court finds Campbell and Lichtenfels to have been a general partnership in which the plaintiff shares the liability for the malpractice claim, even if he was not the partner responsible for the alleged negligence that led to that claim.

The plaintiff correctly points out that reargument is appropriate when the court has "overlooked" a "...principle of law which would have a controlling effect..." on the outcome of the case at hand. [Citation] The principle of law now raised by the plaintiff was "overlooked" by the court at the time of the hearing for two good reasons. First, it was not brought to the court's attention at the time of the hearing. Second, and more importantly, the plaintiff presented no evidence that would have supported the claim that the principle of law in question, namely the provisions of [the limited liability partnership] was applicable to the facts of this case. Because the provisions of [that statute] are inapplicable, they are quite obviously not "controlling." The principle of law which does control this issue is found in [general partnership law] and

that principle makes the plaintiff liable for his share of the malpractice settlement, as the court has previously found. The motion for reargument is therefore denied.

CASE QUESTIONS

1. If the parties had been operating as a limited liability partnership, how would that have changed the result?
2. Why did the court find that there was no limited liability partnership?
3. How does general partnership law treat a debt by one partner incurred in the course of partnership business?
4. Here, as in the case in Section 13.4.2 "Liability Issues in LLCs", there really is no inequitable result. Why is this true?

13.5 Summary and Exercises

Summary

Between partnerships and corporations lie a variety of hybrid business forms: limited partnerships, sub-S corporations, limited liability companies, limited liability partnerships, and limited liability limited partnerships. These business forms were invented to achieve, as much as possible, the corporate benefits of limited liability, centralized control, and easy transfer of ownership interest with the tax treatment of a partnership.

Limited partnerships were recognized in the early twentieth century and today are governed mostly by the Uniform Limited Partnership Act (ULPA-1985 or ULPA-2001). These entities, not subject to double taxation, are composed of one or more general partners and one or more limited partners. The general partner controls the firm and is liable like a partner in a general partnership (except under ULPA-2001 liability is limited); the limited partners are investors and have little say in the daily operations of the firm. If they get too involved, they lose their status as limited partners (except this is not so under ULPA-

2001). The general partner, though, can be a corporation, which finesses the liability problem. A limited partnership comes into existence only when a certificate of limited partnership is filed with the state.

In the mid-twentieth century, Congress was importuned to allow small corporations the benefit of pass-through taxation. It created the sub-S corporation (referring to a section of the IRS code). It affords the benefits of taxation like a partnership and limited liability for its members, but there are several inconvenient limitations on how sub-S corporations can be set up and operate.

The 1990s saw the limited liability company become the entity of choice for many businesspeople. It deftly combines limited liability for all owners—managers and nonmanagers—with pass-through taxation and has none of the restrictions perceived to hobble the sub-S corporate form. Careful crafting of the firm's bylaws and operating certificate allow it to combine the best of all possible business forms. There remained, though, one fly in the ointment: most states did not allow professionals to form limited liability companies (LLCs).

This last barrier was hurtled with the development of the limited liability partnership. This form, though mostly governed by partnership law, eschews the vicarious liability of nonacting partners for another's torts, malpractice, or partnership breaches of contract. The extent to which such exoneration from liability presents a moral hazard—allowing bad actors to escape their just liability—is a matter of concern.

Having polished off liability for all owners with the LLC and the LLP, the next logical step occurred when eyes returned to the venerable limited partnership. The invention of the limited liability limited partnership in ULPA-2001 not only abolished the "control test" that made limited partners liable if they got too involved in the firm's operations but also eliminated the general partner's liability.

Table 13.1 Comparison of Business Organization Forms

Type of Business Form	Formation and Ownership Rules	Funding	Management	Liability	Taxes	Dissolution
Limited partnership	Formal filing of articles of partnership; unlimited number of general and limited partners	General and limited partners contribute capital	General partner	General partner personally liable; limited partners to extent of contribution[1]	Flow-through as in partnership	Death or termination of general partner, unless otherwise agreed
S corporation	Formal filing of articles of incorporation; up to 100 shareholders allowed but only one class of stock	Equity (sell stock) or debt funding (issue bonds); members share profits and losses	Board of directors, officers	Owners not personally liable absent piercing corporate veil (see Chapter 14 "Corporation: General Characteristics and Formation")	Flow-through as in partnership	Only if limited duration or shareholders vote to dissolve
Limited liability company	Formal filing of articles of organization; unlimited "members"	Members make capital contributions, share profits and losses	Member managed or manager managed	Limited liability	Flow-through as in partnership.	Upon death or bankruptcy, unless otherwise agreed
Limited liability partnership (LLP)	Formal filing of articles of LLP	Members make capital contributions, share profits and losses	All partners or delegated to managing partner	Varies, but liability is generally on partnership; nonacting partners have limited liability	Flow-through as in partnership	Upon death or bankruptcy, unless otherwise agreed
Limited liability limited partnership (LLLP)	Formal filing of articles of LLP; choosing LLLP form	Same as above	Same as above	Liability on general partner abolished: all members have limited liability	Flow-through as in partnership	Same as above

EXERCISES

1. Yolanda and Zachary decided to restructure their small bookstore as a limited partnership, called "Y to Z's Books, LP." Under their new arrangement, Yolanda contributed a new infusion of $300; she was named the general partner. Zachary contributed $300 also, and he was named the limited partner: Yolanda was to manage the store on Monday, Wednesday, and Friday, and Zachary to manage it on Tuesday, Thursday,

and Saturday. Y to Z Books, LP failed to pay $800 owing to Vendor. Moreover, within a few weeks, Y to Z's Books became insolvent. Who is liable for the damages to Vendor?

2. What result would be obtained in Exercise 1 if Yolanda and Zachary had formed a limited liability company?
3. Suppose Yolanda and Zachary had formed a limited liability partnership. What result would be obtained then?
4. Jacobsen and Kelly agreed to form an LLC. They filled out the appropriate paperwork and mailed it with their check to the secretary of state's office. However, they made a mistake: instead of sending it to "Boston, MA"—Boston, Massachusetts—they sent it to "Boston, WA"—Boston, Washington. There is a town in Washington State called "Little Boston" that is part of an isolated Indian reservation. The paperwork got to Little Boston but then was much delayed. After two weeks, Jacobsen and Kelly figured the secretary of state in Boston, MA, was simply slow to respond. They began to use their checks, business cards, and invoices labeled "Jacobsen and Kelly, LLC." They made a contract to construct a wind turbine for Pablo; Kelly did the work but used guy wires that were too small to support the turbine. During a modest wind a week after the turbine's erection, it crashed into Pablo's house. The total damages exceeded $35,000. Pablo discovered Jacobsen and Kelly's LLC was defectively created and sought judgment against them personally. May Pablo proceed against them both personally?
5. Holden was the manager of and a member of Frost LLLP, an investment firm. In that capacity, he embezzled $30,000 from one of the firm's clients, Backus. Backus sued the firm and Holden personally, but the latter claimed he was shielded from liability by the firm. Is Holden correct?
6. Bellamy, Carlisle, and Davidson formed a limited partnership. Bellamy and Carlisle were the general partners and Davidson the limited partner. They contributed capital in the amounts of $100,000, $100,000, and $200,000, respectively, but then could not agree on a profit-sharing formula. At the end of the first year, how should they divide their profits?

SELF-TEST QUESTIONS

1 Peron and Quinn formed P and Q Limited Partnership. Peron made a capital contribution of $20,000 and became a general partner. Quinn made a capital contribution of $10,000 and became a limited

partner. At the end of the first year of operation, a third party sued the partnership and both partners in a tort action. What is the potential liability of Peron and Quinn, respectively?

a. $20,000 and $10,000
b. $20,000 and $0
c. unlimited and $0
d. unlimited and $10,000
e. unlimited and unlimited

2 A limited partnership

a. comes into existence when a certificate of partnership is filed
b. always provides limited liability to an investor
c. gives limited partners a say in the daily operation of the firm
d. is not likely to be the business form of choice if a limited liability limited partnership option is available
e. two of these (specify)

3 Puentes is a limited partner of ABC, LP. He paid $30,000 for his interest and he also loaned the firm $20,000. The firm failed. Upon dissolution and liquidation,

a. Puentes will get his loan repaid pro rata along with other creditors.
b. Puentes will get repaid, along with other limited partners, in respect to his capital and loan after all other creditors have been paid.
c. if any assets remain, the last to be distributed will be the general partners' profits.
d. if Puentes holds partnership property as collateral, he can resort to it to satisfy his claim if partnership assets are insufficient to meet creditors' claims.

4 Reference to "moral hazard" in conjunction with hybrid business forms gets to what concern?

a. that general partners in a limited partnership will run the firm for their benefit, not the limited partners' benefit
b. that the members of a limited liability company or limited liability partnership will engage in activities that expose themselves to potential liability

c. that the trend toward limited liability gives bad actors little incentive to behave ethically because the losses caused by their behavior are mostly not borne by them

d. that too few modern professional partnerships will see any need for malpractice insurance

5 One of the advantages to the LLC form over the sub-S form is

a. in the sub-S form, corporate profits are effectively taxed twice.

b. the sub-S form does not provide "full-shield" insulation of liability for its members.

c. the LLC cannot have a "manager-manager" form of control, whereas that is common for sub-S corporations.

d. the LLC form requires fewer formalities in its operation (minutes, annual meetings, etc.).

SELF-TEST ANSWERS

1. d
2. e (that is, a and d)
3. d (Choice a is wrong because as a secured creditor Puentes can realize on the collateral without regard to other creditors' payment.)
4. c
5. d

---

[1] Under ULPA-2001, the general partner has limited liability.

CC BY NC SA

Chapter 14
Corporation: General Characteristics and Formation

LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The historical background of the corporation
2. How partnerships compare with corporations
3. What the corporation is as a legal entity, and how corporate owners can lose limited liability by certain actions
4. How corporations are classified

The corporation is the dominant form of the business enterprise in the modern world. As a legal entity, it is bound by much of the law discussed in the preceding chapters. However, as a significant

CC BY NC SA

institutional actor in the business world, the corporation has a host of relationships that have called forth a separate body of law.

14.1 Historical Background

LEARNING OBJECTIVES

1. Comprehend the historical significance of corporate formation.
2. Learn about key court decisions and their effect on interstate commerce and corporate formation.
3. Become acquainted with how states formed their corporate laws.

A Fixture of Every Major Legal System

Like partnership, the corporation is an ancient concept, recognized in the Code of Hammurabi, and to some degree a fixture in every other major legal system since then. The first corporations were not business enterprises; instead, they were associations for religious and governmental ends in which perpetual existence was a practical requirement. Thus until relatively late in legal history, kings, popes, and jurists assumed that corporations could be created only by political or ecclesiastical authority and that corporations were creatures of the state or church. By the seventeenth century, with feudalism on the wane and business enterprise becoming a growing force, kings extracted higher taxes and intervened more directly in the affairs of businesses by refusing to permit them to operate in corporate form except by royal grant. This came to be known as the **concession theory**, because incorporation was a concession from the sovereign.

The most important concessions, or charters, were those given to the giant foreign trading companies, including the Russia Company (1554), the British East India Company (1600), Hudson's Bay Company (1670, and still operating in Canada under the name "the Bay"), and the South Sea Company (1711). These were **joint-stock companies**—that is, individuals contributed capital to the enterprise, which traded on

behalf of all the stockholders. Originally, trading companies were formed for single voyages, but the advantages of a continuing fund of capital soon became apparent. Also apparent was the legal characteristic that above all led shareholders to subscribe to the stock: limited liability. They risked only the cash they put in, not their personal fortunes.

Some companies were wildly successful. The British East India Company paid its original investors a fourfold return between 1683 and 1692. But perhaps nothing excited the imagination of the British more than the discovery of gold bullion aboard a Spanish shipwreck; 150 companies were quickly formed to salvage the sunken Spanish treasure. Though most of these companies were outright frauds, they ignited the search for easy wealth by a public unwary of the risks. In particular, the South Sea Company promised the sun and the moon: in return for a monopoly over the slave trade to the West Indies, it told an enthusiastic public that it would retire the public debt and make every person rich.

In 1720, a fervor gripped London that sent stock prices soaring. Beggars and earls alike speculated from January to August; and then the bubble burst. Without considering the ramifications, Parliament had enacted the highly restrictive Bubble Act, which was supposed to do away with unchartered **joint-stock** companies. When the government prosecuted four companies under the act for having fraudulently obtained charters, the public panicked and stock prices came tumbling down, resulting in history's first modern financial crisis.

As a consequence, corporate development was severely retarded in England. Distrustful of the chartered company, Parliament issued few corporate charters, and then only for public or quasi-public undertakings, such as transportation, insurance, and banking enterprises. Corporation law languished: William Blackstone devoted less than 1 percent of his immensely influential *Commentaries on the Law of England* (1765) to corporations and omitted altogether any discussion of limited liability. In *The Wealth of Nations* (1776), Adam Smith doubted that the use of corporations would spread. England did not repeal the Bubble Act until 1825, and then only because the value of true incorporation had become apparent from the experience of its former colonies.

US Corporation Formation

The United States remained largely unaffected by the Bubble Act. Incorporation was granted only by special acts of state legislatures, even well into the nineteenth century, but many such acts were passed. Before the Revolution, perhaps fewer than a dozen business corporations existed throughout the thirteen colonies. During the 1790s, two hundred businesses were incorporated, and their numbers swelled thereafter. The theory that incorporation should not be accomplished except through special legislation began to give way. As industrial development accelerated in the mid-1800s, it was possible in many states to incorporate by adhering to the requirements of a general statute. Indeed, by the late nineteenth century, all but three states constitutionally *forbade* their legislatures from chartering companies through special enactments.

The US Supreme Court contributed importantly to the development of corporate law. In *Gibbons v. Ogden*,[1] a groundbreaking case, the Court held that the Commerce Clause of the US Constitution (Article I, Section 8, Clause 3) granted Congress the power to regulate interstate commerce. However, in *Paul v. Virginia*,[2] the Court said that a state could prevent corporations not chartered there—that is, **out-of-state or foreign corporations**—from engaging in what it considered the local, and not interstate, business of issuing insurance policies. The inference made by many was that states could not bar foreign corporations engaged in *interstate* business from their borders.

This decision brought about a competition in corporation laws. The early general laws had imposed numerous restrictions. The breadth of corporate enterprise was limited, ceilings were placed on total capital and indebtedness, incorporators were required to have residence in the state, the duration of the company often was not perpetual but was limited to a term of years or until a particular undertaking was completed, and the powers of management were circumscribed. These restrictions and limitations were thought to be necessary to protect the citizenry of the chartering legislature's own state. But once it became clear that companies chartered in one state could operate in others, states began in effect to "sell" incorporation for tax revenues.

New Jersey led the way in 1875 with a general incorporation statute that greatly liberalized the powers of management and lifted many of the former restrictions. The Garden State was ultimately eclipsed by Delaware, which in 1899 enacted the most liberal corporation statute in the country, so that to the present day there are thousands of "Delaware corporations" that maintain no presence in the state other than an address on file with the secretary of state in Dover.

During the 1920s, the National Conference of Commissioners on Uniform State Laws drafted a Uniform Business Corporation Act, the final version of which was released in 1928. It was not widely adopted, but it did provide the basis during the 1930s for revisions of some state laws, including those in California, Illinois, Michigan, Minnesota, and Pennsylvania. By that time, in the midst of the Great Depression, the federal government for the first time intruded into corporate law in a major way by creating federal agencies, most notably the Securities and Exchange Commission in 1934, with power to regulate the interstate issuance of corporate stock.

Corporate Law Today

Following World War II, most states revised their general corporation laws. A significant development for states was the preparation of the Model Business Corporation Act by the American Bar Association's Committee on Corporate Laws. About half of the states have adopted all or major portions of the act. The 2005 version of this act, the Revised Model Business Corporation Act (RMBCA), will be referred to throughout our discussion of corporation law.

KEY TAKEAWAY

Corporations have their roots in political and religious authority. The concept of limited liability and visions of financial rewards fueled the popularity of joint-stock companies, particularly trading companies, in late-seventeenth- and early eighteenth-century England. The English Parliament successfully enacted the Bubble Act in 1720 to curb the formation of these companies; the restrictions weren't loosened until over one hundred years later, after England viewed the success of corporations in its former colonies. Although early corporate laws in the United States were fairly restrictive, once states began to "sell" incorporation for tax

revenues, the popularity of liberal and corporate-friendly laws caught on, especially in Delaware beginning in 1899. A corporation remains a creature of the state—that is, the state in which it is incorporated. Delaware remains the state of choice because more corporations are registered there than in any other state.

EXERCISES

1. If the English Parliament had not enacted the Bubble Act in 1720, would the "bubble" have burst? If so, what would have been the consequences to corporate development?
2. What were some of the key components of early US corporate laws? What was the rationale behind these laws?
3. In your opinion, what are some of the liberal laws that attract corporations to Delaware?

---

[1] *Gibbons v. Ogden*, 22 U.S. 1 (1824).

[2] *Paul v. Virginia*, 75 U.S. 168 (1868).

14.2 Partnerships versus Corporations

LEARNING OBJECTIVES

1. Distinguish basic aspects of partnership formation from those of corporate formation.
2. Explain ownership and control in partnerships and in publicly held and closely held corporations.
3. Know how partnerships and corporations are taxed.

CC BY NC SA

Let us assume that three people have already formed a partnership to run a bookstore business. Bob has contributed $80,000. Carol has contributed a house in which the business can lawfully operate. Ted has contributed his services; he has been managing the bookstore, and the business is showing a slight profit. A friend has been telling them that they ought to incorporate. What are the major factors they should consider in reaching a decision?

Ease of Formation

Partnerships are easy to form. If the business is simple enough and the partners are few, the agreement need not even be written down. Creating a corporation is more complicated because formal documents must be placed on file with public authorities.

Ownership and Control

All general partners have equal rights in the management and conduct of the business. By contrast, ownership and control of corporations are, in theory, separated. In the **publicly held corporation**, which has many shareholders, the separation is real. Ownership is widely dispersed because millions of shares are outstanding and it is rare that any single shareholder will own more than a tiny percentage of stock. It is difficult under the best of circumstances for shareholders to exert any form of control over corporate operations. However, in the **closely held corporation**, which has few shareholders, the officers or senior managers are usually also the shareholders, so the separation of ownership and control may be less pronounced or even nonexistent.

Transferability of Interests

Transferability of an interest in a partnership is a problem because a transferee cannot become a member unless all partners consent. The problem can be addressed and overcome in the partnership agreement. **Transfer of interest** in a corporation, through a sale of stock, is much easier; but for the stock of a small corporation, there might not be a market or there might be contractual restrictions on transfer.

Financing

Partners have considerable flexibility in financing. They can lure potential investors by offering interests in profits and, in the case of general partnerships, control. Corporations can finance by selling freely transferable stock to the public or by incurring debt. Different approaches to the financing of corporations are discussed in Chapter 15 "Legal Aspects of Corporate Finance".

Taxation

The partnership is a conduit for income and is not taxed as a separate entity. Individual partners are taxed, and although limited by the 1986 Tax Reform Act, they can deduct partnership losses. Corporate earnings, on the other hand, are subject to double taxation. The corporation is first taxed on its own earnings as an entity. Then, when profits are distributed to shareholders in the form of dividends, the shareholders are taxed again. (A small corporation, with no more than one hundred shareholders, can elect S corporation status. Because S corporations are taxed as partnerships, they avoid double taxation.) However, incorporating brings several tax benefits. For example, the corporation can take deductions for life, medical, and disability insurance coverage for its employees, whereas partners or sole proprietors cannot.

KEY TAKEAWAY

Partnerships are easier to form than corporations, especially since no documents are required. General partners share both ownership and control, but in publicly held corporations, these functions are separated. Additional benefits for a partnership include flexibility in financing, single taxation, and the ability to deduct losses. Transfer of interest in a partnership can be difficult if not addressed in the initial agreement, since all partners must consent to the transfer.

EXERCISES

1. Provide an example of when it would be best to form a partnership, and cite the advantages and disadvantages of doing so.

CC BY NC SA

2. Provide an example of when it would be best to form a corporation, and cite the advantages and disadvantages of doing so.

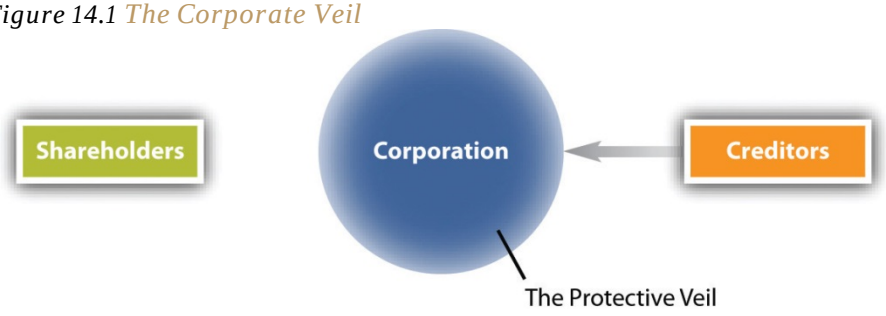
14.3 The Corporate Veil: The Corporation as a Legal Entity

LEARNING OBJECTIVES

1. Know what rights a corporate "person" and a natural person have in common.
2. Recognize when a corporate "veil" is pierced and shareholder liability is imposed.
3. Identify other instances when a shareholder will be held personally liable.

In comparing partnerships and corporations, there is one additional factor that ordinarily tips the balance in favor of incorporating: the corporation is a legal entity in its own right, one that can provide a "veil" that protects its shareholders from personal liability.

Figure 14.1 *The Corporate Veil*



This crucial factor accounts for the development of much of corporate law. Unlike the individual actor in the legal system, the corporation is difficult to deal with in conventional legal terms. The business of the sole proprietor and the sole proprietor herself are one and the same. When a sole proprietor makes a decision, she risks her own capital. When the managers of a corporation take a corporate action, they are

risking the capital of others—the shareholders. Thus accountability is a major theme in the system of law constructed to cope with legal entities other than natural persons.

The Basic Rights of the Corporate "Person"

To say that a **corporation is a "person"** does not automatically describe what its rights are, for the courts have not accorded the corporation every right guaranteed a natural person. Yet the Supreme Court recently affirmed in *Citizens United v. Federal Election Commission* (2010) that the government may not suppress the First Amendment right of political speech because the speaker is a corporation rather than a natural person. According to the Court, "No sufficient governmental interest justifies limits on the political speech of nonprofit or for-profit corporations." [1]

The courts have also concluded that corporations are entitled to the essential constitutional protections of due process and equal protection. They are also entitled to Fourth Amendment protection against unreasonable search and seizure; in other words, the police must have a search warrant to enter corporate premises and look through files. Warrants, however, are not required for highly regulated industries, such as those involving liquor or guns. The Double Jeopardy Clause applies to criminal prosecutions of corporations: an acquittal cannot be appealed nor can the case be retried. For purposes of the federal courts' diversity jurisdiction, a corporation is deemed to be a citizen of both the state in which it is incorporated and the state in which it has its principal place of business (often, the corporate "headquarters").

Until relatively recently, few cases had tested the power of the state to limit the right of corporations to spend their own funds to speak the "corporate mind." Most cases involving corporate free speech address advertising, and few states have enacted laws that directly impinge on the freedom of companies to advertise. But those states that have done so have usually sought to limit the ability of corporations to sway voters in public referenda. In 1978, the Supreme Court finally confronted the issue head on in *First National Bank of Boston v. Bellotti* (Section 14.7.1 "Limiting a Corporation's First Amendment Rights").

The ruling in *Bellotti* was reaffirmed by the Supreme Court in *Citizens United v. Federal Election Commission*. In *Citizens United*, the Court struck down the part of the McCain-Feingold Act[2] that prohibited all corporations, both for-profit and not-for-profit, and unions from broadcasting "electioneering communications."

Absence of Rights

Corporations lack certain rights that natural persons possess. For example, corporations do not have the privilege against self-incrimination guaranteed for natural persons by the Fifth and Fourteenth Amendments. In any legal proceeding, the courts may force a corporation to turn over incriminating documents, even if they also incriminate officers or employees of the corporation. As we explore in Chapter 18 "Corporate Expansion, State and Federal Regulation of Foreign Corporations, and Corporate Dissolution", corporations are not citizens under the Privileges and Immunities Clause of the Constitution, so that the states can discriminate between domestic and foreign corporations. And the corporation is not entitled to federal review of state criminal convictions, as are many individuals.

Piercing the Corporate Veil

Given the importance of the corporate entity as a veil that limits shareholder liability, it is important to note that in certain circumstances, the courts may reach beyond the wall of protection that divides a corporation from the people or entities that exist behind it. This is known as **piercing the corporate veil**, and it will occur in two instances: (1) when the corporation is used to commit a fraud or an injustice and (2) when the corporation does not act as if it were one.

Fraud

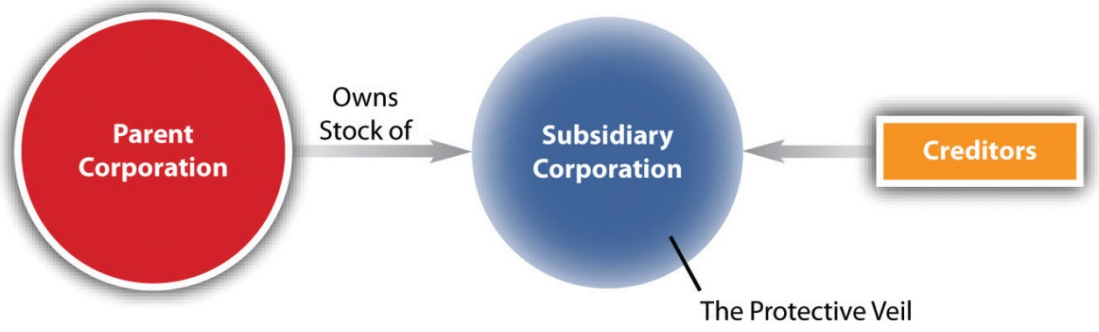
The Felsenthal Company burned to the ground. Its president, one of the company's largest creditors and also virtually its sole owner, instigated the fire. The corporation sued the insurance company to recover the amount for which it was insured. According to the court in the Felsenthal case, "The general rule of law is that the willful burning of property by a stockholder in a corporation is not a defense against the collection of the insurance by the corporation, and...the corporation cannot be prevented from collecting the insurance because its agents willfully set fire to the property without the participation or authority of the corporation or of all of the stockholders of the corporation."[3] But because the fire was caused by the

beneficial owner of “practically all” the stock, who also “has the absolute management of [the corporation’s] affairs and its property, and is its president,” the court refused to allow the company to recover the insurance money; allowing the company to recover would reward fraud.[4]

Failure to Act as a Corporation

In other limited circumstances, individual stockholders may also be found personally liable. Failure to follow corporate formalities, for example, may subject stockholders to **personal liability**. This is a special risk that small, especially one-person, corporations run. Particular factors that bring this rule into play include inadequate capitalization, omission of regular meetings, failure to record minutes of meetings, failure to file annual reports, and commingling of corporate and personal assets. Where these factors exist, the courts may look through the corporate veil and pluck out the individual stockholder or stockholders to answer for a tort, contract breach, or the like. The classic case is the taxicab operator who incorporates several of his cabs separately and services them through still another corporation. If one of the cabs causes an accident, the corporation is usually “judgment proof” because the corporation will have few assets (practically worthless cab, minimum insurance). The courts frequently permit plaintiffs to proceed against the common owner on the grounds that the particular corporation was inadequately financed.

Figure 14.2 *The Subsidiary as a Corporate Veil*



When a corporation owns a subsidiary corporation, the question frequently arises whether the subsidiary is acting as an independent entity (see Figure 14.2 "The Subsidiary as a Corporate Veil"). The Supreme

Court addressed this question of derivative versus direct liability of the corporate parent vis-à-vis its subsidiary in *United States v. Bestfoods*, (see Section 14.7.2 "Piercing the Corporate Veil").

Other Types of Personal Liability

Even when a corporation is formed for a proper purpose and is operated as a corporation, there are instances in which individual shareholders will be personally liable. For example, if a shareholder involved in company management commits a tort or enters into a contract in a personal capacity, he will remain personally liable for the consequences of his actions. In some states, statutes give employees special rights against shareholders. For example, a New York statute permits employees to recover wages, salaries, and debts owed them by the company from the ten largest shareholders of the corporation. (Shareholders of public companies whose stock is traded on a national exchange or over the counter are exempt.) Likewise, federal law permits the IRS to recover from the "responsible persons" any withholding taxes collected by a corporation but not actually paid over to the US Treasury.

KEY TAKEAWAY

Corporations have some of the legal rights of a natural person. They are entitled to the constitutional protections of due process and equal protection, Fourth Amendment protection against unreasonable search and seizure, and First Amendment protection of free speech and expression. For purposes of the federal courts' diversity jurisdiction, a corporation is deemed to be a citizen of both the state in which it is incorporated and the state in which it has its principal place of business. However, corporations do not have the privilege against self-incrimination guaranteed for natural persons by the Fifth and Fourteenth Amendments. Further, corporations are not free from liability. Courts will pierce the corporate veil and hold a corporation liable when the corporation is used to perpetrate fraud or when it fails to act as a corporation.

EXERCISES

1. Do you think that corporations should have rights similar to those of natural persons? Should any of these rights be curtailed?
2. What is an example of speaking the "corporate mind"?
3. If Corporation BCD's president and majority stockholder secretly sells all of his stock before resigning a few days later, and the corporation's unexpected change in majority ownership causes the share price to plummet, do corporate stockholders have a cause of action? If so, under what theory?

---

[1] *Citizens United v. Federal Election Commission*, 558 U.S. ___ (2010).

[2] The Bipartisan Campaign Reform Act of 2002 (BCRA, McCain–Feingold Act, Pub. L. 107-155, 116 Stat. 81, enacted March 27, 2002, H.R. 2356).

[3] *D. I. Felsenthal Co. v. Northern Assurance Co., Ltd.*, 284 Ill. 343, 120 N.E. 268 (1918).

[4] *Felsenthal Co. v. Northern Assurance Co., Ltd.*, 120 N.E. 268 (Ill. 1918).

14.4 Classifications of Corporations

LEARNING OBJECTIVES

1. Distinguish the "public," or municipal, corporation from the publicly held corporation.
2. Explain how the tax structure for professional corporations evolved.
3. Define the two types of business corporations.

Nonprofit Corporations

One of the four major classifications of corporations is the **nonprofit corporation** (also called not-for-profit corporation). It is defined in the American Bar Association's Model Non-Profit Corporation Act as

CC BY NC SA

"a corporation no part of the income of *which* is distributable to its members, directors or officers." Nonprofit corporations may be formed under this law for charitable, educational, civil, religious, social, and cultural purposes, among others.

Public Corporations

The true public corporation is a governmental entity. It is often called a **municipal corporation**, to distinguish it from the publicly held corporation, which is sometimes also referred to as a "public" corporation, although it is in fact private (i.e., it is not governmental). Major cities and counties, and many towns, villages, and special governmental units, such as sewer, transportation, and public utility authorities, are incorporated. These corporations are not organized for profit, do not have shareholders, and operate under different statutes than do business corporations.

Professional Corporations

Until the 1960s, lawyers, doctors, accountants, and other professionals could not practice their professions in corporate form. This inability, based on a fear of professionals' being subject to the direction of the corporate owners, was financially disadvantageous. Under the federal income tax laws then in effect, corporations could establish far better pension plans than could the self-employed. During the 1960s, the states began to let professionals incorporate, but the IRS balked, denying them many tax benefits. In 1969, the IRS finally conceded that it would tax a **professional corporation** just as it would any other corporation, so that professionals could, from that time on, place a much higher proportion of tax-deductible income into a tax-deferred pension. That decision led to a burgeoning number of professional corporations.

Business Corporations

The Two Types

It is the **business corporation** proper that we focus on in this unit. There are two broad types of business corporations: publicly held (or public) and closely held (or close or private) corporations. Again, both types are private in the sense that they are not governmental.

The publicly held corporation is one in which stock is widely held or available for wide public distribution through such means as trading on a national or regional stock exchange. Its managers, if they are also owners of stock, usually constitute a small percentage of the total number of shareholders and hold a small amount of stock relative to the total shares outstanding. Few, if any, shareholders of public corporations know their fellow shareholders.

By contrast, the shareholders of the closely held corporation are fewer in number. Shares in a closely held corporation could be held by one person, and usually by no more than thirty. Shareholders of the closely held corporation often share family ties or have some other association that permits each to know the others.

Though most closely held corporations are small, no economic or legal reason prevents them from being large. Some are huge, having annual sales of several billion dollars each. Roughly 90 percent of US corporations are closely held.

The giant publicly held companies with more than $1 billion in assets and sales, with initials such as IBM and GE, constitute an exclusive group. Publicly held corporations outside this elite class fall into two broad (nonlegal) categories: those that are quoted on stock exchanges and those whose stock *is* too widely dispersed to be called closely held but is not traded on exchanges.

KEY TAKEAWAY

There are four major classifications of corporations: (1) nonprofit, (2) municipal, (3) professional, and (4) business. Business corporations are divided into two types, publicly held and closely held corporations.

EXERCISES

1. Why did professionals, such as doctors, lawyers, and accountants, wait so long to incorporate?
2. Distinguish a publicly held corporation from a closely held one.
3. Are most corporations in the US publicly or closely held? Are closely held corporations subject to different provisions than publicly held ones?

14.5 Corporate Organization

LEARNING OBJECTIVES

1. Recognize the steps to issue a corporate charter.
2. Know the states' rights in modifying a corporate charter.
3. Discuss factors to consider in selecting a state in which to incorporate.
4. Explain the functions and liability of a promoter.
5. Understand the business and legal requirements in executing and filing the articles of incorporation.

As discussed in Section 14.4 "Classifications of Corporations", corporate status offers companies many protections. If the owners of a business decide to incorporate after weighing the pros and cons of incorporation, they need to take the steps explained in this section.

The Corporate Charter

Function of the Charter

CC BY NC SA

The ultimate goal of the incorporation process is issuance of a **corporate charter**. The term used for the document varies from state to state. Most states call the basic document filed in the appropriate public office the "articles of incorporation" or "certificate of incorporation," but there are other variations. There is no legal significance to these differences in terminology.

Chartering is basically a state prerogative. Congress has chartered several enterprises, including national banks (under the National Banking Act), federal savings and loan associations, national farm loan associations, and the like, but virtually all business corporations are chartered at the state level.

Originally a legislative function, chartering is now an administrative function in every state. The secretary of state issues the final indorsement to the articles of incorporation, thus giving them legal effect.

Charter as a Contract

The charter is a contract between the state and the corporation. Under the Contracts Clause of Article I of the Constitution, no state can pass any law "impairing the obligation of contracts." In 1816, the question arose whether a state could revoke or amend a corporate charter once granted. The corporation in question was Dartmouth College. The New Hampshire legislature sought to turn the venerable private college, operating under an old royal charter, into a public institution by changing the membership of its board. The case wound up in the Supreme Court. Chief Justice John Marshall ruled that the legislature's attempt was unconstitutional, because to amend a charter is to impair a contract.[1]

This decision pleased incorporators because it implied that once a corporation had been created, the state could never modify the powers it had been granted. But, in addition, the ruling seemed to favor monopolies. The theory was that by granting a charter to, say, a railroad corporation, the state was barred from creating any further railroad corporations. Why? Because, the lawyers argued, a competitor would cut into the first company's business, reducing the value of the charter, hence impairing the contract. Justice Joseph Story, concurring in the *Dartmouth* case, had already suggested the way out for the states: "If the legislature mean to claim such an authority [to alter or amend the charter], it must be reserved in the grant. The charter of Dartmouth College contains no such reservation...." The states quickly picked up on Justice Story's suggestion and wrote into the charter explicit language giving legislatures the authority

to modify corporations' charters at their pleasure. So the potential immutability of corporate charters had little practical chance to develop.

Selection of a State

Where to Charter

Choosing the particular venue in which to incorporate is the first critical decision to be made after deciding to incorporate. Some corporations, though headquartered in the United States, choose to incorporate offshore to take advantage of lenient taxation laws. Advantages of an offshore corporation include not only lenient tax laws but also a great deal of privacy as well as certain legal protections. For example, the names of the officers and directors can be excluded from documents filed. In the United States, over half of the*Fortune* 500 companies hold Delaware charters for reasons related to Delaware's having a lower tax structure, a favorable business climate, and a legal system—both its statutes and its courts—seen as being up to date, flexible, and often probusiness. Delaware's success has led other states to compete, and the political realities have caused the Revised Model Business Corporation Act (RMBCA), which was intentionally drafted to balance the interests of all significant groups (management, shareholders, and the public), to be revised from time to time so that it is more permissive from the perspective of management.

Why Choose Delaware?

Delaware remains the most popular state in which to incorporate for several reasons, including the following: (1) low incorporation fees; (2) only one person is needed to serve the incorporator of the corporation; the RMBC requires three incorporators; (3) no minimum capital requirement; (4) favorable tax climate, including no sales tax; (5) no taxation of shares held by nonresidents; and (5) no corporate income tax for companies doing business outside of Delaware. In addition, Delaware's Court of Chancery, a court of equity, is renowned as a premier business court with a well-established body of corporate law, thereby affording a business a certain degree of predictability in judicial decision making.

The Promoter

Functions

Once the state of incorporation has been selected, it is time for **promoters**, the midwives of the enterprise, to go to work. Promoters are the individuals who take the steps necessary to form the corporation, and they often will receive stock in exchange for their efforts. They have four principal functions: (1) to seek out or discover business opportunities, (2) to raise capital by persuading investors to sign stock subscriptions, (3) to enter into contracts on behalf of the corporation to be formed, (4) and to prepare the articles of incorporation.

Promoters have acquired an unsavory reputation as fast talkers who cajole investors out of their money. Though some promoters fit this image, it is vastly overstated. Promotion is difficult work often carried out by the same individuals who will manage the business.

Contract Liability

Promoters face two major legal problems. First, they face possible liability on contracts made on behalf of the business before it is incorporated. For example, suppose Bob is acting as promoter of the proposed BCT Bookstore, Inc. On September 15, he enters into a contract with Computogram Products to purchase computer equipment for the corporation to be formed. If the incorporation never takes place, or if the corporation is formed but the corporation refuses to accept the contract, Bob remains liable.

Now assume that the corporation is formed on October 15, and on October 18 it formally accepts all the contracts that Bob signed prior to October 15. Does Bob remain liable? In most states, he does. The ratification theory of agency law will not help in many states that adhere strictly to agency rules, because there was no principal (the corporation) in existence when the contract was made and hence the promoter must remain liable. To avoid this result, Bob should seek an express novation, although in some states, a novation will be implied. The intention of the parties should be stated as precisely as possible in the contract, as the promoters learned in *RKO-Stanley Warner Theatres, Inc. v. Graziano*, (see Section 14.7.3 "Corporate Promoter").

The promoters' other major legal concern is the duty owed to the corporation. The law is clear that promoters owe a fiduciary duty. For example, a promoter who transfers real estate worth $250,000 to the

corporation in exchange for $750,000 worth of stock would be liable for $500,000 for breach of fiduciary duty.

Preincorporation Stock Subscriptions

One of the promoter's jobs is to obtain **preincorporation stock subscriptions** to line up offers by would-be investors to purchase stock in the corporation to be formed. These stock subscriptions are agreements to purchase, at a specified price, a certain number of shares of stock of a corporation, which is to be formed at some point in the future. The contract, however, actually comes into existence *after* formation, once the corporation itself accepts the offer to subscribe. Alice agrees with Bob to invest $10,000 in the BCT Bookstore, Inc. for one thousand shares. The agreement is treated as an offer to purchase. The offer is deemed accepted at the moment the bookstore is incorporated.

The major problem for the corporation is an attempt by subscribers to revoke their offers. A basic rule of contract law is that offers are revocable before acceptance. Under RMBCA, Section 6.20, however, a subscription for shares is irrevocable for six months unless the subscription agreement itself provides otherwise or unless all the subscribers consent to revocation. In many states that have not adopted the model act, the contract rule applies and the offer is always revocable. Other states use various common-law devices to prevent revocation. For example, the subscription by one investor is held as consideration for the subscription of another, so that a binding contract has been formed.

Execution and Filing of the Articles of Incorporation

Once the business details are settled, the promoters, now known as incorporators, must sign and deliver the articles of incorporation to the secretary of state. The articles of incorporation typically include the following: the corporate name; the address of the corporation's initial registered office; the period of the corporation's duration (usually perpetual); the company's purposes; the total number of shares, the classes into which they are divided, and the par value of each; the limitations and rights of each class of shareholders; the authority of the directors to establish preferred or special classes of stock; provisions for preemptive rights; provisions for the regulation of the internal affairs of the corporation, including any provision restricting the transfer of shares; the number of directors constituting the initial board of

directors and the names and addresses of initial members; and the name and address of each incorporator. Although compliance with these requirements is largely a matter of filling in the blanks, two points deserve mention.

First, the choice of a name is often critical to the business. Under RMBCA, Section 4.01, the name must include one of the following words (or abbreviations): corporation, company, incorporated, or limited (Corp., Co., Inc., or Ltd.). The name is not allowed to deceive the public about the corporation's purposes, nor may it be the same as that of any other company incorporated or authorized to do business in the state.

These legal requirements are obvious; the business requirements are much harder. If the name is not descriptive of the business or does not anticipate changes in the business, it may have to be changed, and the change can be expensive. For example, when Standard Oil Company of New Jersey changed its name to Exxon in 1972, the estimated cost was over $100 million. (And even with this expenditure, some shareholders grumbled that the new name sounded like a laxative.)

The second point to bear in mind about the articles of incorporation is that drafting the clause stating corporate purposes requires special care, because the corporation will be limited to the purposes set forth. In one famous case, the charter of Cornell University placed a limit on the amount of contributions it could receive from any one benefactor. When Jennie McGraw died in 1881, leaving to Cornell the carillon that still plays on the Ithaca, New York, campus to this day, she also bequeathed to the university her residuary estate valued at more than $1 million. This sum was greater than the ceiling placed in Cornell's charter. After lengthy litigation, the university lost in the US Supreme Court, and the money went to her family.[2] The dilemma is how to draft a clause general enough to allow the corporation to expand, yet specific enough to prevent it from engaging in undesirable activities.

Some states require the purpose clauses to be specific, but the usual approach is to permit a broad statement of purposes. Section 3.01 of the RMBCA goes one step further in providing that a corporation automatically "has the purpose of engaging in any lawful business" unless the articles specify a more

limited purpose. Once completed, the articles of incorporation are delivered to the secretary of state for filing. The existence of a corporation begins once the articles have been filed.

Organizational Meeting of Directors

The first order of business, once the certificate of incorporation is issued, is a meeting of the board of directors named in the articles of incorporation. They must adopt bylaws, elect officers, and transact any other business that may come before the meeting (RMBCA, Section 2.05). Other business would include accepting (ratifying) promoters' contracts, calling for the payment of stock subscriptions, and adopting bank resolution forms, giving authority to various officers to sign checks drawn on the corporation. Section 10.20 of the RMBCA vests in the directors the power to alter, amend, or repeal the bylaws adopted at the initial meeting, subject to repeal or change by the shareholders. The articles of incorporation may reserve the power to modify or repeal exclusively to the shareholders. The bylaws may contain any provisions that do not conflict with the articles of incorporation or the law of the state.

Typical provisions in the bylaws include fixing the place and time at which annual stockholders' meetings will be held, fixing a quorum, setting the method of voting, establishing the method of choosing directors, creating committees of directors, setting down the method by which board meetings may be called and the voting procedures to be followed, determining the offices to be filled by the directors and the powers with which each officer shall be vested, fixing the method of declaring dividends, establishing a fiscal year, setting out rules governing issuance and transfer of stock, and establishing the method of amending the bylaws.

Section 2.07 of the RMBCA provides that the directors may adopt bylaws that will operate during an emergency. An emergency is a situation in which "a quorum of the corporation's directors cannot readily be assembled because of some catastrophic event."

KEY TAKEAWAY

Articles of incorporation represent a corporate charter—that is, a contract between the corporation and the state. Filing these articles, or "chartering," is accomplished at the state level. The secretary of state's final approval gives these articles legal effect. A state cannot change a charter unless it reserves the right when granting the charter.

In selecting a state in which to incorporate, a corporation looks for a favorable corporate climate. Delaware remains the state of choice for incorporation, particularly for publicly held companies. Most closely held companies choose to incorporate in their home states.

Following the state selection, the promoter commences his or her functions, which include entering into contracts on behalf of the corporation to be formed (for which he or she can be held liable) and preparing the articles of incorporation.

The articles of incorporation must include the corporation's name and its corporate purpose, which can be broad. Finally, once the certificate of incorporation is issued, the corporation's board of directors must hold an organizational meeting.

EXERCISES

1. Does the Contracts Clause of the Constitution, which forbids a state from impeding a contract, apply to corporations?
2. What are some of the advantages of selecting Delaware as the state of incorporation?
3. What are some of the risks that a promoter faces for his or her actions on behalf of the corporation? Can he or she limit these risks?
4. What are the dangers of limiting a corporation's purpose?
5. What is the order of business at the first board of directors' meeting?

---

[1] *Trustees of Dartmouth College v. Woodward*, 17 U.S. 518 (1819).

[2] *Cornell University v. Fiske*, 136 U.S. 152 (1890).

14.6 Effect of Organization

LEARNING OBJECTIVES

1. Distinguish between a de jure and a de facto corporation.
2. Define the doctrine of corporation by estoppel.

De Jure and De Facto Corporations

If promoters meet the requirements of corporate formation, a **de jure corporation**, considered a legal entity, is formed. Because the various steps are complex, the formal prerequisites are not always met. Suppose that a company, thinking its incorporation has taken place when in fact it hasn't met all requirements, starts up its business. What then? Is everything it does null and void? If three conditions exist, a court might decide that a **de facto corporation** has been formed; that is, the business will be recognized as a corporation. The state then has the power to force the de facto corporation to correct the defect(s) so that a de jure corporation will be created.

The three traditional conditions are the following: (1) a statute must exist under which the corporation could have been validly incorporated, (2) the promoters must have made a bona fide attempt to comply with the statute, and (3) corporate powers must have been used or exercised.

A frequent cause of defective incorporation is the promoters' failure to file the articles of incorporation in the appropriate public office. The states are split on whether a de facto corporation results if every other legal requirement is met.

Corporation by Estoppel

Even if the incorporators omit important steps, it is still possible for a court, under estoppel principles, to treat the business as a corporation. Assume that Bob, Carol, and Ted have sought to incorporate the BCT Bookstore, Inc., but have failed to file the articles of incorporation. At the initial directors' meeting, Carol turns over to the corporation a deed to her property. A month later, Bob discovers the omission and hurriedly submits the articles of incorporation to the appropriate public office. Carol decides she wants her land back. It is clear that the corporation was not de jure at the time she surrendered her deed, and it was probably not de facto either. Can she recover the land? Under equitable principles, the answer is no. She is estopped from denying the existence of the corporation, because it would be inequitable to permit one who has conducted herself as though there were a corporation to deny its existence in order to defeat a contract into which she willingly entered. As *Cranson v. International Business Machines Corp.* indicates (Section 14.7.4 "De Jure and De Facto Corporations"), the doctrine of **corporation by estoppel** can also be used by the corporation against one of its creditors.

KEY TAKEAWAY

A court will find that a corporation might exist under fact (de facto), and not under law (de jure) if the following conditions are met: (1) a statute exists under which the corporation could have been validly incorporated, (2) the promoters must have made a bona fide attempt to comply with the statute, and (3) corporate powers must have been used or exercised. A de facto corporation may also be found when a promoter fails to file the articles of incorporation. In the alternative, the court may look to estoppel principles to find a corporation.

EXERCISES

1. What are some of the formal prerequisites to forming a de jure corporation?
2. Are states in agreement over what represents a de facto corporation if a promoter fails to file the articles of incorporation?
3. What is the rationale for corporation by estoppel?

14.7 Cases

Limiting a Corporation's First Amendment Rights

First National Bank of Boston v. Bellotti

435 U.S. 765 (1978)

MR. JUSTICE POWELL delivered the opinion of the Court.

In sustaining a state criminal statute that forbids certain expenditures by banks and business corporations for the purpose of influencing the vote on referendum proposals, the Massachusetts Supreme Judicial Court held that the First Amendment rights of a corporation are limited to issues that materially affect its business, property, or assets. The court rejected appellants' claim that the statute abridges freedom of speech in violation of the First and Fourteenth Amendments. The issue presented in this context is one of first impression in this Court. We postponed the question of jurisdiction to our consideration of the merits. We now reverse.

The statute at issue, Mass. Gen. Laws Ann., Ch. 55, § 8 (West Supp. 1977), prohibits appellants, two national banking associations and three business corporations, from making contributions or expenditures "for the purpose of...influencing or affecting the vote on any question submitted to the voters, other than one materially affecting any of the property, business or assets of the corporation." The statute further specifies that "[no] question submitted to the voters solely concerning the taxation of the income, property or transactions of individuals shall be deemed materially to affect the property, business

or assets of the corporation." A corporation that violates § 8 may receive a maximum fine of $50,000; a corporate officer, director, or agent who violates the section may receive a maximum fine of $10,000 or imprisonment for up to one year, or both. Appellants wanted to spend money to publicize their views on a proposed constitutional amendment that was to be submitted to the voters as a ballot question at a general election on November 2, 1976. The amendment would have permitted the legislature to impose a graduated tax on the income of individuals. After appellee, the Attorney General of Massachusetts, informed appellants that he intended to enforce § 8 against them, they brought this action seeking to have the statute declared unconstitutional.

The court below framed the principal question in this case as whether and to what extent corporations have First Amendment rights. We believe that the court posed the wrong question. The Constitution often protects interests broader than those of the party seeking their vindication. The First Amendment, in particular, serves significant societal interests. The proper question therefore is not whether corporations "have" First Amendment rights and, if so, whether they are coextensive with those of natural persons. Instead, the question must be whether § 8 abridges expression that the First Amendment was meant to protect. We hold that it does. The speech proposed by appellants is at the heart of the First Amendment's protection.

The freedom of speech and of the press guaranteed by the Constitution embraces at the least the liberty to discuss publicly and truthfully all matters of public concern without previous restraint or fear of subsequent punishment. Freedom of discussion, if it would fulfill its historic function in this nation, must embrace all issues about which information is needed or appropriate to enable the members of society to cope with the exigencies of their period. *Thornhill v. Alabama*, 310 U.S. 88, 101-102 (1940).

The referendum issue that appellants wish to address falls squarely within this description. In appellants' view, the enactment of a graduated personal income tax, as proposed to be authorized by constitutional amendment, would have a seriously adverse effect on the economy of the State. The importance of the referendum issue to the people and government of Massachusetts is not disputed. Its merits, however, are the subject of sharp disagreement.

We thus find no support in the First or Fourteenth Amendment, or in the decisions of this Court, for the proposition that speech that otherwise would be within the protection of the First Amendment loses that protection simply because its source is a corporation that cannot prove, to the satisfaction of a court, a material effect on its business or property. The "materially affecting" requirement is not an identification of the boundaries of corporate speech etched by the Constitution itself. Rather, it amounts to an impermissible legislative prohibition of speech based on the identity of the interests that spokesmen may represent in public debate over controversial issues and a requirement that the speaker have a sufficiently great interest in the subject to justify communication.

Section 8 permits a corporation to communicate to the public its views on certain referendum subjects—those materially affecting its business—but not others. It also singles out one kind of ballot question—individual taxation as a subject about which corporations may never make their ideas public. The legislature has drawn the line between permissible and impermissible speech according to whether there is a sufficient nexus, as defined by the legislature, between the issue presented to the voters and the business interests of the speaker.

In the realm of protected speech, the legislature is constitutionally disqualified from dictating the subjects about which persons may speak and the speakers who may address a public issue. If a legislature may direct business corporations to "stick to business," it also may limit other corporations—religious, charitable, or civic—to their respective "business" when addressing the public. Such power in government to channel the expression of views is unacceptable under the First Amendment. Especially where, as here, the legislature's suppression of speech suggests an attempt to give one side of a debatable public question an advantage in expressing its views to the people, the First Amendment is plainly offended.

Because that portion of § 8 challenged by appellants prohibits protected speech in a manner unjustified by a compelling state interest, it must be invalidated. The judgment of the Supreme Judicial Court is reversed.

CASE QUESTIONS

1. According to the court, does § 8 abridge a freedom that the First Amendment is intended to protect? If so, which freedom(s)?
2. Must a corporation prove a material effect on its business or property to maintain protection under the First Amendment?
3. Can a state legislature dictate the subjects on which a corporation may "speak"?

Piercing the Corporate Veil

United States v. Bestfoods

113 F.3d 572 (1998)

SOUTER, JUSTICE

The United States brought this action under §107(a)(2) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) against, among others, respondent CPC International, Inc., the parent corporation of the defunct Ott Chemical Co. (Ott II), for the costs of cleaning up industrial waste generated by Ott II's chemical plant. Section 107(a)(2) authorizes suits against, among others, "any person who at the time of disposal of any hazardous substance owned or operated any facility." The trial focused on whether CPC, as a parent corporation, had "owned or operated" Ott II's plant within the meaning of §107(a)(2). The District Court said that operator liability may attach to a parent corporation both indirectly, when the corporate veil can be pierced under state law, and directly, when the parent has exerted power or influence over its subsidiary by actively participating in, and exercising control over, the subsidiary's business during a period of hazardous waste disposal. Applying that test, the court held CPC liable because CPC had selected Ott II's board of directors and populated its executive ranks with CPC

officials, and another CPC official had played a significant role in shaping Ott II's environmental compliance policy.

The Sixth Circuit reversed. Although recognizing that a parent company might be held directly liable under §107(a)(2) if it actually operated its subsidiary's facility in the stead of the subsidiary, or alongside of it as a joint venturer, that court refused to go further. Rejecting the District Court's analysis, the Sixth Circuit explained that a parent corporation's liability for operating a facility ostensibly operated by its subsidiary depends on whether the degree to which the parent controls the subsidiary and the extent and manner of its involvement with the facility amount to the abuse of the corporate form that will warrant piercing the corporate veil and disregarding the separate corporate entities of the parent and subsidiary. Applying Michigan veil-piercing law, the court decided that CPC was not liable for controlling Ott II's actions, since the two corporations maintained separate personalities and CPC did not utilize the subsidiary form to perpetrate fraud or subvert justice.

Held:

1. When (but only when) the corporate veil may be pierced, a parent corporation may be charged with derivative CERCLA liability for its subsidiary's actions in operating a polluting facility. It is a general principle of corporate law that a parent corporation (so-called because of control through ownership of another corporation's stock) is not liable for the acts of its subsidiaries. CERCLA does not purport to reject this bedrock principle, and the Government has indeed made no claim that a corporate parent is liable as an owner or an operator under §107(a)(2) simply because its subsidiary owns or operates a polluting facility. But there is an equally fundamental principle of corporate law, applicable to the parent-subsidiary relationship as well as generally, that the corporate veil may be pierced and the shareholder held liable for the corporation's conduct when, *inter alia*, the corporate form would otherwise be misused to accomplish certain wrongful purposes, most notably fraud, on the shareholder's behalf. CERCLA does not purport to rewrite this well-settled rule, either, and against this venerable common-law backdrop, the congressional silence is audible. Cf. *Edmonds* v. *Compagnie Generale Transatlantique*, 443 U.S. 256, 266-267. CERCLA's failure to speak to a matter as fundamental as the liability implications of corporate ownership demands application of the rule that, to abrogate a common-law principle, a statute must speak directly to the question addressed by the common law. *United States* v. *Texas*, 507 U.S. 529, 534.

2. A corporate parent that actively participated in, and exercised control over, the operations of its subsidiary's facility may be held directly liable in its own right under §107(a)(2) as an operator of the facility.

(a) Derivative liability aside, CERCLA does not bar a parent corporation from direct liability for its own actions. Under the plain language of §107(a)(2), any person who operates a polluting facility is directly liable for the costs of cleaning up the pollution, and this is so even if that person is the parent corporation of the facility's owner. Because the statute does not define the term "operate," however, it is difficult to define actions sufficient to constitute direct parental "operation." In the organizational sense obviously intended by CERCLA, to "operate" a facility ordinarily means to direct the workings of, manage, or conduct the affairs of the facility. To sharpen the definition for purposes of CERCLA's concern with environmental contamination, an operator must manage, direct, or conduct operations specifically related to the leakage or disposal of hazardous waste, or decisions about compliance with environmental regulations.

(b) The Sixth Circuit correctly rejected the direct liability analysis of the District Court, which mistakenly focused on the relationship between parent and subsidiary, and premised liability on little more than CPC's ownership of Ott II and its majority control over Ott II's board of directors. Because direct liability for the parent's operation of the facility must be kept distinct from derivative liability for the subsidiary's operation of the facility, the analysis should instead have focused on the relationship between CPC and the facility itself, *i.e.*, on whether CPC "operated" the facility, as evidenced by its direct participation in the facility's activities. That error was compounded by the District Court's erroneous assumption that actions of the joint officers and directors were necessarily attributable to CPC, rather than Ott II, contrary to time-honored common-law principles. The District Court's focus on the relationship between parent and subsidiary (rather than parent and facility), combined with its automatic attribution of the actions of dual officers and directors to CPC, erroneously, even if unintentionally, treated CERCLA as though it displaced or fundamentally altered common-law standards of limited liability. The District Court's analysis created what is in essence a relaxed, CERCLA-specific rule of derivative liability that would banish traditional

standards and expectations from the law of CERCLA liability. Such a rule does not arise from congressional silence, and CERCLA's silence is dispositive.

(c) Nonetheless, the Sixth Circuit erred in limiting direct liability under CERCLA to a parent's sole or joint venture operation, so as to eliminate any possible finding that CPC is liable as an operator on the facts of this case. The ordinary meaning of the word "operate" in the organizational sense is not limited to those two parental actions, but extends also to situations in which, *e.g.*, joint officers or directors conduct the affairs of the facility on behalf of the parent, or agents of the parent with no position in the subsidiary manage or direct activities at the subsidiary's facility. Norms of corporate behavior (undisturbed by any CERCLA provision) are crucial reference points, both for determining whether a dual officer or director has served the parent in conducting operations at the facility, and for distinguishing a parental officer's oversight of a subsidiary from his control over the operation of the subsidiary's facility. There is, in fact, some evidence that an agent of CPC alone engaged in activities at Ott II's plant that were eccentric under accepted norms of parental oversight of a subsidiary's facility: The District Court's opinion speaks of such an agent who played a conspicuous part in dealing with the toxic risks emanating from the plant's operation. The findings in this regard are enough to raise an issue of CPC's operation of the facility, though this Court draws no ultimate conclusion, leaving the issue for the lower courts to reevaluate and resolve in the first instance.

113 F.3d 572, vacated and remanded.

CASE QUESTIONS

1. In what ways can operator liability attach to a parent corporation? How did the Sixth Circuit Court disagree with the district court's analysis?

2. Is direct liability for a parent company's operation of the facility distinct from derivative liability for the subsidiary's operation of the facility? Should the focus be on parent and subsidiary or on parent and facility?
3. What norms of corporate behavior does the court look to in determining whether an officer or a director is involved in the operation of a facility?

Corporate Promoter

RKO-Stanley Warner Theatres, Inc. v. Graziano

355 A.2d. 830 (1976)

EAGEN, JUSTICE.

On April 30, 1970, RKO-Stanley Warner Theatres, Inc. [RKO], as seller, entered into an agreement of sale with Jack Jenofsky and Ralph Graziano, as purchasers. This agreement contemplated the sale of the Kent Theatre, a parcel of improved commercial real estate located at Cumberland and Kensington Avenues in Philadelphia, for a total purchase price of $70,000. Settlement was originally scheduled for September 30, 1970, and, at the request of Jenofsky and Graziano, continued twice, first to October 16, 1970, and then to October 21, 1970. However, Jenofsky and Graziano failed to complete settlement on the last scheduled date.

Subsequently, on November 13, 1970, RKO filed a complaint in equity seeking judicial enforcement of the agreement of sale. Although Jenofsky, in his answer to the complaint, denied personal liability for the performance of the agreement, the chancellor, after a hearing, entered a decree nisi granting the requested relief sought by RKO....This appeal ensued.

At the time of the execution of this agreement, Jenofsky and Graziano were engaged in promoting the formation of a corporation to be known as Kent Enterprises, Inc. Reflecting these efforts, Paragraph 19 of the agreement, added by counsel for Jenofsky and Graziano, recited:

It is understood by the parties hereto that it is the intention of the Purchaser to incorporate. Upon condition that such incorporation be completed by closing, all agreements, covenants, and warranties contained herein shall be construed to have been made between Seller and the resultant corporation and all documents shall reflect same.

In fact, Jenofsky and Graziano did file Articles of Incorporation for Kent Enterprises, Inc., with the State Corporation Bureau on October 9, 1971, twelve days prior to the scheduled settlement date. Jenofsky now contends the inclusion of Paragraph 19 in the agreement and the subsequent filing of incorporation papers, released him from any personal liability resulting from the non-performance of the agreement.

The legal relationship of Jenofsky to Kent Enterprises, Inc., at the date of the execution of the agreement of sale was that of promoter. As such, he is subject to the general rule that a promoter, although he may assume to act on behalf of a projected corporation and not for himself, will be held personally liable on contracts made by him for the benefit of a corporation he intends to organize. This personal liability will continue even after the contemplated corporation is formed and has received the benefits of the contract, unless there is a novation or other agreement to release liability.

The imposition of personal liability upon a promoter where that promoter has contracted on behalf of a corporation is based upon the principle that one who assumes to act for a nonexistent principal is himself liable on the contract in the absence of an agreement to the contrary.

[T]here [are] three possible understandings that parties may have when an agreement is executed by a promoter on behalf of a proposed corporation:
When a party is acting for a proposed corporation, he cannot, of course, bind it by anything he does, at the time, but he may (1) take on its behalf an offer from the other which, being accepted after the formation of the company, becomes a contract; (2) make a contract at the time binding himself, with the stipulation or understanding, that if a company is formed it will take his place and that then he shall be relieved of responsibility; or (3) bind himself personally without more and look to the proposed company, when formed, for indemnity.

Both RKO and Jenofsky concede the applicability of alternative No. 2 to the instant case. That is, they both recognize that Jenofsky (and Graziano) was to be initially personally responsible with this personal responsibility subsequently being released. Jenofsky contends the parties, by their inclusion of Paragraph 19 in the agreement, manifested an intention to release him from personal responsibility upon the mere formation of the proposed corporation, provided the incorporation was consummated prior to the scheduled closing date. However, while Paragraph 19 does make provision for recognition of the resultant corporation as to the closing documents, it makes no mention of any release of personal liability. Indeed, the entire agreement is silent as to the effect the formation of the projected corporation would have upon the personal liability of Jenofsky and Graziano. Because the agreement fails to provide expressly for the release of personal liability, it is, therefore, subject to more than one possible construction.

In *Consolidated Tile and Slate Co. v. Fox*, 410 Pa. 336,339,189 A.2d 228, 229 (1963), we stated that where an agreement is ambiguous and reasonably susceptible of two interpretations, "it must be construed most strongly against those who drew it."...Instantly, the chancellor determined that the intent of the parties to the agreement was to hold Jenofsky personally responsible until such time as a corporate entity was formed and until such time as that corporate entity adopted the agreement. We believe this construction represents the only rational and prudent interpretation of the parties' intent.

As found by the court below, this agreement was entered into on the financial strength of Jenofsky and Graziano, alone as individuals. Therefore, it would have been illogical for RKO to have consented to the release of their personal liability upon the mere formation of a resultant corporation prior to closing. For it is a well-settled rule that a contract made by a promoter, even though made for and in the name of a proposed corporation, in the absence of a subsequent adoption (either expressly or impliedly) by the corporation, will not be binding upon the corporation. If, as Jenofsky contends, the intent was to release personal responsibility upon the mere incorporation prior to closing, the effect of the agreement would have been to create the possibility that RKO, in the event of non-performance, would be able to hold no party accountable: there being no guarantee that the resultant corporation would ratify the agreement.

Without express language in the agreement indicating that such was the intention of the parties, we may not attribute this intention to them.

Therefore, we hold that the intent of the parties in entering into this agreement was to have Jenofsky and Graziano personally liable until such time as the intended corporation was formed and ratified the agreement. [And there is no evidence that Kent Enterprises ratified the agreement. The decree is affirmed.]

CASE QUESTIONS

1. Does a promoter's personal liability continue even after the corporation is formed? Can he or she look to the corporation for indemnity after the corporation is formed?
2. In what instance(s) is a contract made by a promoter not binding on a corporation?
3. In whose favor does a court construe an ambiguous agreement?

De Jure and De Facto Corporations

Cranson v. International Business Machines Corp.

234 Md. 477, 200 A.2d 33 (1964)

HORNEY, JUDGE

On the theory that the Real Estate Service Bureau was neither a *de jure* nor a *de facto* corporation and that Albion C. Cranson, Jr., was a partner in the business conducted by the Bureau and as such was personally liable for its debts, the International Business Machines Corporation brought this action against Cranson for the balance due on electric typewriters purchased by the Bureau. At the same time it moved for summary judgment and supported the motion by affidavit. In due course, Cranson filed a general issue plea and an affidavit in opposition to summary judgment in which he asserted in effect that the Bureau was a *de facto* corporation and that he was not personally liable for its debts.

The agreed statement of facts shows that in April 1961, Cranson was asked to invest in a new business corporation which was about to be created. Towards this purpose he met with other interested individuals and an attorney and agreed to purchase stock and become an officer and director. Thereafter, upon being advised by the attorney that the corporation had been formed under the laws of Maryland, he paid for and received a stock certificate evidencing ownership of shares in the corporation, and was shown the corporate seal and minute book. The business of the new venture was conducted as if it were a corporation, through corporate bank accounts, with auditors maintaining corporate books and records, and under a lease entered into by the corporation for the office from which it operated its business. Cranson was elected president and all transactions conducted by him for the corporation, including the dealings with I.B.M., were made as an officer of the corporation. At no time did he assume any personal obligation or pledge his individual credit to I.B.M. Due to an oversight on the part of the attorney, of which Cranson was not aware, the certificate of incorporation, which had been signed and acknowledged prior to May 1, 1961, was not filed until November 24, 1961. Between May 17 and November 8, the Bureau purchased eight typewriters from I.B.M., on account of which partial payments were made, leaving a balance due of $4,333.40, for which this suit was brought.

Although a question is raised as to the propriety of making use of a motion for summary judgment as the means of determining the issues presented by the pleadings, we think the motion was appropriate. Since there was no genuine dispute as to the material facts, the only question was whether I.B.M. was entitled to judgment as a matter of law. The trial court found that it was, but we disagree.

The fundamental question presented by the appeal is whether an officer of a defectively incorporated association may be subjected to personal liability under the circumstances of this case. We think not.

Traditionally, two doctrines have been used by the courts to clothe an officer of a defectively incorporated association with the corporate attribute of limited liability. The first, often referred to as the doctrine of *de facto* corporations, has been applied in those cases where there are elements showing: (1) the existence of law authorizing incorporation; (2) an effort in good faith to incorporate under the existing law; and (3) actual use or exercise of corporate powers. The second, the doctrine of estoppel to deny the corporate

existence, is generally employed where the person seeking to hold the officer personally liable has contracted or otherwise dealt with the association in such a manner as to recognize and in effect admit its existence as a corporate body.

* * *

There is, as we see it, a wide difference between creating a corporation by means of the *de facto* doctrine and estopping a party, due to his conduct in a particular case, from setting up the claim of no incorporation. Although some cases tend to assimilate the doctrines of incorporation *de facto* and by estoppel, each is a distinct theory and they are not dependent on one another in their application. Where there is a concurrence of the three elements necessary for the application of the *de facto* corporation doctrine, there exists an entity which is a corporation *de jure* against all persons but the state.

On the other hand, the estoppel theory is applied only to the facts of each particular case and may be invoked even where there is no corporation *de facto*. Accordingly, even though one or more of the requisites of a *de facto* corporation are absent, we think that this factor does not preclude the application of the estoppel doctrine in a proper case, such as the one at bar.

I.B.M. contends that the failure of the Bureau to file its certificate of incorporation debarred *all* corporate existence. But, in spite of the fact that the omission might have prevented the Bureau from being either a corporation *de jure* or *de facto*, Jones v. Linden Building Ass'n, we think that I.B.M. having dealt with the Bureau as if it were a corporation and relied on its credit rather than that of Cranson, is estopped to assert that the Bureau was not incorporated at the time the typewriters were purchased. In 1 Clark and Marshall, Private Corporations, § 89, it is stated:

> *The doctrine in relation to estoppel is based upon the ground that it would generally be inequitable to permit the corporate existence of an association to be denied by persons who have represented it to be a corporation, or held it out as a corporation, or by any persons who have recognized it as a corporation by dealing with it as such; and by the overwhelming weight of*

authority, therefore, a person may be estopped to deny the legal incorporation of an association which is not even a corporation de facto.

In cases similar to the one at bar, involving a failure to file articles of incorporation, the courts of other jurisdictions have held that where one has recognized the corporate existence of an association, he is estopped to assert the contrary with respect to a claim arising out of such dealings.

Since I.B.M. is estopped to deny the corporate existence of the Bureau, we hold that Cranson was not liable for the balance due on account of the typewriters.

Judgment reversed; the appellee to pay the costs.

CASE QUESTIONS

1. What is the fundamental question presented by the case?
2. What are the differences between creating a corporation de facto and by estoppel?

14.8 Summary and Exercises

Summary

The hallmark of the corporate form of business enterprise is limited liability for its owners. Other features of corporations are separation of ownership and management, perpetual existence, and easy transferability of interests. In the early years of the common law, corporations were thought to be creatures of sovereign power and could be created only by state grant. But by the late nineteenth century, corporations could be formed by complying with the requirements of general corporation statutes in virtually every state. Today the standard is the Revised Model Business Corporation Act.

The corporation, as a legal entity, has many of the usual rights accorded natural persons. The principle of limited liability is broad but not absolute: when the corporation is used to commit a fraud or an injustice or when the corporation does not act as if it were one, the courts will pierce the corporate veil and pin liability on stockholders.

Besides the usual business corporation, there are other forms, including not-for-profit corporations and professional corporations. Business corporations are classified into two types: publicly held and closely held corporations.

To form a corporation, the would-be stockholders must choose the state in which they wish to incorporate. The goal of the incorporation process is issuance of a corporate charter. The charter is a contract between the state and the corporation. Although the Constitution prohibits states from impairing the obligation of contracts, states reserve the right to modify corporate charters.

The corporation is created by the incorporators (or promoters), who raise capital, enter into contracts on behalf of the corporation to be formed, and prepare the articles of incorporation. The promoters are personally liable on the contracts they enter into before the corporation is formed. Incorporators owe a fiduciary duty to each other, to investors, and to the corporation.

The articles of incorporation typically contain a number of features, including the corporate name, corporate purposes, total number of shares and classes into which they are divided, par value, and the like. The name must include one of the following words (or abbreviations): corporation, company, incorporated, or limited (Corp., Co., Inc., or Ltd.). The articles of incorporation must be filed with the secretary of state. Once they have been filed, the board of directors named in the articles must adopt bylaws, elect officers, and conduct other necessary business. The directors are empowered to alter the bylaws, subject to repeal or change by the shareholders.

Even if the formal prerequisites to incorporation are lacking, a de facto corporation will be held to have been formed if (1) a statute exists under which the corporation could have been validly incorporated, (2) the promoters made a bona fide attempt to comply with the statute, and (3) a corporate privilege was exercised. Under appropriate circumstances, a corporation will be held to exist by estoppel.

EXERCISES

1. Two young business school graduates, Laverne and Shirley, form a consulting firm. In deciding between the partnership and corporation form of organization, they are especially concerned about personal liability for giving bad advice to their clients; that is, in the event they are sued, they want to prevent plaintiffs from taking their personal assets to satisfy judgments against the firm. Which form of organization would you recommend? Why?
2. Assume that Laverne and Shirley in Exercise 1 must negotiate a large loan from a local bank in order to finance their firm. A friend advises them that they should incorporate in order to avoid personal liability for the loan. Is this good advice? Why?
3. Assume that Laverne and Shirley decide to form a corporation. Before the incorporation process is complete, Laverne enters into a contract on behalf of the corporation to purchase office furniture and equipment for $20,000. After the incorporation process has been completed, the corporation formally accepts the contract made by Laverne. Is Laverne personally liable on the contract before corporate acceptance? After corporate acceptance? Why?
4. Assume that Laverne and Shirley have incorporated their business. One afternoon, an old college friend visits Shirley at the office. Shirley and her friend decide to go out for dinner to discuss old times. Shirley, being short of cash, takes money from a petty cash box to pay for dinner. (She first obtains permission from Laverne, who has done the same thing many times in the past.) Over dinner, Shirley learns that her friend is now an IRS agent and is investigating Shirley's corporation. What problems does Shirley face in the investigation? Why?
5. Assume that Laverne and Shirley prepare articles of incorporation but forget to send the articles to the appropriate state office. A few months after they begin to operate their consulting business as a

corporation, Laverne visits a client. After her meeting, in driving out of a parking lot, Laverne inadvertently backs her car over the client, causing serious bodily harm. Is Shirley liable for the accident? Why?

6. Ralph, a resident of Oklahoma, was injured when using a consumer product manufactured by a corporation whose principal offices were in Tulsa. Since his damages exceeded $10,000, he filed a products-liability action against the company, which was incorporated in Delaware, in federal court. Does the federal court have jurisdiction? Why?
7. Alice is the president and only shareholder of a corporation. The IRS is investigating Alice and demands that she produce her corporate records. Alice refuses, pleading the Fifth Amendment privilege against self-incrimination. May the IRS force Alice to turn over her corporate records? Why?

SELF-TEST QUESTIONS

1 In comparing partnerships with corporations, the major factor favoring the corporate form is

a. ease of formation
b. flexible financing
c. limited liability
d. control of the business by investors

2 A corporation with no part of its income distributable to its members, directors, or officers is called

a. a publicly held corporation
b. a closely held corporation
c. a professional corporation
d. a nonprofit corporation

3 A corporation in which stock is widely held or available through a national or regional stock exchange is called

a. a publicly held corporation
b. a closely held corporation
c. a public corporation
d. none of the above

4 Essential to the formation of a de facto corporation is

CC BY NC SA

a. a statute under which the corporation could have been validly incorporated

b. promoters who make a bona fide attempt to comply with the corporation statute

c. the use or exercise of corporate powers

d. each of the above

5 Even when incorporators miss important steps, it is possible to create

a. a corporation by estoppel

b. a de jure corporation

c. an S corporation

d. none of the above

SELF-TEST ANSWERS

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

CC BY NC SA

Chapter 15
Legal Aspects of Corporate Finance

LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The general sources of corporate funds
2. The basics of corporate bonds and other debt leveraging
3. What the various types of stocks are
4. Initial public offerings and consideration for stock
5. What dividends are
6. Some of the modern trends in corporate finance

A corporation requires money for many reasons. In this chapter, we look at the methods available to a corporation for raising funds, focusing on how firms generate large amounts of funds and finance large projects, such as building a new factory.

One major method of finance is the sale of stock. A corporation sells shares of stock, often in an initial public offering. In exchange for consideration—usually cash—the purchaser acquires stock in the corporation. This stock may give the owner a share in earnings, the right to transfer the stock, and, depending on the size of the corporation and the number of shares, power to exercise control.

Other methods of corporate finance include bank financing and bonds. We also discuss some more modern financing methods, such as private equity and venture capital. Additional methods of corporate finance, such as commercial paper (see Chapter 19 "Nature and Form of Commercial Paper" and Chapter 20 "Negotiation of Commercial Paper"), are discussed elsewhere in this book.

15.1 General Sources of Corporate Funds

LEARNING OBJECTIVES

1. Discuss the main sources for raising corporate funds.
2. Examine the reinvestment of earnings to finance growth.
3. Review debt and equity as methods of raising funds.
4. Consider private equity and venture capital, and compare their utility to other forms of financing.

Sources

To finance growth, any ongoing business must have a source of funds. Apart from bank and trade debt, the principal sources are plowback, debt securities, equity securities, and private equity.

Plowback

A significant source of new funds that corporations spend on capital projects is earnings. Rather than paying out earnings to shareholders, the corporation plows those earnings back into the business. **Plowback** is simply reinvesting earnings in the corporation. It is an attractive source of capital because it is subject to managerial control. No approval by governmental agencies is necessary for its expenditure, as it is when a company seeks to sell securities, or stocks and bonds. Furthermore, stocks and bonds have costs associated with them, such as the interest payments on bonds (discussed in Section 15.1.3 "Debt Securities"), while retaining profits avoids these costs.

Debt Securities

A second source of funds is borrowing through debt securities. A corporation may take out a debt security such as a loan, commonly evidenced by a note and providing security to the lender. This is covered in Chapter 25 "Secured Transactions and Suretyship" and Chapter 26 "Mortgages and Nonconsensual Liens". A common type of corporate debt security is a **bond**, which is a promise to repay the face value of the bond at maturity and make periodic interest payments called the coupon rate. For example, a bond may have a face value of $1,000 (the amount to be repaid at maturity) and a coupon rate of 7 percent paid annually; the corporation pays $70 interest on such a bond each year. Bondholders have priority over stockholders because a bond is a debt, and in the event of bankruptcy, creditors have priority over equity holders.

Equity Securities

The third source of new capital funds is equity securities—namely, **stock**. **Equity** is an ownership interest in property or a business. Stock is the smallest source of new capital but is of critical importance to the corporation in launching the business and its initial operations. Stock gives the investor a bundle of legal rights—ownership, a share in earnings, transferability and, to some extent, the power to exercise control through voting. The usual way to acquire stock is by paying cash or its equivalent as consideration. Both stock and consideration are discussed in more detail in Section 15.3.2 "Par Value and No-Par Stock" and Section 15.4 "Initial Public Offerings and Consideration for Stock".

Other Forms of Finance

While stock, debt securities, and reinvested profits are the most common types of finance for major corporations (particularly publicly traded corporations), smaller corporations or start-ups cannot or do not want to avail themselves of these financing options. Instead, they seek to raise funds through **private equity**, which involves private investors providing funds to a company in exchange for an interest in the company. A private equity firm is a group of investors who pool their money together for investment purposes, usually to invest in other companies. Looking to private equity firms is an option for start-ups—companies newly formed or in the process of being formed—that cannot raise funds through

the bond market or that wish to avoid debt or a public stock sale. Start-ups need money to begin operations, expand, or conduct further research and development. A private equity firm might provide **venture capital** financing for these start-ups. Generally, private equity firms that provide a lot of venture capital must be extremely savvy about the start-up plans of new businesses and must ask the start-up entrepreneurs numerous challenging and pertinent questions. Such private equity firms expect a higher rate of return on their investment than would be available from established companies. Today, venture capital is often used to finance entrepreneurial start-ups in biotechnology and clean technology.

Sometimes, a private equity firm will buy all the publicly traded shares of a company—a process commonly termed "going private." Private equity may also be involved in providing financing to established firms.

Another source of private equity is angel investors, affluent individuals who operate like venture capitalists, providing capital for a business to get started in exchange for repayment with interest or an ownership interest. The main difference between an angel investor and a venture capitalist is the source of funds: an angel investor invests his or her own money, while venture capitalists use pooled funds.

Private equity firms may also use a **leveraged buyout (LBO)** to finance the acquisition of another firm. Discussed further in Chapter 18 "Corporate Expansion, State and Federal Regulation of Foreign Corporations, and Corporate Dissolution" on Corporate Expansion, in the realm of private equity, an LBO is a financing option using debt to acquire another firm. In an LBO, private equity investors use the assets of the target corporation as collateral for a loan to purchase that target corporation. Such investors may pursue an LBO as a debt acquisition option since they do not need to use much—or even any—of their own money in order to finance the acquisition.

A major drawback to private equity, whether through a firm or through venture capital, is the risk versus return trade-off. Private equity investors may demand a significant interest in the firm, or a high return, to compensate them for the riskiness of their investment. They may demand a say in how the firm is operated or a seat on the board of directors.

KEY TAKEAWAY

There are four main sources of corporate finance. The first is plowback, or reinvesting profits in the corporation. The second is borrowing, commonly through a bond issue. A corporation sells a bond, agreeing to periodic interest payments and repayment of the face value of the bond at maturity. The third source is equity, usually stock, whereby a corporation sells an ownership interest in the corporation. The fourth source is private equity and venture capital.

EXERCISES

1. What are the main sources of corporate finance?
2. What are some of the legal rights associated with stock ownership?
3. Describe private equity. What are some similarities and differences between private equity and venture capital?

15.2 Bonds

LEARNING OBJECTIVES

1. Discuss the basics of corporate bonds.
2. Review the advantages and disadvantages to the corporation of issuing bonds.

Basics of Corporate Bonds

CC BY NC SA

Corporations often raise money through debt. This can be done through loans or bank financing but is often accomplished through the sale of bonds. Large corporations, in particular, use the bond market. Private equity is not ideal for established firms because of the high cost to them, both monetarily and in terms of the potential loss of control.

For financing, many corporations sell corporate bonds to investors. A bond is like an IOU. When a corporation sells a bond, it owes the bond purchaser periodic interest payments as well as a lump sum at the end of the life of the bond (the maturity date). A typical bond is issued with a face value, also called the par value, of $1,000 or some multiple of $1,000. The **face value** is the amount that the corporation must pay the purchaser at the end of the life of the bond. Interest payments, also called **coupon payments**, are usually made on a biannual basis but could be of nearly any duration. There are even zero coupon bonds, which pay only the face value at maturity.

Advantages and Disadvantages of Bonds

One advantage of issuing bonds is that the corporation does not give away ownership interests. When a corporation sells stock, it changes the ownership interest in the firm, but bonds do not alter the ownership structure. Bonds provide flexibility for a corporation: it can issue bonds of varying durations, value, payment terms, convertibility, and so on. Bonds also expand the number of investors available to the corporation. From an investor standpoint, bonds are generally less risky than stock. Most corporate bonds are given ratings—a measurement of the risk associated with holding a particular bond. Therefore, risk-averse investors who would not purchase a corporation's stock could seek lower-risk returns in highly rated corporate bonds. Investors are also drawn to bonds because the bond market is much larger than the stock market and bonds are highly liquid and less risky than many other types of investments.

Another advantage to the corporation is the ability to make bonds "callable"—the corporation can force the investor to sell bonds back to the corporation before the maturity date. Often, there is an additional cost to the corporation (a call premium) that must be paid to the bondholder, but the call provision provides another level of flexibility for the corporation. Bonds may also be convertible; the corporation can include a provision that permits bondholders to convert their bonds into equity shares in the firm.

This would permit the corporation to decrease the cost of the bonds, because bondholders would ordinarily accept lower coupon payments in exchange for the option to convert the bonds into equity. Perhaps the most important advantage to issuing bonds is from a taxation standpoint: the interest payments made to the bondholders may be deductible from the corporation's taxes.

A key disadvantage of bonds is that they are debt. The corporation must make its bond interest payments. If a corporation cannot make its interest payments, the bondholders can force it into bankruptcy. In bankruptcy, the bondholders have a liquidation preference over investors with ownership—that is, the shareholders. Additionally, being highly leveraged can be risky: a corporation could load itself up with too much debt and not be able to make its interest payments or face-value payments. Another major consideration is the "cost" of debt. When interest rates are high, corporations must offer higher interest rates to attract investors.

KEY TAKEAWAY

Corporations often raise capital and finance operations through debt. Bank loans are one source of debt, but large corporations often turn to bonds for financing. Bonds are an IOU, whereby the corporation sells a bond to an investor; agrees to make periodic interest payments, such as 5 percent of the face value of the bond annually; and at the maturity date, pays the face value of the bond to the investor. There are several advantages to the corporation in using bonds as a financial instrument: the corporation does not give up ownership in the firm, it attracts more investors, it increases its flexibility, and it can deduct the interest payments from corporate taxes. Bonds do have some disadvantages: they are debt and can hurt a highly leveraged company, the corporation must pay the interest and principal when they are due, and the bondholders have a preference over shareholders upon liquidation.

EXERCISES

1. Describe a bond.
2. What are some advantages to the corporation in issuing bonds?

CC BY NC SA

3. What are some disadvantages to the corporation in using bonds?

15.3 Types of Stock

LEARNING OBJECTIVES

1. Understand the basic features of corporate stock.
2. Be familiar with the basic terminology of corporate stock.
3. Discuss preferred shares and the rights of preferred shareholders.
4. Compare common stock with preferred stock.
5. Describe treasury stock, and explain its function.
6. Analyze whether debt or equity is a better financing option.

Stocks, or **shares**, represent an ownership interest in a corporation. Traditionally, stock was the original capital paid into a business by its founders. This stock was then divided into shares, or fractional ownership of the stock. In modern usage, the two terms are used interchangeably, as we will do here. Shares in closely held corporations are often identical: each share of stock in BCT Bookstore, Inc. carries with it the same right to vote, to receive dividends, and to receive a distribution of the net assets of the company upon liquidation. Many large corporations do not present so simple a picture. Large corporations may have many different types of stock: different classes of common stock, preferred stock, stock with par value and no-par stock, voting and nonvoting stock, outstanding stock, and treasury stock. To find out which types of stock a company has issued, look at the shareholders' (or stockholders') equity section of the company's balance sheet.

Authorized, Issued, and Outstanding Stock

Stocks have different designations depending on who holds them. The articles of incorporation spell out how many shares of stock the corporation may issue: these are its **authorized shares**. The corporation is not obliged to issue all authorized shares, but it may not issue more than the total without amending the articles of incorporation. The total of stock sold to investors is the issued stock of the corporation; the issued stock in the hands of all shareholders is called outstanding stock.

Par Value and No-Par Stock

Par value is the face value of stock. Par value, though, is not the market value; it is a value placed on the stock by the corporation but has little to do with the buying and selling value of that stock on the open market.

When a value is specified on a stock certificate, it is said to be par value. Par value is established in the articles of incorporation and is the floor price of the stock; the corporation may not accept less than par value for the stock.

Companies in most states can also issue no-par shares. No-par stock may be sold for whatever price is set by the board of directors or by the market—unless the shareholders themselves are empowered to establish the price. But many states permit (and some states require) no-par stock to have a stated value. Corporations issue no-par stock to reduce their exposure to liability: if the par value is greater than the market value, the corporation may be liable for that difference.

Once the universal practice, issuance of par value common stock is now limited. However, preferred stock usually has a par value, which is useful in determining dividend and liquidation rights.

The term *stated capital* describes the sum of the par value of the issued par value stock and the consideration received (or stated value) for the no-par stock. The excess of net assets of a corporation over stated capital is its **surplus**. Surplus is divided into earned surplus (essentially the company's retained earnings) and capital surplus (all surpluses other than earned surplus). We will return to these concepts in our discussion of dividends.

Preferred Stock

The term *preferred* has no set legal meaning, but shareholders of **preferred stock** often have different rights than shareholders of common stock. Holders of preferred stock must look to the articles of incorporation to find out what their rights are. Preferred stock has elements of both stock (equity) and bonds (debt). Thus corporations issue preferred stock to attract more conservative investors: common stock is riskier than preferred stock, so corporations can attract more investors if they have both preferred and common stock.

Preference to Dividends

A dividend is a payment made to stockholders from corporate profits. Assume that one class of preferred stock is entitled to a 7 percent dividend. The percentage applies to the par value; if par value is $100, each share of preferred is entitled to a dividend of $7 per year. Assuming the articles of incorporation say so, this 7 percent preferred stock has preference over other classes of shares for dividend payments.

Liquidation Preference

An additional right of preferred shareholders is the right to share in the distribution of assets in the event of liquidation, after having received assets under a liquidation preference—that is, a preference, according to a predetermined formula, to receive the assets of the company on liquidation ahead of other classes of shareholders.

Convertible Shares

With one exception, the articles of incorporation may grant the right to convert any class of stock into any other at the holder's option according to a fixed ratio. Alternatively, the corporation may force a conversion of a shareholder's convertible stock. Thus if permitted, a preferred shareholder may convert his or her preferred shares into common stock, or vice versa. The exception bars conversion of stock into a class with an asset liquidation preference, although some states permit even that type of so-called upstream conversion to a senior security. Convertible preferred shares can be used as a poison pill (a corporate strategy to avoid a hostile takeover): when an outsider seeks to gain control, convertible

shareholders may elect to convert their preferred shares into common stock, thus increasing the number of common shares and increasing the number of shares the outsider must purchase in order to gain control.

Redeemable Shares

The articles of incorporation may provide for the redemption of shares, unless in doing so the corporation would become insolvent. Redemption may be either at an established price and time or by election of the corporation or the shareholder. Redeemed stock is called cancelled stock. Unless the articles of incorporation prohibit it, the shares are considered authorized but unissued and can be reissued as the need arises. If the articles of incorporation specifically make the cancellation permanent, then the total number of authorized shares is reduced, and new shares cannot be reissued without amending the articles of incorporation. In this case, the redeemed shares cannot be reissued and must be marked as cancelled stock.

Voting Rights

Ordinarily, the articles of incorporation provide that holders of preferred shares do not have a voting right. Or they may provide for contingent voting rights, entitling preferred shareholders to vote on the happening of a particular event—for example, the nonpayment of a certain number of dividends. The articles may allow class voting for directors, to ensure that the class of preferred stockholders has some representation on the board.

Common Stock

Common stock is different from preferred stock. Common stock represents an ownership interest in a corporation. Unless otherwise provided in the articles of incorporation, common stockholders have the following rights:

1. Voting rights. This is a key difference: preferred shareholders usually do not have the right to vote. Common shareholders express their ownership interest in the corporation by voting. Votes are cast at meetings, typically the annual meetings, and the shareholders can vote for directors and on other

important corporate decisions (e.g., there has been a recent push to allow shareholders to vote on executive compensation).

2. The right to ratable participation in earnings (i.e., in proportion to the total shares) and/or the right to ratable participation in the distribution of net assets on liquidation. Bondholders and other creditors have seniority upon liquidation, but if they have been satisfied, or the corporation has no debt, the common shareholders may ratably recover from what is left over in liquidation.
3. Some shares may give holders preemptive rights to purchase additional shares. This right is often invoked in two instances. First, if a corporation is going to issue more shares, a shareholder may invoke this right so that his or her total percentage ownership is not diluted. Second, the right to purchase additional shares can be invoked to prevent a hostile takeover (a poison pill, discussed in Section 15.3.3 "Preferred Stock").

Corporations may issue different classes of shares (including both common and preferred stock). This permits a corporation to provide different rights to shareholders. For example, one class of common stock may give holders more votes than another class of common stock. Stock is a riskier investment for its purchasers compared with bonds and preferred stock. In exchange for this increased risk and junior treatment, common stockholders have the rights noted here.

Treasury Shares

Treasury shares are those that were originally issued and then reacquired by the company (such as in a buyback, discussed next) or, alternatively, never sold to the public in the first place and simply retained by the corporation. Thus treasury shares are shares held or owned by the corporation. They are considered to be issued shares but not outstanding shares.

Buyback

Corporations often reacquire their shares, for a variety of reasons, in a process sometimes called a **buyback**. If the stock price has dropped so far that the shares are worth considerably less than book value, the corporation might wish to buy its shares to prevent another company from taking it over. The

company might decide that investing in itself is a better strategic decision than making other potential expenditures or investments. And although it is essentially an accounting trick, buybacks improve a company's per-share earnings because profits need to be divided into fewer outstanding shares.

Buybacks can also be used to go private. Private equity may play a role in going-private transactions, as discussed in Section 15.1.5 "Other Forms of Finance". The corporation may not have sufficient equity to buy out all its public shareholders and thus will partner with private equity to finance the stock buyback to go private. For example, in early 2011, Playboy Enterprises, Inc., publisher of *Playboy* magazine, went private. Hugh Hefner, the founder of Playboy, teamed up with private equity firm Rizvi Traverse Management to buy back the public shares. Hefner said that the transaction "will give us the resources and flexibility to return Playboy to its unique position and to further expand our business around the world." [1]

Corporations may go private to consolidate control, because of a belief that the shares are undervalued, to increase flexibility, or because of a tender offer or hostile takeover. Alternatively, an outside investor may think that a corporation is not being managed properly and may use a tender offer to buy all the public shares.

Stocks and Bonds and Bears, Oh My!

Suppose that BCT Bookstore, Inc. has become a large, well-established corporation after a round of private equity and bank loans (since repaid) but needs to raise capital. What is the best method? There is no one right answer. Much of the decision will depend on the financial and accounting standing of the corporation: if BCT already has a lot of debt, it might be better to issue stock rather than bring on more debt. Alternatively, BCT could wish to remain a privately held corporation, and thus a stock sale would not be considered, as it would dilute the ownership. The economy in general could impact the decision: a bear market could push BCT more toward using debt, while a bull market could push BCT more toward an initial public offering (discussed in Section 15.4.1 "Sale of stock") or stock sale. Interest rates could be low, increasing the bang-for-the-buck factor of debt. Additionally, public stock sales can be risky for the corporation: the corporation could undervalue its stock in the initial sale, selling the stock for less than

what the marketplace thinks it is worth, missing out on additional funds because of this undervaluation. Debt may also be beneficial because of the tax treatment of interest payments—the corporation can deduct the interest payments from corporate profits. Thus there are many factors a corporation must consider when deciding whether to finance through debt or equity.

KEY TAKEAWAY

Stock, or shares (equity), express an ownership interest in a corporation. Shares have different designations, depending on who holds the shares. The two main types of stock are preferred stock and common stock, each with rights that often differ from the rights of the other. Preferred stock has elements of both debt and equity. Holders of preferred shares have a dividend preference and have a right to share in the distribution of assets in liquidation. Holders of common stock have a different set of rights, namely, the right to vote on important corporate decisions such as the election of directors. A corporation may purchase some of its shares from its shareholders in a process called a buyback. Stock in the hands of the corporation is called treasury stock. There are a variety of factors that a corporation must consider in determining whether to raise capital through bonds or through stock issuance.

EXERCISES

1. What are some key rights of holders of preferred shares?
2. What is the major difference between preferred stock and common stock?
3. Why would a corporation buy back its own shares?
4. What are some factors a corporation must consider in deciding whether to issue stock or bonds?

---

[1] Dawn C. Chmielewski and Robert Channick, "Hugh Hefner Reaches Deal to Take Playboy Private," *Los Angeles Times*, January 11, 2011.http://articles.latimes.com/2011/jan/11/business/la-fi-ct-playboy-hefner-20110111.

15.4 Initial Public Offerings and Consideration for Stock

LEARNING OBJECTIVES

1. Understand what an initial public offering is and under what circumstances one is usually done.
2. Examine the various requirements of selling stock.
3. Discuss what adequate and valid consideration is in exchange for stock.

Sale of stock

Rather than using debt to finance operations, a corporation may instead sell stock. This is most often accomplished through an **initial public offering (IPO)**, or the first time a corporation offers stock for sale to the public. The sale of securities, such as stock, is governed by the Securities Act of 1933. In particular, Section 5 of the 1933 act governs the specifics of the sale of securities. To return to BCT Bookstore, Inc., suppose the company wishes to sell stock on the New York Stock Exchange (NYSE) for the first time. That would be an IPO. The company would partner with securities lawyers and investment banks to accomplish the sale. The banks underwrite the sale of the securities: in exchange for a fee, the bank will buy the shares from BCT and then sell them. The company and its team prepare a registration statement, which contains required information about the IPO and is submitted to the Securities and Exchange Commission (SEC). The SEC reviews the registration statement and makes the decision whether to permit or prohibit BCT's IPO. Once the SEC approves the IPO, BCT's investment banks purchase the shares in the primary market and then resell them to investors on the secondary market on the NYSE. (For a further discussion of these two markets, see Chapter 17 "Securities Regulation"). Stock sales are not limited to an IPO—publicly traded corporations may sell stock several times after going public. The requirements of the 1933 act remain but are loosened for well-known corporations (well-known seasoned issuers).

An IPO or stock sale has several advantages. A corporation may have too much debt and would prefer to raise funds through a sale of stock rather than increasing its debt. The total costs of selling stock are often lower than financing through debt: the IPO may be expensive, but debt costs can vastly exceed the IPO cost because of the interest payments on the debt. Also, IPOs are a popular method of increasing a firm's exposure, bringing the corporation many more investors and increasing its public image. Issuing stock is also beneficial for the corporation because the corporation can use shares as compensation; for example, employment compensation may be in the form of stock, such as in an employee stock ownership plan. Investors also seek common stock, whether in an IPO or in the secondary market. While common stock is a riskier investment than a bond, stock ownership can have tremendous upside—after all, the sky is the limit on the price of a stock. On the other hand, there is the downside: the price of the stock can plummet, causing the shareholder significant monetary loss.

Certainly, an IPO has some disadvantages. Ownership is diluted: BCT had very few owners before its IPO but may have millions of owners after the IPO. As mentioned, an IPO can be expensive. An IPO can also be undervalued: the corporation and its investment banks may undervalue the IPO stock price, causing the corporation to lose out on the difference between its determined price and the market price. Being a public corporation also places the corporation under the purview of the SEC and requires ongoing disclosures. Timing can be problematic: the registration review process can take several weeks. The stock markets can change drastically over that waiting period. Furthermore, the offering could have insufficient purchasers to raise sufficient funds; that is, the public might not have enough interest in purchasing the company's stock to bring in sufficient funds to the corporation. Finally, a firm that goes public releases information that is available to the public, which could be useful to competitors (trade secrets, innovations, new technology, etc.).

As mentioned, one of the main disadvantages of going public is the SEC review and disclosure requirements. The Securities Exchange Act of 1934 governs most secondary market transactions. The 1934 act places certain requirements on corporations that have sold securities. Both the 1933 and 1934 acts require corporations to disseminate information to the public and/or its investors. These requirements were strengthened after the collapse of Enron in 2001. The SEC realized that its disclosure

requirements were not strong enough, as demonstrated by the accounting tricks and downfall of Enron and its accountant, Arthur Andersen.[1]

As a result of Enron's accounting scandal, as well as problems with other corporations, Congress tightened the noose by passing the Sarbanes-Oxley Act of 2002.[2] This act increased the disclosure of financial information, increased transparency, and required the dissemination of information about what a corporation was doing. For example, Section 302 of Sarbanes-Oxley requires that a corporation's chief executive officer and chief financial officer certify annual and quarterly reports and state that the report does not contain any material falsehoods and that the financial data accurately reflect the corporation's condition.

Nature of the Consideration

Consideration is property or services exchanged for stock. While cash is commonly used to purchase stock, a stock purchaser may pay with something other than cash, such as property, whether tangible or intangible, or services or labor performed for the corporation. In most states, promissory notes and contracts for future services are not lawful forms of consideration. The case *United Steel Industries, Inc. v. Manhart*, (see Section 15.7.1 "Consideration in Exchange for Stock"), illustrates the problems that can arise when services or promises of future delivery are intended as payment for stock.

Evaluating the Consideration: Watered Stock

In *United Steel Industries* (Section 15.7.1 "Consideration in Exchange for Stock"), assume that Griffitts's legal services had been thought by the corporation to be worth $6,000 but in fact were worth $1,000, and that he had received stock with par value of $6,000 (i.e., 6,000 shares of $1 par value stock) in exchange for his services. Would Griffitts be liable for the $5,000 difference between the actual value of his services and the stock's par value? This is the problem of **watered stock**: the inflated consideration is in fact less than par value. The term itself comes from the ancient fraud of farmers and ranchers who increased the weight of their cattle (also known as stock) by forcing them to ingest excess water.

CC BY NC SA

The majority of states follow the **good-faith rule**. As noted near the end of the *United Steel Industries* case, in the absence of fraud, "the judgment of the board of directors 'as to the value of consideration received for shares' is conclusive." In other words, if the directors or shareholders conclude in good faith that the consideration does fairly reflect par value, then the stock is not watered and the stock buyer cannot be assessed for the difference. This is in line with the business judgment rule, discussed in Chapter 16 "Corporate Powers and Management". If the directors concluded in good faith that the consideration provided by Griffitts's services accurately reflected the value of the shares, they would not be liable. The minority approach is the true value rule: the consideration must in fact equal par value by an objective standard at the time the shares are issued, regardless of the board's good-faith judgment.

A shareholder may commence a derivative lawsuit (a suit by a shareholder, on behalf of the corporation, often filed against the corporation; see Chapter 16 "Corporate Powers and Management"). In a watered stock lawsuit, the derivative suit is filed against a shareholder who has failed to pay full consideration under either rule to recover the difference between the value received by the corporation and the par value.

KEY TAKEAWAY

Corporations may raise funds through the sale of stock. This can be accomplished through an initial public offering (IPO)—the first time a corporation sells stock—or through stock sales after an IPO. The SEC is the regulatory body that oversees the sale of stock. A sale of stock has several benefits for the corporation, such as avoiding the use of debt, which can be much more expensive than selling stock. Stock sales also increase the firm's exposure and attract investors who prefer more risk than bonds. On the other hand, stock sales have some disadvantages, namely, the dilution of ownership of the corporation. Also, the corporation may undervalue its shares, thus missing out on additional capital because of the undervaluation. Being a publicly traded company places the corporation under the extensive requirements of the SEC and the 1933 and 1934

securities acts, such as shareholder meetings and annual financial reports. The Sarbanes-Oxley Act adds yet more requirements that a corporation may wish to avoid.

Consideration is property or services exchanged for stock. Most investors will exchange money for stock. Certain forms of consideration are not permitted. Finally, a corporation may be liable if it sells watered stock, where consideration received by the corporation is less than the stock par value.

EXERCISES

1. Describe the process of conducting an IPO.
2. What are some advantages of selling stock?
3. What are some disadvantages of selling stock?
4. What is consideration? What are some types of consideration that may not be acceptable?

---

[1] For a full discussion of Enron, see Bethany McLean and Peter Elkind, *Enron: The Smartest Guys in the Room* (New York: Portfolio, 2004).

[2] Sarbanes-Oxley Act can be viewed at University of Cincinnati, "The Sarbanes-Oxley Act of 2002," *Securities Lawyer's Deskbook*, http://taft.law.uc.edu/CCL/SOact/toc.html.

15.5 Dividends

LEARNING OBJECTIVES

1. Discuss several types of dividends.
2. Review legal limitations on distributing dividends.
3. Define the duties of directors when paying dividends.

CC BY NC SA

Types of Dividends

A **dividend** is a share of profits, a dividing up of the company's earnings. The law does not require a corporation to give out a specific type of dividend.

Cash Dividend

If a company's finances are such that it can declare a dividend to stockholders, a cash dividend always is permissible. It is a payment (by check, ordinarily) to the stockholders of a certain amount of money per share. Under current law, qualified dividends are taxed as a long-term capital gain (usually 15 percent, but the figure can be as low as zero percent under current law). These rules are set to expire in 2013, when dividends will be taxed as ordinary income (i.e., at the recipient's ordinary income tax rate).

Stock Dividend

Next to cash, the most frequent type of dividend is stock itself. Normally, the corporation declares a small percentage dividend (between 1 and 10 percent), so that a holder of one hundred shares would receive four new shares on a 4 percent dividend share. Although each shareholder winds up with more stock, he realizes no personal net gain at that moment, as he would with a cash dividend, because each stockholder has the same relative proportion of shares and has not sold or otherwise transferred the shares or dividend. The total outstanding stock represents no greater amount of assets than before. The corporation may issue share dividends either from treasury stock or from authorized but unissued shares.

Property Dividend

Rarely, corporations pay dividends in property rather than in cash. Armand Hammer, the legendary financier and CEO of Occidental Petroleum Corporation, recounts how during World War II he founded a liquor business by buying shares of the American Distilling Company. American Distilling was giving out one barrel of whiskey per share as a dividend. Whiskey was in short supply during the war, so Hammer bought five thousand shares and took five thousand barrels of whiskey as a dividend.

Stock Split

A stock dividend should be distinguished from a stock split. In a **stock split**, one share is divided into more shares—for example, a two-for-one split means that for every one share the stockholder owned before the split, he now has two shares. In a reverse stock split, shares are absorbed into one. In a one-for-two reverse split, the stockholder will get one share in place of the two he held before the split.

The stock split has no effect on the assets of the company, nor is the interest of any shareholder diluted. No transfer from surplus into stated capital is necessary. The only necessary accounting change is the adjustment of par value and stated value. Because par value is being changed, many states require not only the board of directors but also the shareholders to approve a stock split.

Why split? The chief reason is to reduce the current market price of the stock in order to make it affordable to a much wider class of investors. For example, in 1978, IBM, whose stock was then selling for around $284, split four for one, reducing the price to about $70 a share. That was the lowest IBM's stock had been since 1932. Stock need not sell at stratospheric prices to be split, however; for example, American Telnet Corporation, whose stock had been selling at $0.4375 a share, declared a five-for-one split in 1980. Apparently the company felt that the stock would be more affordable at $0.0875 a share. At the opposite end of the spectrum are Class A shares of Warren Buffett's Berkshire Hathaway, which routinely trade for more than $100,000 a share. Buffett has rebuffed efforts to split the Class A shares, but in 2010, shareholders approved a fifty-for-one split of Class B shares.[1]

Legal Limitations on Dividends

The law imposes certain limitations on cash or property dividends a corporation may disburse. Dividends may not be paid if (1) the business is insolvent (i.e., unable to pay its debts as they become due), (2) paying dividends would make it insolvent, or (3) payment would violate a restriction in the articles of incorporation. Most states also restrict the funds available for distribution to those available in earned surplus. Under this rule, a corporation that ran a deficit in the current year could still declare a dividend as long as the total earned surplus offset the deficit.

CC BY NC SA

A few states—significantly, Delaware is one of them—permit dividends to be paid out of the net of current earnings and those of the immediately preceding year, both years taken as a single period, even if the balance sheet shows a negative earned surplus. Such dividends are known as nimble dividends. See *Weinberg v. Baltimore Brick Co.*[2]

Distribution from Capital Surplus

Assets in the form of cash or property may be distributed from capital surplus if the articles of incorporation so provide or if shareholders approve the distribution. Such distributions must be identified to the shareholders as coming from capital surplus.

Record Date, Payment Date, Rights of Stockholders

Under the securities exchange rules, the board of directors cannot simply declare a dividend payable on the date of the board meeting and instruct the treasurer to hand out cash. The board must fix two dates: a record date and a payment date. By the first, the board declares a dividend for shareholders of record as of a certain future date—perhaps ten days hence. Actual payment of the dividend is postponed until the payment date, which could be a month after the record date.

The board's action creates a debtor-creditor relationship between the corporation and its shareholders. The company may not revoke a cash dividend unless the shareholders consent. It may revoke a share dividend as long as the shares have not been issued.

Discretion of Directors to Pay Dividends

When Directors Are Too Stingy

In every state, dividends are normally payable only at the discretion of the directors. Courts will order distribution only if they are expressly mandatory or if it can be shown that the directors abused their discretion by acting fraudulently or in a manner that was manifestly unreasonable. *Dodge v. Ford Motor Co.*, (see Section 15.7.2 "Payment of Dividends"), involves Henry Ford's refusal in 1916 to pay dividends in

CC BY NC SA

order to reinvest profits; it is often celebrated in business annals because of Ford's testimony at trial, although, as it turned out, the courts held his refusal to be an act of miserliness and an abuse of discretion. Despite this ruling, many corporations today do not pay dividends. Corporations may decide to reinvest profits in the corporation rather than pay a dividend to its shareholders, or to just sit on the cash. For example, Apple Computer, Inc., maker of many popular computers and consumer electronics, saw its share price skyrocket in the late 2000s. Apple also became one of the most valuable corporations in the world. Despite an immense cash reserve, Apple has refused to pay a dividend, choosing instead to reinvest in the business, stating that they require a large cash reserve as a security blanket for acquisitions or to develop new products. Thus despite the ruling in *Dodge v. Ford Motor Co.*, courts will usually not intercede in a corporation's decision not to pay dividends, following the business judgment rule and the duties of directors. (For further discussion of the duties of directors, see Chapter 16 "Corporate Powers and Management").

When Directors Are Too Generous

Directors who vote to declare and distribute dividends in excess of those allowed by law or by provisions in the articles of incorporation personally may become jointly and severally liable to the corporation (but liability may be reduced or eliminated under the business judgment rule). Shareholders who receive a dividend knowing it is unlawful must repay any directors held liable for voting the illegal dividend. The directors are said to be entitled to contribution from such shareholders. Even when directors have not been sued, some courts have held that shareholders must repay dividends received when the corporation is insolvent or when they know that the dividends are illegal.

KEY TAKEAWAY

A dividend is a payment made from the corporation to its shareholders. A corporation may pay dividends through a variety of methods, although money and additional shares are the most common. Corporations may increase or decrease the total number of shares through either a stock split or a reverse stock split. A corporation may decide to pay dividends but is not required to do so and cannot issue dividends if the

corporation is insolvent. Directors may be liable to the corporation for dividend payments that violate the articles of incorporation or are illegal.

EXERCISES

1. What is a dividend, and what are the main types of dividends?
2. Is a corporation required to pay dividends? Under what circumstances is a corporation barred from paying dividends?
3. You have ten shares of BCT, valued at $10 each. The company engages in a two-for-one stock split. How many shares do you now have? What is the value of each share, and what is the total value of all of your BCT shares?

---

[1] *BusinessWeek* covers many stock splits and reverse splits in its finance section, available at http://www.businessweek.com/finance.

[2] *Weinberg v. Baltimore Brick Co.*, 35 Del. Ch. 225; 114 A.2d 812 (Del. 1955).

15.6 The Winds of Change

LEARNING OBJECTIVES

1. Know the modern changes to corporate finance terminology and specific requirements imposed by states.
2. Compare the application of the Uniform Commercial Code to corporate finance with the applicability of the 1933 and 1934 federal securities acts.

Changes in the Revised Model Business Corporation Act

CC BY NC SA

Perhaps the most dramatic innovations incorporated into the Revised Model Business Corporation Act (RMBCA) are the financial provisions. The revisions recommend eliminating concepts such as par value stock, no-par stock, stated capital, capital surplus, earned surplus, and treasury shares. It was felt that these concepts—notably par value and stated capital—no longer serve their original purpose of protecting creditors.

A key definition under the revisions is that of *distributions*—that is, any transfer of money or property to the shareholders. In order to make distributions, a corporation must meet the traditional insolvency test and balance sheet tests. Under the balance sheet test, corporate assets must be greater than or equal to liabilities and liquidation preferences on senior equity. The RMBCA also provides that promissory notes and contracts for future services may be used in payment for shares.

It is important to note that the RMBCA is advisory. Not every state has abandoned *par value* or the other financial terms. For example, Delaware is quite liberal with its requirements:

> *Every corporation may issue 1 or more classes of stock or 1 or more series of stock within any class thereof, any or all of which classes may be of stock with par value or stock without par value and which classes or series may have such voting powers, full or limited, or no voting powers, and such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof, as shall be stated and expressed in the certificate of incorporation or of any amendment thereto, or in the resolution or resolutions providing for the issue of such stock adopted by the board of directors pursuant to authority expressly vested in it by the provisions of its certificate of incorporation.*[1]

Therefore, although the modern trend is to move away from *par value* as well as some other previously discussed terms—*and despite the RMBCA's abandonment of these concepts*—they still, in large measure, persist.

Introduction to Article 8 of the Uniform Commercial Code

Partial ownership of a corporation would be an awkward investment if there were no ready means of transfer. The availability of paper certificates as tangible evidence of the ownership of equity securities solves the problem of what to transfer, but since a corporation must maintain records of its owners, a set of rules is necessary to spell out how transfers are to be made. That set of rules is Article 8 of the Uniform Commercial Code (UCC). Article 8 governs certificated securities, uncertificated securities, registration requirements, transfer, purchase, and other specifics of securities. Article 8 can be viewed at http://www.law.cornell.edu/ucc/8/overview.html.

The UCC and the 1933 and 1934 Securities Acts

The Securities Act of 1933 requires the registration of securities that are sold or offered to be sold using interstate commerce. The Securities Exchange Act of 1934 governs the secondary trading of securities, such as stock market sales. The UCC also governs securities, through Articles 8 and 9. The key difference is that the 1933 and 1934 acts are federal law, while the UCC operates at the state level. The UCC was established to standardize state laws governing sales and commercial transactions. There are some substantial differences, however, between the two acts and the UCC. Without going into exhaustive detail, it is important to note a few of them. For one, the definition of *security* in the UCC is different from the definition in the 1933 and 1934 acts. Thus a security may be governed by the securities acts but not by the UCC. The definition of a private placement of securities also differs between the UCC and the securities acts. Other differences exist.[2] The UCC, as well as state-specific laws, and the federal securities laws should all be considered in financial transactions.

KEY TAKEAWAY

The RMBCA advises doing away with financial concepts such as stock par value. Despite this suggestion, these concepts persist. Corporate finance is regulated through a variety of mechanisms, most notably Articles 8 and 9 of the Uniform Commercial Code and the 1933 and 1934 securities acts.

EXERCISES

CC BY NC SA

1. What suggested changes are made by the RMBCA?
2. What does UCC Article 8 govern?

---

[1] Del. Code Ann. tit. 8, § 151 (2011).

[2] See Lynn Soukup, "Securities Law and the UCC: When Godzilla Meets Bambi," *Uniform Commercial Code Law Journal* 38, no. 1 (Summer 2005): 3–28.

15.7 Cases

Consideration in Exchange for Stock

United Steel Industries, Inc. v. Manhart

405 S.W.2d 231 (Tex. 1966)

MCDONALD, CHIEF JUSTICE

This is an appeal by defendants, United Steel Industries, Inc., J. R. Hurt and W. B. Griffitts, from a judgment declaring void and cancelling 5000 shares of stock in United Steel Industries, Inc. issued to Hurt, and 4000 shares of stock in such corporation issued to Griffitts.

Plaintiffs Manhart filed this suit individually and as major stockholders against defendants United Steel Industries, Inc., Hurt, and Griffitts, alleging the corporation had issued Hurt 5000 shares of its stock in consideration of Hurt agreeing to perform CPA and bookkeeping services for the corporation for one year in the future; and had issued Griffitts 4000 shares of its stock in consideration for the promised conveyance of a 5 acre tract of land to the Corporation, which land was never conveyed to the Corporation. Plaintiffs assert the 9000 shares of stock were issued in violation of Article 2.16 Business Corporation Act, and prayed that such stock be declared void and cancelled.

Trial was before the Court without a jury which, after hearing, entered judgment declaring the 5000 shares of stock issued to Hurt, and the 4000 shares issued to Griffitts, issued without valid consideration, void, and decreeing such stock cancelled.

* * *

The trial court found (on ample evidence) that the incorporators of the Corporation made an agreement with Hurt to issue him 5000 shares in consideration of Hurt's agreement to perform bookkeeping and accounting services for the Corporation for the first year of its operation. The Corporation minutes reflect the 5000 shares issued to Hurt "in consideration of labor done, services in the incorporation and organization of the Corporation." The trial court found (on ample evidence) that such minutes do not reflect the true consideration agreed upon, and that Hurt performed no services for the Corporation prior to February 1, 1965. The Articles of Incorporation were filed on January 28, 1965, and the 5000 shares were issued to Hurt on May 29, 1965. There is evidence that Hurt performed some services for the Corporation between January and May 29, 1965; but Hurt himself testified the "5000 (shares) were issued to me for services rendered or to be rendered for the first year in keeping the books...."

The situation is thus one where the stock was issued to Hurt both for services already performed and for services to be rendered in the future.

The trial court concluded the promise of future services was not a valid consideration for the issuance of stock under Article 2.16 Business Corporation Act; that the issuance was void; and that since there was no apportionment of the value of future services from the value of services already rendered, the entire 5000 shares were illegally issued and void.

Article 12, Section 6, Texas Constitution, provides: "No corporation shall issue stock...except for money paid, labor done, or property actually received...." And Article 2.16 Texas Business Corporation Act provides: "Payment for Shares.

"A. The consideration paid for the issuance of shares shall consist of money paid, labor done, or property actually received. Shares may not be issued until the full amount of the consideration, fixed as provided by law, has been paid....

"B. Neither promissory notes nor the promise of future services shall constitute payment or part payment for shares of a corporation.

"C. In the absence of fraud in the transaction, the judgment of the board of directors...as to the value of the consideration received for shares shall be conclusive."

The Fifth Circuit in Champion v. CIR, 303 Fed. 2d 887 construing the foregoing constitutional provision and Article 2.16 of the Business Corporation Act, held:

Where it is provided that stock can be issued for labor done, as in Texas...the requirement is not met where the consideration for the stock is work or services to be performed in the future....The situation is not changed by reason of the provision that the stock was to be given...for services rendered as well as to be rendered, since there was no allocation or apportionment of stock between services performed and services to be performed."

The 5000 shares were issued before the future services were rendered. Such stock was illegally issued and void.

Griffitts was issued 10,000 shares partly in consideration for legal services to the Corporation and partly in exchange for the 5 acres of land. The stock was valued at $1 per share and the land had an agreed value of $4000. The trial court found (upon ample evidence) that the 4000 shares of stock issued to Griffitts was in consideration of his promise to convey the land to the Corporation; that Griffitts never conveyed the land; and the issuance of the stock was illegal and void.

The judgment of the board of directors "as to the value of consideration received for shares" is conclusive, but such does not authorize the board to issue shares contrary to the Constitution, for services to be performed in the future (as in the case of Hurt), or for property not received (as in the case of Griffitts).

The judgment is correct. Defendants' points and contentions are overruled.

AFFIRMED.

CASE QUESTIONS

1. What was wrong with the consideration in the transaction between United Steel and Hurt?
2. What if Hurt had completed one year of bookkeeping prior to receiving his shares?
3. What was wrong with the consideration Griffitts provided for the 4,000 shares he received?

Payment of Dividends

Dodge v. Ford Motor Co.

204 Mich. 459, 170 N.W. 668 (Mich. 1919)

[Action by plaintiffs John F. Dodge and Horace E. Dodge against defendant Ford Motor Company and its directors. The lower court ordered the directors to declare a dividend in the amount of $19,275,385.96. The court also enjoined proposed expansion of the company. The defendants appealed.]

[T]he case for plaintiffs must rest upon the claim, and the proof in support of it, that the proposed expansion of the business of the corporation, involving the further use of profits as capital, ought to be enjoined because it is inimical to the best interests of the company and its shareholders, and upon the further claim that in any event the withholding of the special dividend asked for by plaintiffs is arbitrary action of the directors requiring judicial interference.

The rule which will govern courts in deciding these questions is not in dispute. It is, of course, differently phrased by judges and by authors, and, as the phrasing in a particular instance may seem to lean for or

against the exercise of the right of judicial interference with the actions of corporate directors, the context, or the facts before the court, must be considered.

* * *

In 1 Morawetz on Corporations (2d Ed.), § 447, it is stated:

> *Profits earned by a corporation may be divided among its shareholders; but it is not a violation of the charter if they are allowed to accumulate and remain invested in the company's business. The managing agents of a corporation are impliedly invested with a discretionary power with regard to the time and manner of distributing its profits. They may apply profits in payment of floating or funded debts, or in development of the company's business; and so long as they do not abuse their discretionary powers, or violate the company's charter, the courts cannot interfere.*
>
> *But it is clear that the agents of a corporation, and even the majority, cannot arbitrarily withhold profits earned by the company, or apply them to any use which is not authorized by the company's charter....*

Mr. Henry Ford is the dominant force in the business of the Ford Motor Company. No plan of operations could be adopted unless he consented, and no board of directors can be elected whom he does not favor. One of the directors of the company has no stock. One share was assigned to him to qualify him for the position, but it is not claimed that he owns it. A business, one of the largest in the world, and one of the most profitable, has been built up. It employs many men, at good pay.

> *"My ambition," said Mr. Ford, "is to employ still more men, to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes. To do this we are putting the greatest share of our profits back in the business."*
>
> *"With regard to dividends, the company paid sixty per cent on its capitalization of two million dollars, or $1,200,000, leaving $58,000,000 to reinvest for the growth of the company. This is*

Mr. Ford's policy at present, and it is understood that the other stockholders cheerfully accede to this plan."

He had made up his mind in the summer of 1916 that no dividends other than the regular dividends should be paid, "for the present."

"Q. For how long? Had you fixed in your mind any time in the future, when you were going to pay—

"A. No.

"Q. That was indefinite in the future?

"A. That was indefinite, yes, sir."

The record, and especially the testimony of Mr. Ford, convinces that he has to some extent the attitude towards shareholders of one who has dispensed and distributed to them large gains and that they should be content to take what he chooses to give. His testimony creates the impression, also, that he thinks the Ford Motor Company has made too much money, has had too large profits, and that although large profits might be still earned, a sharing of them with the public, by reducing the price of the output of the company, ought to be undertaken. We have no doubt that certain sentiments, philanthropic and altruistic, creditable to Mr. Ford, had large influence in determining the policy to be pursued by the Ford Motor Company—the policy which has been herein referred to.

* * *

The difference between an incidental humanitarian expenditure of corporate funds for the benefit of the employees, like the building of a hospital for their use and the employment of agencies for the betterment of their condition, and a general purpose and plan to benefit mankind at the expense of others, is obvious. There should be no confusion (of which there is evidence) of the duties which Mr. Ford conceives that he and the stockholders owe to the general public and the duties which in law he and his codirectors owe to protesting, minority stockholders. A business corporation is organized and carried on primarily for the

profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end and does not extend to a change in the end itself, to the reduction of profits or to the nondistribution of profits among stockholders in order to devote them to other purposes.

* * *

We are not, however, persuaded that we should interfere with the proposed expansion of the business of the Ford Motor Company. In view of the fact that the selling price of products may be increased at any time, the ultimate results of the larger business cannot be certainly estimated. The judges are not business experts. It is recognized that plans must often be made for a long future, for expected competition, for a continuing as well as an immediately profitable venture. The experience of the Ford Motor Company is evidence of capable management of its affairs. It may be noticed, incidentally, that it took from the public the money required for the execution of its plan and that the very considerable salaries paid to Mr. Ford and to certain executive officers and employees were not diminished. We are not satisfied that the alleged motives of the directors, in so far as they are reflected in the conduct of the business, menace the interests of shareholders. It is enough to say, perhaps, that the court of equity is at all times open to complaining shareholders having a just grievance.

[The court affirmed the lower court's order that the company declare a dividend and reversed the lower court's decision that halted company expansion].

CASE QUESTIONS

1. What basis does the court use to order the payment of dividends?
2. Does the court have a positive view of Mr. Ford?

3. How do you reconcile 1 Morawetz on Corporations (2d Ed.), § 447 ("Profits earned by a corporation may be divided among its shareholders; but it is not a violation of the charter if they are allowed to accumulate and remain invested in the company's business") with the court's decision?
4. Would the business judgment rule have changed the outcome of this case? Note: The business judgment rule, generally summarized, is that the directors are presumed to act in the best interest of the corporation and its shareholders and to fulfill their fiduciary duties of good faith, loyalty, and due care. The burden is on the plaintiff to prove that a transaction was so one sided that no business person of ordinary judgment would conclude that the transaction was proper and/or fair.

15.8 Summary and Exercises

Summary

Corporations finance through a variety of mechanisms. One method is to reinvest profits in the corporation. Another method is to use private equity. Private equity involves financing from private investors, whether individuals (angel investors) or a private equity firm. Venture capital is often used as a fundraising mechanism by businesses that are just starting operations.

A third method is to finance through debt, such as a loan or a bond. A corporation sells a bond and agrees to make interest payments over the life of the bond and to pay the face value of the bond at the bond's maturity.

The final important method of raising capital is by the sale of stock. The articles of incorporation govern the total number of shares of stock that the corporation may issue, although it need not issue the maximum. Stock in the hands of shareholders is said to be authorized, issued, and outstanding. Stock may have a par value, which is usually the floor price of the stock. No-par shares may be sold for any price set by the directors.

Preferred stock (1) may have a dividend preference, (2) takes preference upon liquidation, and (3) may be convertible. Common stock normally has the right to (1) ratable participation in earnings, (2) ratable participation in the distribution of net assets on liquidation, and (3) ratable vote.

Ordinarily, the good-faith judgment of the directors concerning the fair value of the consideration received for stock is determinative. A minority of states adhere to a true value rule that holds to an objective standard.

A corporation that sells shares for the first time engages in an initial public offering (IPO). The Securities Act of 1933 governs most IPOs and initial stock sales. A corporation that has previously issued stock may do so many times afterward, depending on the corporation's needs. The Securities Exchange Act of 1934 governs most secondary market stock sales. The Sarbanes-Oxley Act of 2002 adds another layer of regulation to the financial transactions discussed in this chapter.

A dividend is a share of a corporation's profits. Dividends may be distributed as cash, property, or stock. The law imposes certain limitations on the amount that the corporation may disburse; most states restrict the cash or property available for distribution to earned surplus. However, a few states, including Delaware, permit dividends to be paid out of the net of current earnings and those of the immediately preceding year, both years taken as a single period; these are known as nimble dividends. The directors have discretion, within broad limits, to set the level of dividends; however, they will be jointly and severally liable if they approve dividends higher than allowed by law or under the articles of incorporation.

With several options available, corporations face many factors to consider in deciding how to raise funds. Each option is not available to every corporation. Additionally, each option has advantages and disadvantages. A corporation must carefully weigh the pros and cons of each before making a decision to proceed on a particular financing path.

EXERCISES

1. Ralph and Alice have decided to incorporate their sewer cleaning business under the name R & A, Inc. Their plans call for the authorization and issuance of 5,000 shares of par value stock. Ralph argues that par value must be set at the estimated market value of the stock, while Alice feels that par value is the equivalent of book value—that is, assets divided by the number of shares. Who is correct? Why?
2. In Exercise 1, Ralph feels that R & A should have an IPO of 1 million shares of common stock, to be sold on the New York Stock Exchange (NYSE). What are the pros and cons of conducting an IPO?
3. Assume that Ralph and Alice decide to issue preferred stock. What does this entail from R & A's standpoint? From the standpoint of a preferred stock purchaser?
4. Alice changes her mind and wants to sell bonds in R & A. What are the pros and cons of selling bonds?
5. Assume that Ralph and Alice go on to consider options other than financing through an IPO or through the sale of bonds. They want to raise $5 million to get their business up and running, to purchase a building, and to acquire machines to clean sewers. What are some other options Ralph and Alice should consider? What would you suggest they do? Would your suggestion be different if Ralph and Alice wanted to raise $500 million? $50,000?

SELF-TEST QUESTIONS

1 Corporate funds that come from earnings are called

a. equity securities
b. depletion
c. debt securities
d. plowback

2 When a value is specified on a stock certificate, it is said to be

a. par value
b. no-par
c. an authorized share
d. none of the above

3 Common stockholders normally

a. have the right to vote ratably

b. do not have the right to vote ratably

c. never have preemptive rights

d. hold all of the company's treasury shares

4 Preferred stock may be

a. entitled to cumulative dividends

b. convertible

c. redeemable

d. all of the above

5 When a corporation issues stock to the public for the first time, the corporation engages in

a. a distribution

b. an initial public offering

c. underwriting

d. a stock split

SELF-TEST ANSWERS

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

CC BY NC SA

Chapter 16
Corporate Powers and Management

LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The powers of a corporation to act
2. The rights of shareholders
3. The duties, powers, and liability of officers and directors

CC BY NC SA

Power within a corporation is present in many areas. The corporation itself has powers, although with limitations. There is a division of power between shareholders, directors, and officers. Given this division of power, certain duties are owed amongst the parties. We focus this chapter upon these powers and upon the duties owed by shareholders, directors, and officers. In Chapter 17 "Securities Regulation", we will continue discussion of officers' and directors' liability within the context of securities regulation and insider trading.

16.1 Powers of a Corporation

LEARNING OBJECTIVES

1. Understand the two types of corporate power.
2. Consider the ramifications when a corporation acts outside its prescribed powers.
3. Review legal issues surrounding corporate actions.

Two Types of Corporate Powers

A corporation generally has three parties sharing power and control: directors, officers, and shareholders. Directors are the managers of the corporation, and officers control the day-to-day decisions and work more closely with the employees. The shareholders are the owners of the corporation, but they have little decision-making authority. The corporation itself has powers; while a corporation is not the same as a person (e.g., a corporation cannot be put in prison), it is allowed to conduct certain activities and has been granted certain rights.

Express Powers

The corporation may exercise all powers expressly given it by statute and by its articles of incorporation. Section 3.02 of the Revised Model Business Corporation Act (RMBCA) sets out a number of **express powers**, including the following: to sue and be sued in the corporate name; to purchase, use, and sell land and dispose of assets to the same extent a natural person can; to make contracts, borrow money, issue notes and bonds, lend money, invest funds, make donations to the public welfare, and establish pension plans; and to join in partnerships, joint ventures, trusts, or other enterprises. The powers set out in this section need not be included in the articles of incorporation.

Implied Powers

Corporate powers beyond those explicitly established are **implied powers**. For example, suppose BCT Bookstore, Inc.'s statement of purpose reads simply, "to operate a bookstore." The company may lawfully conduct all acts that are necessary or appropriate to running a bookstore—hiring employees, advertising special sales, leasing trucks, and so forth. Could Ted, its vice president and general manager, authorize the expenditure of funds to pay for a Sunday afternoon lecture on the perils of nuclear war or the adventures of a professional football player? Yes—if the lectures are relevant to current books on sale or serve to bring people into the store, they comply with the corporation's purpose.

The Ultra Vires Doctrine

The law places limitations upon what acts a corporation may undertake. Corporations cannot do anything they wish, but rather, must act within the prescribed rules as laid out in statute, case law, their articles of incorporation, and their bylaws. Sometimes, though, a corporation will step outside its permitted power (literally "beyond the powers). The **ultra vires doctrine** holds that certain legal consequences attach to an attempt by a corporation to carry out acts that are outside its lawful powers. Ultra vires (literally "beyond the powers") is not limited to illegal acts, although it encompasses actions barred by statute as well as by the corporate charter. Under the traditional approach, either the corporation or the other party could assert ultra vires as a defense when refusing to abide by a wholly executory contract. The ultra vires doctrine loses much of its significance when corporate powers are broadly stated in a corporation's

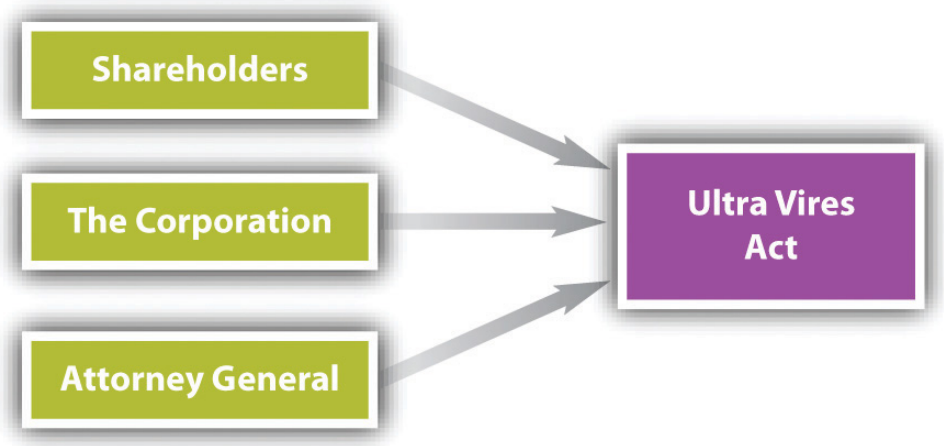
articles. Furthermore, RMBCA Section 3.04 states that “the validity of corporate action may not be challenged on the ground that the corporation lacks or lacked power to act.”

Nonetheless, ultra vires acts are still challenged in courts today. For example, particularly in the area of environmental law, plaintiffs are challenging corporate environmental actions as ultra vires. Delaware corporation law states that the attorney general shall revoke the charter of a corporation for illegal acts. Additionally, the Court of Chancery of Delaware has jurisdiction to forfeit or revoke a corporate charter for abuse of corporate powers.[1] See Adam Sulkowski’s “Ultra Vires Statutes: Alive, Kicking, and a Means of Circumventing the Scalia Standing Gauntlet.”[2]

In essence, ultra vires retains force in three circumstances:

1. Shareholders may bring suits against the corporation to enjoin it from acting beyond its powers.
2. The corporation itself, through receivers, trustees, or shareholders, may sue incumbent or former officers or directors for causing the corporation to act ultra vires.
3. The state attorney general may assert the doctrine in a proceeding to dissolve the corporation or to enjoin it from transacting unauthorized business (see Figure 16.1 "Attacks on Ultra Vires Acts").

Figure 16.1 *Attacks on Ultra Vires Acts*



Suppose an incorporated luncheon club refuses to admit women as club members or guests. What happens if this action is ultra vires? *Cross v. The Midtown Club, Inc.* (see Section 16.5.1 "Ultra Vires Acts"), focuses on this issue. An ultra vires act is not necessarily criminal or tortious. However, every crime and tort is in some sense ultra vires because a corporation never has legal authority to commit crimes or torts. They raise special problems, to which we now turn.

Criminal, Tortious, and Other Illegal Acts

The early common law held that a corporation could not commit a crime because it did not have a mind and could not therefore have the requisite intent. An additional dilemma was that society could not literally imprison a corporation. Modern law is not so constricting. Illegal acts of its agents may be imputed to the corporation. Thus if the board of directors specifically authorizes the company to carry out a criminal scheme, or the president instructs his employees to break a regulatory law for the benefit of the company, the corporation itself may be convicted. Of course, it is rare for people in a corporate setting to avow their criminal intentions, so in most cases courts determine the corporation's liability by deciding whether an employee's crime was part of a job-related activity. The individuals within the corporation are much more likely to be held legally liable, but the corporation may be as well. For example, in extreme cases, a court could order the dissolution of the corporation; revoke some or all of its ability to operate, such as by revoking a license the corporation may hold; or prevent the corporation from engaging in a critical aspect of its business, such as acting as a trustee or engaging in securities transactions. But these cases are extremely rare.

That a corporation is found guilty of a violation of the law does not excuse company officials who authorized or carried out the illegal act. They, too, can be prosecuted and sent to jail. Legal punishments are being routinely added to the newer regulatory statutes, such as the Occupational Safety and Health Act, and the Toxic Substances Control Act—although prosecution depends mainly on whether and where a particular administration wishes to spend its enforcement dollars. Additionally, state prosecuting attorneys have become more active in filing criminal charges against management when employees are injured or die on the job. For instance, a trial court judge in Chicago sentenced a company president, plant manager, and foreman to twenty-five years in prison after they were convicted of murder following

the death of a worker as a result of unsafe working conditions at a plant;[3] the punishments were later overturned, but the three pled guilty several years later and served shorter sentences of varying duration.

More recently, prosecutors have been expanding their prosecutions of corporations and developing methodologies to evaluate whether a corporation has committed a criminal act; for example, US Deputy Attorney General Paul McNulty revised "Principles of Federal Prosecutions of Business Organizations" in 2006 to further guide prosecutors in indicting corporations. The Securities and Exchange Commission, the Department of Justice, other regulatory bodies, and legal professionals have increasingly sought legal penalties against both corporations and its employees. See Exercise 2 at the end of this section to consider the legal ramifications of a corporation and its employees for the drunk-driving death of one of its patrons.

In certain cases, the liability of an executive can be vicarious. The Supreme Court affirmed the conviction of a chief executive who had no personal knowledge of a violation by his company of regulations promulgated by the Food and Drug Administration. In this case, an officer was held strictly liable for his corporation's violation of the regulations, regardless of his knowledge, or lack thereof, of the actions (see Chapter 6 "Criminal Law").[4] This stands in contrast to the general rule that an individual must know, or should know, of a violation of the law in order to be liable. Strict liability does not require knowledge. Thus a corporation's top managers can be found criminally responsible even if they did not directly participate in the illegal activity. Employees directly responsible for violation of the law can also be held liable, of course. In short, violations of tort law, criminal law, and regulatory law can result in negative consequences for both the corporation and its employees.

KEY TAKEAWAY

A corporation has two types of powers: express powers and implied powers. When a corporation is acting outside its permissible power, it is said to be acting ultra vires. A corporation engages in ultra vires acts whenever it engages in illegal activities, such as criminal acts.

EXERCISES

1. What is an ultra vires act?
2. A group of undergraduate students travel from their university to a club. The club provides dinner and an open bar. One student becomes highly intoxicated and dies as the result of an automobile collision caused by the student. Can the club be held liable for the student's death? See *Commonwealth v. Penn Valley Resorts.*[5]

---

[1] Del. Code Ann., Title 8, Section 284 (2011).

[2] Adam Sulkowski, "Ultra Vires Statutes: Alive, Kicking, and a Means of Circumventing the Scalia Standing Gauntlet," *Journal of Environmental Law and Litigation* 14, no. 1 (2009): 75.

[3] *People v. O'Neil*, 550 N.E.2d 1090 (Ill. App. 1990).

[4] *United States v. Park*, 421 U.S. 658 (1975).

[5] *Commonwealth v. Penn Valley Resorts*, 494 A.2d 1139 (Pa. Super. 1985).

16.2 Rights of Shareholders

LEARNING OBJECTIVES

1. Explain the various parts of the corporate management structure and how they relate to one another.
2. Describe the processes and practices of typical corporate meetings, including annual meetings.
3. Explain the standard voting process in most US corporations and what the respective roles of management and shareholders are.
4. Understand what corporate records can be reviewed by a shareholder and under what circumstances.

General Management Functions

In the modern publicly held corporation, ownership and control are separated. The shareholders "own" the company through their ownership of its stock, but power to manage is vested in the directors. In a large publicly traded corporation, most of the ownership of the corporation is diluted across its numerous shareholders, many of whom have no involvement with the corporation other than through their stock ownership. On the other hand, the issue of separation and control is generally irrelevant to the closely held corporation, since in many instances the shareholders are the same people who manage and work for the corporation.

Shareholders do retain some degree of control. For example, they elect the directors, although only a small fraction of shareholders control the outcome of most elections because of the diffusion of ownership and modern proxy rules; proxy fights are extremely difficult for insurgents to win. Shareholders also may adopt, amend, and repeal the corporation's bylaws; they may adopt resolutions ratifying or refusing to ratify certain actions of the directors. And they must vote on certain extraordinary matters, such as whether to amend the articles of incorporation, merge, or liquidate.

Meetings

In most states, the corporation must hold at least one meeting of shareholders each year. The board of directors or shareholders representing at least 10 percent of the stock may call a special shareholders' meeting at any time unless a different threshold number is stated in the articles or bylaws. Timely notice is required: not more than sixty days nor less than ten days before the meeting, under Section 7.05 of the Revised Model Business Corporation Act (RMBCA). Shareholders may take actions without a meeting if every shareholder entitled to vote consents in writing to the action to be taken. This option is obviously useful to the closely held corporation but not to the giant publicly held companies.

Right to Vote

Who Has the Right to Vote?

Through its bylaws or by resolution of the board of directors, a corporation can set a "record date." Only the shareholders listed on the corporate records on that date receive notice of the next shareholders' meeting and have the right to vote. Every share is entitled to one vote unless the articles of incorporation state otherwise.

The one-share, one-vote principle, commonly called **regular voting** or statutory voting, is not required, and many US companies have restructured their voting rights in an effort to repel corporate raiders. For instance, a company might decide to issue both voting and nonvoting shares (as we discussed in Chapter 16 "Corporate Powers and Management"), with the voting shares going to insiders who thereby control the corporation. In response to these new corporate structures, the Securities and Exchange Commission (SEC) adopted a one-share, one-vote rule in 1988 that was designed to protect a shareholder's right to vote. In 1990, however, a federal appeals court overturned the SEC rule on the grounds that voting rights are governed by state law rather than by federal law.[1]

Quorum

When the articles of incorporation are silent, a **shareholder quorum** is a simple majority of the shares entitled to vote, whether represented in person or by proxy, according to RMBCA Section 7.25. Thus if there are 1 million shares, 500,001 must be represented at the shareholder meeting. A simple majority of those represented shares is sufficient to carry any motion, so 250,001 shares are enough to decide upon a matter other than the election of directors (governed by RMBCA, Section 7.28). The articles of incorporation may decree a different quorum but not less than one-third of the total shares entitled to vote.

Cumulative Voting

Cumulative voting means that a shareholder may distribute his total votes in any manner that he chooses—all for one candidate or several shares for different candidates. With cumulative voting, each shareholder has a total number of votes equal to the number of shares he owns multiplied by the number of directors to be elected. Thus if a shareholder has 1,000 shares and there are five directors to be elected, the shareholder has 5,000 votes, and he may vote those shares in a manner he desires (all for one director, or 2,500 each for two directors, etc.). Some states permit this right unless the articles of incorporation deny it. Other states deny it unless the articles of incorporation permit it. Several states have constitutional provisions requiring cumulative voting for corporate directors.

Cumulative voting is meant to provide minority shareholders with representation on the board. Assume that Bob and Carol each owns 2,000 shares, which they have decided to vote as a block, and Ted owns 6,000 shares. At their annual shareholder meeting, they are to elect five directors. Without cumulative voting, Ted's slate of directors would win: under statutory voting, each share represents one vote available for each director position. With this method, by placing as many votes as possible for each director, Ted could cast 6,000 votes for each of his desired directors. Thus each of Ted's directors would receive 6,000 votes, while each of Bob and Carol's directors would receive only 4,000. Under cumulative voting, however, each shareholder has as many votes as there are directors to be elected. Hence with cumulative voting Bob and Carol could strategically distribute their 20,000 votes (4,000 votes multiplied by five directors) among the candidates to ensure representation on the board. By placing 10,000 votes each on two of their candidates, they would be guaranteed two positions on the board. (The candidates from the two slates are not matched against each other on a one-to-one basis; instead, the five candidates with the highest number of votes are elected.) Various formulas and computer programs are available to determine how votes should be allocated, but the principle underlying the calculations is this: cumulative voting is democratic in that it allows the shareholders who own 40 percent of the stock—Bob and Carol—to elect 40 percent of the board.

RMBCA Section 8.08 provides a safeguard against attempts to remove directors. Ordinarily, a director may be removed by a majority vote of the shareholders. Cumulative voting will not aid a given single director whose ouster is being sought because the majority obviously can win on a straight vote. So Section 8.08 provides, "If cumulative voting is authorized, a director may not be removed if the number of votes sufficient to elect him under cumulative voting is voted against his removal."

Voting Arrangements to Concentrate Power

Shareholders use three types of arrangements to concentrate their power: proxies, voting agreements, and voting trusts.

Proxies

A **proxy** is the representative of the shareholder. A proxy may be a person who stands in for the shareholder or may be a written instrument by which the shareholder casts her votes before the shareholder meeting. Modern proxy voting allows shareholders to vote electronically through the Internet, such as at http://www.proxyvoting.com. Proxies are usually solicited by and given to management, either to vote for proposals or people named in the proxy or to vote however the proxy holder wishes. Through the proxy device, management of large companies can maintain control over the election of directors. Proxies must be signed by the shareholder and are valid for eleven months from the time they are received by the corporation unless the proxy explicitly states otherwise. Management may use reasonable corporate funds to solicit proxies if corporate policy issues are involved, but misrepresentations in the solicitation can lead a court to nullify the proxies and to deny reimbursement for the solicitation cost. Only the last proxy given by a particular shareholder can be counted.

Proxy solicitations are regulated by the SEC. For instance, SEC rules require companies subject to the Securities Exchange Act of 1934 to file proxy materials with the SEC at least ten days before proxies are mailed to shareholders. Proxy statements must disclose all material facts, and companies must use a proxy form on which shareholders can indicate whether they approve or disapprove of the proposals.

Dissident groups opposed to management's position are entitled to solicit their own proxies at their own expense. The company must either furnish the dissidents with a list of all shareholders and addresses or mail the proxies at corporate expense. Since management usually prefers to keep the shareholder list private, dissidents can frequently count on the corporation to foot the mailing bill.

Voting Agreements

Unless they intend to commit fraud on a minority of stockholders, shareholders may agree in advance to vote in specific ways. Such a **voting agreement**, often called a shareholder agreement, is generally legal. Shareholders may agree in advance, for example, to vote for specific directors; they can even agree to vote for the dissolution of the corporation in the event that a predetermined contingency occurs. A voting agreement is easier to enter into than a voting trust (discussed next) and can be less expensive, since a

trustee is not paid to administer a voting agreement. A voting agreement also permits shareholders to retain their shares rather than turning the shares over to a trust, as would be required in a voting trust.

Voting Trusts

To ensure that shareholder agreements will be honored, shareholders in most states can create a **voting trust**. By this device, voting shares are given to voting trustees, who are empowered to vote the shares in accordance with the objectives set out in the trust agreement. Section 7.30 of the RMBCA limits the duration of voting trusts to ten years. The voting trust is normally irrevocable, and the shareholders' stock certificates are physically transferred to the voting trustees for the duration of the trust. The voting trust agreement must be on file at the corporation, open for inspection by any shareholder.

Inspection of Books and Records

Shareholders are legally entitled to inspect the records of the corporation in which they hold shares. These records include the articles of incorporation, bylaws, and corporate resolutions. As a general rule, shareholders who want certain records (such as minutes of a board of directors' meeting or accounting records) must also have a "proper purpose," such as to determine the propriety of the company's dividend policy or to ascertain the company's true financial worth. Improper purposes include uncovering trade secrets for sale to a competitor or compiling mailing lists for personal business purposes. A shareholder's motivation is an important factor in determining whether the purpose is proper, as the courts attempt to balance the rights of both the shareholders and the corporation. For example, a Minnesota court applied Delaware law in finding that a shareholder's request to view the corporation's shareholder ledger to identify shareholders and communicate with them about the corporation's involvement in the Vietnam War was improper. A desire to communicate with the other corporate shareholders was found to be insufficient to compel inspection.[2] Contrast that finding with a Delaware court's finding that a shareholder had a proper purpose in requesting a corporation's shareholder list in order to communicate with them about the economic risks of the firm's involvement in Angola.[3]

Preemptive Rights

Assume that BCT Bookstore has outstanding 5,000 shares with par value of ten dollars and that Carol owns 1,000. At the annual meeting, the shareholders decide to issue an additional 1,000 shares at par and

to sell them to Alice. Carol vehemently objects because her percentage of ownership will decline. She goes to court seeking an injunction against the sale or an order permitting her to purchase 200 of the shares (she currently has 20 percent of the total). How should the court rule?

The answer depends on the statutory provision dealing with **preemptive rights**—that is, the right of a shareholder to be protected from dilution of her percentage of ownership. In some states, shareholders have no preemptive rights unless expressly declared in the articles of incorporation, while other states give shareholders preemptive rights unless the articles of incorporation deny it. Preemptive rights were once strongly favored, but they are increasingly disappearing, especially in large publicly held companies where ownership is already highly diluted.

Derivative Actions

Suppose Carol discovers that Ted has been receiving kickbacks from publishers and has been splitting the proceeds with Bob. When at a directors' meeting, Carol demands that the corporation file suit to recover the sums they pocketed, but Bob and Ted outvote her. Carol has another remedy. She can file a **derivative action** against them. A derivative lawsuit is one brought on behalf of the corporation by a shareholder when the directors refuse to act. Although the corporation is named as a defendant in the suit, the corporation itself is the so-called real party in interest—the party entitled to recover if the plaintiff wins.

While derivative actions are subject to abuse by plaintiffs' attorneys seeking settlements that pay their fees, safeguards have been built into the law. At least ninety days before starting a derivative action, for instance, shareholders must demand in writing that the corporation take action. Shareholders may not commence derivative actions unless they were shareholders at the time of the wrongful act. Derivative actions may be dismissed if disinterested directors decide that the proceeding is not in the best interests of the corporation. (A **disinterested director** is a director who has no interest in the disputed transaction.) Derivative actions are discussed further in Chapter 16 "Corporate Powers and Management".

KEY TAKEAWAY

In large publicly traded corporations, shareholders own the corporation but have limited power to affect decisions. The board of directors and officers exercise much of the power. Shareholders exercise their power at meetings, typically through voting for directors. Statutes, bylaws, and the articles of incorporation determine how voting occurs—such as whether a quorum is sufficient to hold a meeting or whether voting is cumulative. Shareholders need not be present at a meeting—they may use a proxy to cast their votes or set up voting trusts or voting agreements. Shareholders may view corporate documents with proper demand and a proper purpose. Some corporations permit shareholders preemptive rights—the ability to purchase additional shares to ensure that the ownership percentage is not diluted. A shareholder may also file suit on behalf of the corporation—a legal proceeding called a derivative action.

EXERCISES

1. Explain cumulative voting. What is the different between cumulative voting and regular voting? Who benefits from cumulative voting?
2. A shareholder will not be at the annual meeting. May that shareholder vote? If so, how?
3. The BCT Bookstore is seeking an additional store location. Ted, a director of BCT, knows of the ideal building that would be highly profitable for BCT and finds out that it is for sale. Unbeknownst to BCT, Ted is starting a clothing retailer. He purchases the building for his clothing business, thereby usurping a corporate opportunity for BCT. Sam, a BCT shareholder, finds out about Ted's business deal. Does Sam have any recourse? See RMBCA Section 8.70.

---

[1] *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

[2] *Pillsbury v. Honeywell*, 291 Minn. 322; 191 N.W.2d 406 (Minn. 1971).

[3] *The Conservative Caucus Research, Analysis & Education Foundation, Inc. v. Chevron*, 525 A.2d 569 (Del. 1987). See Del. Code Ann., Title 8, Section 220 (2011).

16.3 Duties and Powers of Directors and Officers

LEARNING OBJECTIVES

1. Examine the responsibility of directors and the delegation of decisions.
2. Discuss the qualifications, election, and removal of directors.
3. Determine what requirements are placed on directors for meetings and compensation.

General Management Responsibility of the Directors

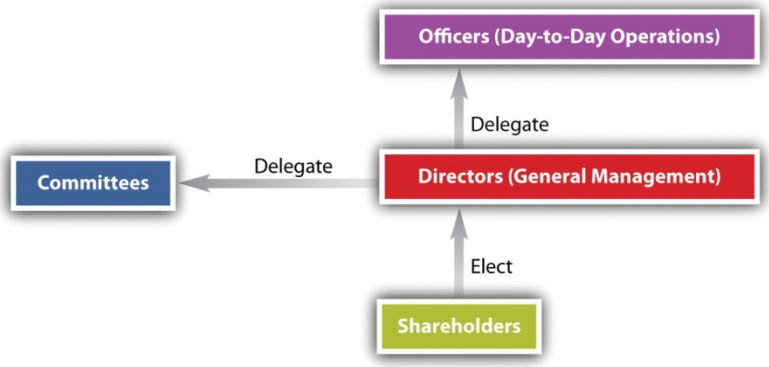
Directors derive their power to manage the corporation from statutory law. Section 8.01 of the Revised Model Business Corporation Act (RMBCA) states that "all corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors." A director is a **fiduciary**, a person to whom power is entrusted for another's benefit, and as such, as the RMBCA puts it, must perform his duties "in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances" (Section 8.30). A director's main responsibilities include the following: (1) to protect shareholder investments, (2) to select and remove officers, (3) to delegate operating authority to the managers or other groups, and (4) to supervise the company as a whole.

Delegation to Committees

Under RMBCA Section 8.25, the board of directors, by majority vote, may delegate its powers to various committees. This authority is limited to some degree. For example, only the full board can determine dividends, approve a merger, and amend the bylaws. The delegation of authority to a committee does not, by itself, relieve a director from the duty to exercise due care.

Delegation to Officers

Figure 16.2 The Corporate Governance Model



The directors often delegate to officers the day-to-day authority to execute the policies established by the board and to manage the firm (see Figure 16.2 "The Corporate Governance Model"). Normally, the president is the chief executive officer (CEO) to whom all other officers and employees report, but sometimes the CEO is also the chairman of the board.

Number and Election of Directors

Section 8.03 of the RMBCA provides that there must be one director, but there may be more, the precise number to be fixed in the articles of incorporation or bylaws. The initial members of the board hold office until the first annual meeting, when elections occur. (The initial board members are permitted to succeed themselves.) Directors are often chosen to serve one-year terms and must be elected or reelected by the shareholders annually, unless there are nine or more directors. In that case, if the articles of incorporation so provide, the board may be divided into two or three roughly equal classes and their terms staggered, so that the second class is elected at the second annual meeting and the third at the third annual meeting. A staggered board allows for the continuity of directors or as a defense against a hostile takeover.

Directors' Qualifications and Characteristics

The statutes do not catalog qualifications that directors are expected to possess. In most states, directors need not be residents of the state or shareholders of the corporation unless required by the articles of incorporation or bylaws, which may also set down more precise qualifications if desired.

Until the 1970s, directors tended to be a homogeneous lot: white male businessmen or lawyers. Political change—rising consumer, environmental, and public interest consciousness—and embarrassment stemming from disclosures made in the wake of Securities and Exchange Commission (SEC) investigations growing out of Watergate prompted companies to diversify their boardrooms. Today, members of minority groups and women are being appointed in increasing numbers, although their proportion to the total is still small. Outside directors (directors who are not employees, officers, or otherwise associated with the corporation; they are also called nonexecutive directors) are becoming a potent force on corporate boards. The trend to promote the use of outside directors has continued—the Sarbanes-Oxley Act of 2002 places emphasis on the use of outside directors to provide balance to the board and protect the corporation's investors.

Removal of Directors and Officers

In 1978, one week before he was scheduled to unveil the 1979 Mustang to trade journalists in person, Lee Iacocca, president of the Ford Motor Company, was summarily fired by unanimous vote of the board of directors, although his departure was billed as a resignation. Iacocca was reported to have asked company chairman Henry Ford II, "What did I do wrong?" To which Ford was said to have replied, "I just don't like you." [1] To return to our usual example: BCT Bookstore is set to announce its acquisition of Borders Group, Inc., a large book retailer that is facing bankruptcy. Alice, one of BCT's directors, was instrumental in the acquisition. One day prior to the announcement of the acquisition, BCT's board relieved Alice of her directorship, providing no reason for the decision. The story raises this question: May a corporate officer, or director for that matter, be fired without cause?

Yes. Many state statutes expressly permit the board to fire an officer with or without cause. However, removal does not defeat an officer's rights under an employment contract. Shareholders may remove

directors with or without cause at any meeting called for the purpose. A majority of the shares entitled to vote, not a majority of the shares represented at the meeting, are required for removal.

Meetings

Directors must meet, but the statutes themselves rarely prescribe how frequently. More often, rules prescribing time and place are set out in the bylaws, which may permit members to participate in any meeting by conference telephone. In practice, the frequency of board meetings varies.

The board or committees of the board may take action without meeting if all members of the board or committee consent in writing. A majority of the members of the board constitutes a quorum, unless the bylaws or articles of incorporation specify a larger number. Likewise, a majority present at the meeting is sufficient to carry any motion unless the articles or bylaws specify a larger number.

Compensation

In the past, directors were supposed to serve without pay, as shareholder representatives. The modern practice is to permit the board to determine its own pay unless otherwise fixed in the articles of incorporation. Directors' compensation has risen sharply in recent years. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, however, has made significant changes to compensation, allowing shareholders a "say on pay," or the ability to vote on compensation.

KEY TAKEAWAY

The directors exercise corporate powers. They must exercise these powers with good faith. Certain decisions may be delegated to a committee or to corporate officers. There must be at least one director, and directors may be elected at once or in staggered terms. No qualifications are required, and directors may be removed without cause. Directors, just like shareholders, must meet regularly and may be paid for their involvement on the board.

EXERCISES

1. What are the fiduciary duties required of a director? What measuring comparison is used to evaluate whether a director is meeting these fiduciary duties?
2. How would a staggered board prevent a hostile takeover?

---

[1] "Friction Triggers Iacocca Ouster," *Michigan Daily*, July 15, 1978.

16.4 Liability of Directors and Officers

LEARNING OBJECTIVES

1. Examine the fiduciary duties owed by directors and officers.
2. Consider constituency statutes.
3. Discuss modern trends in corporate compliance and fiduciary duties.

Nature of the Problem

Not so long ago, boards of directors of large companies were quiescent bodies, virtual rubber stamps for their friends among management who put them there. By the late 1970s, with the general increase in the climate of litigiousness, one out of every nine companies on the *Fortune* 500 list saw its directors or officers hit with claims for violation of their legal responsibilities.[1] In a seminal case, the Delaware Supreme Court found that the directors of TransUnion were grossly negligent in accepting a buyout price of $55 per share without sufficient inquiry or advice on the adequacy of the price, a breach of their duty of care owed to the shareholders. The directors were held liable for $23.5 million for this breach.[2] Thus serving as a director or an officer was never free of business risks. Today, the task is fraught with legal risk as well.

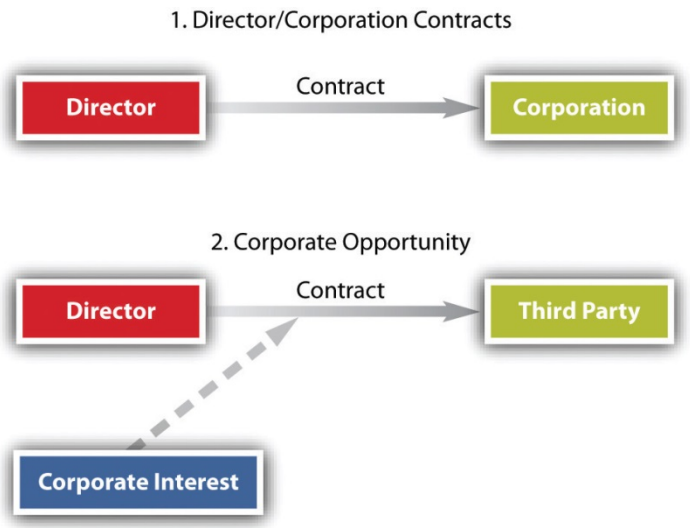
Two main fiduciary duties apply to both directors and officers: one is a duty of loyalty, the other the duty of care. These duties arise from responsibilities placed upon directors and officers because of their

positions within the corporation. The requirements under these duties have been refined over time. Courts and legislatures have both narrowed the duties by defining what is or is not a breach of each duty and have also expanded their scope. Courts have further refined the duties, such as laying out tests such as in the *Caremark* case, outlined in Section 16.4.3 "Duty of Care". Additionally, other duties have been developed, such as the duties of good faith and candor.

Duty of Loyalty

As a fiduciary of the corporation, the director owes his primary loyalty to the corporation and its stockholders, as do the officers and majority shareholders. This responsibility is called the **duty of loyalty**. When there is a conflict between a director's personal interest and the interest of the corporation, he is legally bound to put the corporation's interest above his own. This duty was mentioned in Exercise 3 of Section 16.2 "Rights of Shareholders" when Ted usurped a corporate opportunity and will be discussed later in this section.

Figure 16.3 *Common Conflict Situations*



Two situations commonly give rise to the director or officer's duty of loyalty: (1) contracts with the corporation and (2) corporate opportunity (see Figure 16.3 "Common Conflict Situations").

Contracts with the Corporation

The law does not bar a director from contracting with the corporation he serves. However, unless the contract or transaction is "fair to the corporation," Sections 8.61, 8.62, and 8.63 of the Revised Model Business Corporation Act (RMBCA) impose on him a stringent duty of disclosure. In the absence of a fair transaction, a contract between the corporation and one of its directors is voidable. If the transaction is unfair to the corporation, it may still be permitted if the director has made full disclosure of his personal relationship or interest in the contract and if disinterested board members or shareholders approve the transaction.

Corporate Opportunity

Whenever a director or officer learns of an opportunity to engage in a variety of activities or transactions that might be beneficial to the corporation, his first obligation is to present the opportunity to the corporation. The rule encompasses the chance of acquiring another corporation, purchasing property, and licensing or marketing patents or products. This duty of disclosure was placed into legal lexicon by Judge Cardozo in 1928 when he stated that business partners owe more than a general sense of honor among one another; rather, they owe "the punctilio of honor most sensitive." [3] Thus when a corporate opportunity arises, business partners must disclose the opportunity, and a failure to disclose is dishonest—a breach of the duty of loyalty.

Whether a particular opportunity is a corporate opportunity can be a delicate question. For example, BCT owns a golf course and a country club. A parcel of land adjacent to their course comes on the market for sale, but BCT takes no action. Two BCT officers purchase the land personally, later informing the BCT board about the purchase and receiving board ratification of their purchase. Then BCT decides to liquidate and enters into an agreement with the two officers to sell both parcels of land. A BCT shareholder brings a derivative suit against the officers, alleging that purchasing the adjacent land stole a corporate opportunity. The shareholder would be successful in his suit. In considering *Farber v. Servan Land Co., Inc.*, [4] a case just like the one described, the *Farber* court laid out four factors in considering whether a corporate opportunity has been usurped:

1. Whether there is an actual corporate opportunity that the firm is considering
2. Whether the corporation's shareholders declined to follow through on the opportunity
3. Whether the board or its shareholders ratified the purchase and, specifically, whether there were a sufficient number of disinterested voters
4. What benefit was missed by the corporation

In considering these factors, the *Farber* court held that the officers had breached a duty of loyalty to the corporation by individually purchasing an asset that would have been deemed a corporate opportunity.

When a director serves on more than one board, the problem of corporate opportunity becomes even more complex, because he may be caught in a situation of conflicting loyalties. Moreover, multiple board memberships pose another serious problem. A **direct interlock** occurs when one person sits on the boards of two different companies; an **indirect interlock** happens when directors of two different companies serve jointly on the board of a third company. The Clayton Act prohibits interlocking directorates between direct competitors. Despite this prohibition, as well as public displeasure, corporate board member overlap is commonplace. According to an analysis by *USA Today* and The Corporate Library, eleven of the fifteen largest companies have at least two board members who also sit together on the board of another corporation. Furthermore, CEOs of one corporation often sit on the boards of other corporations. Bank board members may sit on the boards of other corporations, including the bank's own clients. This web of connections has both pros and cons.[5]

Duty of Care

The second major aspect of the director's responsibility is that of **duty of care**. Section 8.30 of RMBCA calls on the director to perform his duties "with the care an ordinarily prudent person in a like position would exercise under similar circumstances." An "ordinarily prudent person" means one who directs his intelligence in a thoughtful way to the task at hand. Put another way, a director must make a reasonable effort to inform himself before making a decision, as discussed in the next paragraph. The director is not held to a higher standard required of a specialist (finance, marketing) unless he is one. A director of a small, closely held corporation will not necessarily be held to the same standard as a director who is given

a staff by a large, complex, diversified company. The standard of care is that which an ordinarily prudent person would use who is in "a like position" to the director in question. Moreover, the standard is not a timeless one for all people in the same position. The standard can depend on the circumstances: a fast-moving situation calling for a snap decision will be treated differently later, if there are recriminations because it was the wrong decision, than a situation in which time was not of the essence.

What of the care itself? What kind of care would an ordinarily prudent person in any situation be required to give? Unlike the standard of care, which can differ, the care itself has certain requirements. At a minimum, the director must pay attention. He must attend meetings, receive and digest information adequate to inform him about matters requiring board action, and monitor the performance of those to whom he has delegated the task of operating the corporation. Of course, documents can be misleading, reports can be slanted, and information coming from self-interested management can be distorted. To what heights must suspicion be raised? Section 8.30 of the RMBCA forgives directors the necessity of playing detective whenever information, including financial data, is received in an apparently reliable manner from corporate officers or employees or from experts such as attorneys and public accountants. Thus the director does not need to check with another attorney once he has received financial data from one competent attorney.

A New Jersey Supreme Court decision considered the requirements of fiduciary duties, particularly the duty of care. Pritchard & Baird was a reissuance corporation owned by Pritchard and having four directors: Pritchard, his wife, and his two sons. Pritchard and his sons routinely took loans from the accounts of the firm's clients. After Pritchard died, his sons increased their borrowing, eventually sending the business into bankruptcy. During this time, Mrs. Pritchard developed a fondness for alcohol, drinking heavily and paying little attention to her directorship responsibilities. Creditors sued Mrs. Pritchard for breaches of her fiduciary duties, essentially arguing that the bankruptcy would not have occurred had she been acting properly. After both the trial court and appellate court found for the creditors, the New Jersey Supreme Court took up the case. The court held that a director must have a basic understanding of the business of the corporation upon whose board he or she sits. This can be accomplished by attending meetings, reviewing and understanding financial documents, investigating irregularities, and generally

being involved in the corporation. The court found that Mrs. Pritchard's being on the board because she was the spouse was insufficient to excuse her behavior, and that had she been performing her duties, she could have prevented the bankruptcy.[6]

Despite the fiduciary requirements, in reality a director does not spend all his time on corporate affairs, is not omnipotent, and must be permitted to rely on the word of others. Nor can directors be infallible in making decisions. Managers work in a business environment, in which risk is a substantial factor. No decision, no matter how rigorously debated, is guaranteed. Accordingly, courts will not second-guess decisions made on the basis of good-faith judgment and due care. This is the **business judgment rule**, mentioned in previous chapters. The business judgment rule was coming into prominence as early as 1919 in *Dodge v. Ford*, discussed in Chapter 15 "Legal Aspects of Corporate Finance". It has been a pillar of corporate law ever since. As described by the Delaware Supreme Court: "The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors....It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[7]

Under the business judgment rule, the actions of directors who fulfill their fiduciary duties will not be second-guessed by a court. The general test is whether a director's decision or transaction was so one sided that no businessperson of ordinary judgment would reach the same decision. The business judgment rule has been refined over time. While the business judgment rule may seem to provide blanket protection for directors (the rule was quite broad as outlined by the court in *Dodge v. Ford*), this is not the case. The rule does not protect every decision made by directors, and they may face lawsuits, a topic to which we now turn. For further discussions of the business judgment rule, see *Cede & Co. v. Technicolor, Inc.*,[8] *In re The Walt Disney Co. Derivative Litigation*,[9] and *Smith v. Van Gorkom*.[10]

If a shareholder is not pleased by a director's decision, that shareholder may file a derivative suit. The derivative suit may be filed by a shareholder on behalf of the corporation against directors or officers of the corporation, alleging breach of their fiduciary obligations. However, a shareholder, as a prerequisite to filing a derivative action, must first demand that the board of directors take action, as the actual party in

interest is the corporation, not the shareholder (meaning that if the shareholder is victorious in the lawsuit, it is actually the corporation that "wins"). If the board refuses, is its decision protected by the business judgment rule? The general rule is that the board may refuse to file a derivative suit and will be protected by the business judgment rule. And even when a derivative suit is filed, directors can be protected by the business judgment rule for decisions even the judge considers to have been poorly made. See *In re The Walt Disney Co. Derivative Litigation*, (see Section 16.5.2 "Business Judgment Rule").

In a battle for control of a corporation, directors (especially "inside" directors, who are employees of the corporation, such as officers) often have an inherent self-interest in preserving their positions, which can lead them to block mergers that the shareholders desire and that may be in the firm's best interest. As a result, Delaware courts have modified the usual business judgment presumption in this situation. In *Unocal Corp. v. Mesa Petroleum*,[11] for instance, the court held that directors who adopt a defensive mechanism "must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed....[T]hey satisfy that burden 'by showing good faith and reasonable investigation.'" The business judgment rule clearly does not protect every decision of the board. The *Unocal* court developed a test for the board: the directors may only work to prevent a takeover when they can demonstrate a threat to the policies of the corporation and that any defensive measures taken to prevent the takeover were reasonable and proportional given the depth of the threat. The *Unocal* test was modified further by requiring a finding, before a court steps in, that the actions of a board were coercive, a step back toward the business judgment rule.[12]

In a widely publicized case, the Delaware Supreme Court held that the board of Time, Inc. met the *Unocal* test—that the board reasonably concluded that a tender offer by Paramount constituted a threat and acted reasonably in rejecting Paramount's offer and in merging with Warner Communications.[13]

The specific elements of the fiduciary duties are not spelled out in stone. For example, the Delaware courts have laid out three factors to examine when determining whether a duty of care has been breached:[14]

1. The directors knew, or should have known, that legal breaches were occurring.
2. The directors took no steps to prevent or resolve the situation.
3. This failure caused the losses about which the shareholder is complaining in a derivative suit.

Thus the court expanded the duty of oversight (which is included under the umbrella of the duty of care; these duties are often referred to as the *Caremark* duties). Furthermore, courts have recognized a **duty of good faith**—a duty to act honestly and avoid violations of corporate norms and business practices.[15] Therefore, the split in ownership and decision making within the corporate structure causes rifts, and courts are working toward balancing the responsibilities of the directors to their shareholders with their ability to run the corporation.

Constituency Statutes and Corporate Social Responsibility

Until the 1980s, the law in all the states imposed on corporate directors the obligation to advance shareholders' economic interests to ensure the long-term profitability of the corporation. Other groups—employees, local communities and neighbors, customers, suppliers, and creditors—took a back seat to this primary responsibility of directors. Of course, directors could consider the welfare of these other groups if in so doing they promoted the interests of shareholders. But directors were not legally permitted to favor the interests of others over shareholders. The prevailing rule was, and often still is, that maximizing shareholder value is the primary duty of the board. Thus in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[16] the Delaware Supreme Court held that Revlon's directors had breached their fiduciary duty to the company's shareholders in response to a hostile tender offer from Pantry Pride. While the facts of the case are intricate, the general gist is that the Revlon directors thwarted the hostile tender by adopting a variation of a poison pill involving a tender offer for their own shares in exchange for debt, effectively eliminating Pantry Pride's ability to take over the firm. Pantry Pride upped its offer price, and in response, Revlon began negotiating with a leveraged buyout by a third party, Forstmann Little. Pantry Pride publicly announced it would top any bid made by Forstmann Little. Despite this, the Revlon board negotiated a deal with Forstmann Little. The court noted an exception to the general rule that permitted directors to consider the interests of other groups as long as "there are rationally related benefits accruing

to the stockholders." But when a company is about to be taken over, the object must be to sell it to the highest bidder, Pantry Pride in this case. It is then, said the court, in situations where the corporation is to be sold, that "concern for nonstockholder interests is inappropriate," thus giving rise to what are commonly called the Revlon duties.

Post-*Revlon*, in response to a wave of takeovers in the late 1980s, some states have enacted laws to give directors legal authority to take account of interests other than those of shareholders in deciding how to defend against hostile mergers and acquisitions. These laws are known as **constituency statutes**, because they permit directors to take account of the interests of other constituencies of corporations. These do not permit a corporation to avoid its Revlon duties (that when a corporation is up for sale, it must be sold to the highest bidder) but will allow a corporation to consider factors other than shareholder value in determining whether to make charitable donations or reinvest profits. This ability has been further expanding as the concept of corporate social responsibility has grown, as discussed later in this section.

Although the other constituency statutes are not identically worded, they are all designed to release directors from their formal legal obligation to keep paramount the interests of shareholders. The Pennsylvania and Indiana statutes make this clear; statutes in other states are worded a bit more ambiguously, but the intent of the legislatures in enacting these laws seems clear: directors may give voice to employees worried about the loss of jobs or to communities worried about the possibility that an out-of-state acquiring company may close down a local factory to the detriment of the local economy. So broadly worded are these laws that although the motive for enacting them was to give directors a weapon in fighting hostile tender offers, in some states the principle applies to any decision by a board of directors. So, for example, it is possible that a board might legally decide to give a large charitable grant to a local community—a grant so large that it would materially decrease an annual dividend, contrary to the general rule that at some point the interests of shareholders in dividends clearly outweighs the board's power to spend corporate profits on "good works."

Critics have attacked the constituency statutes on two major grounds: first, they substitute a clear principle of conduct for an amorphous one, because they give no guidance on how directors are supposed to weigh the interests of a corporation's various constituencies. Second, they make it more difficult for shareholders to monitor the performance of a company's board; measuring decisions against the single goal of profit maximization is far easier than against the subjective goal of "balancing" a host of competing interests. Constituency statutes run contrary to the concept of shareholders as owners, and of the fiduciary duties owed to them, effectively softening shareholder power. Nevertheless, since many states now have constituency statutes, it is only reasonable to expect that the traditional doctrine holding shareholder interests paramount will begin to give way, even as the shareholders challenge new decisions by directors that favor communities, employees, and others with an important stake in the welfare of the corporations with which they deal. For a more complete discussion of constituency statutes, see "Corporate Governance and the Sarbanes-Oxley Act: Corporate Constituency Statutes and Employee Governance." [17]

Many modern corporations have begun to promote socially responsible behavior. While dumping toxic waste out the back door of the manufacturing facility rather than expending funds to properly dispose of the waste may result in an increase in value, the consequences of dumping the waste can be quite severe, whether from fines from regulatory authorities or from public backlash. Corporate social responsibility results from internal corporate policies that attempt to self-regulate and fulfill legal, ethical, and social obligations. Thus under corporate social responsibility, corporations may make donations to charitable organizations or build environmentally friendly or energy-efficient buildings. Socially irresponsible behavior can be quite disastrous for a corporation. Nike, for example, was hit by consumer backlash due to its use of child labor in other countries, such as India and Malaysia. British Petroleum (BP) faced public anger as well as fines and lawsuits for a massive oil spill in the Gulf of Mexico. This spill had serious consequences for BP's shareholders—BP stopped paying dividends, its stock price plummeted, and it had to set aside significant amounts of money to compensate injured individuals and businesses.
Many businesses try to fulfill what is commonly called the triple bottom line, which is a focus on profits, people, and the planet. For example, Ben and Jerry's, the ice cream manufacturer, had followed a triple bottom line practice for many years. Nonetheless, when Ben and Jerry's found itself the desired

acquisition of several other businesses, it feared that a takeover of the firm would remove this focus, since for some firms, there is only one bottom line—profits. Unilever offered $43.60 per share for Ben and Jerry's. Several Ben and Jerry's insiders made a counteroffer at $38 per share, arguing that a lower price was justified given the firm's focus. Ultimately, in a case like this, the Revlon duties come into play: when a corporation is for sale, corporate social responsibility goes out the window and only one bottom line exists—maximum shareholder value. In the case of Ben and Jerry's, the company was acquired in 2000 for $326 million by Unilever, the Anglo-Dutch corporation that is the world's largest consumer products company.

Sarbanes-Oxley and Other Modern Trends

The Sarbanes-Oxley Act of 2002, enacted following several accounting scandals, strengthens the duties owed by the board and other corporate officers. In particular, Title III contains corporate responsibility provisions, such as requiring senior executives to vouch for the accuracy and completeness of their corporation's financial disclosures. While the main goal of Sarbanes-Oxley is to decrease the incidents of financial fraud and accounting tricks, its operative goal is to strengthen the fiduciary duties of loyalty and care as well as good faith.

The modern trend has been to impose more duties. Delaware has been adding to the list of fiduciary responsibilities other than loyalty and care. As mentioned previously, the Delaware judicial system consistently recognizes a duty of good faith. The courts have further added a duty of candor with shareholders when the corporation is disseminating information to its investors. Particular duties arise in the context of mergers, acquisitions, and tender offers. As mentioned previously in the *Revlon* case, the duty owed to shareholders in situations of competing tender offers is that of maximum value. Other duties may arise, such as when directors attempt to retain their positions on the board in the face of a hostile tender offer. Trends in fiduciary responsibilities, as well as other changes in the business legal field, are covered extensively by the American Bar Association at http://www.americanbar.org/groups/business_law.html.

Liability Prevention and Insurance

Alice, the director of BCT, has been charged with breaching her duty of care. Is she personally liable for a breach of the duty of care? How can a director avoid liability? Of course, she can never avoid defending a lawsuit, for in the wake of any large corporate difficulty—from a thwarted takeover bid to a bankruptcy—some group of shareholders will surely sue. But the director can immunize herself ultimately by carrying out her duties of loyalty and care. In practice, this often means that she should be prepared to document the reasonableness of her reliance on information from all sources considered. Second, if the director dissents from action that she considers mistaken or unlawful, she should ensure that her negative vote is recorded. Silence is construed as assent to any proposition before the board, and assent to a woefully mistaken action can be the basis for staggering liability.

Corporations, however, are permitted to limit or eliminate the personal liability of its directors. For example, Delaware law permits the articles of incorporation to contain a provision eliminating or limiting the personal liability of directors to the corporation, with some limitations.[18]

Beyond preventive techniques, another measure of protection from director liability is **indemnification** (reimbursement). In most states, the corporation may agree under certain circumstances to indemnify directors, officers, and employees for expenses resulting from litigation when they are made party to suits involving the corporation. In third-party actions (those brought by outsiders), the corporation may reimburse the director, officer, or employee for all expenses (including attorneys' fees), judgments, fines, and settlement amounts. In derivative actions, the corporation's power to indemnify is more limited. For example, reimbursement for litigation expenses of directors adjudged liable for negligence or misconduct is allowed only if the court approves. In both third-party and derivative actions, the corporation must provide indemnification expenses when the defense is successful.

Whether or not they have the power to indemnify, corporations may purchase liability insurance for directors, officers, and employees (for directors and officers, the insurance is commonly referred to as D&O insurance). But insurance policies do not cover every act. Most exclude "willful negligence" and criminal conduct in which intent is a necessary element of proof. Furthermore, the cost of liability insurance has increased dramatically in recent years, causing some companies to cancel their coverage.

This, in turn, jeopardizes the recent movement toward outside directors because many directors might prefer to leave or decline to serve on boards that have inadequate liability coverage. As a result, most states have enacted legislation that allows a corporation, through a charter amendment approved by shareholders, to limit the personal liability of its outside directors for failing to exercise due care. In 1990, Section 2.02 of the RMBCA was amended to provide that the articles of incorporation may include "a provision eliminating or limiting the liability of a director to the corporation or its shareholders for money damages...." This section includes certain exceptions; for example, the articles may not limit liability for intentional violations of criminal law. Delaware Code Section 102(b)(7), as mentioned previously, was enacted after *Smith v. Van Gorkom* (discussed in Section 16.4.3 "Duty of Care") and was prompted by an outcry about the court's decision. As a result, many corporations now use similar provisions to limit director liability. For example, Delaware and California permit the limitation or abolition of liability for director's breach of the duty of care except in instances of fraud, bad faith, or willful misconduct.

KEY TAKEAWAY

Directors and officers have two main fiduciary duties: the duty of loyalty and the duty of care. The duty of loyalty is a responsibility to act in the best interest of the corporation, even when that action may conflict with a personal interest. This duty commonly arises in contracts with the corporation and with corporate opportunities. The duty of care requires directors and officers to act with the care of an ordinarily prudent person in like circumstances. The business judgment rule may protect directors and officers, since courts give a presumption to the corporation that its personnel are informed and act in good faith. A shareholder may file a derivative lawsuit on behalf of the corporation against corporate insiders for breaches of these fiduciary obligations or other actions that harm the corporation. While directors and officers have obligations to the corporation and its shareholders, they may weigh other considerations under constituency statutes. In response to recent debacles, state and federal laws, such as Sarbanes-Oxley, have placed further requirements on officers and directors. Director and officer expenses in defending claims of wrongful acts may be covered through indemnification or insurance.

EXERCISES

1. What are the two major fiduciary responsibilities that directors and officers owe to the corporation and its shareholders?
2. What are some benefits of having interlocking directorates? What are some disadvantages?
3. Is there any connection between the business judgment rule and constituency statutes?

---

[1] "D & O Claims Incidence Rises," *Business Insurance*, November 12, 1979, 18.

[2] *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

[3] *Meinhard v. Salmon*, 164 N.W. 545 (N.Y. 1928).

[4] *Farber v. Servan Land Co., Inc.*, 662 F.2d 371 (5th Cir. 1981).

[5] For a further discussion of board member connectedness, see Matt Krant, "Web of Board Members Ties Together Corporation America," at http://www.usatoday.com/money/companies/management/2002-11-24-interlock_x.htm.

[6] *Francis v. United Jersey Bank*, 87 N.J. 15, 432 A.2d 814 (N.J. 1981).

[7] *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

[8] *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993).

[9] *In re The Walt Disney Co. Derivative Litigation*, 906 A.2d 27 (Del. 2006).

[10] *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

[11] *Unocal Corp. v. Mesa Petroleum*, 493 A.2d 946 (Del. 1985).

[12] *Unitrin v. American General Corp.*, 651 A.2d 1361 (Del. 1995).

[13] *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989).

[14] *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

[15] For more information, see Melvin Eisenberg, "The Duty of Good Faith in Corporate Law," 31 *Delaware Journal of Corporate Law*, 1 (2005).

[16] *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

[17] Brett H. McDonnell, "Corporate Governance and the Sarbanes-Oxley Act: Corporate Constituency Statutes and Employee Governance," *William Mitchell Law Review* 30 (2004): 1227.

[18] Del. Code Ann., Title 8, Section 102(b)(7) (2011).

16.5 Cases

Ultra Vires Acts

Cross v. The Midtown Club, Inc.

33 Conn. Supp. 150; 365 A.2d 1227 (Conn. 1976)

STAPLETON, JUDGE.

The following facts are admitted or undisputed: The plaintiff is a member in good standing of the defendant nonstock Connecticut corporation. Each of the individual defendants is a director of the corporation, and together the individual defendants constitute the entire board of directors. The certificate of incorporation sets forth that the sole purpose of the corporation is "to provide facilities for the serving of luncheon or other meals to members." Neither the certificate of incorporation nor the bylaws of the corporation contain any qualifications for membership, nor does either contain any restrictions on the luncheon guests members may bring to the club. The plaintiff sought to bring a female to lunch with him, and both he and his guest were refused seating at the luncheon facility. The plaintiff wrote twice to the president of the corporation to protest the action, but he received no reply to either letter. On three different occasions, the plaintiff submitted applications for membership on behalf of a different female, and only on the third of those occasions did the board process the application, which it then rejected. Shortly after both of the above occurrences, the board of directors conducted two separate pollings of its members, one by mail, the other by a special meeting held to vote on four alternative proposals for amending the bylaws of corporation concerning the admission of women members and guests. None of these proposed amendments to the bylaws received the required number of votes for adoption. Following that balloting, the plaintiff again wrote to the president of the corporation and asked that the directors stop interfering with his rights as a member to bring women guests to the luncheon facility and to propose women for membership. The president's reply was that "the existing bylaws, house rules and customs continue in effect, and therefore [the board] consider[s] the matter closed."

* * *

In addition to seeking a declaratory judgment which will inform him of his rights vis-à-vis the corporation and its directors, the plaintiff is also seeking injunctive relief, orders directing the admission of the plaintiff's candidate to membership and denying indemnity to the directors, money damages, and costs and expenses including reasonable attorney's fees. It should be noted at the outset that the plaintiff is not making a claim under either the federal or state civil rights or equal accommodations statutes, but that he is solely asserting his membership rights under the certificate of incorporation, the bylaws, and the statutes governing the regulation of this nonstock corporation. As such, this is a case of first impression in Connecticut.

* * *

Connecticut has codified the common-law right of a member to proceed against his corporation or its directors in the event of an ultra vires act. In fact, it has been done specifically under the Nonstock Corporation Act.

No powers were given to the defendant corporation in its certificate of incorporation, only a purpose, and as a result the only incidental powers which the defendant would have under the common law are those which are necessary to effect its purpose, that being to serve lunch to its members. Since the club was not formed for the purpose of having an exclusively male luncheon club, it cannot be considered necessary to its stated purpose for the club to have the implied power at common law to exclude women members.

Under the Connecticut Nonstock Corporation Act, the corporation could have set forth in its certificate of incorporation that its purpose was to engage in any lawful activity permitted that corporation. That was not done. Its corporate purposes were very narrowly stated to be solely for providing "facilities for the serving of luncheon or other meals to members." The certificate did not restrict the purpose to the serving of male members. Section 33-428 of the General Statutes provides that the corporate powers of a nonstock corporation are those set forth in the Nonstock Corporation Act, those specifically stated in the

certificate of incorporation, neither of which includes the power to exclude women members, and the implied power to "exercise all legal powers necessary or convenient to effect any or all of the purposes stated in its certificate of incorporation...."

We come, thus, to the nub of this controversy and the basic legal question raised by the facts in this case: Is it necessary or convenient to the purpose for which this corporation was organized for it to exclude women members? This court concludes that it is not. While a corporation might be organized for the narrower purpose of providing a luncheon club for men only, this one was not so organized. Its stated purpose is broader and this court cannot find that it is either necessary or convenient to that purpose for its membership to be restricted to men. It should be borne in mind that this club is one of the principal luncheon clubs for business and professional people in Stamford. It is a gathering place where a great many of the civic, business, and professional affairs of the Stamford community are discussed in an atmosphere of social intercourse. Given the scope of the entry of women today into the business and professional life of the community and the changing status of women before the law and in society, it would be anomalous indeed for this court to conclude that it is either necessary or convenient to the stated purpose for which it was organized for this club to exclude women as members or guests.

While the bylaws recognize the right of a member to bring guests to the club, the exclusion of women guests is nowhere authorized and would not appear to be any more necessary and convenient to the purpose of the club than the exclusion of women members. The bylaws at present contain no restrictions against female members or guests and even if they could be interpreted as authorizing those restrictions, they would be of no validity in light of the requirement of § 33-459 (a) of the General Statutes, that the bylaws must be "reasonable [and] germane to the purposes of the corporation...."

The court therefore concludes that the actions and policies of the defendants in excluding women as members and guests solely on the basis of sex is ultra vires and beyond the power of the corporation and its management under its certificate of incorporation and the Nonstock Corporation Act, and in derogation of the rights of the plaintiff as a member thereof. The plaintiff is entitled to a declaratory judgment to that effect and one may enter accordingly.

CASE QUESTIONS

1. What is the basis of the plaintiff's claim?
2. Would the club have had a better defense against the plaintiff's claim if its purpose was "to provide facilities for the serving of luncheon or other meals to male members"?
3. Had the corporation's purpose read as it does in Question 2, would the plaintiff have had other bases for a claim?

Business Judgment Rule

In re The Walt Disney Co. Derivative Litigation

907 A.2d 693 (Del. Ch. 2005)

JACOBS, Justice:

[The Walt Disney Company hired Ovitz as its executive president and as a board member for five years after lengthy compensation negotiations. The negotiations regarding Ovitz's compensation were conducted predominantly by Eisner and two of the members of the compensation committee (a four-member panel). The terms of Ovitz's compensation were then presented to the full board. In a meeting lasting around one hour, where a variety of topics were discussed, the board approved Ovitz's compensation after reviewing only a term sheet rather than the full contract. Ovitz's time at Disney was tumultuous and short-lived.]...In December 1996, only fourteen months after he commenced employment, Ovitz was terminated without cause, resulting in a severance payout to Ovitz valued at approximately $ 130 million. [Disney shareholders then filed derivative actions on behalf of Disney against Ovitz and the directors of Disney at the time of the events complained of (the "Disney defendants"), claiming that the $130 million severance payout was the product of fiduciary duty and contractual breaches by Ovitz and of breaches of fiduciary duty by the Disney defendants and a waste of assets. The Chancellor found in favor of the defendants. The plaintiff appealed.]

We next turn to the claims of error that relate to the Disney defendants. Those claims are subdivisible into two groups: (A) claims arising out of the approval of the OEA [Ovitz employment agreement] and of Ovitz's election as President; and (B) claims arising out of the NFT [nonfault termination] severance payment to Ovitz upon his termination. We address separately those two categories and the issues that they generate....

...[The due care] argument is best understood against the backdrop of the presumptions that cloak director action being reviewed under the business judgment standard. Our law presumes that "in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company." Those presumptions can be rebutted if the plaintiff shows that the directors breached their fiduciary duty of care or of loyalty or acted in bad faith. If that is shown, the burden then shifts to the director defendants to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders....

The appellants' first claim is that the Chancellor erroneously (i) failed to make a "threshold determination" of gross negligence, and (ii) "conflated" the appellants' burden to rebut the business judgment presumptions, with an analysis of whether the directors' conduct fell within the 8 *Del. C.* § 102(b)(7) provision that precludes exculpation of directors from monetary liability "for acts or omissions not in good faith." The argument runs as follows: *Emerald Partners v. Berlin* required the Chancellor first to determine whether the business judgment rule presumptions were rebutted based upon a showing that the board violated its duty of care, *i.e.*, acted with gross negligence. If gross negligence were established, the burden would shift to the directors to establish that the OEA was entirely fair. Only if the directors failed to meet that burden could the trial court then address the directors' Section 102(b)(7) exculpation defense, including the statutory exception for acts not in good faith.

This argument lacks merit. To make the argument the appellants must ignore the distinction between (i) a determination of bad faith for the threshold purpose of rebutting the business judgment rule presumptions, and (ii) a bad faith determination for purposes of evaluating the availability of charter-authorized exculpation from monetary damage liability after liability has been established. Our law clearly

permits a judicial assessment of director good faith for that former purpose. Nothing in *Emerald Partners* requires the Court of Chancery to consider only evidence of lack of due care (*i.e.* gross negligence) in determining whether the business judgment rule presumptions have been rebutted....

The appellants argue that the Disney directors breached their duty of care by failing to inform themselves of all material information reasonably available with respect to Ovitz's employment agreement....[but the] only properly reviewable action of the entire board was its decision to elect Ovitz as Disney's President. In that context the sole issue, as the Chancellor properly held, is "whether [the remaining members of the old board] properly exercised their business judgment and acted in accordance with their fiduciary duties when they elected Ovitz to the Company's presidency." The Chancellor determined that in electing Ovitz, the directors were informed of all information reasonably available and, thus, were not grossly negligent. We agree.

...[The court turns to good faith.] The Court of Chancery held that the business judgment rule presumptions protected the decisions of the compensation committee and the remaining Disney directors, not only because they had acted with due care but also because they had not acted in bad faith. That latter ruling, the appellants claim, was reversible error because the Chancellor formulated and then applied an incorrect definition of bad faith.

...Their argument runs as follows: under the Chancellor's 2003 definition of bad faith, the directors must have "*consciously and intentionally disregarded their responsibilities*, adopting a 'we don't care about the risks' attitude concerning a material corporate decision." Under the 2003 formulation, appellants say, "directors violate their duty of good faith if they are making material decisions without adequate information and without adequate deliberation[,]" but under the 2005 post-trial definition, bad faith requires proof of a subjective bad motive or intent. This definitional change, it is claimed, was procedurally prejudicial because appellants relied on the 2003 definition in presenting their evidence of bad faith at the trial....

Second, the appellants claim that the Chancellor's post-trial definition of bad faith is erroneous substantively. They argue that the 2003 formulation was (and is) the correct definition, because it is "logically tied to board decision-making under the duty of care." The post-trial formulation, on the other hand, "wrongly incorporated substantive elements regarding the rationality of the decisions under review rather than being constrained, as in a due care analysis, to strictly procedural criteria." We conclude that both arguments must fail.

The appellants' first argument—that there is a real, significant difference between the Chancellor's pre-trial and post-trial definitions of bad faith—is plainly wrong. We perceive no substantive difference between the Court of Chancery's 2003 definition of bad faith—a "conscious and intentional disregard [of] responsibilities, adopting a we don't care about the risks' attitude..."—and its 2005 post-trial definition—an "intentional dereliction of duty, a conscious disregard for one's responsibilities." Both formulations express the same concept, although in slightly different language.

The most telling evidence that there is no substantive difference between the two formulations is that the appellants are forced to contrive a difference. Appellants assert that under the 2003 formulation, "directors violate their duty of good faith if they are making material decisions without adequate information and without adequate deliberation." For that *ipse dixit* they cite no legal authority. That comes as no surprise because their verbal effort to collapse the duty to act in good faith into the duty to act with due care, is not unlike putting a rabbit into the proverbial hat and then blaming the trial judge for making the insertion.

...The precise question is whether the Chancellor's articulated standard for bad faith corporate fiduciary conduct—intentional dereliction of duty, a conscious disregard for one's responsibilities—is legally correct. In approaching that question, we note that the Chancellor characterized that definition as "*an*appropriate (*although not the only*) standard for determining whether fiduciaries have acted in good faith." That observation is accurate and helpful, because as a matter of simple logic, at least three different categories of fiduciary behavior are candidates for the "bad faith" pejorative label.

CC BY NC SA

The first category involves so-called "subjective bad faith," that is, fiduciary conduct motivated by an actual intent to do harm. That such conduct constitutes classic, quintessential bad faith is a proposition so well accepted in the liturgy of fiduciary law that it borders on axiomatic....The second category of conduct, which is at the opposite end of the spectrum, involves lack of due care—that is, fiduciary action taken solely by reason of gross negligence and without any malevolent intent. In this case, appellants assert claims of gross negligence to establish breaches not only of director due care but also of the directors' duty to act in good faith. Although the Chancellor found, and we agree, that the appellants failed to establish gross negligence, to afford guidance we address the issue of whether gross negligence (including a failure to inform one's self of available material facts), without more, can also constitute bad faith. The answer is clearly no.

..."issues of good faith are (to a certain degree) inseparably and necessarily intertwined with the duties of care and loyalty...." But, in the pragmatic, conduct-regulating legal realm which calls for more precise conceptual line drawing, the answer is that grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith. The conduct that is the subject of due care may overlap with the conduct that comes within the rubric of good faith in a psychological sense, but from a legal standpoint those duties are and must remain quite distinct....

The Delaware General Assembly has addressed the distinction between bad faith and a failure to exercise due care (*i.e.*, gross negligence) in two separate contexts. The first is Section 102(b)(7) of the DGCL, which authorizes Delaware corporations, by a provision in the certificate of incorporation, to exculpate their directors from monetary damage liability for a breach of the duty of care. That exculpatory provision affords significant protection to directors of Delaware corporations. The statute carves out several exceptions, however, including most relevantly, "for acts or omissions not in good faith...." Thus, a corporation can exculpate its directors from monetary liability for a breach of the duty of care, but not for conduct that is not in good faith. To adopt a definition of bad faith that would cause a violation of the duty of care automatically to become an act or omission "not in good faith," would eviscerate the protections accorded to directors by the General Assembly's adoption of Section 102(b)(7).

A second legislative recognition of the distinction between fiduciary conduct that is grossly negligent and conduct that is not in good faith, is Delaware's indemnification statute, found at 8 *Del. C.* § 145. To oversimplify, subsections (a) and (b) of that statute permit a corporation to indemnify (*inter alia*) any person who is or was a director, officer, employee or agent of the corporation against expenses...where (among other things): (i) that person is, was, or is threatened to be made a party to that action, suit or proceeding, and (ii) that person "acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation...." Thus, under Delaware statutory law a director or officer of a corporation can be indemnified for liability (and litigation expenses) incurred by reason of a violation of the duty of care, but not for a violation of the duty to act in good faith.

Section 145, like Section 102(b)(7), evidences the intent of the Delaware General Assembly to afford significant protections to directors (and, in the case of Section 145, other fiduciaries) of Delaware corporations. To adopt a definition that conflates the duty of care with the duty to act in good faith by making a violation of the former an automatic violation of the latter, would nullify those legislative protections and defeat the General Assembly's intent. There is no basis in policy, precedent or common sense that would justify dismantling the distinction between gross negligence and bad faith.

That leaves the third category of fiduciary conduct, which falls in between the first two categories of (1) conduct motivated by subjective bad intent and (2) conduct resulting from gross negligence. This third category is what the Chancellor's definition of bad faith—intentional dereliction of duty, a conscious disregard for one's responsibilities—is intended to capture. The question is whether such misconduct is properly treated as a non-exculpable, non-indemnifiable violation of the fiduciary duty to act in good faith. In our view it must be, for at least two reasons.

First, the universe of fiduciary misconduct is not limited to either disloyalty in the classic sense (*i.e.*, preferring the adverse self-interest of the fiduciary or of a related person to the interest of the corporation) or gross negligence. Cases have arisen where corporate directors have no conflicting self-interest in a decision, yet engage in misconduct that is more culpable than simple inattention or failure to be informed of all facts material to the decision. To protect the interests of the corporation and its

shareholders, fiduciary conduct of this kind, which does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence, should be proscribed. A vehicle is needed to address such violations doctrinally, and that doctrinal vehicle is the duty to act in good faith. The Chancellor implicitly so recognized in his Opinion, where he identified different examples of bad faith as follows:

The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty, in the narrow sense that I have discussed them above, but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders. A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.

...Second, the legislature has also recognized this intermediate category of fiduciary misconduct, which ranks between conduct involving subjective bad faith and gross negligence. Section 102(b)(7)(ii) of the DGCL expressly denies money damage exculpation for "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law." By its very terms that provision distinguishes between "intentional misconduct" and a "knowing violation of law" (both examples of subjective bad faith) on the one hand, and "acts...not in good faith," on the other. Because the statute exculpates directors only for conduct amounting to gross negligence, the statutory denial of exculpation for "acts...not in good faith" must encompass the intermediate category of misconduct captured by the Chancellor's definition of bad faith.

For these reasons, we uphold the Court of Chancery's definition as a legally appropriate, although not the exclusive, definition of fiduciary bad faith. We need go no further. To engage in an effort to craft (in the Court's words) "a definitive and categorical definition of the universe of acts that would constitute bad faith" would be unwise and is unnecessary to dispose of the issues presented on this appeal....

For the reasons stated above, the judgment of the Court of Chancery is affirmed.

CASE QUESTIONS

1. How did the court view the plaintiff's argument that the Chancellor had developed two different types of bad faith?
2. What are the three types of bad faith that the court discusses?
3. What two statutory provisions has the Delaware General Assembly passed that address the distinction between bad faith and a failure to exercise due care (i.e., gross negligence)?

16.6 Summary and Exercises

Summary

A corporation may exercise two types of powers: (1) express powers, set forth by statute and in the articles of incorporation, and (2) implied powers, necessary to carry out its stated purpose. The corporation may always amend the articles of incorporation to change its purposes. Nevertheless, shareholders may enjoin their corporation from acting ultra vires, as may the state attorney general. However, an individual stockholder, director, or officer (except in rare instances under certain regulatory statutes) may not be held vicariously liable if he did not participate in the crime or tort.

Because ownership and control are separated in the modern publicly held corporation, shareholders generally do not make business decisions. Shareholders who own voting stock do retain the power to elect directors, amend the bylaws, ratify or reject certain corporate actions, and vote on certain extraordinary matters, such as whether to amend the articles of incorporation, merge, or liquidate.

In voting for directors, various voting methodologies may be used, such as cumulative voting, which provides safeguards against removal of minority-shareholder-supported directors. Shareholders may use several voting arrangements that concentrate power, including proxies, voting agreements, and voting trusts. Proxies are regulated under rules promulgated by the Securities and Exchange Commission (SEC).

Corporations may deny preemptive rights—the rights of shareholders to prevent dilution of their percentage of ownership—by so stating in the articles of incorporation. Some states say that in the absence of such a provision, shareholders do have preemptive rights; others say that there are no preemptive rights unless the articles specifically include them.

Directors have the ultimate authority to run the corporation and are fiduciaries of the firm. In large corporations, directors delegate day-to-day management to salaried officers, whom they may fire, in most states, without cause. The full board of directors may, by majority, vote to delegate its authority to committees.

Directors owe the company a duty of loyalty and of care. A contract between a director and the company is voidable unless fair to the corporation or unless all details have been disclosed and the disinterested directors or shareholders have approved. Any director or officer is obligated to inform fellow directors of any corporate opportunity that affects the company and may not act personally on it unless he has received approval. The duty of care is the obligation to act "with the care an ordinarily prudent person in a like position would exercise under similar circumstances." Other fiduciary duties have also been recognized, and constituency statutes permit the corporation to consider factors other than shareholders in making decisions. Shareholders may file derivative suits alleging breaches of fiduciary responsibilities. The duties have been expanded. For example, when the corporation is being sold, the directors have a duty to maximize shareholder value. Duties of oversight, good faith, and candor have been applied.

The corporation may agree, although not in every situation, to indemnify officers, directors, and employees for litigation expenses when they are made party to suits involving the corporation. The corporation may purchase insurance against legal expenses of directors and officers, but the policies do

not cover acts of willful negligence and criminal conduct in which intent is a necessary element of proof. Additionally, the business judgment rule may operate to protect the decisions of the board.

The general rule is to maximize shareholder value, but over time, corporations have been permitted to consider other factors in decision making. Constituency statutes, for example, allow the board to consider factors other than maximizing shareholder value. Corporate social responsibility has increased, as firms consider things such as environmental impact and consumer perception in making decisions.

EXERCISES

1. First Corporation, a Massachusetts company, decides to expend $100,000 to publicize its support of a candidate in an upcoming presidential election. A Massachusetts statute forbids corporate expenditures for the purpose of influencing the vote in elections. Chauncey, a shareholder in First Corporation, feels that the company should support a different presidential candidate and files suit to stop the company's publicizing efforts. What is the result? Why?
2. Assume in Exercise 1 that Chauncey is both an officer and a director of First Corporation. At a duly called meeting of the board, the directors decide to dismiss Chauncey as an officer and a director. If they had no cause for this action, is the dismissal valid? Why?
3. A book publisher that specializes in children's books has decided to publish pornographic literature for adults. Amanda, a shareholder in the company, has been active for years in an antipornography campaign. When she demands access to the publisher's books and records, the company refuses. She files suit. What arguments should Amanda raise in the litigation? Why?
4. A minority shareholder brought suit against the Chicago Cubs, a Delaware corporation, and their directors on the grounds that the directors were negligent in failing to install lights in Wrigley Field. The shareholder specifically alleged that the majority owner, Philip Wrigley, failed to exercise good faith in that he personally believed that baseball was a daytime sport and felt that night games would cause the surrounding neighborhood to deteriorate. The shareholder accused Wrigley and the other directors of not acting in the best financial interests of the corporation. What counterarguments should the directors assert? Who will win? Why?

5. The CEO of First Bank, without prior notice to the board, announced a merger proposal during a two-hour meeting of the directors. Under the proposal, the bank was to be sold to an acquirer at $55 per share. (At the time, the stock traded at $38 per share.) After the CEO discussed the proposal for twenty minutes, with no documentation to support the adequacy of the price, the board voted in favor of the proposal. Although senior management strongly opposed the proposal, it was eventually approved by the stockholders, with 70 percent in favor and 7 percent opposed. A group of stockholders later filed a class action, claiming that the directors were personally liable for the amount by which the fair value of the shares exceeded $55—an amount allegedly in excess of $100 million. Are the directors personally liable? Why or why not?

SELF-TEST QUESTIONS

1 Acts that are outside a corporation's lawful powers are considered

a. ultra vires
b. express powers
c. implied powers
d. none of the above

2 Powers set forth by statute and in the articles of incorporation are called

a. implied powers
b. express powers
c. ultra vires
d. incorporation by estoppel

3 The principle that mistakes made by directors on the basis of good-faith judgment can be forgiven

a. is called the business judgment rule
b. depends on whether the director has exercised due care
c. involves both of the above
d. involves neither of the above

4 A director of a corporation owes

a. a duty of loyalty

b. a duty of care

c. both a duty of loyalty and a duty of care

d. none of the above

5 A corporation may purchase indemnification insurance

a. to cover acts of simple negligence

b. to cover acts of willful negligence

c. to cover acts of both simple and willful negligence

d. to cover acts of criminal conduct

SELF-TEST ANSWERS

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

Chapter 17
Securities Regulation

LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The nature of securities regulation
2. The Securities Act of 1933 and the Securities Exchange Act of 1934
3. Liability under securities laws
4. What insider trading is and why it's unlawful

CC BY NC SA

5. Civil and criminal penalties for violations of securities laws

In Chapter 15 "Legal Aspects of Corporate Finance", we examined state law governing a corporation's issuance and transfer of stock. In Chapter 16 "Corporate Powers and Management", we covered the liability of directors and officers. This chapter extends and ties together the themes raised in Chapter 15 "Legal Aspects of Corporate Finance" and Chapter 16 "Corporate Powers and Management" by examining government regulation of securities and insider trading. Both the registration and the trading of securities are highly regulated by the Securities and Exchange Commission (SEC). A violation of a securities law can lead to severe criminal and civil penalties. But first we examine the question, Why is there a need for securities regulation?

17.1 The Nature of Securities Regulation

LEARNING OBJECTIVES

1. Recognize that the definition of *security* encompasses a broad range of interests.
2. Understand the functions of the Securities and Exchange Commission and the penalties for violations of the securities laws.
3. Understand which companies the Securities Exchange Act of 1934 covers.
4. Explore the purpose of state Blue Sky Laws.
5. Know the basic provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

What we commonly refer to as "**securities**" are essentially worthless pieces of paper. Their inherent value lies in the interest in property or an ongoing enterprise that they represent. This disparity between the tangible property—the stock certificate, for example—and the intangible interest it represents gives rise to several reasons for regulation. First, there is need for a mechanism to inform the buyer accurately what it is he is buying. Second, laws are necessary to prevent and provide remedies for deceptive and manipulative acts designed to defraud buyers and sellers. Third, the evolution of stock trading on a massive scale has led to the development of numerous types of specialists and professionals, in dealings with whom the public can be at a severe disadvantage, and so the law undertakes to ensure that they do not take unfair advantage of their customers.

The **Securities Act of 1933** and the **Securities Exchange Act of 1934** are two federal statutes that are vitally important, having virtually refashioned the law governing corporations during the past half century. In fact, it is not too much to say that although they deal with securities, they have become the general federal law of corporations. This body of federal law has assumed special importance in recent years as the states have engaged in a race to the bottom in attempting to compete with Delaware's permissive corporation law (see Chapter 14 "Corporation: General Characteristics and Formation").

What Is a Security?

Securities law questions are technical and complex and usually require professional counsel. For the nonlawyer, the critical question on which all else turns is whether the particular investment or document is a **security**. If it is, anyone attempting any transaction beyond the routine purchase or sale through a broker should consult legal counsel to avoid the various civil and criminal minefields that the law has strewn about.

The definition of *security*, which is set forth in the Securities Act of 1933, is comprehensive, but it does not on its face answer all questions that financiers in a dynamic market can raise. Under Section 2(1) of the act, "security" includes "any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate,

preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

Under this definition, an investment may not be a security even though it is so labeled, and it may actually be a security even though it is called something else. For example, does a service contract that obligates someone who has sold individual rows in an orange orchard to cultivate, harvest, and market an orange crop involve a security subject to regulation under federal law? Yes, said the Supreme Court in *Securities & Exchange Commission v. W. J. Howey Co.*[1] The Court said the test is whether "the person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." Under this test, courts have liberally interpreted "**investment contract**" and "certificate of interest or participation in any profit-sharing agreement" to be securities interests in such property as real estate condominiums and cooperatives, commodity option contracts, and farm animals.

The Supreme Court ruled that notes that are not "investment contracts" under the *Howey* test can still be considered securities if certain factors are present, as discussed in *Reves v. Ernst & Young*, (see Section 17.3.1 "What Is a Security?"). These factors include (1) the motivations prompting a reasonable seller and buyer to enter into the transaction, (2) the plan of distribution and whether the instruments are commonly traded for speculation or investment, (3) the reasonable expectations of the investing public, and (4) the presence of other factors that significantly reduce risk so as to render the application of the Securities Act unnecessary.

The Securities and Exchange Commission

Functions

The **Securities and Exchange Commission** (SEC) is over half a century old, having been created by Congress in the Securities Exchange Act of 1934. It is an independent regulatory agency, subject to the rules of the Administrative Procedure Act (see Chapter 5 "Administrative Law"). The commission is

composed of five members, who have staggered five-year terms. Every June 5, the term of one of the commissioners expires. Although the president cannot remove commissioners during their terms of office, he does have the power to designate the chairman from among the sitting members. The SEC is bipartisan: not more than three commissioners may be from the same political party.

The SEC's primary task is to investigate complaints or other possible violations of the law in securities transactions and to bring enforcement proceedings when it believes that violations have occurred. It is empowered to conduct information inquiries, interview witnesses, examine brokerage records, and review trading data. If its requests are refused, it can issue subpoenas and seek compliance in federal court. Its usual leads come from complaints of investors and the general public, but it has authority to conduct surprise inspections of the books and records of brokers and dealers. Another source of leads is price fluctuations that seem to have been caused by manipulation rather than regular market forces.

Among the violations the commission searches out are these: (1) unregistered sale of securities subject to the registration requirement of the Securities Act of 1933, (2) fraudulent acts and practices, (3) manipulation of market prices, (4) carrying out of a securities business while insolvent, (5) misappropriation of customers' funds by brokers and dealers, and (4) other unfair dealings by brokers and dealers.

When the commission believes that a violation has occurred, it can take one of three courses. First, it can refer the case to the Justice Department with a recommendation for **criminal prosecution** in cases of fraud or other willful violation of law.

Second, the SEC can seek a **civil injunction** in federal court against further violations. As a result of amendments to the securities laws in 1990 (the Securities Enforcement Remedies and Penny Stock Reform Act), the commission can also ask the court to impose **civil penalties**. The maximum penalty is $100,000 for each violation by a natural person and $500,000 for each violation by an entity other than a natural person. Alternatively, the defendant is liable for the gain that resulted from violating securities law if the gain exceeds the statutory penalty. The court is also authorized to bar an individual who has

committed securities fraud from serving as an officer or a director of a company registered under the securities law.

Third, the SEC can proceed administratively—that is, hold its own hearing, with the usual due process rights, before an **administrative law judge**. If the commissioners by majority vote accept the findings of the administrative law judge after reading briefs and hearing oral argument, they can impose a variety of sanctions: suspend or expel members of exchanges; deny, suspend, or revoke the registrations of broker-dealers; censure individuals for misconduct; and bar censured individuals (temporarily or permanently) from employment with a registered firm. The 1990 securities law amendments allow the SEC to impose civil fines similar to the court-imposed fines described. The amendments also authorize the SEC to order individuals to cease and desist from violating securities law.

Fundamental Mission

The SEC's fundamental mission is to ensure adequate disclosure in order to facilitate informed investment decisions by the public. However, whether a particular security offering is worthwhile or worthless is a decision for the public, not for the SEC, which has no legal authority to pass on the merits of an offering or to bar the sale of securities if proper disclosures are made.

One example of SEC's regulatory mandate with respect to disclosures involved the 1981 sale of $274 million in limited partnership interests in a company called Petrogene Oil & Gas Associates, New York. The Petrogene offering was designed as a tax shelter. The company's filing with the SEC stated that the offering involved "a high degree of risk" and that only those "who can afford the complete loss of their investment" should contemplate investing. Other disclosures included one member of the controlling group having spent four months in prison for conspiracy to commit securities fraud; that he and another principal were the subject of a New Mexico cease and desist order involving allegedly unregistered tax-sheltered securities; that the general partner, brother-in-law of one of the principals, had no experience in the company's proposed oil and gas operations (Petrogene planned to extract oil from plants by using radio frequencies); that one of the oils to be produced was potentially carcinogenic; and that the principals "stand to benefit substantially" whether or not the company fails and whether or not

purchasers of shares recovered any of their investment. The prospectus went on to list specific risks. Despite this daunting compilation of troublesome details, the SEC permitted the offering because all disclosures were made (*Wall Street Journal*, December 29, 1981). It is the business of the marketplace, not the SEC, to determine whether the risk is worth taking.

The SEC enforces securities laws through two primary federal acts: The Securities Act of 1933 and The Securities Exchange Act of 1934.

Securities Act of 1933

Goals

The **Securities Act of 1933** is the fundamental "truth in securities" law. Its two basic objectives, which are written in its preamble, are "to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof."

Registration

The primary means for realizing these goals is the requirement of registration. Before securities subject to the act can be offered to the public, the issuer must file a **registration statement** and **prospectus** with the SEC, laying out in detail relevant and material information about the offering as set forth in various schedules to the act. If the SEC approves the registration statement, the issuer must then provide any prospective purchaser with the prospectus. Since the SEC does not pass on the fairness of price or other terms of the offering, it is unlawful to state or imply in the prospectus that the commission has the power to disapprove securities for lack of merit, thereby suggesting that the offering is meritorious.

The SEC has prepared special forms for registering different types of issuing companies. All call for a description of the registrant's business and properties and of the significant provisions of the security to be offered, facts about how the issuing company is managed, and detailed financial statements certified by independent public accountants.

Once filed, the registration and prospectus become public and are open for public inspection. Ordinarily, the effective date of the registration statement is twenty days after filing. Until then, the offering may not be made to the public. Section 2(10) of the act defines *prospectus* as any "notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security." (An exception: brief notes advising the public of the availability of the formal prospectus.) The import of this definition is that any communication to the public about the offering of a security is unlawful unless it contains the requisite information.

The SEC staff examines the registration statement and prospectus, and if they appear to be materially incomplete or inaccurate, the commission may suspend or refuse the effectiveness of the registration statement until the deficiencies are corrected. Even after the securities have gone on sale, the agency has the power to issue a stop order that halts trading in the stock.

Section 5(c) of the act bars any person from making any sale of any security unless it is first registered. Nevertheless, there are certain classes of exemptions from the registration requirement. Perhaps the most important of these is Section 4(3), which exempts "transactions by any person other than an issuer, underwriter or dealer." Section 4(3) also exempts most transactions of dealers. So the net is that trading in outstanding securities (the secondary market) is exempt from registration under the Securities Act of 1933: you need not file a registration statement with the SEC every time you buy or sell securities through a broker or dealer, for example. Other exemptions include the following: (1) private offerings to a limited number of persons or institutions who have access to the kind of information registration would disclose and who do not propose to redistribute the securities; (2) offerings restricted to the residents of the state in which the issuing company is organized and doing business; (3) securities of municipal, state, federal and other government instrumentalities, of charitable institutions, of banks, and of carriers subject to the Interstate Commerce Act; (4) offerings not in excess of certain specified amounts made in compliance with regulations of the Commission...: and (5) offerings of "small business investment companies" made in accordance with rules and regulations of the Commission.

Penalties

Section 24 of the Securities Act of 1933 provides for fines not to exceed $10,000 and a prison term not to exceed five years, or both, for willful violations of any provisions of the act. This section makes these criminal penalties specifically applicable to anyone who "willfully, in a registration statement filed under this title, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading."

Sections 11 and 12 provide that anyone injured by false declarations in registration statements, prospectuses, or oral communications concerning the sale of the security—as well as anyone injured by the unlawful failure of an issuer to register—may file a civil suit to recover the net consideration paid for the security or for damages if the security has been sold.

Although these civil penalty provisions apply only to false statements in connection with the registration statement, prospectus, or oral communication, the Supreme Court held, in *Case v. Borak*,[2] that there is an "**implied private right of action**" for damages resulting from a violation of SEC rules under the act. The Court's ruling in *Borak* opened the courthouse doors to many who had been defrauded but were previously without a practical remedy.

Securities Exchange Act of 1934

Companies Covered

The Securities Act of 1933 is limited, as we have just seen, to new securities issues—that is the **primary market**. The trading that takes place in the **secondary market** is far more significant, however. In a normal year, trading in outstanding stock totals some twenty times the value of new stock issues.

To regulate the secondary market, Congress enacted the **Securities Exchange Act of 1934**. This law, which created the SEC, extended the disclosure rationale to securities listed and registered for public trading on the national securities exchanges. Amendments to the act have brought within its ambit every corporation whose equity securities are traded over the counter if the company has at least $10 million in assets and five hundred or more shareholders.

CC BY NC SA

Reporting Proxy Solicitation

Any company seeking listing and registration of its stock for public trading on a national exchange—or over the counter, if the company meets the size test—must first submit a registration application to both the exchange and the SEC. The registration statement is akin to that filed by companies under the Securities Act of 1933, although the Securities Exchange Act of 1934 calls for somewhat fewer disclosures. Thereafter, companies must file annual and certain other periodic reports to update information in the original filing.

The Securities Exchange Act of 1934 also covers **proxy solicitation**. Whenever management, or a dissident minority, seeks votes of holders of registered securities for any corporate purpose, disclosures must be made to the stockholders to permit them to vote yes or no intelligently.

Penalties

The logic of the *Borak* case (discussed in Section 17.1.3 "Securities Act of 1933") also applies to this act, so that private investors may bring suit in federal court for violations of the statute that led to financial injury. Violations of any provision and the making of false statements in any of the required disclosures subject the defendant to a maximum fine of $5 million and a maximum twenty-year prison sentence, but a defendant who can show that he had no knowledge of the particular rule he was convicted of violating may not be imprisoned. The maximum fine for a violation of the act by a person other than a natural person is $25 million. Any issuer omitting to file requisite documents and reports is liable to pay a fine of $100 for each day the failure continues.

Blue Sky Laws

Long before congressional enactment of the securities laws in the 1930s, the states had legislated securities regulations. Today, every state has enacted a **blue sky law**, so called because its purpose is to prevent "speculative schemes which have no more basis than so many feet of 'blue sky.'" [3] The federal

Securities Act of 1933, discussed in Section 17.1.3 "Securities Act of 1933", specifically preserves the jurisdiction of states over securities.

Blue sky laws are divided into three basic types of regulation. The simplest is that which prohibits fraud in the sale of securities. Thus at a minimum, issuers cannot mislead investors about the purpose of the investment. All blue sky laws have antifraud provisions; some have no other provisions. The second type calls for registration of broker-dealers, and the third type for registration of securities. Some state laws parallel the federal laws in intent and form of proceeding, so that they overlap; other blue sky laws empower state officials (unlike the SEC) to judge the merits of the offerings, often referred to as **merit review laws**. As part of a movement toward deregulation, several states have recently modified or eliminated merit provisions.

Many of the blue sky laws are inconsistent with each other, making national uniformity difficult. In 1956, the National Conference of Commissioners on Uniform State Laws approved the Uniform Securities Act. It has not been designed to reconcile the conflicting philosophies of state regulation but to take them into account and to make the various forms of regulation as consistent as possible. States adopt various portions of the law, depending on their regulatory philosophies. The Uniform Securities Act has antifraud, broker-dealer registration, and securities registration provisions. More recent acts have further increased uniformity. These include the National Securities Markets Improvement Act of 1996, which preempted differing state philosophies with regard to registration of securities and regulation of brokers and advisors, and the Securities Litigation Uniform Standards Act of 1998, which preempted state law securities fraud claims from being raised in class action lawsuits by investors.

Dodd-Frank Wall Street Reform and Consumer Protection Act

In 2010, Congress passed the **Dodd-Frank Wall Street Reform and Consumer Protection Act**, which is the largest amendment to financial regulation in the United States since the Great Depression. This amendment was enacted in response to the economic recession of the late 2000s for the following purposes: (1) to promote the financial stability of the United States by improving accountability and transparency in the financial system, (2) to end “too big to fail” institutions, (3) to protect the American taxpayer by ending bailouts, and (4) to protect consumers from abusive financial services practices. The

institutions most affected by the regulatory changes include those involved in monitoring the financial system, such as the Federal Deposit Insurance Corporation (FDIC) and the SEC. Importantly, the amendment ended the exemption for investment advisors who previously were not required to register with the SEC because they had fewer than fifteen clients during the previous twelve months and did not hold out to the public as investment advisors. This means that in practice, numerous investment advisors, as well as hedge funds and private equity firms, are now subject to registration requirements.[4]

KEY TAKEAWAY

The SEC administers securities laws to prevent the fraudulent practices in the sales of securities. The definition of *security* is intentionally broad to protect the public from fraudulent investments that otherwise would escape regulation. The Securities Act of 1933 focuses on the issuance of securities, and the Securities Exchange Act of 1934 deals predominantly with trading in issued securities. Numerous federal and state securities laws are continuously created to combat securities fraud, with penalties becoming increasingly severe.

EXERCISES

1. What differentiates an ordinary investment from a security? List all the factors.
2. What is the main objective of the SEC?
3. What are the three courses of action that the SEC may take against one who violates a securities law?
4. What is the difference between the Securities Act of 1933 and the Securities Exchange Act of 1934?
5. What do blue sky laws seek to protect?

---

[1] *Securities & Exchange Commission v. W. J. Howey Co.*, 328 U.S. 293 (1946).

[2] *Case v. Borak*, 377 U.S. 426 (1964).

[3] *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917).

[4] For more information on the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111-203, H.R. 4173), see Thomas, "Major Actions," Bill Summary & Status 111th Congress (2009–2010) H.R.4173, http://thomas.loc.gov/cgi-bin/bdquery/z?d111:HR04173:@@@L&summ2=m&#major%20actions.

17.2 Liability under Securities Law

LEARNING OBJECTIVES

1. Understand how the Foreign Corrupt Practices Act prevents American companies from using bribes to enter into contracts or gain licenses from foreign governments.
2. Understand the liability for insider trading for corporate insiders, "tippees," and secondary actors under Sections 16(b) and 10(b) of the 1934 Securities Exchange Act.
3. Recognize how the Sarbanes-Oxley Act has amended the 1934 act to increase corporate regulation, transparency, and penalties.

Corporations may be found liable if they engage in certain unlawful practices, several of which we explore in this section.

The Foreign Corrupt Practices Act

Investigations by the Securities and Exchange Commission (SEC) and the Watergate Special Prosecutor in the early 1970s turned up evidence that hundreds of companies had misused corporate funds, mainly by bribing foreign officials to induce them to enter into contracts with or grant licenses to US companies. Because revealing the bribes would normally be self-defeating and, in any event, could be expected to stir up immense criticism, companies paying bribes routinely hid the payments in various accounts. As a result, one of many statutes enacted in the aftermath of Watergate, the **Foreign Corrupt Practices Act (FCPA)** of 1977, was incorporated into the 1934 Securities Exchange

Act. The SEC's legal interest in the matter is not premised on the morality of bribery but rather on the falsity of the financial statements that are being filed.

Congress's response to abuses of financial reporting, the FCPA, was much broader than necessary to treat the violations that were uncovered. The FCPA prohibits an issuer (i.e., any US business enterprise), a stockholder acting on behalf of an issuer, and "any officer, director, employee, or agent" of an issuer from using either the mails or interstate commerce corruptly to offer, pay, or promise to pay anything of value to foreign officials, foreign political parties, or candidates if the purpose is to gain business by inducing the foreign official to influence an act of the government to render a decision favorable to the US corporation.

But not all payments are illegal. Under 1988 amendments to the FCPA, payments may be made to expedite routine governmental actions, such as obtaining a visa. And payments are allowed if they are lawful under the written law of a foreign country. More important than the foreign-bribe provisions, the act includes accounting provisions, which broaden considerably the authority of the SEC. These provisions are discussed in *SEC v. World-Wide Coin Investments, Ltd.*,[1] the first accounting provisions case brought to trial.

Insider Trading

Corporate insiders—directors, officers, or important shareholders—can have a substantial trading advantage if they are privy to important confidential information. Learning bad news (such as financial loss or cancellation of key contracts) in advance of all other stockholders will permit the privileged few to sell shares before the price falls. Conversely, discovering good news (a major oil find or unexpected profits) in advance gives the insider a decided incentive to purchase shares before the price rises. Because of the unfairness to those who are ignorant of inside information, federal law prohibits **insider trading**. Two provisions of the 1934 Securities Exchange Act are paramount: **Section 16(b)** and 10(b).

Recapture of Short-Swing Profits: Section 16(b)

The Securities Exchange Act assumes that any director, officer, or shareholder owning 10 percent or more of the stock in a corporation is using inside information if he or any family member makes a profit from trading activities, either buying and selling or selling and buying, during a six-month period. Section 16(b) penalizes any such person by permitting the corporation or a shareholder suing on its behalf to recover the **short-swing profits**. The law applies to any company with more than $10 million in assets and at least five hundred or more shareholders of any class of stock.

Suppose that on January 1, Bob (a company officer) purchases one hundred shares of stock in BCT Bookstore, Inc., for $60 a share. On September 1, he sells them for $100 a share. What is the result? Bob is in the clear, because his $4,000 profit was not realized during a six-month period. Now suppose that the price falls, and one month later, on October 1, he repurchases one hundred shares at $30 a share and holds them for two years. What is the result? He will be forced to pay back $7,000 in profits even if he had no inside information. Why? In August, Bob held one hundred shares of stock, and he did again on October 1—within a six-month period. His net gain on these transactions was $7,000 ($10,000 realized on the sale less the $3,000 cost of the purchase).

As a consequence of Section 16(b) and certain other provisions, trading in securities by directors, officers, and large stockholders presents numerous complexities. For instance, the law requires people in this position to make periodic reports to the SEC about their trades. As a practical matter, directors, officers, and large shareholders should not trade in their own company stock in the short run without legal advice.

Insider Trading: Section 10(b) and Rule 10b-5

Section 10(b) of the Securities Exchange Act of 1934 prohibits any person from using the mails or facilities of interstate commerce "to use or employ, in connection with the purchase or sale of any security...any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." In 1942, the SEC learned of a company president who misrepresented the company's financial condition in order to buy shares at a low price from current stockholders. So the commission adopted a rule under the authority of Section 10(b). **Rule 10b-5**, as it was dubbed, has

remained unchanged for more than forty years and has spawned thousands of lawsuits and SEC proceedings. It reads as follows:

> *It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,*
>
> *(1) to employ any device, scheme, or artifice to defraud,*
> *(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or*
> *(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.*

Rule 10b-5 applies to any person who purchases or sells any security. It is not limited to securities registered under the 1934 Securities Exchange Act. It is not limited to publicly held companies. It applies to any security issued by any company, including the smallest closely held company. In substance, it is an antifraud rule, enforcement of which seems, on its face, to be limited to action by the SEC. But over the years, the courts have permitted people injured by those who violate the statute to file private damage suits. This sweeping rule has at times been referred to as the "federal law of corporations" or the "catch everybody" rule.

Insider trading ran headlong into Rule 10b-5 beginning in 1964 in a series of cases involving Texas Gulf Sulphur Company (TGS). On November 12, 1963, the company discovered a rich deposit of copper and zinc while drilling for oil near Timmins, Ontario. Keeping the discovery quiet, it proceeded to acquire mineral rights in adjacent lands. By April 1964, word began to circulate about TGS's find.

Newspapers printed rumors, and the Toronto Stock Exchange experienced a wild speculative spree. On April 12, an executive vice president of TGS issued a press release downplaying the discovery, asserting

that the rumors greatly exaggerated the find and stating that more drilling would be necessary before coming to any conclusions. Four days later, on April 16, TGS publicly announced that it had uncovered a strike of 25 million tons of ore. In the months following this announcement, TGS stock doubled in value.

The SEC charged several TGS officers and directors with having purchased or told their friends, so-called **tippees**, to purchase TGS stock from November 12, 1963, through April 16, 1964, on the basis of material inside information. The SEC also alleged that the April 12, 1964, press release was deceptive. The US Court of Appeals, in *SEC v. Texas Gulf Sulphur Co.*,[2] decided that the defendants who purchased the stock before the public announcement had violated Rule 10b-5. According to the court, "anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed." On remand, the district court ordered certain defendants to pay $148,000 into an escrow account to be used to compensate parties injured by the insider trading.

The court of appeals also concluded that the press release violated Rule 10b-5 if "misleading to the reasonable investor." On remand, the district court held that TGS failed to exercise "due diligence" in issuing the release. Sixty-nine private damage actions were subsequently filed against TGS by shareholders who claimed they sold their stock in reliance on the release. The company settled most of these suits in late 1971 for $2.7 million.

Following the TGS episode, the Supreme Court refined Rule 10b-5 on several fronts. First, in *Ernst & Ernst v. Hochfelder*,[3] the Court decided that proof of **scienter**—defined as "mental state embracing intent to deceive, manipulate, or defraud"—is required in private damage actions under Rule 10b-5. In other words, negligence alone will not result in Rule 10b-5 liability. The Court also held that scienter, which is an intentional act, must be established in SEC injunctive actions.[4]

The Supreme Court has placed limitations on the liability of tippees under Rule 10b-5. In 1980, the Court reversed the conviction of an employee of a company that printed tender offer and merger prospectuses.

Using information obtained at work, the employee had purchased stock in target companies and later sold it for a profit when takeover attempts were publicly announced. In *Chiarella v. United States*, the Court held that the employee was not an insider or a fiduciary and that "a duty to disclose under Section 10(b) does not arise from the mere possession of nonpublic market information."[5] Following *Chiarella*, the Court ruled in *Dirks v. Securities and Exchange Commission* (see Section 17.3.2 "Tippee Liability"), that tippees are liable if they had reason to believe that the tipper breached a fiduciary duty in disclosing confidential information and the tipper received a personal benefit from the disclosure.

The Supreme Court has also refined Rule 10b-5 as it relates to the duty of a company to disclose **material information**, as discussed in *Basic, Inc. v. Levinson* (see Section 17.3.3 "Duty to Disclose Material Information"). This case is also important in its discussion of the degree of reliance investors must prove to support a Rule 10b-5 action.

In 2000, the SEC enacted **Rule 10b5-1**, which defines trading "on the basis of" inside information as any time a person trades while aware of material nonpublic information. Therefore, a defendant is not saved by arguing that the trade was made independent of knowledge of the nonpublic information. However, the rule also creates an affirmative defense for trades that were planned prior to the person's receiving inside information.

In addition to its decisions relating to intent (*Ernst & Ernst*), tippees (*Dirks*), materiality (*Basic*), and awareness of nonpublic information (10b5-1), the Supreme Court has considered the **misappropriation theory**, under which a person who misappropriates information from an employer faces insider trading liability. In a leading misappropriation theory case, the Second Circuit Court of Appeals reinstated an indictment against employees who traded on the basis of inside information obtained through their work at investment banking firms. The court concluded that the employees' violation of their fiduciary duty to the firms violated securities law.[6] The US Supreme Court upheld the misappropriation theory in *United States v. O'Hagan*,[7] and the SEC adopted the theory as new **Rule 10b5-2**. Under this new rule, the duty of trust or confidence exists when (1) a person agrees to maintain information in confidence; (2) the recipient knows or should have known through history, pattern, or practice of sharing confidences that the person communicating the information expects

confidentiality; and (3) a person received material nonpublic information from his or her spouse, parent, child, or sibling.

In 1987, in *Carpenter v. United States*,[8] the Supreme Court affirmed the conviction of a *Wall Street Journal* reporter who leaked advanced information about the contents of his "Heard on the Street" column. The reporter, who was sentenced to eighteen months in prison, had been convicted on both mail and wire fraud and securities law charges for misappropriating information. The Court upheld the mail and wire fraud conviction by an 8–0 vote and the securities law conviction by a 4–4 vote. (In effect, the tie vote affirmed the conviction.)[9]

Beyond these judge-made theories of liability, Congress had been concerned about insider trading, and in 1984 and 1988, it substantially increased the penalties. A person convicted of insider trading now faces a maximum criminal fine of $1 million and a possible ten-year prison term. A civil penalty of up to three times the profit made (or loss avoided) by insider trading can also be imposed. This penalty is in addition to liability for profits made through insider trading. For example, financier Ivan Boesky, who was sentenced in 1987 to a three-year prison term for insider trading, was required to disgorge $50 million of profits and was liable for another $50 million as a civil penalty. In 2003, Martha Stewart was indicted on charges of insider trading but was convicted for obstruction of justice, serving only five months. More recently, in 2009, billionaire founder of the Galleon Group, Raj Rajaratnam, was arrested for insider trading; he was convicted in May 2011 of all 14 counts of insider trading. For the SEC release on the Martha Stewart case, seehttp://www.sec.gov/news/press/2003-69.htm.

Companies that knowingly and recklessly fail to prevent insider trading by their employees are subject to a civil penalty of up to three times the profit gained or loss avoided by insider trading or $1 million, whichever is greater. Corporations are also subject to a criminal fine of up to $2.5 million.

Secondary Actor

In *Stoneridge Investment Partners v. Scientific-Atlanta*,[10] the US Supreme Court held that "aiders and abettors" of fraud cannot be held secondarily liable under 10(b) for a private cause of action. This means

that **secondary actors**, such as lawyers and accountants, cannot be held liable unless their conduct satisfies all the elements for 10(b) liability.

For an overview of insider trading, go to http://www.sec.gov/answers/insider.htm.

Sarbanes-Oxley Act

Congress enacted the Sarbanes-Oxley Act in 2002 in response to major corporate and accounting scandals, most notably those involving Enron, Tyco International, Adelphia, and WorldCom. The act created the **Public Company Accounting Oversight Board**, which oversees, inspects, and regulates accounting firms in their capacity as auditors of public companies. As a result of the act, the SEC may include civil penalties to a disgorgement fund for the benefit of victims of the violations of the Securities Act of 1933 and the Securities Exchange Act of 1934.

KEY TAKEAWAY

Corrupt practices, misuse of corporate funds, and insider trading unfairly benefit the minority and cost the public billions. Numerous federal laws have been enacted to create liability for these bad actors in order to prevent fraudulent trading activities. Both civil and criminal penalties are available to punish those actors who bribe officials or use inside information unlawfully.

EXERCISES

1. Why is the SEC so concerned with bribery? What does the SEC really aim to prevent through the FCPA?
2. What are short-swing profits?
3. To whom does Section 16(b) apply?
4. Explain how Rule 10b-5 has been amended "on the basis of" insider information.
5. Can a secondary actor (attorney, accountant) be liable for insider trading? What factors must be present?

[1] *SEC v. World-Wide Coin Investments, Ltd.*, 567 F. Supp. 724 (N.D. Ga. 1983).

[2] *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

[3] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

[4] *Aaron v. SEC*, 446 U.S. 680 (1980).

[5] *Chiarella v. United States*, 445 U.S. 222 (1980).

[6] *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981).

[7] *United States v. O'Hagan*, 521 U.S. 642 (1997).

[8] *Carpenter v. United States*, 484 U.S. 19 (1987).

[9] *Carpenter v. United States*, 484 U.S. 19 (1987).

[10] *Stoneridge Investment Partners v. Scientific-Atlanta*, 552 U.S. 148 (2008).

17.3 Cases

What Is a Security?

Reves v. Ernst & Young

494 U.S. 56, 110 S.Ct. 945 (1990)

JUSTICE MARSHALL delivered the opinion of the Court.

This case presents the question whether certain demand notes issued by the Farmer's Cooperative of Arkansas and Oklahoma are "securities" within the meaning of § 3(a)(10) of the Securities and Exchange Act of 1934. We conclude that they are.

The Co-Op is an agricultural cooperative that, at the same time relevant here, had approximately 23,000 members. In order to raise money to support its general business operations, the Co-Op sold promissory notes payable on demand by the holder. Although the notes were uncollateralized and uninsured, they paid a variable rate of interest that was adjusted monthly to keep it higher than the rate paid by local

financial institutions. The Co-Op offered the notes to both members and nonmembers, marketing the scheme as an "Investment Program." Advertisements for the notes, which appeared in each Co-Op newsletter, read in part: "YOUR CO-OP has more than $11,000,000 in assets to stand behind your investments. The Investment is not Federal [sic] insured but it is...Safe...Secure...and available when you need it." App. 5 (ellipses in original). Despite these assurances, the Co-Op filed for bankruptcy in 1984. At the time of the filing, over 1,600 people held notes worth a total of $10 million.

After the Co-Op filed for bankruptcy, petitioners, a class of holders of the notes, filed suit against Arthur Young & Co., the firm that had audited the Co-Op's financial statements (and the predecessor to respondent Ernst & Young). Petitioners alleged, inter alia, that Arthur Young had intentionally failed to follow generally accepted accounting principles in its audit, specifically with respect to the valuation of one of the Co-Op's major assets, a gasohol plant. Petitioners claimed that Arthur Young violated these principles in an effort to inflate the assets and net worth of the Co-Op. Petitioners maintained that, had Arthur Young properly treated the plant in its audits, they would not have purchased demand notes because the Co-Op's insolvency would have been apparent. On the basis of these allegations, petitioners claimed that Arthur Young had violated the antifraud provisions of the 1934 Act as well as Arkansas' securities laws.

Petitioners prevailed at trial on both their federal and state claims, receiving a $6.1 million judgment. Arthur Young appealed, claiming that the demand notes were not "securities" under either the 1934 Act or Arkansas law, and that the statutes' antifraud provisions therefore did not apply. A panel of the Eighth Circuit, agreeing with Arthur Young on both the state and federal issues, reversed. Arthur Young & Co. v. Reves, 856 F.2d 52 (1988). We granted certiorari to address the federal issue, 490 U.S. 1105, 109 S.Ct. 3154, 104 L.Ed.2d 1018 (1989), and now reverse the judgment of the Court of Appeals.

* * *

The fundamental purpose undergirding the Securities Acts is "to eliminate serious abuses in a largely unregulated securities market." United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 849, 95 S.Ct. 2051, 2059, 44 L.Ed.2d 621 (1975). In defining the scope of the market that it wished to regulate, Congress

painted with a broad brush. It recognized the virtually limitless scope of human ingenuity, especially in the creation of "countless and variable schemes devised by those who seek the use of the money of others on the promise of profits," SEC v. W.J. Howey Co., 328 U.S. 293, 299, 66 S.Ct. 1100, 1103, 90 L.Ed. 1244 (1946), and determined that the best way to achieve its goal of protecting investors was "to define 'the term "security" in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.'" Forman, supra, 421 U.S., at 847-848, 95 S.Ct., at 2058-2059 (quoting H.R.Rep. No. 85, 73d Cong., 1st Sess., 11 (1933)). Congress therefore did not attempt precisely to cabin the scope of the Securities Acts. Rather, it enacted a definition of "security" sufficiently broad to encompass virtually any instrument that might be sold as an investment.

* * *

[In deciding whether this transaction involves a "security," four factors are important.] First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security." Second, we examine the "plan of distribution" of the instrument to determine whether it is an instrument in which there is "common trading for speculation or investment." Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction. Finally, we examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.

* * *

CC BY NC SA

[We] have little difficulty in concluding that the notes at issue here are "securities."

CASE QUESTIONS

1. What are the four factors the court uses to determine whether or not the transaction involves a security?
2. How does the definition of security in this case differ from the definition in *Securities & Exchange Commission v. W. J. Howey*?

Tippee Liability

Dirks v. Securities and Exchange Commission

463 U.S. 646 (1983)

[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.

* * *

Whether disclosure is a breach of duty therefore depends in large part on the purpose of the disclosure. This standard was identified by the SEC itself in Cady, Roberts: a purpose of the securities laws was to eliminate "use of inside information for personal advantage." Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.

* * *

Under the inside-trading and tipping rules set forth above, we find that there was no actionable violation by Dirks. It is undisputed that Dirks himself was a stranger to Equity Funding, with no preexisting fiduciary duty to its shareholders. He took no action, directly, or indirectly, that induced the shareholders or officers of Equity Funding to repose trust or confidence in him. There was no expectation by Dirk's sources that he would keep their information in confidence. Nor did Dirks misappropriate or illegally obtain the information about Equity Funding. Unless the insiders breached their Cady, Roberts duty to shareholders in disclosing the nonpublic information to Dirks, he breached no duty when he passed it on to investors as well as to the Wall Street Journal.

* * *

It is clear that neither Secrist nor the other Equity Funding employees violated their Cady, Roberts duty to the corporation's shareholders by providing information to Dirks. The tippers received no monetary or personal benefit for revealing Equity Funding's secrets, nor was their purpose to make a gift of valuable information to Dirks. As the facts of this case clearly indicate, the tippers were motivated by a desire to expose the fraud. In the absence of a breach of duty to shareholders by the insiders, there was no derivative breach by Dirks. Dirks therefore could not have been "a participant after the fact in [an] insider's breach of a fiduciary duty." Chiarella, 445 U.S., at 230, n. 12.

* * *

We conclude that Dirks, in the circumstances of this case, had no duty to abstain from the use of the inside information that he obtained. The judgment of the Court of Appeals therefore is reversed.

CASE QUESTIONS

1. When does a tippee assume a fiduciary duty to shareholders of a corporation?

2. Did Dirks violate any insider trading laws? Why or why not?

3. How does this case refine Rule 10b-5?

Duty to Disclose Material Information

Basic Inc v. Levinson

485 U.S. 224 (1988)

[In December 1978, Basic Incorporated agreed to merge with Consolidated Engineering. Prior to the merger, Basic made three public statements denying it was involved in merger negotiations. Shareholders who sold their stock after the first of these statements and before the merger was announced sued Basic and its directors under Rule 10b-5, claiming that they sold their shares at depressed prices as a result of Basic's misleading statements. The district court decided in favor of Basic on the grounds that Basic's statements were not material and therefore were not misleading. The court of appeals reversed, and the Supreme Court granted certiorari.]

JUSTICE BLACKMUN.

We granted certiorari to resolve the split among the Courts of Appeals as to the standard of materiality applicable to preliminary merger discussions, and to determine whether the courts below properly applied a presumption of reliance in certifying the class, rather than requiring each class member to show direct reliance on Basic's statements.

* * *

The Court previously has addressed various positive and common-law requirements for a violation of § 10(b) or of Rule 10b-5. The Court also explicitly has defined a standard of materiality under the securities laws, see TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976), concluding in the proxy-solicitation context that "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder

would consider it important in deciding how to vote."...We now expressly adopt the TSC Industries standard of materiality for the 5 10(b) and Rule 10b-5 context.

The application of this materiality standard to preliminary merger discussions is not self-evident. Where the impact of the corporate development on the target's fortune is certain and clear, the TSC Industries materiality definition admits straight-forward application. Where, on the other hand, the event is contingent or speculative in nature, it is difficult to ascertain whether the "reasonable investor" would have considered the omitted information significant at the time. Merger negotiations, because of the ever-present possibility that the contemplated transaction will not be effectuated, fall into the latter category.

* * *

Even before this Court's decision in TSC Industries, the Second Circuit had explained the role of the materiality requirement of Rule 10b-5, with respect to contingent or speculative information or events, in a manner that gave that term meaning that is independent of the other provisions of the Rule. Under such circumstances, materiality "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity." SEC v. Texas Gulf Sulphur Co., 401 F.2d, at 849.

* * *

Whether merger discussions in any particular case are material therefore depends on the facts. Generally, in order to assess the probability that the event will occur, a factfinder will need to look to indicia of interest in the transactions at the highest corporate levels. Without attempting to catalog all such possible factors, we note by way of example that board resolutions, instructions to investment bankers, and actual negotiations between principals or their intermediaries may serve as indicia of interest. To assess the magnitude of the transaction to the issuer of the securities allegedly manipulated, a factfinder will need to consider such facts as the size of the two corporate entities and of the potential premiums over market

value. No particular event or factor short of closing the transaction need to be either necessary or sufficient by itself to render merger discussions material.

As we clarify today, materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information. The fact-specific inquiry we endorse here is consistent with the approach a number of courts have taken in assessing the materiality of merger negotiations. Because the standard of materiality we have adopted differs from that used by both courts below, we remand the case for reconsideration of the question whether a grant of summary judgment is appropriate on this record.

We turn to the question of reliance and the fraud on-the-market theory. Succinctly put:

> *The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available information regarding the company and its business.... Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.... The causal connection between the defendants' fraud and the plaintiff's purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations. Peil v. Speiser, 806 F.2d 1154, 1160-1161 (CA3 1986).*

* * *

We agree that reliance is an element of a Rule 10b-5 cause of action. Reliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's misrepresentation and a plaintiff's injury. There is, however, more than one way to demonstrate the causal connection.

* * *

Presumptions typically serve to assist courts in managing circumstances in which direct proof, for one reason or another, is rendered difficult. The courts below accepted a presumption, created by the fraud-on-the-market theory and subject to rebuttal by petitioners, that persons who had traded Basic shares had

done so in reliance on the integrity of the price set by the market, but because of petitioners' material misrepresentations that price had been fraudulently depressed. Requiring a plaintiff to show a speculative state of facts, i.e., how he would have acted if omitted material information had been disclosed, or if the misrepresentation had not been made, would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market.

Arising out of considerations of fairness, public policy, and probability, as well as judicial economy, presumptions are also useful devices for allocating the burdens of proof between parties. The presumption of reliance employed in this case is consistent with, and, by facilitating Rule 10b-5 litigation, supports, the congressional policy embodied in the 1934 Act....

The presumption is also supported by common sense and probability. Recent empirical studies have tended to confirm Congress' premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations. It has been noted that "it is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?" Schlanger v. Four-Phase Systems, Inc., 555 F.Supp. 535, 538 (SDNY 1982)....An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.

* * *

The judgment of the Court of Appeals is vacated and the case is remanded to that court for further proceedings consistent with this opinion.

CASE QUESTIONS

1. How does the court determine what is or is not material information? How does this differ from its previous rulings?
2. What is the fraud-on-the-market theory?

17.4 Summary and Exercises

Summary

Beyond state corporation laws, federal statutes—most importantly, the Securities Act of 1933 and the Securities Exchange Act of 1934—regulate the issuance and trading of corporate securities. The federal definition of *security* is broad, encompassing most investments, even those called by other names.

The law does not prohibit risky stock offerings; it bans only those lacking adequate disclosure of risks. The primary means for realizing this goal is the registration requirement: registration statements, prospectuses, and proxy solicitations must be filed with the Securities and Exchange Commission (SEC). Penalties for violation of securities law include criminal fines and jail terms, and damages may be awarded in civil suits by both the SEC and private individuals injured by the violation of SEC rules. A 1977 amendment to the 1934 act is the Foreign Corrupt Practices Act, which prohibits an issuer from paying a bribe or making any other payment to foreign officials in order to gain business by inducing the foreign official to influence his government in favor of the US company. This law requires issuers to keep accurate sets of books reflecting the dispositions of their assets and to maintain internal accounting controls to ensure that transactions comport with management's authorization.

The Securities Exchange Act of 1934 presents special hazards to those trading in public stock on the basis of inside information. One provision requires the reimbursement to the company of any profits made from selling and buying stock during a six-month period by directors, officers, and shareholders owning 10 percent or more of the company's stock. Under Rule 10b-5, the SEC and private parties may sue

insiders who traded on information not available to the general public, thus gaining an advantage in either selling or buying the stock. Insiders include company employees.

The Sarbanes-Oxley Act amended the 1934 act, creating more stringent penalties, increasing corporate regulation, and requiring greater transparency.

EXERCISES

1. Anne operated a clothing store called Anne's Rags, Inc. She owned all of the stock in the company. After several years in the clothing business, Anne sold her stock to Louise, who personally managed the business. Is the sale governed by the antifraud provisions of federal securities law? Why?
2. While waiting tables at a campus-area restaurant, you overhear a conversation between two corporate executives who indicate that their company has developed a new product that will revolutionize the computer industry. The product is to be announced in three weeks. If you purchase stock in the company before the announcement, will you be liable under federal securities law? Why?
3. Eric was hired as a management consultant by a major corporation to conduct a study, which took him three months to complete. While working on the study, Eric learned that someone working in research and development for the company had recently made an important discovery. Before the discovery was announced publicly, Eric purchased stock in the company. Did he violate federal securities law? Why?
4. While working for the company, Eric also learned that it was planning a takeover of another corporation. Before announcement of a tender offer, Eric purchased stock in the target company. Did he violate securities law? Why?
5. The commercial lending department of First Bank made a substantial loan to Alpha Company after obtaining a favorable confidential earnings report from Alpha. Over lunch, Heidi, the loan officer who handled the loan, mentioned the earnings report to a friend who worked in the bank's trust department. The friend proceeded to purchase stock in Alpha for several of the bank's trusts. Discuss the legal implications.
6. In Exercise 5, assume that a week after the loan to Alpha, First Bank financed Beta Company's takeover of Alpha. During the financing negotiations, Heidi mentioned the Alpha earnings report to Beta officials;

furthermore, the report was an important factor in Heidi's decision to finance the takeover. Discuss the legal implications.

7. In Exercise 6, assume that after work one day, Heidi told her friend in the trust department that Alpha was Beta's takeover target. The friend proceeded to purchase additional stock in Alpha for a bank trust he administered. Discuss the legal implications.

SELF-TEST QUESTIONS

1 The issuance of corporate securities is governed by

a. various federal statutes
b. state law
c. both of the above
d. neither of the above

2 The law that prohibits the payment of a bribe to foreign officials to gain business is called

a. the Insider Trading Act
b. the blue sky law
c. the Foreign Corrupt Practices Act
d. none of the above

3 The primary means for banning stock offerings that inadequately disclose risks is

a. the registration requirement
b. SEC prohibition of risky stock offerings
c. both of the above
d. neither of the above

4 To enforce its prohibition under insider trading, the SEC requires reimbursement to the company of any profits made from selling and buying stock during any six-month period by directors owing

a. 60 percent or more of company stock
b. 40 percent or more of company stock
c. 10 percent or more of company stock

d. none of the above

5 Under Rule 10b-5, insiders include

a. all company employees

b. any person who possesses nonpublic information

c. all tippees

d. none of the above

6 The purpose of the Dodd-Frank Act is to

a. promote financial stability

b. end “too big to fail”

c. end bailouts

d. protect against abusive financial services practices

e. all of the above

SELF-TEST ANSWERS

1. c
2. c
3. a
4. d
5. a
6. e

CC BY NC SA

Chapter 18
Corporate Expansion, State and Federal Regulation of Foreign Corporations, and Corporate Dissolution

LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. How a corporation can expand by purchasing assets of another company without purchasing stock or otherwise merging with the company whose assets are purchased
2. The benefits of expanding through a purchase of assets rather than stock
3. Both the benefits and potential detriments of merging with another company
4. How a merger differs from a stock purchase or a consolidation
5. Takeovers and tender offers
6. Appraisal rights
7. Foreign corporations and the requirements of the US Constitution
8. The taxation of foreign corporations
9. Corporate dissolution and its various types

CC BY NC SA

This chapter begins with a discussion of the various ways a corporation can expand. We briefly consider successor liability—whether a successor corporation, such as a corporation that purchases all of the assets of another corporation, is liable for debts, lawsuits, and other liabilities of the purchased corporation. We then turn to appraisal rights, which are a shareholder's right to dissent from a corporate expansion. Next, we look at several aspects, such as jurisdiction and taxation, of foreign corporations—corporations that are incorporated in a state that is different from the one in which they do business. We conclude the chapter with dissolution of the corporation.

18.1 Corporate Expansion

LEARNING OBJECTIVE

1. Understand the four methods of corporate expansion: purchase of assets other than in the regular course of business, merger, consolidation, and purchase of stock in another corporation.

In popular usage, "**merger**" often is used to mean any type of expansion by which one corporation acquires part or all of another corporation. But in legal terms, merger is only one of four methods of achieving expansion other than by internal growth.

Purchase of Assets

One method of corporate expansion is the **purchase of assets** of another corporation. At the most basic level, ABC Corporation wishes to expand, and the assets of XYZ Corporation are attractive to ABC. So ABC purchases the assets of XYZ, resulting in the expansion of ABC. After the purchase, XYZ may remain in corporate form or may cease to exist, depending on how many of its assets were purchased by ABC.

There are several advantages to an asset purchase, most notably, that the acquiring corporation can pick what assets and liabilities (with certain limitations, discussed further on in this section) it wishes to

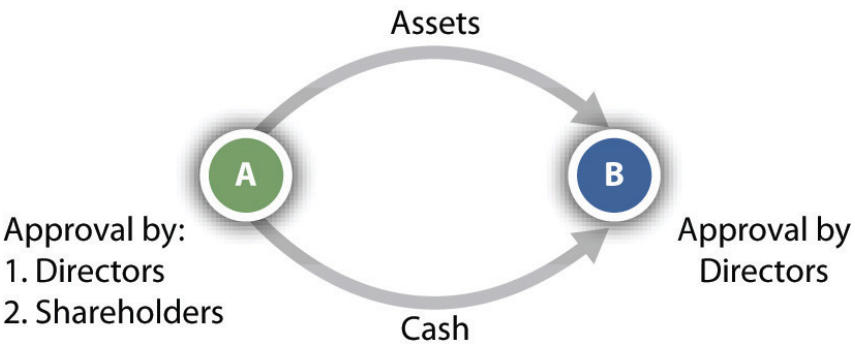
acquire. Furthermore, certain transactions may avoid a shareholder vote. If the selling corporation does not sell substantially all of its assets, then its shareholders may not get a vote to approve the sale.

For example, after several years of successful merchandising, a corporation formed by Bob, Carol, and Ted (BCT Bookstore, Inc.) has opened three branch stores around town and discovered its transportation costs mounting. Inventory arrives in trucks operated by the Flying Truckman Co., Inc. The BCT corporation concludes that the economics of delivery do not warrant purchasing a single truck dedicated to hauling books for its four stores alone. Then Bob learns that the owners of Flying Truckman might be willing to part with their company because it has not been earning money lately. If BCT could reorganize Flying Truckman's other routes, it could reduce its own shipping costs while making a profit on other lines of business.

Under the circumstances, the simplest and safest way to acquire Flying Truckman is by purchasing its assets. That way BCT would own the trucks and whatever routes it chooses, without taking upon itself the stigma of the association. It could drop the name Flying Truckman.

In most states, the board of directors of both the seller and the buyer must approve a transfer of assets. Shareholders of the selling corporation must also consent by majority vote, but shareholders of the acquiring company need not be consulted, so Ted's opposition can be effectively mooted; see Figure 18.1 "Purchase of Assets". (When inventory is sold in bulk, the acquiring company must also comply with the law governing bulk transfers.) By purchasing the assets—trucks, truck routes, and the trademark Flying Truckman (to prevent anyone else from using it)—the acquiring corporation can carry on the functions of the acquired company without carrying on its business as such.[1]

Figure 18.1 *Purchase of Assets*



Successor Liability

One of the principal advantages of this method of expansion is that the acquiring company generally is not liable for the debts and/or lawsuits of the corporation whose assets it purchased, generally known as **successor liability**. Suppose BCT paid Flying Truckman $250,000 for its trucks, routes, and name. With that cash, Flying Truckman paid off several of its creditors. Its shareholders then voted to dissolve the corporation, leaving one creditor unsatisfied. The creditor can no longer sue Flying Truckman since it does not exist. So he sues BCT. Unless certain circumstances exist, as discussed in *Ray v. Alad Corporation* (see Section 18.4.1 "Successor Liability"), BCT is not liable for Flying Truckman's debts.

Several states, although not a majority, have adopted the Ray product-line exception approach to successor liability. The general rule is that the purchasing corporation does not take the liabilities of the acquired corporation. Several exceptions exist, as described in *Ray*, the principal exception being the product-line approach. This minority exception has been further limited in several jurisdictions by applying it solely to cases involving products liability. Other jurisdictions also permit a continuity-of-enterprise exception, whereby the court examines how closely the acquiring corporation's business is to the acquired corporation's business (e.g., see *Turner v. Bituminous Casualty Co.*).[2]

Merger

When the assets of a company are purchased, the selling company itself may or may not go out of existence. By contrast, in a merger, the acquired company goes out of existence by being absorbed into the acquiring company. In the example in Section 18.1.2 "Merger", Flying Truck would merge into BCT, resulting in Flying Truckman losing its existence. The acquiring company receives all of the acquired

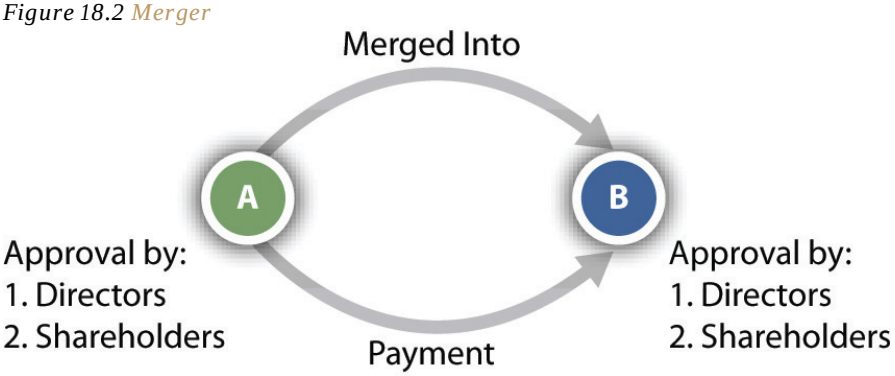
company's assets, including physical property and intangible property such as contracts and goodwill. The acquiring company also assumes all debts of the acquired company.

A merger begins when two or more corporations negotiate an agreement outlining the specifics of a merger, such as which corporation survives and the identities of management personnel. There are two main types of merger: a cash merger and a noncash merger. In a cash merger, the shareholders of the disappearing corporation surrender their shares for cash. These shareholders retain no interest in the surviving corporation, having been bought out. This is often called a freeze-out merger, since the shareholders of the disappearing corporation are frozen out of an interest in the surviving corporation.

In a noncash merger, the shareholders of the disappearing corporation retain an interest in the surviving corporation. The shareholders of the disappearing corporation trade their shares for shares in the surviving corporation; thus they retain an interest in the surviving corporation when they become shareholders of that surviving corporation.

Unless the articles of incorporation state otherwise, majority approval of the merger by both boards of directors and both sets of shareholders is necessary (see Figure 18.2 "Merger"). The shareholder majority must be of the total shares eligible to vote, not merely of the total actually represented at the special meeting called for the purpose of determining whether to merge.

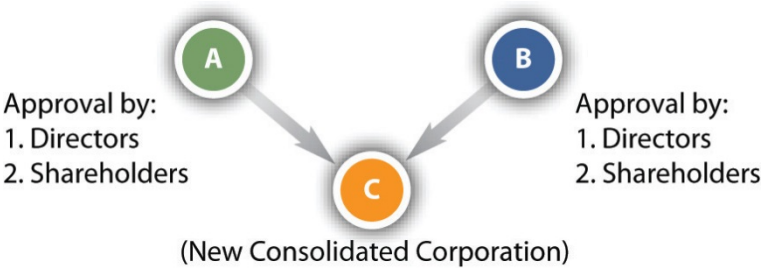
Figure 18.2 Merger



Consolidation

Consolidation is virtually the same as a merger. The companies merge, but the resulting entity is a new corporation. Returning to our previous example, BCT and Flying Truckman could consolidate and form a new corporation. As with mergers, the boards and shareholders must approve the consolidation by majority votes (see Figure 18.3 "Consolidation"). The resulting corporation becomes effective when the secretary of state issues a certificate of merger or incorporation.

Figure 18.3Consolidation



For more information on mergers and consolidation under Delaware law, see Del. Code Ann., Title 8, Sections 251–267 (2011), at http://delcode.delaware.gov/title8/index.shtml#TopOfPage.

Purchase of Stock

Takeovers

The fourth method of expanding, purchase of a company's stock, is more complicated than the other methods. The takeover has become a popular method for gaining control because it does not require an affirmative vote by the target company's board of directors. In a **takeover**, the acquiring company appeals directly to the target's shareholders, offering either money or other securities, often at a premium over market value, in exchange for their shares. The acquiring company usually need not purchase 100 percent of the shares. Indeed, if the shares are numerous and widely enough dispersed, control can be achieved by acquiring less than half the outstanding stock. In our example, if Flying Truckman has shareholders, BCT would make an offer directly to those shareholders to acquire their shares.

Tender Offers

In the case of closely held corporations, it is possible for a company bent on takeover to negotiate with each stockholder individually, making a direct offer to purchase his or her shares. That is impossible in the case of large publicly held companies since it is impracticable and/or too expensive to reach each individual shareholder. To reach all shareholders, the acquiring company must make a tender offer, which is a public offer to purchase shares. In fact, the tender offer is not really an offer at all in the technical sense; the **tender offer** is an invitation to shareholders to sell their shares at a stipulated price. The tender offer might express the price in cash or in shares of the acquiring company. Ordinarily, the offeror will want to purchase only a controlling interest, so it will limit the tender to a specified number of shares and reserve the right not to purchase any above that number. It will also condition the tender offer on receiving a minimum number of shares so that it need buy none if stockholders do not offer a threshold number of shares for purchase.

Leveraged Buyouts

A tender offer or other asset purchase can be financed as a **leveraged buyout (LBO)**, a purchase financed by debt. A common type of LBO involves investors who are members of the target corporation and/or outsiders who wish to take over the target or retain a controlling interest. These purchasers use the assets of the target corporation, such as its real estate or a manufacturing plant, as security for a loan to purchase the target. The purchasers also use other types of debt, such as the issuance of bonds or a loan, to implement the LBO.

For more information about tender offers and mergers, see *Unocal v. Mesa*[3] and *Revlon v. MacAndrews & Forbes*.[4] The *Wall Street Journal* provides comprehensive coverage of tender offers, mergers, and LBOs, at http://www.wsj.com.

State versus Federal Regulation of Takeovers

Under the federal Williams Act, upon commencement of a tender offer for more than 5 percent of the target's stock, the offeror must file a statement with the Securities and Exchange Commission (SEC) stating the source of funds to be used in making the purchase, the purpose of the purchase, and the extent of its holdings in the target company. Even when a tender offer has not been made, the Williams Act

requires any person who acquires more than 5 percent ownership of a corporation to file a statement with the SEC within ten days. The Williams Act, which made certain amendments to the Securities Exchange Act of 1934, can be viewed at http://taft.law.uc.edu/CCL/34Act/. The US Constitution is also implicated in the regulation of foreign corporations. The Commerce Clause of Article I, Section 8, of the Constitution provides that Congress has power "to regulate Commerce...among the several States."

Because officers and directors of target companies have no legal say in whether stockholders will tender their shares, many states began, in the early 1970s, to enact takeover laws. The first generation of these laws acted as delaying devices by imposing lengthy waiting periods before a tender offer could be put into effect. Many of the laws expressly gave management of the target companies a right to a hearing, which could be dragged out for weeks or months, giving the target time to build up a defense. The political premise of the laws was the protection of incumbent managers from takeover by out-of-state corporations, although the "localness" of some managers was but a polite fiction. One such law was enacted in Illinois. It required notifying the Illinois secretary of state and the target corporation of the intent to make a tender offer twenty days prior to the offer. During that time, the corporation seeking to make the tender offer could not spread information about the offer. Finally, the secretary of state could delay the tender offer by ordering a hearing and could even deny the offer if it was deemed inequitable. In 1982, the Supreme Court, in *Edgar v. Mite Corp.*, struck down the Illinois takeover law because it violated the Commerce Clause, which prohibits states from unduly burdening the flow of interstate commerce, and also was preempted by the Williams Act.[5]

Following the *Mite* decision, states began to enact a second generation of takeover laws. In 1987, in *CTS Corporation v. Dynamics Corporation of America*, the Supreme Court upheld an Indiana second-generation statute that prevents an offeror who has acquired 20 percent or more of a target's stock from voting unless other shareholders (not including management) approve. The vote to approve can be delayed for up to fifty days from the date the offeror files a statement reporting the acquisition. The Court concluded that the Commerce Clause was not violated nor was the Williams Act, because the Indiana law, unlike the Illinois law in *Mite*, was consistent with the Williams Act, since it protects shareholders, does not unreasonably delay the tender offer, and does not discriminate against interstate commerce.[6]

Emboldened by the *CTS* decision, almost half the states have adopted a third-generation law that requires a bidder to wait several years before merging with the target company unless the target's board agrees in advance to the merger. Because in many cases a merger is the reason for the bid, these laws are especially powerful. In 1989, the Seventh Circuit Court of Appeals upheld Wisconsin's third-generation law, saying that it did not violate the Commerce Clause and that it was not preempted by the Williams Act. The Supreme Court decided not to review the decision.[7]

Short-Form Mergers

If one company acquires 90 percent or more of the stock of another company, it can merge with the target company through the so-called **short-form merger**. Only the parent company's board of directors need approve the merger; consent of the shareholders of either company is unnecessary.

Appraisal Rights

If a shareholder has the right to vote on a corporate plan to merge, consolidate, or sell all or substantially all of its assets, that shareholder has the right to dissent and invoke **appraisal rights**. Returning again to BCT, Bob and Carol, as shareholders, are anxious to acquire Flying Truckman, but Ted is not sure of the wisdom of doing that. Ted could invoke his appraisal rights to dissent from an expansion involving Flying Truckman. The law requires the shareholder to file with the corporation, before the vote, a notice of intention to demand the fair value of his shares. If the plan is approved and the shareholder does not vote in favor, the corporation must send a notice to the shareholder specifying procedures for obtaining payment, and the shareholder must demand payment within the time set in the notice, which cannot be less than thirty days. Fair value means the value of shares immediately before the effective date of the corporate action to which the shareholder has objected. Appreciation and depreciation in anticipation of the action are excluded, unless the exclusion is unfair.

If the shareholder and the company cannot agree on the fair value, the shareholder must file a petition requesting a court to determine the fair value. The method of determining fair value depends on the circumstances. When there is a public market for stock traded on an exchange, fair value is usually the

price quoted on the exchange. In some circumstances, other factors, especially net asset value and investment value—for example, earnings potential—assume greater importance.

See *Hariton v. Arco Electronics, Inc.*[8] and *M.P.M. Enterprises, Inc. v. Gilbert*[9] for further discussion of appraisal rights and when they may be invoked.

KEY TAKEAWAY

There are four main methods of corporate expansion. The first involves the purchase of assets not in the ordinary course of business. Using this method, the purchase expands the corporation. The second and third methods, merger and consolidation, are very similar: two or more corporations combine. In a merger, one of the merging companies survives, and the other ceases to exist. In a consolidation, the merging corporations cease to exist when they combine to form a new corporation. The final method is a stock purchase, accomplished via a tender offer, takeover, or leveraged buyout. Federal and state regulations play a significant role in takeovers and tender offers, particularly the Williams Act. A shareholder who does not wish to participate in a stock sale may invoke his appraisal rights and demand cash compensation for his shares.

EXERCISES

1. What are some dangers in purchasing the assets of another corporation?
2. What are some possible rationales behind statutes such as the Williams Act and state antitakeover statutes?
3. When may a shareholder invoke appraisal rights?

---

[1] For a discussion of asset purchases see *Airborne Health v. Squid Soap*, 984 A.2d 126 (Del. 2010).

[2] *Turner v. Bituminous Casualty Co.*, 244 N.W.2d 873 (Mich. 1976).

[3] *Unocal Corp. v. Mesa Petroleum*, 493 A.2d 946 (Del. 1985).

[4] *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985).

[5] *Edgar v. Mite Corp.*, 457 U.S. 624 (1982).

[6] *CTS Corporation v. Dynamics Corporation of America*, 481 U.S. 69 (1987).

[7] *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496 (7th Cir. 1989).

[8] *Hariton v. Arco Electronics, Inc.*, 40 Del. Ch. 326; 182 A.2d 22 (Del. 1962).

[9] *M.P.M. Enterprises, Inc. v. Gilbert*, 731 A.2d 790 (Del. 1999).

18.2 Foreign Corporations

LEARNING OBJECTIVES

1. Discuss state-imposed conditions on the admission of foreign corporations.
2. Discuss state court jurisdiction over foreign corporations.
3. Explain how states may tax foreign corporations.
4. Apply the US Constitution to foreign corporations.

A **foreign corporation** is a company incorporated outside the state in which it is doing business. A Delaware corporation, operating in all states, is a foreign corporation in forty-nine of them.

Conditions on Admission to Do Business

States can impose on foreign corporations conditions on admission to do business if certain constitutional barriers are surmounted. One potential problem is the Privileges and Immunities Clause in Article IV, Section 2, of the Constitution, which provides that "citizens shall be entitled to all privileges and immunities of citizens in the several states." The Supreme Court has interpreted this murky language to mean that states may not discriminate between their own citizens and those of other states. For example, the Court voided a tax New Hampshire imposed on out-of-state commuters on the grounds that "the tax falls exclusively on the incomes of nonresidents." [1] However, corporations are uniformly held not to be

citizens for purposes of this clause, so the states may impose burdens on foreign corporations that they do not put upon companies incorporated under their laws. But these burdens may only be imposed on companies that conduct intrastate business, having some level of business transactions within that state.

Other constitutional rights of the corporation or its members may also come into play when states attempt to license foreign corporations. Thus when Arkansas sought to revoke the license of a Missouri construction company to do business within the state, the Supreme Court held that the state had acted unconstitutionally (violating Article III, Section 2, of the US Constitution) in conditioning the license on a waiver of the right to remove a case from the state courts to the federal courts.[2]

Typical Requirements for Foreign Corporations

Certain preconditions for doing business are common to most states. Foreign corporations are required to obtain from the secretary of state a certificate of authority to conduct business. The foreign corporation also must maintain a registered office with a registered agent who works there. The registered agent may be served with all legal process, demands, or notices required by law to be served on the corporation. Foreign corporations are generally granted every right and privilege enjoyed by domestic corporations.

These requirements must be met whenever the corporation transacts business within the state. As mentioned previously, some activities do not fall within the definition of **transacting business** and may be carried on even if the foreign corporation has not obtained a certificate of authority. These include filing or defending a lawsuit, holding meetings of directors or shareholders, maintaining bank accounts, maintaining offices for the transfer of the company's own securities, selling through independent contractors, soliciting orders through agents or employees (but only if the orders become binding contracts upon acceptance outside the state), creating or acquiring security interests in real or personal property, securing or collecting debts, transacting any business in interstate commerce, and "conducting an isolated transaction that is completed within 30 days and that is not one in the course of repeated transactions of a like nature" (Revised Model Business Corporation Act, Section 15.01).

Penalties for Failure to Comply with a Statute

A corporation may not sue in the state courts to enforce its rights until it obtains a certificate of authority. It may defend any lawsuits brought against it, however. The state attorney general has authority to collect civil penalties that vary from state to state. Other sanctions in various states include fines and penalties on taxes owed; fines and imprisonment of corporate agents, directors, and officers; nullification of corporate contracts; and personal liability on contracts by officers and directors. In some states, contracts made by a corporation that has failed to qualify are void.

Jurisdiction over Foreign Corporations

Whether corporations are subject to state court jurisdiction depends on the extent to which they are operating within the state. If the corporation is qualified to do business within the state and has a certificate of authority or license, then state courts have jurisdiction and process may be served on the corporation's registered agent. If the corporation has failed to name an agent or is doing business without a certificate, the plaintiff may serve the secretary of state on the corporation's behalf.

Even if the corporation is not transacting enough business within the state to be required to qualify for a certificate or license, it may still be subject to suit in state courts under long-arm statutes. These laws permit state courts to exercise personal jurisdiction over a corporation that has sufficient contacts with the state.

The major constitutional limitation on long-arm statutes is the Due Process Clause. The Supreme Court upheld the validity of long-arm statutes applied to corporations in *International Shoe Co. v. Washington*.[3] But the long-arm statute will only be constitutionally valid where there are minimum contacts—that is, for a state to exercise personal jurisdiction over a foreign corporation, the foreign corporation must have at least "minimum contacts" the state. That jurisdictional test is still applied many years after the *International Shoe* decision was handed down.[4] Since *International Shoe*, the nationalization of commerce has given way to the internationalization of commerce. This change has resulted in difficult jurisdictional questions that involve conflicting policy considerations.[5]

Taxing Authority

May states tax foreign corporations? Since a state may obviously tax its domestic corporations, the question might seem surprising. Why should a state ever be barred from taxing foreign corporations licensed to do business in the state? If the foreign corporation was engaged in purely local, intrastate business, no quarrel would arise. The constitutional difficulty is whether the tax constitutes an unreasonable burden on the company's interstate business, in violation of the **Commerce Clause**. The basic approach, illustrated in *D. H. Holmes Co., Ltd. v. McNamara* (see Section 18.4.2 "Constitutional Issues Surrounding Taxation of a Foreign Corporation"), is that a state can impose a tax on activities for which the state gives legal protection, so long as the tax does not unreasonably burden interstate commerce.

State taxation of corporate income raises special concerns. In the absence of ground rules, a company doing business in many states could be liable for paying income tax to several different states on the basis of its total earnings. A company doing business in all fifty states, for example, would pay five times its earnings in income taxes if each state were to charge a 10 percent tax on those earnings. Obviously, such a result would seriously burden interstate commerce. The courts have long held, therefore, that the states may only tax that portion of the company's earnings attributable to the business carried on in the state. To compute the proportion of a company's total earnings subject to tax within the state, most states have adopted a formula based on the local percentage of the company's total sales, property, and payroll.

KEY TAKEAWAY

A foreign corporation is a company incorporated outside of the state in which it is doing business. States can place reasonable limitations upon foreign corporations subject to constitutional requirements. A foreign corporation must do something that is sufficient to rise to the level of transacting business within a state in order to fall under the jurisdiction of that state. These transactions must meet the minimum-contacts requirement for jurisdiction under long-arm statutes. A state may tax a foreign corporation as long as it does not burden interstate commerce.

EXERCISES

1. What are some typical requirements that a corporation must meet in order to operate in a foreign state?
2. Provide examples of business activities that rise to the level of minimum contacts such as that a state may exercise jurisdiction over a foreign corporation.
3. What are some possible jurisdictional problems that arise from increasing globalization and from many corporations providing input for a particular product? For more information, see the *Asahi Metal* and *Pavlovich* court cases, cited in endnotes 13 and 14 below.

---

[1] *Austin v. New Hampshire*, 420 U.S. 656 (1975).

[2] *Terral v. Burke Construction Co.*, 257 U.S. 529 (1922).

[3] *International Shoe Co. v. Washington*, 326 U.S. 310 (1945).

[4] *Judas Priest v. District Court*, 104 Nev. 424; 760 P.2d 137 (Nev. 1988); *Pavlovich v. Superior Court*, 29 Cal. 4th 262; 58 P.3d 2 (Cal. 2002).

[5] *Asahi Metal Industry v. Superior Court of California*, 480 U.S. 102, 107 S.Ct. 1026, 94 L. Ed. 92 (1987).

18.3 Dissolution

LEARNING OBJECTIVES

1. Define and distinguish dissolution and liquidation.
2. Discuss the different types of dissolution and liquidation.
3. Discuss claims against a dissolved corporation.

Dissolution is the end of the legal existence of the corporation, basically "corporate death." It is not the same as **liquidation**, which is the process of paying the creditors and distributing the assets. Until dissolved, a corporation endures, despite the vicissitudes of the economy or the corporation's internal

affairs. As Justice Cardozo said while serving as chief judge of the New York court of appeals: "Neither bankruptcy...nor cessation of business...nor dispersion of stockholders, nor the absence of directors...nor all combined, will avail without more to stifle the breath of juristic personality. The corporation abides as an ideal creation, impervious to the shocks of these temporal vicissitudes. Not even the sequestration of the assets at the hands of a receiver will terminate its being." [1]

See http://www.irs.gov/businesses/small/article/0,,id=98703,00.html for the Internal Revenue Service's checklist of closing and dissolving a business. State and local government regulations may also apply.

Voluntary Dissolution

Any corporation may be dissolved with the unanimous written consent of the shareholders; this is a **voluntary dissolution**. This provision is obviously applicable primarily to closely held corporations. Dissolution can also be accomplished even if some shareholders dissent. The directors must first adopt a resolution by majority vote recommending the dissolution. The shareholders must then have an opportunity to vote on the resolution at a meeting after being notified of its purpose. A majority of the outstanding voting shares is necessary to carry the resolution. Although this procedure is most often used when a company has been inactive, nothing bars its use by large corporations. In 1979, UV Industries, 357th on the *Fortune* 500 list, with profits of $40 million annually, voted to dissolve and to distribute some $500 million to its stockholders, in part as a means of fending off a hostile takeover. *Fortune* magazine referred to it as "a company that's worth more dead than alive." [2]

Once dissolution has been approved, the corporation may dissolve by filing a certificate or articles of dissolution with the secretary of state. The certificate may be filed as the corporation begins to wind up its affairs or at any time thereafter. The process of winding up is liquidation. The company must notify all creditors of its intention to liquidate. It must collect and dispose of its assets, discharge all obligations, and distribute any remainder to its stockholders.

Involuntary Dissolution

CC BY NC SA

In certain cases, a corporation can face **involuntary dissolution**. A state may bring an action to dissolve a corporation on one of five grounds: failure to file an annual report or pay taxes, fraud in procuring incorporation, exceeding or abusing authority conferred, failure for thirty days to appoint and maintain a registered agent, and failure to notify the state of a change of registered office or agent. State-specific differences exist as well. Delaware permits its attorney general to involuntarily dissolve a corporation for abuse, misuse, or nonuse of corporate powers, privileges, or franchise.[3] California, on the other hand, permits involuntary dissolution for abandonment of a business, board deadlocks, internal strife and deadlocked shareholders, mismanagement, fraud or abuse of authority, expiration of term of corporation, or protection of a complaining shareholder if there are fewer than thirty-five shareholders.[4]California permits the initiation of involuntary dissolution by either half of the directors in office or by a third of shareholders.

Judicial Liquidation

Action by Shareholder

A shareholder may file suit to have a court dissolve the company on a showing that the company is being irreparably injured because the directors are deadlocked in the management of corporate affairs and the shareholders cannot break the deadlock. Shareholders may also sue for liquidation if corporate assets are being misapplied or wasted, or if directors or those in control are acting illegally, oppressively, or fraudulently.

Claims against a Dissolved Corporation

Under Sections 14.06 and 14.07 of the Revised Model Business Corporation Act, a dissolved corporation must provide written notice of the dissolution to its creditors. The notice must state a deadline, which must be at least 120 days after the notice, for receipt of creditors' claims. Claims not received by the deadline are barred. The corporation may also publish a notice of the dissolution in a local newspaper. Creditors who do not receive written notice or whose claim is not acted on have five years to file suit against the corporation. If the corporate assets have been distributed, shareholders are personally liable, although the liability may not exceed the assets received at liquidation.

Bankruptcy

As an alternative to dissolution, a corporation in financial trouble may look to federal bankruptcy law for relief. A corporation may use liquidation proceedings under Chapter 7 of the Bankruptcy Reform Act or may be reorganized under Chapter 11 of the act. Both remedies are discussed in detail in Chapter 27 "Bankruptcy".

KEY TAKEAWAY

Dissolution is the end of the legal existence of a corporation. It usually occurs after liquidation, which is the process of paying debts and distributing assets. There are several methods by which a corporation may be dissolved. The first is voluntary dissolution, which is an elective decision to dissolve the entity. A second is involuntary dissolution, which occurs upon the happening of statute-specific events such as a failure to pay taxes. Last, a corporation may be dissolved judicially, either by shareholder or creditor lawsuit. A dissolved corporation must provide notice to its creditors of upcoming dissolution.

EXERCISES

1. What are the main types of dissolution?
2. What is the difference between dissolution and liquidation?
3. What are the rights of a stockholder to move for dissolution?

CC BY NC SA

[1] *Petrogradsky Mejdunarodny Kommerchesky Bank v. National City Bank*, 170 N.E. 479, 482 (N.Y. 1930).

[2] *Fortune*, February 26, 1979, 42–44.

[3] Del. Code Ann. tit. 8, § 282 (2011).

[4] Cal. Corp. Code § 1800 et seq. (West 2011).

18.4 Cases

Successor Liability

Ray v. Alad Corporation

19 Cal. 3d 22; 560 P2d 3; 136 Cal. Rptr. 574 (Cal. 1977)

Claiming damages for injury from a defective ladder, plaintiff asserts strict tort liability against defendant Alad Corporation (Alad II) which neither manufactured nor sold the ladder but prior to plaintiff's injury succeeded to the business of the ladder's manufacturer, the now dissolved "Alad Corporation" (Alad I), through a purchase of Alad I's assets for an adequate cash consideration. Upon acquiring Alad I's plant, equipment, inventory, trade name, and good will, Alad II continued to manufacture the same line of ladders under the "Alad" name, using the same equipment, designs, and personnel, and soliciting Alad I's customers through the same sales representatives with no outward indication of any change in the ownership of the business. The trial court entered summary judgment for Alad II and plaintiff appeals....

Our discussion of the law starts with the rule ordinarily applied to the determination of whether a corporation purchasing the principal assets of another corporation assumes the other's liabilities. As typically formulated, the rule states that the purchaser does not assume the seller's liabilities unless (1) there is an express or implied agreement of assumption, (2) the transaction amounts to a consolidation or

merger of the two corporations, (3) the purchasing corporation is a mere continuation of the seller, or (4) the transfer of assets to the purchaser is for the fraudulent purpose of escaping liability for the seller's debts.

If this rule were determinative of Alad II's liability to plaintiff it would require us to affirm the summary judgment. None of the rule's four stated grounds for imposing liability on the purchasing corporation is present here. There was no express or implied agreement to assume liability for injury from defective products previously manufactured by Alad I. Nor is there any indication or contention that the transaction was prompted by any fraudulent purpose of escaping liability for Alad I's debts.

With respect to the second stated ground for liability, the purchase of Alad I's assets did not amount to a consolidation or merger. This exception has been invoked where one corporation takes all of another's assets without providing any consideration that could be made available to meet claims of the other's creditors or where the consideration consists wholly of shares of the purchaser's stock which are promptly distributed to the seller's shareholders in conjunction with the seller's liquidation. In the present case the sole consideration given for Alad I's assets was cash in excess of $ 207,000. Of this amount Alad I was paid $ 70,000 when the assets were transferred and at the same time a promissory note was given to Alad I for almost $ 114,000. Shortly before the dissolution of Alad I the note was assigned to the Hamblys, Alad I's principal stockholders, and thereafter the note was paid in full. The remainder of the consideration went for closing expenses or was paid to the Hamblys for consulting services and their agreement not to compete. There is no contention that this consideration was inadequate or that the cash and promissory note given to Alad I were not included in the assets available to meet claims of Alad I's creditors at the time of dissolution. Hence the acquisition of Alad I's assets was not in the nature of a merger or consolidation for purposes of the aforesaid rule.

Plaintiff contends that the rule's third stated ground for liability makes Alad II liable as a mere continuation of Alad I in view of Alad II's acquisition of all Alad I's operating assets, its use of those assets and of Alad I's former employees to manufacture the same line of products, and its holding itself out to customers and the public as a continuation of the same enterprise. However, California decisions holding

that a corporation acquiring the assets of another corporation is the latter's mere continuation and therefore liable for its debts have imposed such liability only upon a showing of one or both of the following factual elements: (1) no adequate consideration was given for the predecessor corporation's assets and made available for meeting the claims of its unsecured creditors; (2) one or more persons were officers, directors, or stockholders of both corporations....

We therefore conclude that the general rule governing succession to liabilities does not require Alad II to respond to plaintiff's claim....

[However], we must decide whether the policies underlying strict tort liability for defective products call for a special exception to the rule that would otherwise insulate the present defendant from plaintiff's claim.

The purpose of the rule of strict tort liability "is to insure that the costs of injuries resulting from defective products are borne by the manufacturers that put such products on the market rather than by the injured persons who are powerless to protect themselves." However, the rule "does not rest on the analysis of the financial strength or bargaining power of the parties to the particular action. It rests, rather, on the proposition that 'The cost of an injury and the loss of time or health may be an overwhelming misfortune to the person injured, and a needless one, for the risk of injury can be insured by the manufacturer and distributed among the public as a cost of doing business. (*Escola* v. *Coca Cola Bottling Co*., 24 Cal.2d 453, 462 [150 P.2d 436] [concurring opinion]) Thus, "the paramount policy to be promoted by the rule is the protection of otherwise defenseless victims of manufacturing defects and the *spreading throughout society* of the cost of compensating them." Justification for imposing strict liability upon a *successor* to a manufacturer under the circumstances here presented rests upon (1) the virtual destruction of the plaintiff's remedies against the original manufacturer caused by the successor's acquisition of the business, (2) the successor's ability to assume the original manufacturer's risk-spreading role, and (3) the fairness of requiring the successor to assume a responsibility for defective products that was a burden necessarily attached to the original manufacturer's good will being enjoyed by the successor in the continued operation of the business.

We therefore conclude that a party which acquires a manufacturing business and continues the output of its line of products under the circumstances here presented assumes strict tort liability for defects in units of the same product line previously manufactured and distributed by the entity from which the business was acquired.

The judgment is reversed.

CASE QUESTIONS

1. What is the general rule regarding successor liability?
2. How does the *Ray* court deviate from this general rule?
3. What is the court's rationale for this deviation?
4. What are some possible consequences for corporations considering expansion?

Constitutional Issues Surrounding Taxation of a Foreign Corporation

D. H. Holmes Co. Ltd. V. McNamara

486 U.S. 24; 108 S.Ct. 1619, 100 L. Ed. 2d 21 (1988)

Appellant D. H. Holmes Company, Ltd., is a Louisiana corporation with its principal place of business and registered office in New Orleans. Holmes owns and operates 13 department stores in various locations throughout Louisiana that employ about 5,000 workers. It has approximately 500,000 credit card customers and an estimated 1,000,000 other customers within the State.

In 1979–1981, Holmes contracted with several New York companies for the design and printing of merchandise catalogs. The catalogs were designed in New York, but were actually printed in Atlanta, Boston, and Oklahoma City. From these locations, 82% of the catalogs were directly mailed to residents of Louisiana; the remainder of the catalogs was mailed to customers in Alabama, Mississippi, and Florida, or was sent to Holmes for distribution at its flagship store on Canal Street in New Orleans. The catalogs were shipped free of charge to the addressee, and their entire cost (about $ 2 million for the 3-year period),

including mailing, was borne by Holmes. Holmes did not, however, pay any sales tax where the catalogs were designed or printed.

Although the merchandise catalogs were mailed to selected customers, they contained instructions to the postal carrier to leave them with the current resident if the addressee had moved, and to return undeliverable catalogs to Holmes' Canal Street store. Holmes freely concedes that the purpose of the catalogs was to promote sales at its stores and to instill name recognition in future buyers. The catalogs included inserts which could be used to order Holmes' products by mail.

The Louisiana Department of Revenue and Taxation, of which appellee is the current Secretary, conducted an audit of Holmes' tax returns for 1979–1981 and determined that it was liable for delinquent use taxes on the value of the catalogs. The Department of Revenue and Taxation assessed the use tax pursuant to La. Rev. Stat. Ann. §§ 47:302 and 47:321 (West 1970 and Supp. 1988), which are set forth in the margin. Together, §§ 47:302(A)(2) and 47:321(A)(2) impose a use tax of 3% on all tangible personal property used in Louisiana. "Use," as defined elsewhere in the statute, is the exercise of any right or power over tangible personal property incident to ownership, and includes consumption, distribution, and storage. The use tax is designed to compensate the State for sales tax that is lost when goods are purchased out-of-state and brought for use into Louisiana, and is calculated on the retail price the property would have brought when imported.

When Holmes refused to pay the use tax assessed against it, the State filed suit in Louisiana Civil District Court to collect the tax. [The lower courts held for the State.]...

The Commerce Clause of the Constitution, Art. I, § 8, cl. 3, provides that Congress shall have the power "to regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." Even where Congress has not acted affirmatively to protect interstate commerce, the Clause prevents States from discriminating against that commerce. The "distinction between the power of the State to shelter its people from menaces to their health or safety and from fraud, even when those dangers emanate from interstate commerce, and its lack of power to retard, burden or constrict the flow of such

commerce for their economic advantage, is one deeply rooted in both our history and our law." *H. P. Hood & Sons v. Du Mond, 336 U.S. 525, 533, 93 L. Ed. 865, 69 S.Ct. 657 (1949).*

One frequent source of conflict of this kind occurs when a State seeks to tax the sale or use of goods within its borders. This recurring dilemma is exemplified in what has come to be the leading case in the area. *Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 51 L. Ed. 2d 326, 97 S.Ct. 1076 (1977).* In *Complete Auto*, Mississippi imposed a tax on appellant's business of in-state transportation of motor vehicles manufactured outside the State. We found that the State's tax did not violate the Commerce Clause, because appellant's activity had a substantial nexus with Mississippi, and the tax was fairly apportioned, did not discriminate against interstate commerce, and was fairly related to benefits provided by the State.

Complete Auto abandoned the abstract notion that interstate commerce "itself" cannot be taxed by the States. We recognized that, with certain restrictions, interstate commerce may be required to pay its fair share of state taxes. Accordingly, in the present case, it really makes little difference for Commerce Clause purposes whether Holmes' catalogs "came to rest" in the mailboxes of its Louisiana customers or whether they were still considered in the stream of interstate commerce....

In the case before us, then, the application of Louisiana's use tax to Holmes' catalogs does not violate the Commerce Clause if the tax complies with the four prongs of *Complete Auto*. We have no doubt that the second and third elements of the test are satisfied. The Louisiana taxing scheme is fairly apportioned, for it provides a credit against its use tax for sales taxes that have been paid in other States. Holmes paid no sales tax for the catalogs where they were designed or printed; if it had, it would have been eligible for a credit against the use tax exacted. Similarly, Louisiana imposed its use tax only on the 82% of the catalogs distributed in-state; it did not attempt to tax that portion of the catalogs that went to out-of-state customers.

The Louisiana tax structure likewise does not discriminate against interstate commerce. The use tax is designed to compensate the State for revenue lost when residents purchase out-of-state goods for use

within the State. It is equal to the sales tax applicable to the same tangible personal property purchased in-state; in fact, both taxes are set forth in the same sections of the Louisiana statutes.

Complete Auto requires that the tax be fairly related to benefits provided by the State, but that condition is also met here. Louisiana provides a number of services that facilitate Holmes' sale of merchandise within the State: It provides fire and police protection for Holmes' stores, runs mass transit and maintains public roads which benefit Holmes' customers, and supplies a number of other civic services from which Holmes profits. To be sure, many others in the State benefit from the same services; but that does not alter the fact that the use tax paid by Holmes, on catalogs designed to increase sales, is related to the advantages provided by the State which aid Holmes' business.

Finally, we believe that Holmes' distribution of its catalogs reflects a substantial nexus with Louisiana. To begin with, Holmes' contention that it lacked sufficient control over the catalogs' distribution in Louisiana to be subject to the use tax verges on the nonsensical. Holmes ordered and paid for the catalogs and supplied the list of customers to whom the catalogs were sent; any catalogs that could not be delivered were returned to it. Holmes admits that it initiated the distribution to improve its sales and name recognition among Louisiana residents. Holmes also has a significant presence in Louisiana, with 13 stores and over $100 million in annual sales in the State. The distribution of catalogs to approximately 400,000 Louisiana customers was directly aimed at expanding and enhancing its Louisiana business. There is "nexus" aplenty here. [Judgment affirmed.]

CASE QUESTIONS

1. What is the main constitutional issue in this case?
2. What are the four prongs to test whether a tax violates the Constitution, as laid out in *Complete Auto?*
3. Does this case hold for the proposition that a state may levy any tax upon a foreign corporation?

CC BY NC SA

18.5 Summary and Exercises

Summary

Beyond the normal operations of business, a corporation can expand in one of four ways: (1) purchase of assets, (2) merger, (3) consolidation, and (4) purchase of another corporation's stock.

A purchase of assets occurs when one corporation purchases some or all of the assets of another corporation. When assets are purchased, the purchasing corporation is not generally liable for the debts of the corporation whose assets were sold. There are several generally recognized exceptions, such as when the asset purchase is fraudulent or to avoid creditors. Some states have added additional exceptions, such as in cases involving products liability.

In a merger, the acquired company is absorbed into the acquiring company and goes out of business. The acquiring corporation assumes the other company's debts. Unless the articles of incorporation say otherwise, a majority of directors and shareholders of both corporations must approve the merger. There are two main types of merger: a cash merger and a noncash merger. A consolidation is virtually the same as a merger, except that the resulting entity is a new corporation.

A corporation may take over another company by purchasing a controlling interest of its stock, commonly referred to as a takeover. This is accomplished by appealing directly to the target company's shareholders. In the case of a large publicly held corporation, the appeal is known as a tender offer, which is not an offer but an invitation to shareholders to tender their stock at a stated price. A leveraged buyout involves using the target corporation's assets as security for a loan used to purchase the target.
A shareholder has the right to fair value for his stock if he dissents from a plan to merge, consolidate, or sell all or substantially all of the corporate assets, referred to as appraisal rights. If there is disagreement over the value, the shareholder has the right to a court appraisal. When one company acquires 90 percent of the stock of another, it may merge with the target through a short-form merger, which eliminates the requirement of consent of shareholders and the target company's board.

Certain federal regulations are implicated in corporate expansion, particularly the Williams Act. States may impose conditions on admission of a foreign corporation to do business of a purely local nature but not if its business is exclusively interstate in character, which would violate the Commerce Clause. Among the requirements are obtaining a certificate of authority from the secretary of state and maintaining a registered office with a registered agent. But certain activities do not constitute doing business, such as filing lawsuits and collecting debts, and may be carried on even if the corporation is not licensed to do business in a state. Under long-arm statutes, state courts have jurisdiction over foreign corporations as long as the corporations have minimum contacts in the state. States may also tax corporate activities as long as the tax does not unduly burden interstate commerce.

Dissolution is the legal termination of a corporation's existence, as distinguished from liquidation, the process of paying debts and distributing assets. A corporation may be dissolved by shareholders if they unanimously agree in writing, or by majority vote of the directors and shareholders. A corporation may also be dissolved involuntarily on one of five grounds, including failure to file an annual report or to pay taxes. Shareholders may sue for judicial liquidation on a showing that corporate assets are being wasted or directors or officers are acting illegally or fraudulently.

EXERCISES

1. Preston Corporation sold all of its assets to Adam Corporation in exchange for Adam stock. Preston then distributed the stock to its shareholders, without paying a debt of $150,000 owed to a major supplier, Corey. Corey, upon discovery that Preston is now an empty shell, attempts to recover the debt from Adam. What is the result? Why?
2. Would the result in Exercise 1 be different if Adam and Preston had merged? Why?
3. Would the result in Exercise 1 be different if Gorey had a products-liability claim against Preston? Why? What measures might you suggest to Adam to prevent potential losses from such claims?

4. In Exercise 1, assuming that Preston and Adam had merged, what are the rights of Graham, a shareholder who opposed the merger? Explain the procedure for enforcing his rights.
5. A bus driver from Massachusetts was injured when his seat collapsed while he was driving his bus through Maine. He brought suit in Massachusetts against the Ohio corporation that manufactured the seat. The Ohio corporation did not have an office in Massachusetts but occasionally sent a sales representative there and delivered parts to the state. Assuming that process was served on the company at its Ohio office, would a Massachusetts court have jurisdiction over the Ohio corporation? Why?

SELF-TEST QUESTIONS

1 In a merger, the acquired company

a. goes out of existence
b. stays in existence
c. is consolidated into a new corporation
d. does none of the above

2 An offer by an acquiring company to buy shareholders' stock at a stipulated price is called

a. an appraisal
b. a short-form merger
c. a tender offer
d. none of the above

3 The legal termination of a corporation's existence is called

a. liquidation
b. bankruptcy
c. extinguishment
d. dissolution

4 The most important constitutional provision relating to a state's ability to tax foreign corporations is

a. the Commerce Clause
b. the First Amendment

CC BY NC SA

c. the Due Process Clause

d. the Privileges and Immunities Clause

5 An act that is considered to be a corporation's "transacting business" in a state is

a. collecting debts

b. holding directors' meetings

c. filing lawsuits

d. none of the above

SELF-TEST ANSWERS

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

Chapter 19
Nature and Form of Commercial Paper

LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. Why commercial paper is important in modern economic systems
2. How the law of commercial paper has developed over the past four hundred years, and what role it plays in economics and finance
3. What the types of commercial paper are, and who the parties to such paper are
4. What is required for paper to be negotiable

CC BY NC SA

Here we begin our examination of commercial paper, documents representing an obligation by one party to pay another money. You are familiar with one kind of commercial paper: a check.

19.1 Introduction to Commercial Paper

LEARNING OBJECTIVES

1. Understand why commercial paper is an important concept in modern finance.
2. Be familiar with the historical development of commercial paper.
3. Recognize how commercial paper is viewed in economics and finance.

The Importance of Commercial Paper

Because commercial paper is a vital invention for the working of our economic system, brief attention to its history and its function as a medium of exchange in economics and finance is appropriate.

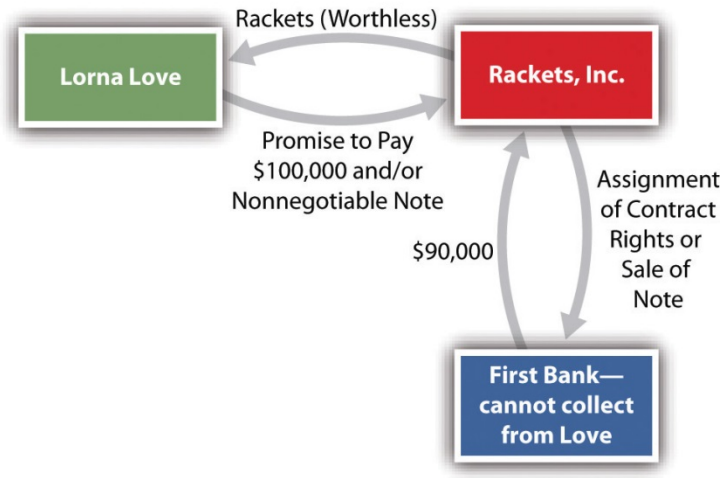
The Central Role of Commercial Paper

Commercial paper is the collective term for various financial instruments, or tools, that include checks drawn on commercial banks, drafts (drawn on something other than a bank), certificates of deposit, and notes evidencing a promise to pay. Like money, commercial paper is a medium of exchange, but because it is one step removed from money, difficulties arise that require a series of interlocking rules to protect both sellers and buyers.

To understand the importance of commercial paper, consider the following example. It illustrates a distinction that is critical to the discussion in our four chapters on commercial paper.

Lorna Love runs a tennis club. She orders a truckload of new tennis rackets from Rackets, Inc., a manufacturer. The contract price of the rackets is $100,000. Rackets ships the rackets to Love. Rackets then sells for $90,000 its contract rights (rights to receive the payment from Love of $100,000) to First Bank (see Figure 19.1 "Assignment of Contract Rights"). Unfortunately, the rackets that arrive at Love's are warped and thus commercially worthless. Rackets files for bankruptcy.

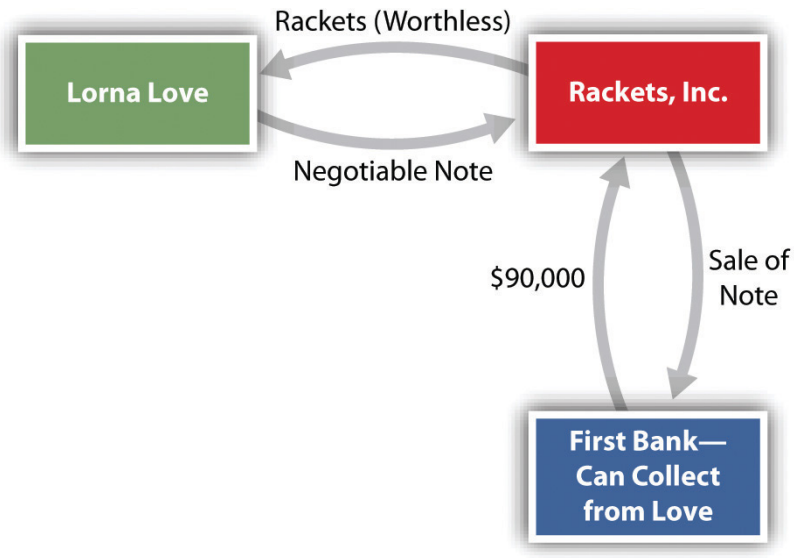
Figure 19.1 *Assignment of Contract Rights*



May the bank collect from Love $100,000, the value of the contract rights it purchased? No. Under the "shoe rule" an assignee—here, the bank—steps into the shoes of the assignor and takes the assigned rights subject to any defense of the obligor, Love. (Here, of course, Love's defense against paying is that the rackets are worthless.) The result would be the same if Love had given Rackets a nonnegotiable note, which Rackets proceeded to sell to the bank. (By nonnegotiable we do not mean that the note cannot be sold but only that certain legal requirements, discussed in Section 19.3 "Requirements for Negotiability" of this chapter, have not been met.)

Now let us add one fact: In addition to signing a contract, Love gives Rackets a *negotiable* note in exchange for the rackets, and Rackets sells the note to the bank. By adding that the note is negotiable, the result changes significantly. Because the note is negotiable and because the bank, we assume, bought the note in good faith (i.e., unaware that the rackets were warped), the bank will recover the $100,000 (see Figure 19.2 "Sale of Negotiable Note").

Figure 19.2 *Sale of Negotiable Note*



The key to the central role that commercial paper plays in modern finance is **negotiability**. *Negotiability* means that the paper is freely and unconditionally transferable from one person to another by delivery or by delivery and indorsement. ("Indorsement," not "endorsement," is the spelling used in the UCC, though the latter is more common in nonlegal usage.) Without the ability to pay and finance through commercial paper, the business world would be paralyzed. At bottom, negotiability is the means by which a person is empowered to transfer to another more than what the transferor himself possesses. In essence, this is the power to convey to a transferee the right in turn to convey clear title, when the original transferor does not have clear title.

Overview of Chapters on Commercial Paper

In this chapter, we examine the history and nature of commercial paper and define the types of parties (persons who have an interest in the paper) and the types of instruments. We then proceed to four fundamental issues that must be addressed to determine whether parties such as First Bank, in the preceding example, can collect:

1. Is the paper negotiable? That is, is the paper in the proper form? We explore that issue in this chapter.
2. Was the paper negotiated properly? See Chapter 20 "Negotiation of Commercial Paper".

3. Is the purchaser of the paper a holder in due course? See Chapter 21 "Holder in Due Course and Defenses".
4. Does the maker of the paper have available any defenses against even the holder in due course? See Chapter 21 "Holder in Due Course and Defenses".

In most transactions, especially when the first three questions are answered affirmatively, the purchaser will have little trouble collecting. But when the purchaser is unable to collect, questions of liability arise. These questions, along with termination of liability, are discussed in Chapter 22 "Liability and Discharge".

Finally, in Chapter 23 "Legal Aspects of Banking" we examine other legal aspects of banking, including letters of credit and electronic funds transfer.

History of Commercial Paper

Development of the Law

Negotiable instruments are no modern invention; we know that merchants used them as long ago as the age of Hammurabi, around 1700 BC. They fell into disuse after the collapse of the Roman Empire and then reappeared in Italy around the fourteenth century. They became more common as long-distance commerce spread. In an era before paper currency, payment in coins or bullion was awkward, especially for merchants who traveled great distances across national boundaries to attend the fairs at which most economic exchanges took place. Merchants and traders found it far more efficient to pay with paper.

Bills of exchange, today commonly known as *drafts*, were recognized instruments in the law merchant. (The "law merchant" was the system of rules and customs recognized and adopted by early-modern traders and is the basis of the UCC Article 3.) A draft is an unconditional order by one person (the drawer) directing another person (drawee or payor) to pay money to a named third person or to bearer; a check is the most familiar type of draft. The international merchant courts regularly enforced drafts and permitted them to be transferred to others by indorsement (the legal spelling of *endorsement*). By the beginning of the sixteenth century, the British common-law courts began to hear cases involving bills of exchange, but

it took a half century before the courts became comfortable with them and accepted them as crucial to the growing economy.

Courts were also hesitant until the end of the seventeenth century about sanctioning a transferor's assignment of a promissory note if it meant that the transferee would have better title than the transferor. One reason for the courts' reluctance to sanction assignments stemmed from the law that permitted debtors to be jailed, a law that was not repealed until 1870. The buyer of goods might have been willing originally to give a promissory note because he knew that a particular seller would not attempt to jail him for default, but who could be sure that a transferee, probably a complete stranger, would be so charitable?

The inability to negotiate promissory notes prevented a banking system from fully developing. During the English Civil War in the seventeenth century, merchants began to deposit cash with the goldsmiths, who lent it out at interest and issued the depositors promissory notes, the forerunner of bank notes. But a judicial decision in 1703 declared that promissory notes were not negotiable, whether they were made payable to the order of a specific person or to the bearer. Parliament responded the following year with the Promissory Notes Act, which for the first time permitted an assignee to sue the note's maker.

Thereafter the courts in both England and the United States began to shape the modern law of negotiable instruments. By the late nineteenth century, Parliament had codified the law of negotiable instruments in England. Codification came later in the United States. In 1896, the National Conference of Commissioners on Uniform State Laws proposed the Negotiable Instruments Act, which was adopted in all states by 1924. That law eventually was superseded by the adoption of Articles 3 and 4 of the Uniform Commercial Code (UCC), which we study in these chapters.

In 1990, the American Law Institute and the National Conference of Commissioners on Uniform State Laws approved revised Article 3, entitled "Negotiable Instruments," and related amendments in Article 4. The revisions clarified and updated the law. All states except New York and North Carolina have adopted Articles 3 and 4.

The Future of Commercial Paper: Federal and International Preemption

State law governing commercial paper is vulnerable to federal preemption. This preemption could take two major forms. First, the Federal Reserve Board governs the activities of Federal Reserve Banks. As a result, Federal Reserve regulations provide important guidelines for the check collection process. Second, Article 3 of the UCC can be preempted by federal statutes. An important example is the Expedited Funds Availability Act, which became effective in 1988 (discussed in Chapter 23 "Legal Aspects of Banking").

Federal preemption may also become intertwined with international law. In 1988, the United Nations General Assembly adopted the Convention on International Bills of Exchange and International Promissory Notes. Progress on the treaty emanating from the convention has been slow, however: the United States, Canada, and Russia have approved the convention (in 1989 and 1990) but have not ratified the treaty; Gabon, Guinea, Honduras, Liberia, and Mexico are the only countries to have ratified it.

Commercial Paper in Economics and Finance

Economics

To the economist, one type of commercial paper—the bank check—is the primary component of M1, the basic money supply. It is easy to see why. When you deposit cash in a checking account, you may either withdraw the currency—coins and bills—or draw on the account by writing out a check. If you write a check to "cash," withdraw currency, and pay a creditor, there has been no change in the money supply. But if you pay your creditor by check, the quantity of money has increased: the cash you deposited remains available, and your creditor deposits the check to his own account as though it were cash. (A more broadly defined money supply, M2, includes savings deposits at commercial banks.)

Finance

Commercial paper is defined more narrowly in finance than in law. To the corporate treasurer and other financiers, commercial paper ordinarily means short-term promissory notes sold by finance companies and large corporations for a fixed rate of interest. Maturity dates range from a low of three days to a high of nine months. It is an easy way for issuers to raise short-term money quickly. And although short-term notes are unsecured, historically they have been almost as safe as obligations of the US government. By

contrast, for legal purposes, commercial paper includes long-term notes (which are often secured), drafts, checks, and certificates of deposit.

KEY TAKEAWAY

Commercial paper is a medium of exchange used like cash but safer than cash; cash is rarely used today except for small transactions. The key to the success of this invention is the concept of negotiability: through this process, a person can pass on—in most cases—better title to receive payment than he had; thus the transferee of such paper will most likely get paid by the obligor and will not be subject to most defenses of any prior holders. The law of commercial paper has developed over the past four hundred years. It is now the Uniform Commercial Code that governs most commercial paper transactions in the United States, but federal or international preemption is possible in the future. Commercial paper is important in both economics and finance.

EXERCISES

1. If there were no such thing as commercial paper, real or virtual (electronic funds transfers), how would you pay your bills? How did merchants have to pay their bills four hundred years ago?
2. What is it about negotiability that it is the key to the success of commercial paper?
3. How could state law—the UCC—be preempted in regard to commercial paper?

19.2 Scope of Article 3 and Types of Commercial Paper and Parties

LEARNING OBJECTIVES

1. Understand the scope of Article 3 of the Uniform Commercial Code.
2. Recognize the types of commercial paper: drafts, checks, notes, and certificates of deposit.
3. Give the names of the various parties to commercial paper.

Scope of Article 3

Article 3 of the Uniform Commercial Code (UCC) covers commercial paper but explicitly excludes money, documents of title, and investment securities. Documents of title include bills of lading and warehouse receipts and are governed by Article 7 of the UCC. Investment securities are covered by Article 8. Instruments that fall within the scope of Article 3 may also be subject to Article 4 (bank deposits and collections), Article 8 (securities), and Article 9 (secured transactions). If so, the rules of these other articles supersede the provisions of Article 3 to the extent of conflict. Article 3 is a set of general provisions on negotiability; the other articles deal more narrowly with specific transactions or instruments.

Types of Commercial Paper

There are four types of commercial paper: drafts, checks, notes, and certificates of deposit.

Drafts

A **draft** is an unconditional written order by one person (the drawer) directing another person (the drawee) to pay a certain sum of money on demand or at a definite time to a named third person (the payee) or to bearer. The draft is one of the two basic types of commercial paper; the other is the note. As indicated by its definition, the draft is a three-party transaction.

Parties to a Draft

The **drawer** is one who directs a person or an entity, usually a bank, to pay a sum of money stated in an instrument—for example, a person who makes a draft or writes a check. The drawer prepares a document (a form, usually)—the draft—ordering the drawee to remit a stated sum of money to the payee. The **drawee** is the person or entity that a draft is directed to and that is ordered to pay the amount stated on

it. The most common drawee is a bank. The drawer, drawee, and payee need not be different people; the same person may have different capacities in a single transaction. For example, a drawer (the person asking that payment be made) may also be the payee (the person to whom the payment is to be made). A drawee who signs the draft becomes an **acceptor**: the drawee pledges to honor the draft as written. To accept, the drawee need only sign her name on the draft, usually vertically on the face, but anywhere will do. Words such as "accepted" or "good" are unnecessary. However, a drawee who indicates that she might refuse to pay will not be held to have accepted. Thus in the archetypal case, the court held that a drawee who signed his name and appended the words "Kiss my foot" did not accept the draft.[1]

The drawer directs the funds to be drawn from—pulled from—the drawee, and the drawee pays the person entitled to payment as directed.

Types of Drafts

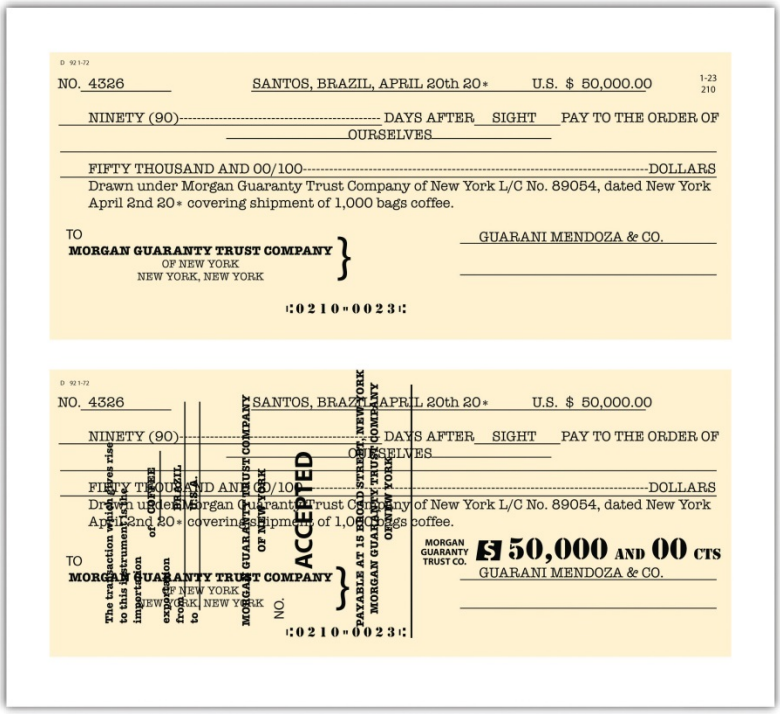
Drafts can be divided into two broad subcategories: sight drafts and time drafts.

A **sight draft** calls for payment "on sight," that is, when presented. Recall from Section 19.1 "Introduction to Commercial Paper" that Lorna Love wished to buy tennis rackets from Rackets, Inc. Suppose Love had the money to pay but did not want to do so before delivery. Rackets, on the other hand, did not want to ship before Love paid. The solution: a sight draft, drawn on Love, to which would be attached an order bill of lading that Rackets received from the trucker when it shipped the rackets. The sight draft and bill of lading go to a bank in Love's city. When the tennis rackets arrive, the carrier notifies the bank, which presents the draft to Love for payment. When she has done so, the bank gives Love the bill of lading, entitling her to receive the shipment. The bank forwards the payment to Rackets' bank, which credits Rackets' account with the purchase amount.

A **time draft**, not surprisingly, calls for payment on a date specified in the draft. Suppose that Love will not have sufficient cash to pay until she has sold the rackets but that Rackets needs to be paid immediately. The solution: a common form of time draft known as a trade acceptance. Rackets, the seller, draws a draft on Love, who thus becomes a drawee. The draft orders Love to pay the purchase price to the

order of Rackets, as payee, on a fixed date. Rackets presents the draft to Love, who accepts it by signing her name. Rackets then can indorse the draft (by signing it) and sell it, at a discount, to its bank or some other financial institution. Rackets thus gets its money right away; the bank may collect from Love on the date specified. See the example of a time draft in Figure 19.3 "A Time Draft".

Figure 19.3 *A Time Draft*



Drafts in International Trade

Drafts are an international convention. In England and the British Commonwealth, drafts are called bills of exchange. Like a draft, a **bill of exchange** is a kind of check or promissory note without interest. Used primarily in international trade, it is a written order by one person to pay another a specific sum on a specific date sometime in the future. If the bill of exchange is drawn on a bank, it is called a bank draft. If it is drawn on another party, it is called a trade draft. Sometimes a bill of exchange will simply be called a draft, but whereas a draft is always negotiable (transferable by endorsement), this is not necessarily true of a bill of exchange.

A widely used draft in international trade is the **banker's acceptance**. It is a short-term credit investment created by a nonfinancial firm and guaranteed by a bank. This instrument is used when an exporter agrees to extend credit to an importer.

Assume Love, the importer, is in New York; Rackets, the exporter, is in Taiwan. Rackets is willing to permit Love to pay ninety days after shipment. Love makes a deal with her New York bank to issue Rackets' bank in Taiwan a letter of credit. This tells the seller's bank that the buyer's bank is willing to accept a draft drawn on the buyer in accordance with terms spelled out in the letter of credit. Love's bank may insist on a security interest in the tennis rackets, or it may conclude that Love is creditworthy. On receipt of the letter of credit, Rackets presents its bank in Taiwan with a draft drawn on Love's bank. That bank antes up the purchase amount (less its fees and interest), paying Rackets directly. It then forwards the draft, bill of lading, and other papers to a correspondent bank in New York, which in turn presents it to Love's bank. If the papers are in order, Love's bank will "accept" the draft (sign it). The signed draft is the banker's acceptance (see Figure 19.3 "A Time Draft"). It is returned to the bank in Taiwan, which can then discount the banker's acceptance if it wishes payment immediately or else wait the ninety days to present it to the New York bank for payment. After remitting to the Taiwanese bank, the New York bank then demands payment from Love.

Checks

A second type of commercial paper is the common bank check, a special form of draft. Section 3-104(2)(b) of the UCC defines a **check** as "a draft drawn on a bank and payable on demand." **Postdating** a check (putting in a future date) does not invalidate it or change its character as payable on demand. Postdating simply changes the first time at which the payee may demand payment. Checks are, of course, usually written on paper forms, but a check can be written on anything—a door, a shirt, a rock—though certainly the would-be holder is not obligated to accept it.

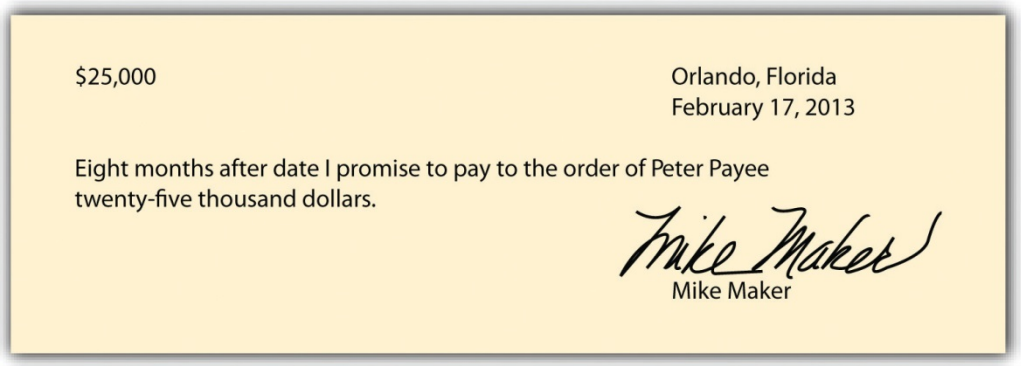
Like drafts, checks may be accepted by the drawee bank. Bank acceptance of a check is called **certification**; the check is said to be certified by stamping the word "certified" on the face of the check. When the check is certified, the bank guarantees that it will honor the check when presented. It can offer this guarantee because it removes from the drawer's account the face amount of the check and holds it for payment. The payee may demand payment from the bank but not from the drawer or any prior indorser of the check.

A certified check is distinct from a cashier's check. A **cashier's check** is drawn on the account of the bank itself and signed by an authorized bank representative in return for a cash payment to it from the customer. The bank guarantees payment of the cashier's check also.

Notes

A note—often called a **promissory note**—is a written promise to pay a specified sum of money on demand or at a definite time. There are two parties to a note: the **maker** (promisor), and the **payee** (promisee). For an example of a promissory note, see Figure 19.4 "A Promissory Note". The maker might execute a promissory note in return for a money loan from a bank or other financial institution or in return for the opportunity to make a purchase on credit.

Figure 19.4 A Promissory Note



Certificates of Deposit

A fourth type of commercial paper is the **certificate of deposit**, commonly called a CD. The CD is a written acknowledgment by a bank that it has received money and agrees to repay it at a time specified in the certificate. The first negotiable CD was issued in 1961 by First National City Bank of New York (now Citibank); it was designed to compete for corporate cash that companies were investing in Treasury notes and other funds. Because CDs are negotiable, they can be traded easily if the holder wants cash, though their price fluctuates with the market.

Other Parties to Commercial Paper

In addition to makers, drawees, and payees, there are five other capacities in which one can deal with commercial paper.

Indorser and Indorsee

The **indorser** (also spelled *endorser*) is one who transfers ownership of a negotiable instrument by signing it. A depositor indorses a check when presenting it for deposit by signing it on the back. The bank deposits its own funds, in the amount of the check, to the depositor's account. By indorsing it, the depositor transfers ownership of the check to the bank. The depositor's bank then can present it to the drawer's bank for repayment from the drawer's funds. The **indorsee** is the one to whom a draft or note is indorsed. When a check is deposited in a bank, the bank is the indorsee.

Holder

A **holder** is "a person in possession of a negotiable that is payable either to bearer, or to an identified person that is the person in possession."[2] *Holder* is thus a generic term that embraces several of the specific types of parties already mentioned. An indorsee and a drawee can be holders. But a holder can also be someone unnamed whom the original parties did not contemplate by name—for example, the holder of a bearer note.

Holder in Due Course

A **holder in due course** is a special type of holder who, if certain requirements are met, acquires rights beyond those possessed by the transferor (we alluded to this in describing the significance of Lorna Love's making of a negotiable—as opposed to a nonnegotiable—instrument). We discuss the requirements for a holder in due course in Chapter 21 "Holder in Due Course and Defenses".

Accommodation Party

An **accommodation party** is one who signs a negotiable instrument in order to lend her name to another party to the instrument. It does not matter in what capacity she signs, whether as maker or comaker, drawer or codrawer, or indorser. As a signatory, an accommodation party is always a surety (Chapter 23 "Legal Aspects of Banking"; a surety is one who guarantees payment if the primarily obligated party fails to pay). The extent of the accommodation party's liability to pay depends on whether she has added language specifying her purposes in signing. Section 3-416 of the UCC distinguishes between a guaranty of payment and a guaranty of collection. An accommodation party who adds words such as "payment guaranteed" subjects herself to primary liability: she is guaranteeing that she will pay if the principal signatory fails to pay when the instrument is due. But if the accommodation party signs "collection guaranteed," the holder must first sue the maker and win a court judgment. Only if the judgment is unsatisfied can the holder seek to collect from the accommodation party. When words of guaranty do not specify the type, the law presumes a payment guaranty.

KEY TAKEAWAY

The modern law of commercial paper is, in general, covered by UCC Article 3. The two basic types of commercial paper are drafts and notes. The note is a two-party instrument whereby one person (maker) promises to pay money to a second person (payee). The draft is a three-party instrument whereby one person (drawer) directs a second (drawee) to pay money to the third (payee). Drafts may be sight drafts, payable on sight, or they may be time drafts, payable at a date specified on the draft. Checks are drafts drawn on banks. Other parties include indorser and indorsee, holder, holder in due course, and accommodation party.

EXERCISES

1. What are the two basic types of commercial paper?
2. What are the two types of drafts?
3. What kind of commercial paper is a check?

---

[1] *Norton v. Knapp*, 19 N.W. 867 (IA 1884).

[2] Uniform Commercial Code, Section 1-201(21).

19.3 Requirements for Negotiability

LEARNING OBJECTIVE

1. Know what is required for an instrument to be negotiable.

Overview

CC BY NC SA

Whether or not a paper is negotiable is the first of our four major questions, and it is one that nonlawyers must confront. Auditors, retailers, and financial institutions often handle notes and checks and usually must make snap judgments about negotiability. Unless the required elements of Sections 3-103 and 3-104 of the Uniform Commercial Code (UCC) are met, the paper is not negotiable. Thus the paper meets the following criteria:

1. It must be in writing.
2. It must be signed by the maker or drawer.
3. It must be an unconditional promise or order to pay.
4. It must be for a fixed amount in money.
5. It must be payable on demand or at a definite time.
6. It must be payable to order or bearer, unless it is a check.

This definition states the basic premise of a negotiable instrument: the holder must be able to ascertain all essential terms from the face of the instrument.

Analysis of Required Elements

In Writing

Under UCC Section 1-201, "written" or "writing" includes "printing, typewriting or any other intentional reduction to tangible form." That definition is broad—so broad, in fact, that from time to time the newspapers report checks written on material ranging from a girdle (an Ohio resident wanted to make his tax payment stretch) to granite. Since these are tangible materials, the checks meet the writing requirement. The writing can be made in any medium: ink, pencil, or even spray paint, as was the case with the granite check. Of course, there is a danger in using pencil or an ink that can be erased, since the drawer might be liable for alterations. For example, if you write out in pencil a check for $10 and someone erases your figures and writes in $250, you may lose your right to protest when the bank cashes it.

Signed by the Maker or Drawer

Signature is not limited to the personal handwriting of one's name. "Any symbol executed or adopted by a party with present intention to authenticate a writing" will serve.[1] That means that a maker or drawer may make an impression of his signature with a rubber stamp or even an *X* if he intends that by so doing

he has signed. It can be typed or by thumbprint. In some cases, an appropriate letterhead may serve to make the note or draft negotiable without any other signature. Nor does the position of the signature matter. Blackstone Kent's handwritten note, "Ten days from this note, I, Blackstone Kent, promise to pay $5,000 to the order of Webster Mews," is sufficient to make the note negotiable, even though there is no subsequent signature. Moreover, the signature may be in a trade name or an assumed name. (Note: special problems arise when an agent signs on behalf of a principal. We consider these problems in Chapter 22 "Liability and Discharge".)

Unconditional Promise or Order to Pay

Section 3-106(a) of the UCC provides that an instrument is *not* negotiable if it "states (i) an express condition to payment, (ii) that the promise or order is subject to or governed by another writing, or (iii) that rights or obligations with respect to the promise or order are stated in another writing. A reference to another writing does not of itself make the promise or order conditional." Under 3-106(b), a promise is not made conditional by "(i) reference to another writing for a statement of rights with respect to collateral, pre-payment, or acceleration, or (ii) because payment is limited to resort to a particular fund or source." As to "reference to another writing," see *Holly Hill Acres, Ltd. v. Charter Bank of Gainesville,* in Section 19.4 "Cases".

The only permissible promise or order in a negotiable instrument is to pay a sum certain in money. Any other promise or order negates negotiability. The reason for this rule is to prevent an instrument from having an indeterminate value. The usefulness of a negotiable instrument as a substitute for money would be seriously eroded if the instrument's holder had to investigate whether a stipulation or condition had been met before the thing had any value (i.e., before the obligor's obligation to pay ripened).

Fixed Amount in Money

The value of the paper must be fixed (specific) so it can be ascertained, and it must be payable in money.

Fixed Amount

The instrument must recite an exact amount of money that is to be paid, although the exact amount need not be expressed in a single figure. For example, the note can state that the principal is $1,000 and the interest is 11.5 percent, without specifying the total amount. Or the note could state the amount in installments: twelve equal installments of $88.25. Or it could state different interest rates before and after a certain date or depending on whether or not the maker has defaulted; it could be determinable by a formula or by reference to a source described in the instrument.[2] It could permit the maker to take a discount if he pays before a certain date or could assess a penalty if he pays after the date. It could also provide for an attorney's fees and the costs of collection on default. If it is clear that interest is to be included but no interest amount is set, UCC Section 3-112 provides that it is "payable at the judgment rate in effect at the place of payment of the instrument and at the time interest first accrues." The fundamental rule is that for any time of payment, the holder must be able to determine, after the appropriate calculations, the amount then payable. See Section 19.4 "Cases", *Centerre Bank of Branson v. Campbell*, for a case involving the "fixed amount" rule.

In Money

Section 1-201(24) of the UCC defines money as "a medium of exchange authorized or adopted by a domestic or foreign government as a part of its currency." As long as the medium of exchange was such at the time the instrument was made, it is payable in money, even if the medium of exchange has been abolished at the time the instrument is due. Section 3-107 provides the following as to payment in foreign currency: "Unless the instrument otherwise provides, an instrument that states the amount payable in foreign money may be paid in the foreign money or in an equivalent amount in dollars calculated by using the current bank-offered spot rate at the place of payment for the purchase of dollars on the day on which the instrument is paid."

Payable on Demand or at a Definite Time

An instrument that says it is payable on sight is payable on demand, as is one that states no time for payment. "Definite time" may be stated in several ways; it is not necessary to set out a specific date. For example, a note might say that it is payable on or before a stated date, at a fixed period after the date, at a fixed period after sight, at a definite time subject to acceleration, or at a definite time subject to extension

at the option of the holder or automatically on or after the occurrence of a particular event. However, if the only time fixed is on the occurrence of a contingent event, the time is not definite, even though the event in fact has already occurred. An example of a valid acceleration clause is the following: "At the option of the holder, this note shall become immediately due and payable in the event that the maker fails to comply with any of the promises contained in this note or to perform any other obligation of the maker to the holder."

Is the note "Payable ten days after I give birth" negotiable? No, because the date the baby is due is uncertain. Is the note "Payable on January 1, but if the Yankees win the World Series, payable four days earlier" negotiable? Yes: this is a valid acceleration clause attached to a definite date.

One practical difference between a demand instrument and a time instrument is the date on which the statute of limitations begins to run. (A statute of limitations is a limit on the time a creditor has to file a lawsuit to collect the debt.) Section 3-118(1) of the UCC says that a lawsuit to enforce payment at a definite time "must be commenced within six years after the due date" (or the accelerated due date). For demand paper, an action must be brought "within six years after the demand."

Payable to Order or Bearer

An instrument payable to order is one that will be paid to a particular person or organization identifiable in advance. To be payable to order, the instrument must so state, as most ordinarily do, by placing the words "payable to order of" before the name of the payee. An instrument may be payable to the order of the maker, drawer, drawee, or someone else. It also may be payable to the order of two or more payees (together or in the alternative), to an estate, a trust, or a fund (in which case it is payable to the representative, to an office or officer, or to a partnership or unincorporated association). Suppose a printed form says that the instrument is payable both to order and to bearer. In that event, the instrument is payable only to order. However, if the words "to bearer" are handwritten or typewritten, then the instrument can be payable either to order or to bearer.

A negotiable instrument not payable to a particular person must be payable to bearer, meaning to any person who presents it. To be payable to bearer, the instrument may say "payable to bearer" or "to the

order of bearer." It may also say "payable to John Doe or bearer." Or it may be made payable to cash or the order of cash.

Section 3-104(c) of the UCC excepts checks from the requirement that the instrument be "payable to bearer or order." Official Comment 2 to that section explains why checks are not required to have the "payable" wording: "Subsection (c) is based on the belief that it is good policy to treat checks, which are payment instruments, as negotiable instruments whether or not they contain the words 'to the order of.' These words are almost always pre-printed on the check form....Absence of the quoted words can easily be overlooked and should not affect the rights of holders who may pay money or give credit for a check without being aware that it is not in the conventional form."

Also affecting this policy is the fact that almost all checks are now read by machines, not human beings. There is no one to see that the printed form does not contain the special words, and the significance of the words is recognized by very few people. In short, it doesn't matter for checks.

Missing and Ambiguous Terms

The rules just stated make up the conditions for negotiability. Dealing with two additional details—missing terms or ambiguous terms—completes the picture. Notwithstanding the presence of readily available form instruments, sometimes people leave words out or draw up confusing documents.

Incompleteness

An incomplete instrument—one that is missing an essential element, like the due date or amount—can be signed before being completed if the contents at the time of signing show that the maker or drawer intends it to become a negotiable instrument. Unless the date of an instrument is required to determine when it is payable, an undated instrument can still be negotiable.[3] Otherwise, to be enforceable, the instrument must first be completed—if not by the maker or drawer, then by the holder in accordance with whatever authority he has to do so.[4] See the case presented in Section 19.4 "Cases", *Newman v. Manufacturers Nat. Bank of Detroit*.

Ambiguity

When it is unclear whether the instrument is a note or draft, the holder may treat it as either. Handwritten terms control typewritten and printed terms, and typewritten terms control printed terms. Words control figures, unless the words themselves are ambiguous, in which case the figures control. If the instrument contains a "conspicuous statement, however expressed, to the effect that the promise or order is not negotiable," its negotiability is destroyed, except for checks, and "an instrument may be a check even though it is described on its face by another term, such as 'money order.'" [5]

KEY TAKEAWAY

If an instrument is not negotiable, it generally will not be acceptable as payment in commercial transactions. The UCC requires that the value of a negotiable instrument be ascertainable on its face, without reference to other documents. Thus the negotiable instrument must be in writing, signed by the maker or drawer, an unconditional promise or order to pay, for a fixed amount in money, payable on demand or at a definite time, and payable to order or bearer, unless it is a check. If the instrument is incomplete or ambiguous, the UCC provides rules to determine what the instrument means.

EXERCISES

1. Why does the UCC require that the value of a negotiable instrument be ascertainable from its face, without extrinsic reference?
2. What are the six requirements for an instrument to meet the negotiability test?
3. Why are the words "pay to order" or "pay to bearer" or similar words required on negotiable instruments (except for checks—and why not for checks)?
4. If an instrument is incomplete, is it invalid?

---

[1] Uniform Commercial Code, Section 1-201(39).

CC BY NC SA

[2] Uniform Commercial Code, Section 3-112(b).

[3] Uniform Commercial Code, Section 3-113(b).

[4] Uniform Commercial Code, Section 3-115.

[5] Uniform Commercial Code, Section 3-104(d); Uniform Commercial Code, Section 3-104(f).

19.4 Cases

Negotiability: Requires Unconditional Promise to Pay

Holly Hill Acres, Ltd. v. Charter Bank of Gainesville

314 So.2d 209 (Fla. App. 1975)

Scheb, J.

Appellant/defendant [Holly Hill] appeals from a summary judgment in favor of appellee/plaintiff Bank in a suit wherein the plaintiff Bank sought to foreclose a note and mortgage given by defendant.

The plaintiff Bank was the assignee from Rogers and Blythe of a promissory note and purchase money mortgage executed and delivered by the defendant. The note, executed April 28, 1972, contains the following stipulation:

> *This note with interest is secured by a mortgage on real estate, of even date herewith, made by the maker hereof in favor of the said payee, and shall be construed and enforced according to the laws of the State of Florida.* ***The terms of said mortgage are by this reference made a part hereof.*** *(emphasis added)*

Rogers and Blythe assigned the promissory note and mortgage in question to the plaintiff Bank to secure their own note. Plaintiff Bank sued defendant [Holly Hill] and joined Rogers and Blythe as defendants alleging a default on their note as well as a default on defendant's [Holly Hill's] note.

Defendant answered incorporating an affirmative defense that fraud on the part of Rogers and Blythe induced the sale which gave rise to the purchase money mortgage. Rogers and Blythe denied the fraud. In opposition to plaintiff Bank's motion for summary judgment, the defendant submitted an affidavit in support of its allegation of fraud on the part of agents of Rogers and Blythe. The trial court held the plaintiff Bank was a holder in due course of the note executed by defendant and entered a summary final judgment against the defendant.

The note having incorporated the terms of the purchase money mortgage was not negotiable. The plaintiff Bank was not a holder in due course, therefore, the defendant was entitled to raise against the plaintiff any defenses which could be raised between the appellant and Rogers and Blythe. Since defendant asserted an affirmative defense of fraud, it was incumbent on the plaintiff to establish the non-existence of any genuine issue of any material fact or the legal insufficiency of defendant's affirmative defense. Having failed to do so, plaintiff was not entitled to a judgment as a matter of law; hence, we reverse.

The note, incorporating by reference the terms of the mortgage, did not contain the unconditional promise to pay required by [the UCC]. Rather, the note falls within the scope of [UCC 3-106(a)(ii)]: "A promise or order is unconditional unless it states that...it is subject to or governed by any other writing."

Plaintiff Bank relies upon *Scott v. Taylor* [Florida] 1912 [Citation], as authority for the proposition that its note is negotiable. *Scott*, however, involved a note which stated: "this note secured by mortgage." Mere reference to a note being secured by mortgage is a common commercial practice and such reference in itself does not impede the negotiability of the note. There is, however, a significant difference in a note stating that it is "secured by a mortgage" from one which provides, "the terms of said mortgage are by this reference made a part hereof." In the former instance the note merely refers to a separate agreement which does not impede its negotiability, while in the latter instance the note is rendered non-negotiable.

As a general rule the assignee of a mortgage securing a non-negotiable note, even though a bona fide purchaser for value, takes subject to all defenses available as against the mortgagee. [Citation] Defendant

raised the issue of fraud as between himself and other parties to the note, therefore, it was incumbent on the plaintiff Bank, as movant for a summary judgment, to prove the non-existence of any genuinely triable issue. [Citation]

Accordingly, the entry of a summary final judgment is reversed and the cause remanded for further proceedings.

CASE QUESTIONS

1. What was wrong with the promissory note that made it nonnegotiable?
2. How did the note's nonnegotiability—as determined by the court of appeals—benefit the defendant, Holly Hill?
3. The court determined that the bank was not a holder in due course; on remand, what happens now?

Negotiability: Requires Fixed Amount of Money

Centerre Bank of Branson v. Campbell

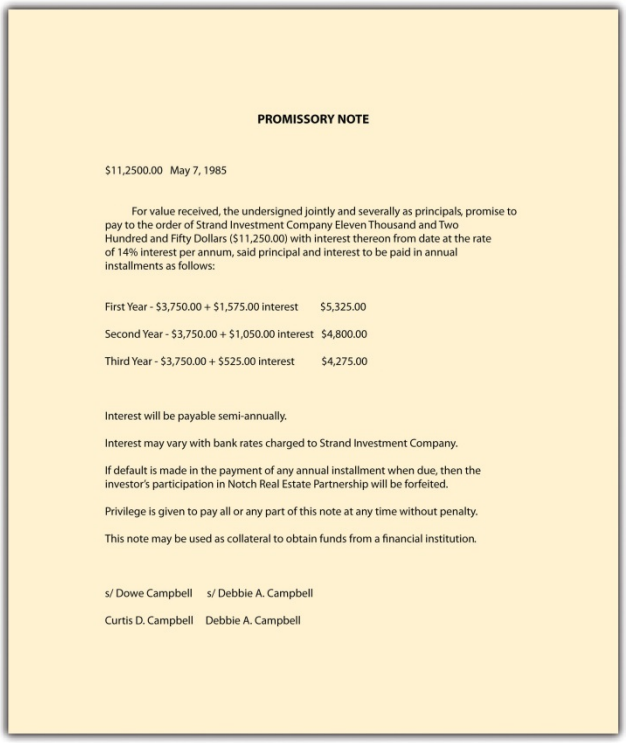
744 S.W.2d 490 (Mo. App. 1988)

Crow, J.

On or about May 7, 1985, appellants ("the Campbells") signed the following document:

CC BY NC SA

Figure 19.5



PROMISSORY NOTE

$11,2500.00 May 7, 1985

For value received, the undersigned jointly and severally as principals, promise to pay to the order of Strand Investment Company Eleven Thousand and Two Hundred and Fifty Dollars ($11,250.00) with interest thereon from date at the rate of 14% interest per annum, said principal and interest to be paid in annual installments as follows:

First Year - $3,750.00 + $1,575.00 interest $5,325.00

Second Year - $3,750.00 + $1,050.00 interest $4,800.00

Third Year - $3,750.00 + $525.00 interest $4,275.00

Interest will be payable semi-annually.

Interest may vary with bank rates charged to Strand Investment Company.

If default is made in the payment of any annual installment when due, then the investor's participation in Notch Real Estate Partnership will be forfeited.

Privilege is given to pay all or any part of this note at any time without penalty.

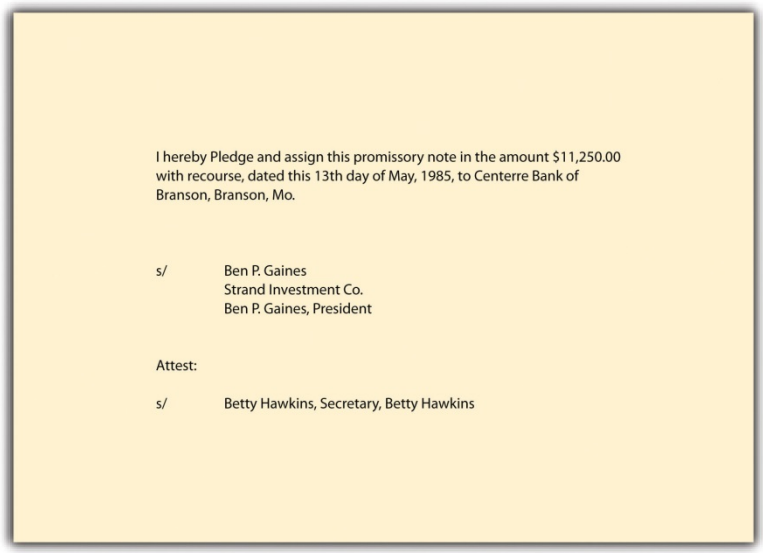
This note may be used as collateral to obtain funds from a financial institution.

s/ Dowe Campbell s/ Debbie A. Campbell

Curtis D. Campbell Debbie A. Campbell

On May 13, 1985, the president and secretary of Strand Investment Company ("Strand") signed the following provision [see Figure 22.6] on the reverse side of the above [Figure 19.5] document:

Figure 19.6



I hereby Pledge and assign this promissory note in the amount $11,250.00 with recourse, dated this 13th day of May, 1985, to Centerre Bank of Branson, Branson, Mo.

s/ Ben P. Gaines
Strand Investment Co.
Ben P. Gaines, President

Attest:

s/ Betty Hawkins, Secretary, Betty Hawkins

CC BY NC SA

On June 30, 1986, Centerre Bank of Branson ("Centerre") sued the Campbells. Pertinent to the issues on this appeal, Centerre's petition averred:

"1. ...on [May 7,] 1985, the [Campbells] made and delivered to Strand...their promissory note...and thereby promised to pay to Strand...or its order...($11,250.00) with interest thereon from date at the rate of fourteen percent (14%) per annum; that a copy of said promissory note is attached hereto...and incorporated herein by reference.

2. That thereafter and before maturity, said note was assigned and delivered by Strand...to [Centerre] for valuable consideration and [Centerre] is the owner and holder of said promissory note."

Centerre's petition went on to allege that default had been made in payment of the note and that there was an unpaid principal balance of $9,000, plus accrued interest, due thereon. Centerre's petition prayed for judgment against the Campbells for the unpaid principal and interest.

[The Campbells] aver that the note was given for the purchase of an interest in a limited partnership to be created by Strand, that no limited partnership was thereafter created by Strand, and that by reason thereof there was "a complete and total failure of consideration for the said promissory note." Consequently, pled the answers, Centerre "should be estopped from asserting a claim against [the Campbells] on said promissory note because of such total failure of consideration for same."

The cause was tried to the court, all parties having waived trial by jury. At trial, the attorney for the Campbells asked Curtis D. Campbell what the consideration was for the note. Centerre's attorney interrupted: "We object to any testimony as to the consideration for the note because it's our position that is not a defense in this lawsuit since the bank is the holder in due course."...

The trial court entered judgment in favor of Centerre and against the Campbells for $9,000, plus accrued interest and costs. The trial court filed no findings of fact or conclusions of law, none having been

requested. The trial court did, however, include in its judgment a finding that Centerre "is a holder in due course of the promissory note sued upon."

The Campbells appeal, briefing four points. Their first three, taken together, present a single hypothesis of error consisting of these components: (a) the Campbells showed "by clear and convincing evidence a valid and meritorious defense in that there existed a total lack and failure of consideration for the promissory note in question," (b) Centerre acquired the note subject to such defense in that Centerre was not a holder in due course, as one can be a holder in due course of a note only if the note is a negotiable instrument, and (c) the note was not a negotiable instrument inasmuch as "it failed to state a sum certain due the payee."...

We have already noted that if Centerre is not a holder in due course, the Campbells can assert the defense of failure of consideration against Centerre to the same degree they could have asserted it against Strand. We have also spelled out that Centerre cannot be a holder in due course if the note is not a negotiable instrument. The pivotal issue, therefore, is whether the provision that interest may vary with bank rates charged to Strand prevents the note from being a negotiable instrument....

Neither side has cited a Missouri case applying [UCC 3-104(a)] to a note containing a provision similar to: "Interest may vary with bank rates charged to Strand." Our independent research has likewise proven fruitless. There are, however, instructive decisions from other jurisdictions.

In *Taylor v. Roeder*, [Citation, Virginia] (1987), a note provided for interest at "[t]hree percent (3.00%) over Chase Manhattan prime to be adjusted monthly." A second note provided for interest at "3% over Chase Manhattan prime adjusted monthly." Applying sections of the Uniform Commercial Code adopted by Virginia identical to [the Missouri UCC], the court held the notes were not negotiable instruments in that the amounts required to satisfy them could not be ascertained without reference to an extrinsic source, the varying prime rate of interest charged by Chase Manhattan Bank.

In *Branch Banking and Trust Co. v. Creasy*, [Citation, North Carolina] (1980), a guaranty agreement provided that the aggregate amount of principal of all indebtedness and liabilities at any one time for which the guarantor would be liable shall not exceed $35,000. The court, emphasizing that to be a negotiable instrument a writing must contain, among other things, an unconditional promise to pay a sum certain in money, held the agreement was not a negotiable instrument. The opinion recited that for the requirement of a sum certain to be met, it is necessary that at the time of payment the holder be able to determine the amount which is then payable from the instrument itself, with any necessary computation, without reference to any outside source. It is essential, said the court, for a negotiable instrument "to bear a definite sum so that subsequent holders may take and transfer the instrument without having to plumb the intricacies of the instrument's background....

In *A. Alport & Son, Inc. v. Hotel Evans, Inc.*, [Citation] (1970), a note contained the notation "with interest at bank rates." Applying a section of the Uniform Commercial Code adopted by New York identical to [3-104(a)] the court held the note was not a negotiable instrument in that the amount of interest had to be established by facts outside the instrument.

In the instant case, the Campbells insist that it is impossible to determine from the face of the note the amount due and payable on any payment date, as the note provides that interest may vary with bank rates charged to Strand. Consequently, say the Campbells, the note is not a negotiable instrument, as it does not contain a promise to pay a "sum certain" [UCC 3-104(a)].

Centerre responds that the provision that interest may vary with bank rates charged to Strand is not "directory," but instead is merely "discretionary." The argument begs the question. Even if one assumes that Strand would elect not to vary the interest charged the Campbells if interest rates charged Strand by banks changed, a holder of the note would have to investigate such facts before determining the amount due on the note at any time of payment. We hold that under 3-104 and 3-106, supra, and the authorities discussed earlier, the provision that interest may vary with bank rates charged to Strand bars the note from being a negotiable instrument, thus no assignee thereof can be a holder in due course. The trial court therefore erred as a matter of law in ruling that Centerre was a holder in due course....

An alert reader will have noticed two other extraordinary features about the note, not mentioned in this opinion. First, the note provides in one place that principal and interest are to be paid in annual installments; in another place it provides that interest will be payable semiannually. Second, there is no acceleration clause providing that if default be made in the payment of any installment when due, then all remaining installments shall become due and payable immediately. It would have thus been arguable that, at time of trial, only the first year's installment of principal and interest was due. No issue is raised, however, regarding any of these matters, and we decline to consider them sua sponte [on our own].

The judgment is reversed and the cause is remanded for a new trial.

CASE QUESTIONS

1. What was defective about this note that made it nonnegotiable?
2. What was the consequence to Centerre of the court's determination that the note was nonnegotiable?
3. What did the Campbells give the note for in the first place, and why do they deny liability on it?

Undated or Incomplete Instruments

Newman v. Manufacturers Nat. Bank of Detroit

152 N.W.2d 564 (Mich. App. 1967)

Holbrook, J.

As evidence of [a debt owed to a business associate, Belle Epstein], plaintiff [Marvin Newman in 1955] drew two checks on the National Bank of Detroit, one for $1,000 [about $8,000 in 2010 dollars] and the other for $200 [about $1,600 in 2010 dollars]. The checks were left undated.

Plaintiff testified that he paid all but $300 of this debt during the following next 4 years. Thereafter, Belle Epstein told plaintiff that she had destroyed the two checks....

Plaintiff never notified defendant Bank to stop payment on the checks nor that he had issued the checks without filling in the dates. The date line of National Bank of Detroit check forms contained the first 3 numbers of the year but left the last numeral, month and day entries, blank, viz., "Detroit 1, Mich. _ _ 195_ _." The checks were cashed in Phoenix, Arizona, April 17, 1964, and the date line of each check was completed...They were presented to and paid by Manufacturers National Bank of Detroit, April 22, 1964, under the endorsement of Belle Epstein. The plaintiff protested such payment when he was informed of it about a month later. Defendant Bank denied liability and plaintiff brought suit.

...

The two checks were dated April 16, 1964. It is true that the dates were completed in pen and ink subsequent to the date of issue. However, this was not known by defendant. Defendant had a right to rely on the dates appearing on the checks as being correct. [UCC 3-113] provides in part as follows:

(a) An instrument may be antedated or postdated.

Also, [UCC 3-114] provides in part as follows:

[T]ypewritten terms prevail over printed terms, handwritten terms prevail over both...

Without notice to the contrary, defendant was within its rights to assume that the dates were proper and filled in by plaintiff or someone authorized by him....

Plaintiff admitted at trial that defendant acted in good faith in honoring the two checks of plaintiff's in question, and therefore defendant's good faith is not in issue.

In order to determine if defendant bank's action in honoring plaintiff's two checks under the facts present herein constituted an exercise of proper procedure, we turn to article 4 of the UCC....[UCC 4-401(d)] provides as follows:

A bank that in good faith makes payment to a holder may charge the indicated account of its customer according to:

(1) the original tenor of his altered item; or

(2) the tenor of his completed item, even though the bank knows the item has been completed unless the bank has notice that the completion was improper.

...[W]e conclude it was shown that two checks were issued by plaintiff in 1955, filled out but for the dates which were subsequently completed by the payee or someone else to read April 16, 1964, and presented to defendant bank for payment, April 22, 1964. Applying the rules set forth in the UCC as quoted herein, the action of the defendant bank in honoring plaintiff's checks was in good faith and in accord with the standard of care required under the UCC.

Since we have determined that there was no liability under the UCC, plaintiff cannot succeed on this appeal.

Affirmed.

CASE QUESTIONS

1. Why does handwriting control over printing or typing on negotiable instruments?
2. How could the plaintiff have protected himself from liability in this case?

19.5 Summary and Exercises

CC BY NC SA

Summary

Commercial paper is the collective term for a variety of instruments—including checks, certificates of deposit, and notes—that are used to pay for goods; commercial paper is basically a contract to pay money. The key to the central role of commercial paper is negotiability, the means by which a person is empowered to transfer to another more than what the transferor himself possesses. The law regulating negotiability is Article 3 of the Universal Commercial Code.

Commercial paper can be divided into two basic types: the draft and the note. A draft is a document prepared by a drawer ordering the drawee to remit a stated sum of money to the payee. Drafts can be subdivided into two categories: sight drafts and time drafts. A note is a written promise to pay a specified sum of money on demand or at a definite time.

A special form of draft is the common bank check, a draft drawn on a bank and payable on demand. A special form of note is the certificate of deposit, a written acknowledgment by a bank that it has received money and agrees to repay it at a time specified in the certificate.

In addition to drawers, makers, drawees, and payees, one can deal with commercial paper in five other capacities: as indorsers, indorsees, holders, holders in due course, and accommodation parties.
A holder of a negotiable instrument must be able to ascertain all essential terms from its face. These terms are that the instrument (1) be in writing, (2) be signed by the maker or drawer, (3) contain an unconditional promise or order to pay (4) a sum certain in money, (5) be payable on demand or at a definite time, and (6) be payable to order or to bearer. If one of these terms is missing, the document is not negotiable, unless it is filled in before being negotiated according to authority given.

EXERCISES

1 Golf Inc. manufactures golf balls. Jack orders 1,000 balls from Golf and promises to pay $4,000 two weeks after delivery. Golf Inc. delivers the balls and assigns its contract rights to First Bank for $3,500. Golf Inc. then declares bankruptcy. May First Bank collect $3,500 from Jack? Explain.

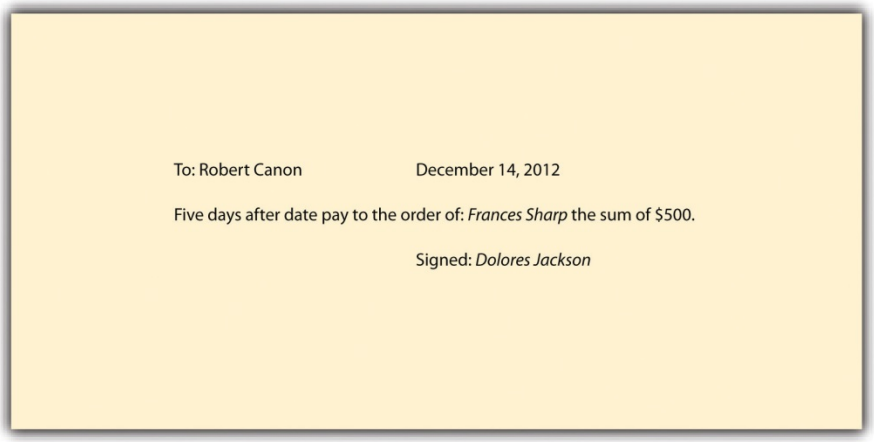
CC BY NC SA

2 Assume in problem 1 that Jack gives Golf Inc. a nonnegotiable note for $3,500 and Golf sells the note to the bank shortly after delivering the balls. May the bank collect the $3,500? Would the result be different if the note were negotiable? Explain.

3 George decides to purchase a new stereo system on credit. He signs two documents—a contract and a note. The note states that it is given "in payment for the stereo" and "if stereo is not delivered by July 2, the note is cancelled." Is the note negotiable? Explain.

4 Is the following instrument a note, check, or draft? Explain.

i) *Figure 19.7*



5 State whether the following provisions in an instrument otherwise in the proper form make the instrument nonnegotiable and explain why:

a. A note stating, "This note is secured by a mortgage of the same date on property located at 1436 Dayton Street, Jameson, New York"

b. A note for $25,000 payable in twenty installments of $1,250 each that provides, "In the event the maker dies all unpaid installments are cancelled"

c. An instrument reading, "I.O.U., Rachel Donaldson, $3,000"

d. A note reading, "I promise to pay Rachel Donaldson $3,000"

e. A note stating, "In accordance with our telephone conversation of January 7th, I promise to pay Sally Wilkenson or order $1,500"

f. An undated note for $1,500 "payable one year after date"

g. A note for $1,500 "payable to the order of Marty Dooley, six months after Nick Solster's death"

h. A note for $18,000 payable in regular installments also stating, “In the event any installment is not made as provided here, the entire amount remaining unpaid may become due immediately”

6 Lou enters into a contract to buy Alan’s car and gives Alan an instrument that states, “This acknowledges my debt to Alan in the amount of $10,000 that I owe on my purchase of the 2008 Saturn automobile I bought from him today.” Alan assigns the note to Judy for $8,000. Alan had represented to Lou that the car had 20,000 miles on it, but when Lou discovered the car had 120,000 miles he refused to make further payments on the note. Can Judy successfully collect from Lou? Explain.

7 The same facts as above are true, but the instrument Lou delivered to Alan reads, “I promise to pay to Alan or order $10,000 that I owe on my purchase of the 2008 automobile I bought from him today.” Can Judy successfully collect from Lou? Explain.

8 Joe Mallen, of Sequim, Washington, was angry after being cited by a US Fish and Wildlife Service for walking his dog without a leash in a federal bird refuge. He was also aggravated with his local bank because it held an out-of-state check made out to Mallen for ten days before honoring it. To vent his anger at both, Mallen spray painted a twenty-five-pound rock from his front yard with three coats of white paint, and with red paint, spelled out his account number, the bank’s name, the payee, his leash law citation number, and his signature. Should the US District Court in Seattle—the payee—attempt to cash the rock, would it be good? Explain.[1]

9 Raul Castana purchased a new stereo system from Eddington Electronics Store. He wrote a check on his account at Silver Bank in the amount of $1,200 and gave it to Electronics’ clerk. David Eddington, the store owner, stamped the back of the check with his rubber indorsement stamp, and then wrote, “Pay to the order of City Water,” and he mailed it to City Water to pay the utility bill. Designate the parties to this instrument using the vocabulary discussed in this chapter.

10 Would Castana’s signed note made out to Eddington Electronics Store be negotiable if it read, “I promise to pay Eddington’s or order $1,200 on or before May 1, 2012, but only if the stereo I bought from them works to my satisfaction”? Explain. And—disregarding negotiability for a moment—designate the parties to this instrument using the vocabulary discussed in this chapter.

SELF-TEST QUESTIONS

1 A negotiable instrument must

a. be signed by the payee

b. contain a promise to pay, which may be conditional

c. include a sum certain

d. be written on paper or electronically

2 The law governing negotiability is found in

a. Article 3 of the UCC

b. Article 9 of the UCC

c. the Uniform Negotiability Act

d. state common law

3 A sight draft

a. calls for payment on a certain date

b. calls for payment when presented

c. is not negotiable

d. is the same as a certificate of deposit

4 A note reads, "Interest hereon is 2% above the prime rate as determined by First National Bank in New York City." Under the UCC,

a. the interest rate provision is not a "sum certain" so negotiability is destroyed

b. the note is not negotiable because the holder must look to some extrinsic source to determine the interest rate

c. the note isn't negotiable because the prime rate can vary before the note comes due

d. variable interest rates are OK

5 A "maker" in negotiable instrument law does what?

a. writes a check

b. becomes obligated to pay on a draft

c. is the primary obligor on a note

d. buys commercial paper of dubious value for collection

SELF-TEST ANSWERS

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

---

[1] Joel Schwarz, "Taking Things for Granite," *Student Lawyer*, December 1981.

Chapter 20
Negotiation of Commercial Paper

LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The distinction between *transfer* and *negotiation* of commercial paper
2. The liability of a person who transfers paper
3. The types of indorsements and their effects
4. Special problems that arise with forged indorsements

In the previous chapter, we took up the requirements for paper to be negotiable. Here we take up negotiation.

20.1 Transfer and Negotiation of Commercial Paper

CC BY NC SA

LEARNING OBJECTIVES

1. Understand what a transfer of commercial paper is.
2. Recognize the rights and liabilities of transferees and the liabilities of transferors.
3. Know how a transfer becomes a negotiation payable to order or to bearer.

Definitions, Rights, and Liabilities

Transfer means physical delivery of any instrument—negotiable or not—intending to pass title. Section 3-203(a) of the Uniform Commercial Code (UCC) provides that "an instrument is transferred when it is delivered by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument."

Negotiation and Holder

Section 3-201(a) of the UCC defines **negotiation** as "a transfer of possession, whether voluntary or involuntary, of an instrument to a person who thereby becomes its holder if possession is obtained from a person other than the issuer of the instrument." A **holder** is defined in Section 1-201(2) as "a person who is in possession of an instrument drawn, issued, or indorsed to him or his order or to bearer or in blank" ("in blank" means that no indorsement is required for negotiation). The original issuing or making of an instrument is not negotiation, though a holder can be the beneficiary of either a transfer or a negotiation. The Official Comment to 3-201(a) is helpful:

> *A person can become holder of an instrument when the instrument is issued to that person, or the status of holder can arise as the result of an event that occurs after issuance. "Negotiation" is the term used in article 3 to describe this post-issuance event. Normally, negotiation occurs as the result of a voluntary transfer of possession of an instrument by a holder to another person who becomes the holder as a result of the transfer. Negotiation always requires a change in possession of the instrument because nobody can be a holder without possessing the instrument, either*

CC BY NC SA

> *directly or through an agent. But in some cases the transfer of possession is involuntary and in some cases the person transferring possession is not a holder....[S]ubsection (a) states that negotiation can occur by an involuntary transfer of possession. For example, if an instrument is payable to bearer and it is stolen by Thief or is found by Finder, Thief or Finder becomes the holder of the instrument when possession is obtained. In this case there is an involuntary transfer of possession that results in negotiation to Thief or Finder.*[1]

In other words, to qualify as a holder, a person must possess an instrument that runs to her. An instrument "runs" to a person if (1) it has been issued to her or (2) it has been transferred to her by negotiation (negotiation is the "post-issuance event" cited in the comment). Commercially speaking, the status of the immediate person to whom the instrument was issued (the payee) is not very interesting; the thing of interest is whether the instrument is passed *on* by the payee *after* possession, through negotiation. Yes, the payee of an instrument is a holder, and can be a holder in due course, but the crux of negotiable instruments involves taking an instrument free of defenses that might be claimed by anybody against paying on the instrument; the payee would know of defenses, usually, so—as the comment puts it—"use of the holder-in-due-course doctrine by the payee of an instrument is not the normal situation....[r]ather, the holder in due course is an immediate or remote transferee of the payee."[2]

Liability of Transferors

We discuss liability in Chapter 22 "Liability and Discharge". However, a brief introduction to liability will help in understanding the types of indorsements discussed in this chapter. There are two types of liability affecting transferors: contract liability and warranty liability.

Contract Liability

Persons who sign the instrument—that is, makers, acceptors, drawers, indorsers—have signed a contract and are subject to contract liabilities. Drafts (checks) and notes are, after all, contracts. Makers and acceptors are *primary parties* and are unconditionally liable to pay the instrument. Drawers and indorsers are *secondary parties* and are conditionally liable. The conditions creating liability—that is, presentment, dishonor, and notice—are discussed in Chapter 22 "Liability and Discharge".

Warranty Liability

The transferor's *contract* liability is limited. It applies only to those who sign and only if certain additional conditions are met and, as will be discussed, can even be disclaimed. Consequently, a holder who has not been paid often must resort to a suit based on one of five warranties. These warranties are implied by law; UCC, Section 3-416, details them:

> *(A) A person who transfers an instrument for consideration warrants all of the following to the transferee and, if the transfer is by indorsement, to any subsequent transferee:*
> *(1) The warrantor is a person entitled to enforce the instrument.*
> *(2) All signatures on the instrument are authentic and authorized.*
> *(3) The instrument has not been altered.*
> *(4) The instrument is not subject to a defense or claim in recoupment of any party which can be asserted against the warrantor.*
> *(5) The warrantor has no knowledge of any insolvency proceeding commenced with respect to the maker or acceptor or, in the case of an unaccepted draft, the drawer.*

Breach of one of these warranties must be proven at trial if there is no general contract liability.

Liability of Transferees

The transferee takes by assignment; as an assignee, the new owner of the instrument has only those rights held by the assignor. Claims that could be asserted by third parties against the assignor can be asserted against the assignee. A negotiable instrument can be transferred in this sense without being negotiated. A payee, for example, might fail to meet all the requirements of negotiation; in that event, the instrument might wind up being merely transferred (assigned). When all requirements of negotiability and negotiation have been met, the buyer is a holder and may (if a holder in due course—see Chapter 21 "Holder in Due Course and Defenses") collect on the instrument without having to prove anything more. But if the instrument was not properly negotiated, the purchaser is at most a transferee and cannot collect if defenses are available, even if the paper itself is negotiable.

How Negotiation Is Accomplished

Negotiation can occur with either bearer paper or order paper.

Negotiation of Instrument Payable to Bearer

An instrument payable to bearer—**bearer paper**—can be negotiated simply by delivering it to the transferee (see Figure 20.1 "Negotiation of Bearer Paper"; recall that "Lorna Love" is the proprietor of a tennis club introduced in Chapter 19 "Nature and Form of Commercial Paper"): bearer paper runs to whoever is in possession of it, even a thief. Despite this simple rule, the purchaser of the instrument may require an indorsement on some bearer paper anyway. You may have noticed that sometimes you are requested to indorse your own check when you make it out to cash. That is because the indorsement increases the liability of the indorser if the holder is unable to collect. *Chung v. New York Racing Association* (Section 20.4 "Cases") deals with issues involving bearer paper.

Figure 20.1 Negotiation of Bearer Paper



Negotiation of Instrument Payable to Order

Negotiation is usually voluntary, and the issuer usually directs payment "to order"—that is, to someone's order, originally the payee. **Order paper** is this negotiable instrument that by its term is payable to a specified person or his assignee. If it is to continue its course through the channels of commerce, it must be indorsed—signed, usually on the back—by the payee and passed on to the transferee. Continuing with the example used in Chapter 19 "Nature and Form of Commercial Paper", Rackets, Inc. (the payee) negotiates Lorna Love's check (Lorna is the issuer or drawer) drawn to the order of Rackets when an agent of Rackets "signs" the company's name on the reverse of the check and passes it to the indorsee, such as

the bank or someone to whom Rackets owed money. (A company's signature is usually a rubber stamp for mere deposit, but an agent can sign the company name and direct the instrument elsewhere.) The transferee is a holder (see Figure 20.2 "Negotiation of Order Paper"). Had Rackets neglected to indorse the check, the transferee, though in physical possession, would not be a holder. Issues regarding indorsement are discussed in Section 20.2 "Indorsements".

Figure 20.2 Negotiation of Order Paper



KEY TAKEAWAY

A transfer is the physical delivery of an instrument with the intention to pass title—the right to enforce it. A mere transferee stands in the transferor's shoes and takes the instrument subject to all the claims and defenses against paying it that burdened it when the transferor delivered it. Negotiation is a special type of transfer—voluntary or involuntary—to a holder. A holder is a person who has an instrument drawn, issued, or indorsed to him or his order or to bearer or in blank. If the instrument is order paper, negotiation is accomplished by indorsement and delivery to the next holder; if it is bearer paper or blank paper, delivery alone accomplishes negotiation. Transferors incur two types of liability: those who sign the instrument are contractually liable; those who sign or those who do not sign are liable to the transferee in warranty.

EXERCISES

1. What is a transfer of commercial paper, and what rights and liabilities has the transferee?
2. What is a negotiation of commercial paper?
3. What is a holder?
4. How is bearer paper negotiated?

5. How is order paper negotiated?

---

[1] Uniform Commercial Code, Section 3-201, Official Comment.

[2] Uniform Commercial Code, Section 3-302, Comment 4.

20.2 Indorsements

LEARNING OBJECTIVES

1. Understand the meaning of indorsement and its formal requirements.
2. Know the effects of various types of indorsements: no indorsement, partial, blank, special, restrictive, conditional, qualified.

Definition and Formal Requirements of Indorsement

Definition

Most commonly, paper is transferred by indorsement. The indorsement is evidence that the indorser intended the instrument to move along in the channels of commerce. An **indorsement** is defined by UCC Section 3-204(a) as

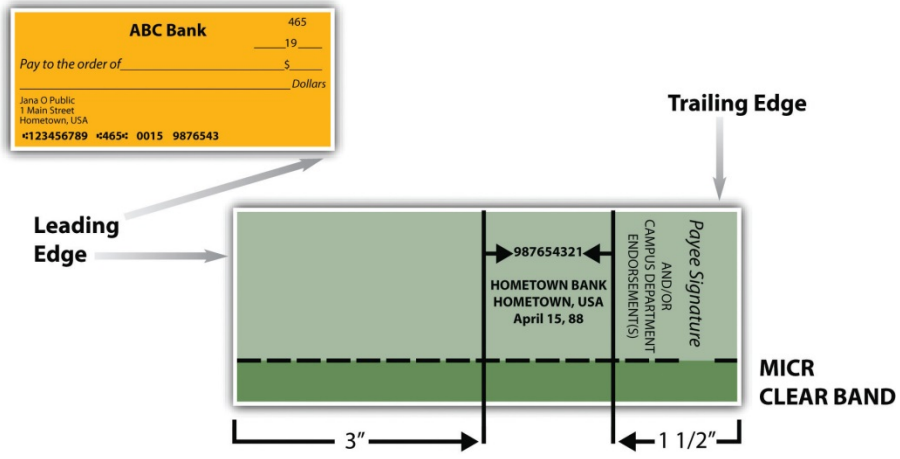
> *a signature, other than that of a signer as maker, drawer, or acceptor, that alone or accompanied by other words is made on an instrument for the purpose of (i) negotiating the instrument, (ii) restricting payment of the instrument, or (iii) incurring indorser's liability on the instrument, but regardless of the intent of the signer, a signature and its accompanying words is an indorsement unless the accompanying words, terms of the instrument, place of the signature, or other circumstances unambiguously indicated that the signature was made for a purpose other than indorsement.*

Placement of Indorsement

Indorse (or *endorse*) literally means "on the back of," as fish, say, have dorsal fins—fins on their backs. Usually indorsements are on the back of the instrument, but an indorsement could be on a piece of paper affixed to the instrument. Such an attachment is called an **allonge**—it comes along with the instrument (UCC, Section 3-204(a)).

There are rules about where indorsements are placed. The Expedited Funds Availability Act was enacted in 1987 by Congress to standardize holding periods on deposits made to commercial banks and to regulate institutions' use of deposit holds—that is, how soon customers can access the money after they have deposited a check in the bank. The Federal Reserve Board subsequently adopted "Regulation CC, Check Endorsement Standards" to improve funds availability and expedite the return of checks. See Figure 20.3 "Indorsement Standard".

Figure 20.3 Indorsement Standard



From UC Irvine Administrative Policies & Procedures, Business and Financial Affairs, Financial Services, Sec. 704-13: Check Endorsement Procedures, at http://www.policies.uci.edu/adm/procs/700/704-13.html.

As shown in Figure 20.3 "Indorsement Standard", specific implementing guidelines define criteria for the placement, content, and ink color of endorsement areas on the back of checks for the depositary bank (bank of first deposit), subsequent indorsers (paying banks), and corporate or payee indorsers. Indorsements must be made within 1½ inches of the trailing (left) edge of the back of the check; remaining space is for bank indorsements. There is no penalty for violating the standard—it is a guideline. The abbreviation "MICR" stands for magnetic ink character recognition. The "clear band" is a section of the back of the check that is not supposed to be intruded upon with any magnetic (machine-readable) printing that would interfere with machine reading on the front side (the bank routing numbers).

Sometimes an indorser adds words intended to strengthen the indorsement; for example, "I hereby assign all my right, title, and interest in this note to Carl Carpenter." Words of assignment such as these and also words of condition, waiver, guaranty, limitation, or disclaimer of liability do not negate the effect of an indorsement.

Misspelled or Incorrect Indorsements

When the instrument is made payable to a person under a misspelled name (or in a name other than his own), he may indorse in the wrong name or the right one or both. It is safer to sign in both names, and the purchaser of the instrument may demand a signature in both names (UCC, Section 3-204(d)).

Various Indorsements and Their Effects

A holder can indorse in a variety of ways; indorsements are not identical and have different effects.

No Indorsement

If the instrument requires a signature, transfer without indorsement is an assignment only. Bearer paper does not require indorsement, so it can be negotiated simply by delivering it to the transferee, who becomes a holder. The transferor has no contract liability on the instrument, however, because he has not signed it. He does remain liable on the warranties, but only to the person who receives the paper, not to subsequent transferees.

Because it is common practice for a depository bank (the bank into which a person makes a deposit) to receive unindorsed checks under so-called lockbox agreements from customers who receive a high volume of checks, a customer who is a holder can deposit a check or other instrument for credit to his account without indorsement. Section 4-205(1) of the UCC provides that a "depositary bank becomes a holder...at the time it receives the item for collection if the customer at the time of delivery was a holder, whether or not the customer indorses the item."

Partial Indorsement

To be effective as negotiation, an indorsement must convey the entire instrument. An indorsement that purports to convey only a portion of the sum still due amounts to a partial assignment. If Rackets' agent signs the check "Rackets, Inc." together with the words "Pay half to City Water, /s/ Agent" and delivers the check to City Water, that does not operate as an indorsement, and City Water becomes an assignee, not a holder.

Blank Indorsement

A **blank indorsement** consists of the indorser's signature alone (see Figure 20.4 "Forms of Endorsement", left). A blank indorsement converts the instrument into paper closely akin to cash. Since the indorsement does not specify to whom the instrument is to be paid, it is treated like bearer paper—assuming, of course, that the first indorser is the person to whom the instrument was payable originally. A paper with blank indorsement may be negotiated by delivery alone, until such time as a holder converts it into a*special indorsement* (discussed next) by writing over the signature any terms consistent with the indorsement. For example, a check indorsed by the payee (signed on the back) may be passed from one person to another and cashed in by any of them.

Figure 20.4 Forms of Endorsement



A blank indorsement creates conditional contract liability in the indorser: he is liable to pay if the paper is dishonored. The blank indorser also has warranty liability toward subsequent holders.

Special Indorsement

A **special indorsement**, sometimes known as an "indorsement in full," names the transferee-holder. The payee of a check can indorse it over to a third party by writing "Pay to the order of [name of the third party]" and then signing his name (see Figure 20.4 "Forms of Endorsement", center). Once specially indorsed, the check (or other instrument) can be negotiated further only when the special indorsee adds his own signature. A holder may convert a blank indorsement into a special indorsement by writing above the signature of the indorser words of a contractual nature consistent with the character of the instrument.

So, for example, Lorna Love's check to Rackets, Inc., indorsed in blank (signed by its agent or stamped with Rackets' indorsement stamp—its name alone) and handed to City Water, is not very safe: it is bearer paper. If the check fell onto the floor, anybody could be a holder and cash it. It can easily be converted into a check with special indorsement: City Water's clerk need only add the words "Pay City Water" above Rackets' indorsement. (The magic words of negotiability—"pay to order of bearer"—are not required in an indorsement.) Before doing so, City Water could have negotiated it simply by giving it to someone (again, a blank indorsement acts as bearer paper). After converting it to a special indorsement, City Water must indorse it in order to transfer it by negotiation to someone else. The liabilities of a special indorser are the same as those of a blank indorser.

The dichotomy here of indorsement in blank or special indorsement is the indorser's way of indicating how the instrument can be subsequently negotiated: with or without further indorsing.

Restrictive Indorsement

A **restrictive indorsement** attempts to limit payment to a particular person or otherwise prohibit further transfer or negotiation. We say "attempts to limit" because a restrictive indorsement is generally invalid. Section 3-206(a) of the UCC provides that an attempt to limit payment to a particular person or

prohibit further transfer "is not effective." Nor is "[a]n indorsement stating a condition to the right of the indorsee to receive payment"; the restriction may be disregarded. However, two legitimate restrictive indorsements are valid: collection indorsements and trust indorsements. *Wisner Elevator Company, Inc. v. Richland State Bank* (Section 20.4 "Cases") deals with conditional and restrictive indorsements.

Collection Indorsement

It is very common for people and businesses to mail checks to their bank for deposit to their accounts. Sometimes mail goes astray or gets stolen. Surely it must be permissible for the customer to safeguard the check by restricting its use to depositing it in her account. A **collection indorsement**, such as "For deposit" or "For collection," is effective. Section 3-206(c) of the UCC provides that anybody other than a bank who purchases the instrument with such an indorsement converts the instrument—effectively steals it. A depositary bank that takes it must deposit it as directed, or the bank has converted it. A payor bank that is also the depositary bank that takes the instrument for immediate payment over the counter converts it: the check cannot be cashed; it must be deposited (see Figure 20.4 "Forms of Endorsement").

To illustrate, suppose that Kate Jones indorses her paycheck "For deposit only, Kate Jones," which is by far the most common type of restrictive indorsement (see Figure 20.4 "Forms of Endorsement", right). A thief steals the check, indorses his name below the restrictive indorsement, and deposits the check in Last Bank, where he has an account, or cashes it. The check moves through the collection process to Second Bank and then to First Bank, which pays the check. Kate has the right to recover only from Last Bank, which did not properly honor the indorsement by depositing the payment in her account.

Trust Indorsement

A second legitimate restrictive indorsement is indorsement in trust, called a **trust indorsement** (sometimes *agency indorsement*). Suppose Paul Payee owes Carlene Creditor a debt. Payee indorses a check drawn to him by a third party, "Pay to Tina Attorney in trust for Carlene Creditor." Attorney indorses in blank and delivers it to (a) a holder for value, (b) a depository bank for collection, or (c) a payor bank for payment. In each case, these takers can safely pay Attorney so long as they have no notice under Section 3-307 of the UCC of any breach of fiduciary duty that Attorney may be

committing. For example, under Section 3-307(b), these takers have notice of a breach of trust if the check was taken in any transaction known by the taker to be for Attorney's personal benefit. Subsequent transferees of the check from the holder or depositary bank are not affected by the restriction unless they have knowledge that Attorney dealt with the check in breach of trust (adapted from UCC, Section 3-206, Official Comment 4). (Of course Attorney should not indorse in blank; she should indorse "Tina Attorney, in trust for Carlene Creditor" and deposit the check in her trust account.)

The dichotomy here between restrictive and unrestrictive indorsements is the indorser's way of showing to what use the instrument may be put.

Conditional Indorsement

An indorser might want to condition the negotiation of an instrument upon some event, such as "Pay Carla Green if she finishes painting my house by July 15." Such a **conditional indorsement** is generally ineffective: the UCC, Section 3-206(b), says a person paying for value can disregard the condition without liability.

Qualified Indorsement

An indorser can limit his liability by making a **qualified indorsement**. The usual qualified indorsement consists of the words "**without recourse**," which mean that the indorser has no contract liability to subsequent holders if a maker or drawee defaults. A qualified indorsement does not impair negotiability. The qualification must be in writing by signature on the instrument itself. By disclaiming contract liability, the qualified indorser also limits his warranty liabilities, though he does not eliminate them. Section 3-415(a) of the UCC narrows the indorser's warranty that no defense of any party is good against the indorser. In its place, the qualified indorser warrants merely that he has no *knowledge* of any defense.

"Without recourse" indorsements can have a practical impact on the balance sheet. A company holding a promissory note can obtain cash by discounting it—indorsing it over to a bank for maturity value less the bank's discount. As an indorser, however, the company remains liable to pay the amount to subsequent holders should the maker default at maturity. The balance sheet must reflect this possibility as a

contingent liability. However, if the note is indorsed without recourse, the company need not account for any possible default of the maker as a contingent liability.

The dichotomy here between qualified and unqualified indorsements is the indorser's way of indicating what liability she is willing to incur to subsequent holders.

KEY TAKEAWAY

An indorsement is, usually, the signature of an instrument's holder on the back of the instrument, indicating an intention that the instrument should proceed through the channels of commerce. The Federal Reserve Board has recommendations for how instruments should be indorsed to speed machine reading of them. Indorsements are either blank or special; they are either restrictive or nonrestrictive; and they are either qualified or unqualified. These pairings show the indorser's intention as to *how* further negotiation may be accomplished, to *what uses* the instrument may be put, and *what liability* the indorser is willing to assume.

EXERCISES

1. If an instrument is not indorsed according to Federal Reserve Board standards, is it still valid?
2. Suppose that Indorsee signs an instrument in blank and drops it. Suppose that the instrument is found by Finder and that Finder delivers it to Third Person with the intention to sell it. Is this successful negotiation?
3. Why would a person make a restrictive indorsement? A qualified indorsement?

CC BY NC SA

20.3 Problems and Issues in Negotiation

LEARNING OBJECTIVES

1. Recognize under what circumstances a negotiation is subject to rescission.
2. Know the effect of reacquisition of an instrument.
3. Understand how instruments made payable to two or more persons are negotiated.
4. Understand how the UCC treats forged indorsements, imposters, and other signatures in the name of the payee.

Common Issues Arising in Negotiation of Commercial Paper

A number of problems commonly arise that affect the negotiation of commercial paper. Here we take up three.

Negotiation Subject to Rescission

A negotiation—again, transfer of possession to a person who becomes a holder—can be effective even when it is made by a person without the capacity to sign. Section 3-202(a) of the UCC declares that negotiation is effective even when the indorsement is made by an infant or by a corporation exceeding its powers; is obtained by fraud, duress, or mistake; is part of an illegal transaction; or is made in breach of a duty.

However, unless the instrument was negotiated to a holder in due course, the indorsement can be rescinded or subjected to another appropriate legal remedy. The Official Comment to this UCC section is helpful:

> *Subsection (a) applies even though the lack of capacity or the illegality is of a character which goes to the essence of the transaction and makes it entirely void. It is inherent in the character of negotiable instruments that any person in possession of an instrument which by its terms is*

payable to that person or to bearer is a holder and may be dealt with by anyone as a holder. The principle finds its most extreme application in the well-settled rule that a holder in due course may take the instrument even from a thief and be protected against the claim of the rightful owner. The policy of subsection (a) is that any person to whom an instrument is negotiated is a holder until the instrument has been recovered from that person's possession.[1]

So suppose a mentally incapacitated person under a guardianship evades her guardian, goes to town, and writes a check for a new car. Normally, contracts made by such persons are void. But the check is negotiable here. If the guardian finds out about the escapade before the check leaves the dealer's hands, the deal could be rescinded: the check could be retrieved and the car returned.

Effect of Reacquisition

A prior party who reacquires an instrument may reissue it or negotiate it further. But doing so discharges intervening parties as to the reacquirer and to later purchasers who are not holders in due course. Section 3-207 of the UCC permits the reacquirer to cancel indorsements unnecessary to his title or ownership; in so doing, he eliminates the liability of such indorsers even as to holders in due course.

Instruments Payable to Two or More Persons

A note or draft can be payable to two or more persons. In form, the payees can be listed in the alternative or jointly. When a commercial paper says "Pay to the order of Lorna Love or Rackets, Inc.," it is stated in the alternative. Either person may negotiate (or discharge or enforce) the paper without the consent of the other. On the other hand, if the paper says "Pay to the order of Lorna Love and Rackets, Inc." or does not clearly state that the payees are to be paid in the alternative, then the instrument is payable to both of them and may be negotiated (or discharged or enforced) only by both of them acting together. The case presented in Section 20.4 "Cases", *Wisner Elevator Company, Inc. v. Richland State Bank*, deals, indirectly, with instruments payable to two or more persons.

Forged Indorsements, Imposters, and Fictitious Payees

The General Rule on Forged Indorsements

When a check already made out to a payee is stolen, an unscrupulous person may attempt to negotiate it by forging the payee's name as the indorser. Under UCC Section 1-201(43), a forgery is an "unauthorized signature." Section 3-403(a) provides that any unauthorized signature on an instrument is "ineffective except as the signature of the unauthorized signer." The consequence is that, generally, the loss falls on the first party to take the instrument with a forged or unauthorized signature because that person is in the best position to prevent the loss.

Lorna Love writes a check to Steve Supplier on her account at First State Bank, but the check goes astray and is found by Carl Crooks. Crooks indorses the check "Steve Supplier" and presents it for cash to a busy teller who fails to request identification. Two days later, Steve Supplier inquires about his check. Love calls First State Bank to stop payment. Too late—the check has been cashed. Who bears the loss—Love, Supplier, or the bank? The bank does, and it must recredit Love's account. The forged indorsement on the check was ineffective; the bank was not a holder, and the check should not have been allowed into the channels of commerce. This is why banks may retain checks for a while before allowing access to the money. It is, in part, what the Expedited Funds Availability Act (mentioned in Section 20.2 "Indorsements", "Indorsements") addresses—giving banks time to assess the validity of checks.

Exceptions: Imposter, Fictitious Payee, and Dishonest Employee Rules

The loss for a forged indorsement usually falls on the first party to take the instrument with a forged signature. However, there are three important exceptions to this general rule: the imposter rule, the fictitious payee rule, and the dishonest employee rule.

The Imposter Rule

If one person poses as the named payee or as an agent of the named payee, inducing the maker or drawer to issue an instrument in the name of the payee to the imposter (or his confederate), the imposter's indorsement of the payee's name is effective. The paper can be negotiated according to the **imposter rule**.

If the named payee is a real person or firm, the negotiation of the instrument by the imposter is good and has no effect on whatever obligation the drawer or maker has to the named payee. Lorna Love owes Steve Supplier $2,000. Knowing of the debt, Richard Wright writes to Love, pretending to be Steve Supplier, requesting her to send a check to Wright's address in Supplier's name. When the check arrives, Wright indorses it by signing "Pay to the order of Richard Wright, (signed) Steve Supplier," and then indorses it in his own name and cashes it. Love remains liable to Steve Supplier for the money that she owes him, and Love is out the $2,000 unless she can find Wright.

The difference between this case and the one involving the forger Carl Crooks is that in the second case the imposter (Wright) "induced the maker or drawer [Lorna Love] to issue the instrument...by impersonating the payee of the instrument [Steve Supplier]" (UCC, Section 3-404(a)), whereas in the first case the thief did not induce Love to issue the check to him—he simply found it. And the rationale for making Lorna Love bear the loss is that she failed to detect the scam: she *intended* the imposter, Wright, to receive the instrument. Section 3-404(c) provides that the indorsement of the imposter (Wright, posing as Steve Supplier) is effective. The same rule applies if the imposter poses as an agent: if the check is payable to Supplier, Inc., a company whose president is Steve Supplier, and an impostor impersonates Steve Supplier, the check could be negotiated if the imposter indorses it as Supplier, Inc.'s, agent "Steve Supplier."[2]

Similarly, suppose Love is approached by a young man who says to her, "My company sells tennis balls, and we're offering a special deal this month: a can of three high-quality balls for $2 each. We'll send your order to you by UPS." He hands her a sample ball: it is substantial, and the price is good. Love has heard of the company the man says he represents; she makes out a check for $100 to "Sprocket Athletic Supply." The young man does not represent the company at all, but he cashes the check by forging the indorsement and the bank pays. Love takes the loss: surely she is more to blame than the bank.

The Fictitious Payee Rule

Suppose Lorna Love has a bookkeeper, Abby Accountant. Abby presents several checks for Love to sign, one made out to Carlos Aquino. Perhaps there really is no such person, or perhaps he is somebody whom

Love deals with regularly, but Accountant intends him to have no interest here. No matter: Love signs the check in the amount of $2,000. Accountant takes the check and indorses it: "Carlos Aquino, pay to the order of Abby Accountant." Then she signs her name as the next indorser and cashes the check at Love's bank. The check is good, even though it was never intended by Accountant that "Carlos Aquino"—the **fictitious payee**—have any interest in the instrument. The theory here is to "place the loss on the drawer of the check rather than on the drawee or the Depositary Bank that took the check for collection....The drawer is in the best position to avoid the fraud and thus should take the loss." [3] This is also known as "the padded-payroll rule."

In the *imposter* cases, Love drew checks made out to real names but gave them to the wrong person (the imposter); in the *fictitious payee* cases she wrote checks to a nonexistent person (or a real person who was not intended to have any interest at all).

The Dishonest Employee Rule

The UCC takes head-on the recurring problem of a dishonest employee. It says that if an employer "entrust[s] an employee with responsibility with respect to the instrument and the employee or a person acting in concert with the employee makes a fraudulent indorsement of the instrument, the indorsement is effective." [4] For example (adapted from UCC 3-405, Official Comment 3; the Comment does not use the names of these characters, of course), the duties of Abby Accountant, a bookkeeper, include posting the amounts of checks payable to Lorna Love to the accounts of the drawers of the checks. Accountant steals a check payable to Love, which was entrusted to Accountant, and forges Love's indorsement. The check is deposited by Accountant to an account in the depositary bank that Accountant opened in the same name as Lorna Love, and the check is honored by the drawee bank. The indorsment is effective as Love's indorsement because Accountant's duties include processing checks for bookkeeping purposes. Thus Accountant is entrusted with "responsibility" with respect to the check. Neither the depositary bank nor the drawee bank is liable to Love for conversion of the check. The same result would follow if Accountant deposited the check in the account in the depositary bank without indorsement (UCC, Section 4-205(a)). Under Section 4-205(c), deposit in a depositary bank in an account in a name substantially similar to that of Lorna Love is the equivalent of an indorsement in the name of Lorna Love. If, say, the

janitor had stolen the checks, the result would be different, as the janitor is not entrusted with responsibility regarding the instrument.

Negligence

Not surprisingly, though, if a person fails to exercise ordinary care and thereby substantially contributes to the success of a forgery, that person cannot assert "the alteration or the forgery against a person that, in good faith, pays the instrument or takes it for value." [5] If the issuer is also negligent, the loss is allocated between them based on comparative negligence theories. Perhaps the bank teller in the example about the tennis-ball scam should have inquired whether the young man had any authority to cash the check made out to Sprocket Athletic Supply. If so, the bank could be partly liable. Or suppose Lorna Love regularly uses a rubber signature stamp for her tennis club business but one day carelessly leaves it unprotected. As a result, the stamp and some checks are stolen; Love bears any loss for being negligent. Similarly liable is a person who has had previous notice that his signature has been forged and has taken no steps to prevent reoccurrences, as is a person who negligently mails a check to the wrong person, one who has the same name as the payee. The UCC provides that the negligence of two or more parties might be compared in order to determine whether each party bears a percentage of the loss, as illustrated in *Victory Clothing Co., Inc. v. Wachovia Bank, N.A.* (Section 20.4 "Cases").

KEY TAKEAWAY

A negotiation is effective even if the transaction involving it is void or voidable, but the transferor—liable on the instrument—can regain its possession and rescind the deal (except as to holders in due course or a person paying in good faith without notice). Instruments may be made payable to two or more parties in the alternative or jointly and must be indorsed accordingly. Generally, a forged indorsement is ineffective, but exceptions hold for cases involving imposters, fictitious payees, and certain employee dishonesty. If a person's own negligence contributes to the forgery, that person must bear as much of the loss as is attributable to his or her negligence.

EXERCISES

1. A makes a check out to B for $200 for property both parties know is stolen. Is the check good?
2. What is the difference between (a) the imposter rule, (b) the fictitious payee rule, and (c) the dishonest employee rule?
3. How does comparative negligence work as it relates to forged indorsements?

---

[1] Uniform Commercial Code, Section 3-404, Official Comment 1.

[2] Uniform Commercial Code, Section 3-404, Official Comment 1.

[3] Uniform Commercial Code, Section 3-404, Comment 3.

[4] Uniform Commercial Code, Section 3-405(B).

[5] Uniform Commercial Code, Section 4-406(a).

20.4 Cases

Bearer Paper

(Note: this is a trial court's opinion.)

Chung v. New York Racing Ass'n

714 N.Y.S.2d 429 (N.Y. Dist. Ct. 2000)

Gartner, J.

A published news article recently reported that an investigation into possible money laundering being conducted through the racetracks operated by the defendant New York Racing Association was prompted by a small-time money laundering case in which a Queens bank robber used stolen money to purchase betting vouchers and then exchanged the vouchers for clean cash. [Citation] The instant case does not involve any such question of wrongdoing, but does raise a novel legal issue regarding the negotiability of

those same vouchers when their possession is obtained by a thief or finder. The defendant concedes that "there are no cases on point."

The defendant is a private stock corporation incorporated and organized in New York as a non-profit racing association pursuant to [New York law]. The defendant owns and operates New York's largest thoroughbred racetracks—Belmont Park Racetrack, Aqueduct Racetrack, and Saratoga Racetrack—where it stages thoroughbred horse races and conducts pari-mutuel wagering on them pursuant to a franchise granted to the defendant by the State of New York.

The plaintiff was a Belmont Park Racetrack horse player. He attended the track and purchased from the defendant a voucher for use in SAMS machines. As explained in [Citation]:

> *In addition to accepting bets placed at parimutuel facility windows staffed by facility employees, [some] facilities use SAMS. SAMS are automated machines which permit a bettor to enter his bet by inserting money, vouchers or credit cards into the machine, thereby enabling him to select the number or combination he wishes to purchase. A ticket is issued showing those numbers.*[1]

When a voucher is utilized for the purpose of placing a bet at a SAMS machine, the SAMS machine, after deducting the amount bet by the horse player during the particular transaction, provides the horse player with, in addition to his betting ticket(s), a new voucher showing the remaining balance left on the voucher.

In the instant case, the unfortunate horse player departed the SAMS machine with his betting tickets, but *without* his new voucher—showing thousands of dollars in remaining value—which he inadvertently left sitting in the SAMS machine. Within several minutes he realized his mistake and hurried back to the SAMS machine, only to find the voucher gone. He immediately notified a security guard. The defendant's personnel thereafter quickly confirmed the plaintiff as the original purchaser of the lost voucher. The defendant placed a computerized "stop" on the voucher. However, whoever had happened upon the voucher in the SAMS machine and taken it had acted even more quickly: the voucher had been brought to

a nearby track window and "cashed out" within a minute or so of the plaintiff having mistakenly left it in the SAMS machine.

The plaintiff now sues the defendant, contending that the defendant should be liable for having failed to "provide any minimal protection to its customers" in checking the identity and ownership of vouchers prior to permitting their "cash out." The defendant, in response, contends that the voucher consists of "bearer paper," negotiable by anyone having possession, and that it is under no obligation to purchasers of vouchers to provide any such identity or ownership checks.

As opposed to instruments such as ordinary checks, which are typically made payable to the order of a specific person and are therefore known as "order paper," bearer paper is payable to the "bearer," *i.e.*, whoever walks in carrying (or "bearing") the instrument. Pursuant to [New York's UCC] "[a]n instrument is payable to bearer when by its terms it is payable to...(c) 'cash' or the order of 'cash', or any other indication which does not purport to designate a specific payee."

Each New York Racing Association voucher is labeled "Cash Voucher." Each voucher contains the legend "Bet Against the Value or Exchange for Cash." Each voucher is also encoded with certain computer symbols which are readable by SAMS machines. The vouchers do by their terms constitute "bearer paper."

There is no doubt that under the [1990 Revision] Model Uniform Commercial Code the defendant would be a "holder in due course" of the voucher, deemed to have taken it free from all defenses that could be raised by the plaintiff. As observed in 2 White & Summers, *Uniform Commercial Code* pp. 225–226, 152–153 (4th ed.1995):

> *Consider theft of bearer instruments...[T]he thief can make his or her transferee a holder simply by transfer to one who gives value in good faith. If the thief's transferee cashes the check and so gives value in good faith and without notice of any defense, that transferee will be a holder in due course under 3-302, free of all claims to the instrument on the part...of any person and free of all personal defenses of any prior party. Therefore, the holder in due course will not be liable in*

conversion to the true owner....Of course, the owner of the check will have a good cause of action against the thief, but no other cause of action....

If an instrument is payable to bearer...the possessor of the instrument will be a holder and, if he meets the other tests, a holder in due course. This is so even though the instrument may have passed through the hands of a thief; the holder in due course is one of the few purchasers in Anglo-Saxon jurisprudence who may derive a good title from a chain of title that includes a thief in its links.

However, the Model Uniform Commercial Code in its present form is not in effect in New York.[2] In 1990, the National Conference of Commissioners on Uniform State Laws and the American Law Institute approved a revised Article 3. This revised Article 3 has never been enacted in New York. Comment 1 to § 3-201 of the [1990] Uniform Commercial Code, commenting on the difference between it and its predecessor (which is still in effect in New York), states:

A person can become holder of an instrument...as the result of an event that occurs after issuance. "Negotiation" is the term used in Article 3 to describe this post-issuance event....In defining "negotiation" former Section 3-202(1) used the word "transfer," an undefined term, and "delivery," defined in Section 1-201(14) to mean voluntary change of possession. Instead, subsections (a) and (b) [now] use the term "transfer of possession," and subsection (a) states that negotiation can occur by an involuntary transfer of possession. For example, if an instrument is payable to bearer and it is stolen by Thief or is found by Finder, Thief or Finder becomes the holder of the instrument when possession is obtained. In this case there is an involuntary transfer of possession that results in negotiation to Thief or Finder.

Thus, it would initially appear that under the prior Model Uniform Commercial Code, still in effect in New York, a thief or finder of bearer paper, as the recipient of an involuntary transfer, could not become a "holder," and thus could not pass holder-in-due-course status, or good title, to someone in the position of the defendant.

This conclusion, however, is not without doubt. For instance, in 2 Anderson, *Uniform Commercial Code* § 3-202:35 (2nd ed.1971), it was observed that:

> *The Code states that bearer paper is negotiated by "delivery." This is likely to mislead for one is not inclined to think of the acquisition of paper by a finder or a thief as a "voluntary transfer of possession."*

By stating that the Code's terminology was "misleading," the treatise appears to imply that despite the literal import of the words, the contrary was true—negotiation could be accomplished by involuntary transfer, *i.e.*, loss or theft.

In [Citation], the Appellate Division determined that the Tropicana Casino in New Jersey became a holder in due course of signed cashier's checks with blank payee designations which a thief had stolen from the defendant and negotiated to the casino for value after filling in the payee designation with his brother-in-law's name. The Appellate Division, assuming without discussion that the thief was a "holder" of the stolen instruments and therefore able to transfer good title, held the defendant obligated to make payment on the stolen checks. *Accord* [Citation] (check cashing service which unknowingly took for value from an intervening thief the plaintiff's check, which the plaintiff had endorsed in blank and thus converted to a bearer instrument, was a holder in due course of the check, having received good title from the thief).

Presumably, these results have occurred because the courts in New York have implicitly interpreted the undefined term "transfer" as utilized in [the pre-1990] U.C.C. § 3-202(1) as including the involuntary transfer of possession, so that as a practical matter the old Code (as still in effect in New York) has the same meaning as the new Model Uniform Commercial Code, which represents a clarification rather than a change in the law.

This result makes sense. A contrary result would require extensive verification procedures to be undertaken by all transferees of bearer paper. The problem with imposing an identity or ownership check

requirement on the negotiation of bearer paper is that such a requirement would impede the free negotiability which is the essence of bearer paper. As held in [Citation (1970)],

> *[Where] the instrument entrusted to a dishonest messenger or agent was freely negotiable bearer paper...the drawee bank [cannot] be held liable for making payment to one presenting a negotiable instrument in bearer form who may properly be presumed to be a holder [citations omitted].*

...Moreover, the plaintiff in the instant case knew that the voucher could be "Exchange[d] for cash." The plaintiff conceded at trial that (1) when he himself utilized the voucher prior to its loss, no identity or ownership check was ever made; and (2) he nevertheless continued to use it. The plaintiff could therefore not contend that he had any expectation that the defendant had in place any safeguards against the voucher's unencumbered use, or that he had taken any actions in reliance on the same.

This Court is compelled to render judgment denying the plaintiff's claim, and in favor of the defendant.

CASE QUESTIONS

1. Was the instrument in question a note or a draft?
2. How did the court determine it was bearer paper?
3. What would the racetrack have to have done if it wanted the machine to dispense order paper?
4. What confusion arose from the UCC's pre-1990 use of the words "transfer" and "delivery," which was clarified by the revised Article 3's use of the phrase "transfer of possession"? Does this offer any insight into why the change was made?
5. How had—have—the New York courts decided the question as to whether a thief could be a holder when the instrument was acquired from its previous owner involuntarily?

Forged Drawer's Signature, Forged Indorsements, Fictitious Payee, and Comparative Negligence

Victory Clothing Co., Inc. v. Wachovia Bank, N.A.

2006 WL 773020 (Penn. [Trial Court] 2006)

Abramson, J.

Background

This is a subrogation action brought by the insurance carrier for plaintiff Victory Clothing, Inc. ("Victory"), to recover funds paid to Victory under an insurance policy. This matter arises out of thefts from Victory's commercial checking account by its office manager and bookkeeper, Jeanette Lunny ("Lunny"). Lunny was employed by Victory for approximately twenty-four (24) years until she resigned in May 2003. From August 2001 through May 2003, Lunny deposited approximately two hundred (200) checks drawn on Victory's corporate account totaling $188,273.00 into her personal checking account at defendant Wachovia Bank ("Wachovia"). Lunny's scheme called for engaging in "double forgeries" (discussed infra). Lunny would prepare the checks in the company's computer system, and make the checks payable to known vendors of Victory (e.g., Adidas, Sean John), to whom no money was actually owed. The checks were for dollar amounts that were consistent with the legitimate checks to those vendors. She would then forge the signature of Victory's owner, Mark Rosenfeld ("Rosenfeld"), on the front of the check, and then forge the indorsement of the unintended payee (Victory's various vendors) on the reverse side of the check. The unauthorized checks were drawn on Victory's bank account at Hudson Bank (the "drawee bank" or "payor bank"). After forging the indorsement of the payee, Lunny either indorsed the check with her name followed by her account number, or referenced her account number following the forged indorsement. She then deposited the funds into her personal bank account at Wachovia (the "depositary bank" or "collecting bank").

At the time of the fraud by Lunny, Wachovia's policies and regulations regarding the acceptance of checks for deposit provided that "checks payable to a non-personal payee can be deposited ONLY into a non-personal account with the same name." [Emphasis in original]

Rosenfeld reviewed the bank statements from Hudson Bank on a monthly basis. However, among other observable irregularities, he failed to detect that Lunny had forged his signature on approximately two hundred (200) checks. Nor did he have a procedure to match checks to invoices.

In its Complaint, Victory asserted a claim against Wachovia pursuant to the Pennsylvania Commercial Code, [3-405]...[it] states, in relevant part:

> *Employer's responsibility for fraudulent indorsement by employee*
>
> *(b) RIGHTS AND LIABILITIES.-For the purpose of determining the rights and liabilities of a person who, in good faith, pays an instrument or takes it for value or for collection, if an employer entrusted an employee with responsibility with respect to the instrument and the employee or a person acting in concert with the employee makes a fraudulent indorsement of the instrument, the indorsement is effective as the indorsement of the person to whom the instrument is payable if it is made in the name of that person. If the person paying the instrument or taking it for value or for collection fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss resulting from the fraud, the person bearing the loss may recover from the person failing to exercise ordinary care to the extent the failure to exercise ordinary care contributed to the loss.*

In essence, Victory contends that Wachovia's actions in accepting the checks payable to various businesses for deposit into Lunny's personal account were commercially unreasonable, contrary to Wachovia's own internal rules and regulations, and exhibited a want of ordinary care.

Discussion

I. Double Forgeries

As stated supra, this case involves a double forgery situation. This matter presents a question of first impression in the Pennsylvania state courts, namely how should the loss be allocated in double forgery situations. A double forgery occurs when the negotiable instrument contains both a forged maker's [bank customer's] signature and a forged indorsement. The Uniform Commercial Code ("UCC" or "Code")

CC BY NC SA

addresses the allocation of liability in cases where either the maker's signature is forged or where the indorsement of the payee or holder is forged. [Citation] ("the Code accords separate treatment to forged drawer signatures...and forged indorsements"). However, the drafters of the UCC failed to specifically address the allocation of liability in double forgery situations....Consequently, the courts have been left to determine how liability should be allocated in a double forgery case....

II. The Effect of the UCC Revisions

In 1990, new revisions to Articles 3 and 4 of the UCC were implemented (the "revisions")....The new revisions made a major change in the area of double forgeries. Before the revisions, the case law was uniform in treating a double forgery case as a forged drawer's signature case [only], with the loss falling [only] on the drawee bank. The revisions, however, changed this rule by shifting to a comparative fault approach. Under the revised version of the UCC, the loss in double forgery cases is allocated between the depositary and drawee banks based on the extent that each contributed to the loss....

Specifically, revised § 3-405 of the UCC, entitled "Employer's Responsibility for Fraudulent Indorsement by Employee," introduced the concept of comparative fault as between the employer of the dishonest employee/embezzler and the bank(s). This is the section under which Victory sued Wachovia. Section 3-405(b) states, in relevant part:

> *If the person paying the instrument or taking it for value or for collection fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss resulting from the fraud, the person bearing the loss may recover from the person failing to exercise ordinary care to the extent the failure to exercise ordinary care contributed to the loss.*

Wachovia argues that this section is applicable only in cases of forged indorsements, and not in double forgery situations. However, at least one court has found that the new revisions have made section 3-405 apply to double forgery situations. "Nothing in the [Revised UCC] statutory language indicates that, where the signature of the drawer is forged...the drawer is otherwise precluded from seeking recovery from a

depositary bank under these sections" [Citation]...The Court finds the reasoning persuasive and holds that...Victory can maintain its cause of action against Wachovia.

III. The Fictitious Payee Rule

Lunny made the fraudulent checks payable to actual vendors of Victory with the intention that the vendors not get paid. Wachovia therefore argues that Victory's action against it should be barred by the fictitious payee rule under UCC 3-404 [which] states, in relevant part:

> *(b) Fictitious Payee. If a person...does not intend the person identified as payee to have any interest in the instrument or the person identified as payee of an instrument is a fictitious person, the following rules apply until the instrument is negotiated by special indorsement:*
> *(1) Any person in possession of the instrument is its holder.*
> *(2) An indorsement by any person in the name of the payee stated in the instrument is effective as the indorsement of the payee in favor of a person who, in good faith, pays the instrument or takes it for value or for collection....*

The theory under the rule is that since the indorsement is "effective," the drawee bank was justified in debiting the company's account. Therefore, [Wachovia argues] the loss should fall on the company whose employee committed the fraud.

...[However] under revised UCC §§ 3-404 and 3-405, the fictitious payee defense triggers principles of comparative fault, so a depositary bank's own negligence may be considered by the trier of fact....Therefore, based on the foregoing reasons, the fictitious payee defense does not help Wachovia in this case.

IV. Allocation of Liability

As stated supra, comparative negligence applies in this case because of the revisions in the Code. In determining the liability of the parties, the Court has considered, *inter alia* [among other things], the following factors:

- At the time of the fraud by Lunny, Wachovia's policies and regulations regarding the acceptance of checks for deposit provided that "checks payable to a non-personal payee can be deposited ONLY into a non-personal account with the same name." [Emphasis in original]
- Approximately two hundred (200) checks drawn on Victory's corporate account were deposited into Lunny's personal account at Wachovia.
- The first twenty-three (23) fraudulent checks were made payable to entities that were not readily distinguishable as businesses, such as "Sean John." The check dated December 17, 2001 was the first fraudulent check made payable to a payee that was clearly a business, specifically "Beverly Hills Shoes, Inc."
- In 2001, Victory had approximately seventeen (17) employees, including Lunny.
- Lunny had been a bookkeeper for Victory from approximately 1982 until she resigned in May 2003. Rosenfeld never had any problems with Lunny's bookkeeping before she resigned.
- Lunny exercised primary control over Victory's bank accounts.
- Between 2001 and 2003, the checks that were generated to make payments to Victory's vendors were all computerized checks generated by Lunny. No other Victory employee, other than Lunny, knew how to generate the computerized checks, including Rosenfeld.
- The fraudulent checks were made payable to known vendors of Victory in amounts that were consistent with previous legitimate checks to those vendors.
- After forging the indorsement of the payee, Lunny either indorsed the check with her name followed by her account number, or referenced her account number following the forged indorsement.
- About ten (10) out of approximately three hundred (300) checks each month were forged by Lunny and deposited into her personal account.
- Rosenfeld reviewed his bank statements from Hudson Bank on a monthly basis.

- Rosenfeld received copies of Victory's cancelled checks from Hudson Bank on a monthly basis. However, the copies of the cancelled checks were not in their normal size; instead, they were smaller, with six checks (front and back side) on each page.
- The forged indorsements were written out in longhand, i.e., Lunny's own handwriting, rather than a corporate stamped signature.
- Victory did not match its invoices for each check at the end of each month.
- An outside accounting firm performed quarterly reviews of Victory's bookkeeping records, and then met with Rosenfeld. This review was not designed to pick up fraud or misappropriation.

Based on the foregoing, the Court finds that Victory and Wachovia are comparatively negligent.

With regard to Wachovia's negligence, it is clear that Wachovia was negligent in violating its own rules in repeatedly depositing corporate checks into Lunny's personal account at Wachovia. Standard commercial bank procedures dictate that a check made payable to a business be accepted only into a business checking account with the same title as the business. Had a single teller at Wachovia followed Wachovia's rules, the fraud would have been detected as early as December 17, 2001, when the first fraudulently created non-personal payee check was presented for deposit into Lunny's personal checking account. Instead, Wachovia permitted another one hundred and seventy-six (176) checks to be deposited into Lunny's account after December 17, 2001. The Court finds that Wachovia failed to exercise ordinary care, and that failure substantially contributed to Victory's loss resulting from the fraud. Therefore, the Court concludes that Wachovia is seventy (70) percent liable for Victory's loss.

Victory, on the other hand, was also negligent in its supervision of Lunny, and for not discovering the fraud for almost a two-year period. Rosenfeld received copies of the cancelled checks, albeit smaller in size, on a monthly basis from Hudson Bank. The copies of the checks displayed both the front and back of the checks. Rosenfeld was negligent in not recognizing his own forged signature on the front of the checks, as well as not spotting his own bookkeeper's name and/or account number on the back of the checks (which appeared far too many times and on various "payees" checks to be seen as regular by a non-negligent business owner).

Further, there were inadequate checks and balances in Victory's record keeping process. For example, Victory could have ensured that it had an adequate segregation of duties, meaning that more than one person would be involved in any control activity. Here, Lunny exercised primary control over Victory's bank accounts. Another Victory employee, or Rosenfeld himself, could have reviewed Lunny's work. In addition, Victory could have increased the amount of authorization that was needed to perform certain transactions. For example, any check that was over a threshold monetary amount would have to be authorized by more than one individual. This would ensure an additional control on checks that were larger in amounts. Furthermore, Victory did not match its invoices for each check at the end of each month. When any check was created by Victory's computer system, the value of the check was automatically assigned to a general ledger account before the check could be printed. The values in the general ledger account could have been reconciled at the end of each month with the actual checks and invoices. This would not have been overly burdensome or costly because Victory already had the computer system that could do this in place. Based on the foregoing, the Court concludes that Victory is also thirty (30) percent liable for the loss.

Conclusion

For all the foregoing reasons, the Court finds that Wachovia is 70% liable and Victory is 30% liable for the $188,273.00 loss. Therefore, Victory Clothing Company, Inc. is awarded $131,791.10.

CASE QUESTIONS

1. How does the double-forgery scam work?
2. What argument did Wachovia make as to why it should not be liable for the double forgeries?
3. What argument did Wachovia make as to why it should not be liable under the fictitious payee rule?
4. What change in the revised UCC (from the pre-1990 version) made Wachovia's arguments invalid, in the court's opinion?

5. What factors appear to have caused the court to decide that Wachovia was more than twice as responsible for the embezzlement as Victory was?

Joint Payees and Conditional and Restrictive Indorsements

Wisner Elevator Company, Inc. v. Richland State Bank

862 So.2d 1112 (La. App. 2003)

Gaskins, J.

Wisner Elevator Company, Inc. [plaintiff] ("Wisner"), appeals from a summary judgment in favor of the defendant, Richland State Bank. At issue is the deposit of a check with a typed statement on the back directing that a portion of the funds be paid to a third party. We affirm the trial court judgment.

Facts

On July 13, 2001, the United States Treasury, through the Farm Service Agency, issued a check in the amount of $17,420.00, made payable to Chad E. Gill. On the back of the check the following was typed:

PAY TO THE ORDER OF RICHLAND STATE BANK FOR ISSUANCE OF A CASHIER'S CHECK PAYABLE TO WISNER ELEVATOR IN THE AMOUNT OF $13,200.50 AND PAY THE BALANCE TO CHAD GILL IN THE AMOUNT OF $4,219.50.

On July 23, 2001, the check was deposited into Gill's checking account at Richland State Bank. Gill's signature is found on the back of the check below the typed paragraph. No cashier check to Wisner Elevator was issued; instead the entire amount was deposited into Gill's checking account as per Gill's deposit ticket.

...On May 28, 2002, Wisner filed suit against the bank, claiming that its failure to apply the funds as per the restrictive indorsement constituted a conversion of the portion of the check due to Wisner under UCC

3-206(c)(2) [that a depositary bank converts an instrument if it pays out on an indorsement "indicating a purpose of having the instrument collected for the indorser or for a particular account"].

[The bank] asserted that the indorsement on the back of the check was a conditional indorsement and ineffective under 3-206(b), [which states:]

> *An indorsement stating a condition to the right of the indorsee to receive payment does not affect the right of the indorsee to enforce the instrument. A person paying the instrument or taking it for value or collection may disregard the condition, and the rights and liabilities of that person are not affected by whether the condition has been fulfilled.*

...[T]he bank asserts the fault of the United States Treasury..., in failing to make the check payable to both Gill and Wisner. To the extent that the indorsement was conditional, the bank contends that it was unenforceable; to the extent that it was restrictive, it maintains that the restrictions were waived by the indorser when he deposited the full amount of the check into his own checking account.

Wisner...[stated that it] was owed $13,200.50 by Gill for seeds, chemicals, crop supplies and agricultural seed technology fees. [It] further stated that Gill never paid the $13,200.50 he owed and that Wisner did not receive a cashier's check issued in that amount by Richland State Bank....According to [the bank teller], Gill asked to deposit the entire amount in his account. She further stated that the bank was unaware that the indorsement was written by someone other than Gill.

...The court found that the typed indorsement placed on the check was the indorsement of the maker, not Gill. However, when Gill signed below the indorsement, he made it his own indorsement. The court concluded that Gill had the legal power and authority to verbally instruct that the entire proceeds be deposited into his account. The court stated that as long as the indorsement was his own, whether it was restrictive or conditional, Gill had the power to ignore it, strike it out or give contrary instructions. The court further concluded that the bank acted properly when it followed the verbal instructions given by Gill

to the teller and the written instructions on his deposit slip to deposit the entire proceeds into Gill's account. Consequently, the court gave summary judgment in favor of the bank. Wisner appeals....

Discussion

Wisner contends that the trial court erred in holding that the bank could disregard what Wisner characterizes as a special and restrictive indorsement on the back of the check. It claims that under UCC 3-206, the amount paid by the bank had to be "applied consistently with" the indorsement and that the bank's failure to comply with the indorsement made it liable to Wisner. According to Wisner, Gill was not entitled to deposit the amount due to Wisner by virtue of his own special indorsement and the bank converted the check under 3-420 by crediting the full amount to Gill's account.

The bank argues that the indorsement was conditional and thus could be ignored pursuant to 3-206(b). It also asserts that nothing on the check indicated that the indorsement was written by someone other than Gill. Since the check was made payable to Gill, the indorsement was not necessary to his title and could be ignored, struck out or simply waived. The bank also claims that Wisner had no ownership interest in the check, did not receive delivery of the check, and had no claim for conversion under 3-420.

We agree with the bank that the true problem in this case is the failure of the government to issue the check jointly to Gill and Wisner as co-payees. Had the government done so, there would be no question as to Wisner's entitlement to a portion of the proceeds from the check.

Although the writing on the back of the check is referred to as an indorsement, we note that, standing alone, it does not truly conform to the definition found in 3-204(a) [which states]:

> *"Indorsement" means a signature, other than that of a signer as maker, drawer, or acceptor, that alone or accompanied by other words is made on an instrument for the purpose of (i) negotiating the instrument, (ii) restricting payment of the instrument, or (iii) incurring indorser's liability on the instrument, but regardless of the intent of the signer, a signature and its accompanying words is an indorsement unless the accompanying words, terms of the instrument, place of the*

signature, or other circumstances unambiguously indicate that the signature was made for a purpose other than indorsement.

This paragraph was placed on the back of the check by the government as the maker or drawer of the check. Consequently, the bank argues that Gill as sole payee could waive, ignore or strike out the language.

Although the Louisiana jurisprudence contains no similar case dealing with the Uniform Commercial Code, we may look to other jurisdictions for guidance...In [Citation, a New Jersey case] (1975), the drawer of a check placed instructions on the backs of several checks...that the instruments not be deposited until a specific future date. However, the payee presented some of the checks prior to the date specified on the back. The court found that the drawer did not have the capacity to indorse the instruments; as a result the typed instructions on the backs of the checks could not be indorsements. Instead, they were "merely requests to plaintiff who may or may not comply at its own pleasure. The instructions are neither binding on plaintiff nor the subsequent holders." In other words, the payee could ignore the instructions.

In the instant case, the payee did precisely that. Gill ignored the writing on the back of the check and instructed the teller at the defendant bank to do the same through verbal and written instructions.

Wisner argues that by affixing his signature under the writing on the back of the check, Gill made it his own indorsement. Furthermore, it asserts that it was a restrictive indorsement, not a conditional one which could be disregarded pursuant to 3-206. Wisner relies upon the provisions of 3-206 for the proposition that the check had a restrictive indorsement and that the bank converted the check because it failed to apply the amount it paid consistently with the indorsement. However, Comment 3 to 3-206 states, in pertinent part:

This Article does not displace the law of waiver as it may apply to restrictive indorsements. The circumstances under which a restrictive indorsement may be waived by the person who made it is not determined by this Article.

Not all jurisdictions recognize a doctrine of waiver of restrictive indorsements. [Citing cases from various jurisdictions in which a bank customer effectively requested the bank to disregard a restrictive indorsement; some cases affirmed the concept that the restriction could be waived (disregarded), others did not.]

...

In two cases arising under pre-UCC law, Louisiana recognized that indorsements could be ignored or struck out. In [Citation] (1925), the Louisiana Supreme Court held that the holder of a check could erase or strike out a restrictive indorsement on a check that was not necessary to the holder's title. In [Citation] (1967), the court stated that an erroneous indorsement could be ignored and even struck out as unnecessary to the plaintiff's title.

Like the trial court, we find that when Gill affixed his signature under the writing on the back of the check, he made it his own indorsement. We further find that the indorsement was restrictive, not conditional. As Gill's own restrictive indorsement, he could waive it and direct that the check, upon which he was designated as the sole payee, be deposited in his account in its entirety.

Affirmed.

CASE QUESTIONS

1. Notice that the check was made payable to Chad Gill—he was the named payee on the front side of the check. To avoid the problems here, if the drawer (the US government) wanted to control the uses to which the check could be put, how should it have named the payee?
2. The court held that when Gill "affixed his signature under the writing on the back of the check, he made it his own indorsement." But why wasn't it the indorsement of the drawer—the US government?

3. If the language on the back was considered his own conditional indorsement (the instrument was not valid unless the stated conditions were met), how could the condition be disregarded by the bank?
4. If it was his own restrictive indorsement, how could it be disregarded by the bank?
5. What recourse does Wisner have now?

---

[1] Authors' note: Pari-mutuel betting (from the French *pari mutuel*, meaning mutual stake) is a betting system in which all bets of a particular type are placed together in a pool; taxes and a house take are removed, and payoff odds are calculated by sharing the pool among all winning bets.

[2] Authors' note: As of 2010, New York is the sole remaining state yet to adopt the 1990 revisions to Articles 3 and 4; it entertained a bill in 2007 and 2008 that would have enacted the 1990 revisions as amended by the 2002 amendments. However, that bill floundered. Keith A. Rowley, *UCC Update* [American Bar Association, Business Law Committee], available at http://www.abanet.org/buslaw/committees/CL190000pub/newsletter/200901/subcommittees/developments.pdf .

20.5 Summary and Exercises

Summary

Negotiation is the transfer of an instrument in such a form that the transferee becomes a holder. There are various methods for doing so; if the procedures are not properly adhered to, the transfer is only an assignment.

An instrument payable to the order of someone must be negotiated by indorsement and delivery to the transferee. The indorsement must convey the entire instrument. An instrument payable to bearer may be negotiated simply by delivery to the transferee.

Those who sign the instrument have made a contract and are liable for its breach. Makers and acceptors are primary parties and are liable to pay the instrument. Drawers and indorsers are secondary parties and are conditionally liable. Signatories are liable under a warranty theory.

Various forms of indorsement are possible: blank or special, restrictive or unrestrictive, qualified or unqualified.

Between drawer and drawee, liability for a forged instrument—one signed without authority—usually falls on the drawee who paid it. There are, however, several exceptions to this rule: where an imposter induces the maker or drawer to issue an instrument in the name of the payee, where the instrument is made to a fictitious payee (or to a real person who is intended to have no interest in it), and where the instrument is made by an employee authorized generally to deal in such paper

EXERCISES

1 Mal, a minor, purchased a stereo from Howard for $425 and gave Howard a negotiable note in that amount. Tanker, a thief, stole the note from Howard, indorsed Howard's signature and sold the note to Betty. Betty then sold the note to Carl; she did not indorse it. Carl was unable to collect on the note because Mal disaffirmed the contract. Is Betty liable to Carl on a contract or warranty theory? Why?

2 Would the result in Exercise 1 be different if Betty had given a qualified indorsement? Explain.

3 Alphonse received a check one Friday from his employer and cashed the check at his favorite tavern, using a blank indorsement. After the tavern closed that evening, the owner, in reviewing the receipts for the evening, became concerned that if the check was stolen and cashed by a thief, the loss would fall on the tavern. Is this concern justified? What can the owner of the tavern do for protection?

4 Martha owns a sporting goods store. She employs a bookkeeper, Bob, who is authorized to indorse checks received by the store and to deposit them in the store's bank account at Second Bank. Instead of depositing all the checks, Bob cashes some of them and uses the proceeds for personal purposes. Martha sues the bank for her loss, claiming that the bank should have deposited the money in the store's account rather than paying Bob. Is the bank liable? Explain.

5 Daniel worked as a writer in order to support himself and his wife while she earned her MBA degree. Daniel's paychecks were important, as the couple had no other source of income. One day, Daniel drove to Old Faithful State Bank to deposit his paycheck. Standing at a counter, he indorsed the check with a blank indorsement and then proceeded to fill out a deposit slip. While he was completing the slip, a thief stole the check and cashed it. Whose loss? How could the loss be avoided?

6 You are the branch manager of a bank. A well-respected local attorney walks into the bank with a check for $100,000 that he wants to deposit in the general account his firm has at your bank. The payee on the check is an elderly widow, Hilda Jones, who received the check from the profit-sharing plan of her deceased husband, Horatio Jones. The widow indorsed the check "Pay to the order of the estate of Horatio Jones. Hilda Jones." The attorney produces court documents showing that he is the executor of the estate. After the attorney indorses the check, you deposit the check in the attorney's account. The attorney later withdraws the $100,000 and spends it on a pleasure trip, in violation of his duties as executor. Discuss the bank's liability.

7 Stephanie borrows $50,000 from Ginny and gives Ginny a negotiable note in that amount. Ginny sells the note to Roe for $45,000. Ginny's indorsement reads, "For valuable consideration, I assign all of my rights in this note to Roe. Ginny." When Stephanie refuses to pay the note and skips town, Roe demands payment from Ginny, claiming contract liability on the basis of her signature. Ginny argues that she is not liable because the indorsement is qualified by the language she used on the note. Who is correct? Explain.

8 The state of California issued a check that read, "To Alberto Cruz and Roberta Gonzales." Alberto endorsed it "Pay to the order of Olivia Cruz." What rights does Olivia get in the instrument?

9

a. Bill's weekly paycheck was stolen by a thief. The thief indorsed Bill's name and cashed the check at the drawee bank before Bill's employer had time to stop payment. May the drawee bank charge this payment against the drawer's account? Explain.
b. Would the result change in (a) if Bill had carelessly left his check where it could easily be picked up by the thief? Explain.
c. Would the result change in (a) if the bank had specific regulations that tellers were not to cash any check without examining the identification of the person asking for cash?

d. Would the result change if Bill's employer had carelessly left the check where it could be found by the thief?

SELF-TEST QUESTIONS

1 A person who signs a negotiable instrument with a blank endorsement has

a. warranty liability

b. contract liability

c. both of the above

d. neither of the above

2 "For deposit" is an example of

a. a special indorsement

b. a restrictive indorsement

c. a qualified indorsement

d. a blank indorsement

3 "Pay to the order of XYZ Company" is an example of

a. a special indorsement

b. a restrictive indorsement

c. a qualified indorsement

d. a blank indorsement

4 The indorser's signature alone is

a. a special indorsement

b. a restrictive indorsement

c. a qualified indorsement

d. a blank indorsement

5 Generally, liability for a forged instrument falls on

a. the drawer

b. the drawee

c. both of the above

d. neither of the above

6 State whether each of the following is (1) blank or special, (2) restrictive or nonrestrictive, or (3) qualified or unqualified:

a. “Pay to David Murphy without recourse.”

b. “Ronald Jackson”

c. “For deposit only in my account at Industrial Credit Union.”

d. “Pay to ABC Co.”

e. “I assign to Ken Watson all my rights in this note.”

SELF-TEST ANSWERS

1 c

2 b

3 a

4 d

5 b

6

a. special, nonrestrictive, qualified

b. blank, nonrestrictive, unqualified

c. special, nonrestrictive, unqualified

d. special, restrictive, unqualified

e. special, restrictive, unqualified

Chapter 21
Holder in Due Course and Defenses

LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. What a holder in due course is, and why that status is critical to commercial paper
2. What defenses are good against a holder in due course
3. How the holder-in-due-course doctrine is modified in consumer transactions

In this chapter, we consider the final two questions that are raised in determining whether a holder can collect:

1. Is the holder a holder in due course?
2. What defenses, if any, can be asserted against the holder in due course to prevent collection on the instrument?

21.1 Holder in Due Course

LEARNING OBJECTIVES

1. Understand why the concept of holder in due course is important in commercial transactions.
2. Know what the requirements are for being a holder in due course.
3. Determine whether a payee may be a holder in due course.

CC BY NC SA

4. Know what the shelter rule is and why the rule exists.

Overview of the Holder-in-Due-Course Concept

Importance of the Holder-in-Due-Course Concept

A holder is a person in possession of an instrument payable to bearer or to the identified person possessing it. But a holder's rights are ordinary, as we noted briefly in Chapter 19 "Nature and Form of Commercial Paper". If a person to whom an instrument is negotiated becomes nothing more than a holder, the law of commercial paper would not be very significant, nor would a negotiable instrument be a particularly useful commercial device. A mere holder is simply an assignee, who acquires the assignor's rights but also his liabilities; an ordinary holder must defend against claims and overcome defenses just as his assignor would. The holder in due course is really the crux of the concept of commercial paper and the key to its success and importance. What the holder in due course gets is an instrument free of claims or defenses by previous possessors. A holder with such a preferred position can then treat the instrument almost as money, free from the worry that someone might show up and prove it defective.

Requirements for Being a Holder in Due Course

Under Section 3-302 of the Uniform Commercial Code (UCC), to be a holder in due course (HDC), a transferee must fulfill the following:

1. Be a holder of a negotiable instrument;

2. Have taken it:

a) for value,

b) in good faith,

c) without notice

(1) that it is overdue or

(2) has been dishonored (not paid), or

(3) is subject to a valid claim or defense by any party, or

(4) that there is an uncured default with respect to payment of another instrument issued as part of the same series, or

(5) that it contains an unauthorized signature or has been altered, and

3. Have no reason to question its authenticity on account of apparent evidence of forgery, alteration, irregularity or incompleteness.

The point is that the HDC should honestly pay for the instrument and not know of anything wrong with it. If that's her status, she gets paid on it, almost no matter what.

Specific Analysis of Holder-in-Due-Course Requirements

Holder

Again, a holder is a person who possesses a negotiable instrument "payable to bearer or, the case of an instrument payable to an identified person, if the identified person is in possession." [1] An instrument is payable to an identified person if she is the named payee, or if it is indorsed to her. So a holder is one who possesses an instrument and who has all the necessary indorsements.

Taken for Value

Section 3-303 of the UCC describes what is meant by transferring an instrument "for value." In a broad sense, it means the holder has given something for it, which sounds like consideration. But "value" here is not the same as consideration under contract law. Here is the UCC language:

An instrument is issued or transferred for value if any of the following apply:

(1) The instrument is issued or transferred for a promise of performance, to the extent the promise has been performed.

(2) The transferee acquires a security interest or other lien in the instrument other than a lien obtained by judicial proceeding.

(3) The instrument is issued or transferred as payment of, or as security for, an antecedent claim against any person, whether or not the claim is due.

(4) The instrument is issued or transferred in exchange for a negotiable instrument.

(5) The instrument is issued or transferred in exchange for the incurring of an irrevocable obligation to a third party by the person taking the instrument.

1. *For a promise, to the extent performed*. Suppose A contracts with B: "I'll buy your car for $5,000." Under contract law, A has given consideration: the promise is enough. But this executory (not yet performed) promise given by A is not giving "value" to support the HDC status because the promise has not been performed.

Lorna Love sells her car to Paul Purchaser for $5,000, and Purchaser gives her a note in that amount. Love negotiates the note to Rackets, Inc., for a new shipment of tennis rackets to be delivered in thirty days. Rackets never delivers the tennis rackets. Love has a claim for $5,000 against Rackets, which is not an HDC because its promise to deliver is still executory. Assume Paul Purchaser has a defense against Love (a reason why he doesn't want to pay on the note), perhaps because the car was defective. When Rackets presents the note to Purchaser for payment, he refuses to pay, raising his defense against Love. If Rackets had been an HDC, Purchaser would be obligated to pay on the note regardless of the defense he might have had against Love, the payee. See *Carter & Grimsley v. Omni Trading, Inc.*, Section 21.3 "Cases", regarding value as related to executory contracts.

A taker for value can be a partial HDC if the consideration was only partly performed. Suppose the tennis rackets were to come in two lots, each worth $2,500, and Rackets only delivered one lot. Rackets would be an HDC only to the extent of $2,500, and the debtor—Paul Purchaser—could refuse to pay $2,500 of the promised sum.

The UCC presents two exceptions to the rule that an executory promise is not value. Section 3-303(a)(4) provides that an instrument is issued or transferred for value if the issuer or transferor gives it in exchange for a negotiable instrument, and Section 3-303(5) says an instrument is transferred for value if the issuer gives it in exchange for an irrevocable obligation to a third party.

2. *Security interest*. Value is not limited to cash or the fulfillment of a contractual obligation. A holder who acquires a lien on, or a security interest in, an instrument other than by legal process has taken for value.

3. *Antecedent debt*. Likewise, taking an instrument in payment of, or as security for, a prior claim, whether or not the claim is due, is a taking for value. Blackstone owes Webster $1,000, due in thirty days. Blackstone unexpectedly receives a refund check for $1,000 from the Internal Revenue Service and indorses it to Webster. Webster is an HDC though he gave value in the past.

The rationale for the rule of value is that if the holder has not yet given anything of value in exchange for the instrument, he still has an effective remedy should the instrument prove defective: he can rescind the transaction, given the transferor's breach of warranty.

In Good Faith

Section 3-103(4) of the UCC defines **good faith** as "honesty in fact and the observance of reasonable commercial standards of fair dealing."

Honesty in Fact

"Honesty in fact" is subjectively tested. Suppose Lorna Love had given Rackets, Inc., a promissory note for the tennis rackets. Knowing that it intended to deliver defective tennis rackets and that Love is likely to protest as soon as the shipment arrives, Rackets offers a deep discount on the note to its fleet mechanic: instead of the $1,000 face value of the note, Rackets will give it to him in payment of an outstanding bill of $400. The mechanic, being naive in commercial dealings, has no suspicion from the large discount that Rackets might be committing fraud. He has acted in good faith under the UCC test. That is not to say that no set of circumstances will ever exist to warrant a finding that there was a lack of good faith.

Observance of Reasonable Commercial Standards of Fair Dealing

Whether reasonable commercial standards were observed in the dealings is objectively tested, but buying an instrument at a discount—as was done in the tennis rackets example—is not commercially unreasonable, necessarily.

Without Notice

It obviously would be unjust to permit a holder to enforce an instrument that he knew—when he acquired it—was defective, was subject to claims or defenses, or had been dishonored. A purchaser with knowledge cannot become an HDC. But proving knowledge is difficult, so the UCC at Section 3-302(2) lists several types of notice that presumptively defeat any entitlement to status as HDC. Notice is not limited to receipt of an explicit statement; it includes an inference that a person should have made from the circumstances. The explicit things that give a person notice include those that follow.

Without Notice That an Instrument Is Overdue

The UCC provides generally that a person who has notice that an instrument is overdue cannot be an HDC. What constitutes notice? When an inspection of the instrument itself would show that it was due before the purchaser acquired it, notice is presumed. A transferee to whom a promissory note due April 23 is negotiated on April 24 has notice that it was overdue and consequently is not an HDC. Not all paper contains a due date for the entire amount, and demand paper has no due date at all. In Sections 3-302(a)(2) and 3-304, the UCC sets out specific rules dictating what is overdue paper.

Without Notice That an Instrument Has Been Dishonored

Dishonor means that instrument is not paid when it is presented to the party who should pay it.

Without Notice of a Defense or Claim

A purchaser of an instrument cannot be an HDC if he has notice that there are any defenses or claims against it. A defense is a reason why the would-be obligor will not pay; a claim is an assertion of ownership in the instrument. If a person is fraudulently induced to issue or make an instrument, he has a claim to its ownership and a defense against paying.

Without Notice of Unauthorized Signature or Alteration

This is pretty clear: a person will fail to achieve the HDC status if he has notice of alteration or an unauthorized signature.

Without Reason to Question the Instrument's Authenticity Because of Apparent Forgery, Alteration, or Other Irregularity or Incompleteness as to Call into Question Its Authenticity

This also is pretty straightforward, though it is worth observing that a holder will flunk the HDC test if she has notice of unauthorized signature or alteration, or if she *should* have notice on account of apparent irregularity. So a clever forgery would not by itself defeat the HDC status, unless the holder had notice of it.

Payee as Holder in Due Course

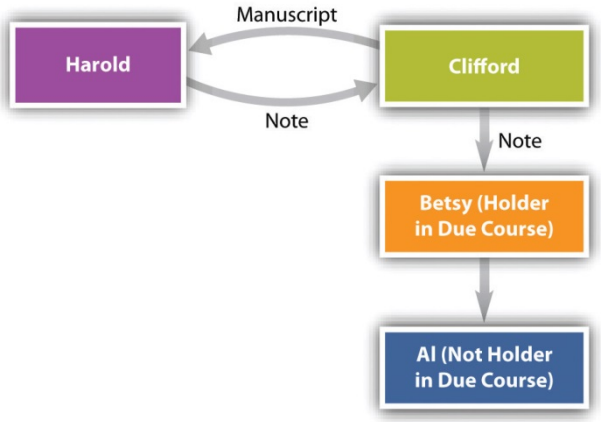
The payee can be an HDC, but in the usual circumstances, a payee would have knowledge of claims or defenses because the payee would be one of the original parties to the instrument. Nevertheless, a payee may be an HDC if all the prerequisites are met. For instance, Blackstone fraudulently convinces Whitestone into signing a note as a comaker, with Greenstone as the payee. Without authority, Blackstone then delivers the note for value to Greenstone. Having taken the note in good faith, for value, without notice of any problems, and without cause to question its validity because of apparent irregularities, Greenstone is an HDC. In any event, typically the HDC is not the payee of the instrument, but rather, is an immediate or remote transferee of the payee.

The Shelter Rule

There is one last point to mention before we get to the real nub of the holder-in-due-course concept (that the sins of her predecessors are washed away for an HDC). The **shelter rule** provides that the transferee of an instrument acquires the same rights that the transferor had. Thus a person who does not himself qualify as an HDC can still acquire that status if some previous holder (someone "upstream") was an HDC.

On June 1, Clifford sells Harold the original manuscript of Benjamin Franklin's autobiography. Unknown to Harold, however, the manuscript is a forgery. Harold signs a promissory note payable to Clifford for $250,000 on August 1. Clifford negotiates the note to Betsy on July 1 for $200,000; she is unaware of the fraud. On August 2, Betsy gives the note to Al as a token of her affection. Al is Clifford's friend and knows about the scam (see Figure 21.1 "The Shelter Rule"). May Al collect?

Figure 21.1 *The Shelter Rule*



Begin the analysis by noting that Al is not an HDC. Why? For three reasons: he did not take the instrument for value (it was a gift), he did not take in good faith (he knew of the fraud), and he had notice (he acquired it after the due date). Nevertheless, Al is entitled to collect from Harold the full $250,000. His right to do so flows from UCC, Section 3-203(b): "Transfer of an instrument, whether or not the transfer is a negotiation, vests in the transferee any right of the transferor to enforce the instrument, including any right as a holder in due course, but the transferee cannot acquire rights of a holder in due course by a direct or indirect transfer from a holder in due course if the transferee engaged in fraud or illegality affecting the instrument."

By virtue of the shelter rule, Al as transferee from Betsy acquires all rights that she had as transferor. Clearly Betsy is an HDC: she paid for the instrument, she took it in good faith, had no notice of any claim or defense against the instrument, and there were no apparent irregularities. Since Betsy is an HDC, so is Al. His knowledge of the fraud does not undercut his rights as HDC because he was not a party to it and was not a prior holder. Now suppose that after negotiating the instrument to Betsy, Clifford repurchased

it from her. He would not be an HDC—and would not acquire all Betsy's rights—because he had been a party to fraud and as a prior holder had notice of a defense. The purpose of the shelter rule is "to assure the holder in due course a free market for the paper."[2]

KEY TAKEAWAY

The holder-in-due-course doctrine is important because it allows the holder of a negotiable instrument to take the paper free from most claims and defenses against it. Without the doctrine, such a holder would be a mere transferee. The UCC provides that to be an HDC, a person must be a holder of paper that is not suspiciously irregular, and she must take it in good faith, for value, and without notice of anything that a reasonable person would recognize as tainting the instrument. A payee may be an HDC but usually would not be (because he would know of problems with it). The shelter rule says that a transferee of an instrument acquires the same rights her transferor had, so a person can have the rights of an HDC without satisfying the requirements of an HDC (provided she does not engage in any fraud or illegality related to the transaction).

EXERCISES

1. Summarize the requirements to be a holder in due course.
2. Why is the status of holder in due course important in commercial transactions?
3. Why is it unlikely that a payee would be a holder in due course?
4. What is the shelter rule, and why does it exist?

---

[1] Uniform Commercial Code, Section 1-201(20).

[2] Uniform Commercial Code, Section 3-203, Comment 2.

21.2 Defenses and Role in Consumer Transactions

CC BY NC SA

LEARNING OBJECTIVE

1. Know to what defenses the holder in due course is not subject.
2. Know to what defenses the holder in due course is subject.
3. Understand how the holder-in-due-course doctrine has been modified for consumer transactions and why.

Defenses

We mentioned in Section 21.1 "Holder in Due Course" that the importance of the holder-in-due-course status is that it promotes ready transferability of commercial paper by giving transferees confidence that they can buy and in turn sell negotiable instruments without concern that somebody upstream—previous holders in the chain of distribution—will have some reason not to pay. The holder-in-due-course doctrine makes the paper almost as readily transferable as cash. Almost, but not quite. We examine first the defenses to which the holder in due course (HDC) is *not subject* and then—the "almost" part—the defenses to which even HDCs are subject.

Holder in Due Course Is Not Subject to Personal Defenses

An HDC is *not* subject to the obligor's **personal defenses**. But a holder who is not an HDC is subject to them: he takes a negotiable instrument subject to the possible personal claims and defenses of numerous people.

In general, the personal defenses—to which the HDC is *not* subject—are similar to the whole range of defenses for breach of simple contract: lack of consideration; failure of consideration; duress, undue influence, and misrepresentation that does not render the transaction void; breach of warranty; unauthorized completion of an incomplete instrument; prior payment. Incapacity that does not render the transaction void (except infancy) is also a personal defense. As the Uniform Commercial Code (UCC) puts it, this includes "mental incompetence, guardianship, ultra vires acts or lack of corporate capacity to do business, or any other incapacity apart from infancy. If under the state law the effect is to render the obligation of the instrument entirely null and void, the defense may be asserted against a holder in due

course. If the effect is merely to render the obligation voidable at the election of the obligor, the defense is cut off." [1] James White and Robert Summers, in their hornbook on the UCC, opine that unconscionability is almost always a personal defense, not assertable against an HDC. [2] But again, the HDC takes free only from personal defenses of parties with whom she has not dealt. So while the payee of a note can be an HDC, if he dealt with the maker, he is subject to the maker's defenses.

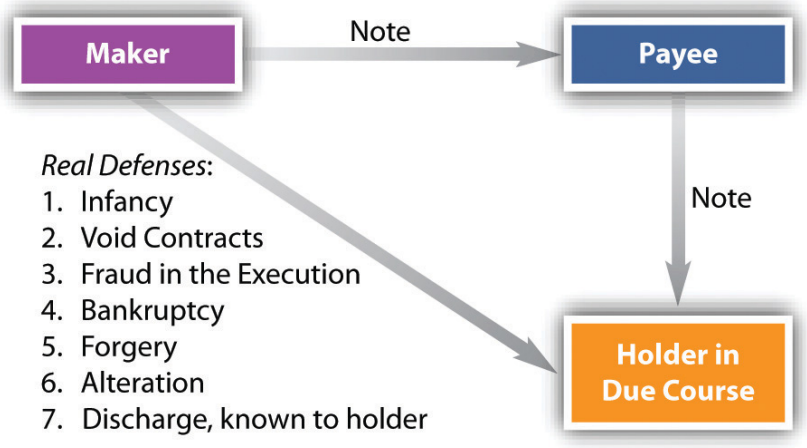
Holder in Due Course Is Subject to Real Defenses

An HDC in a nonconsumer transaction is not subject to personal defenses, but he *is* subject to the so-called **real defenses** (or "universal defenses")—they are good against an HDC.

The real defenses good against any holder, including HDCs, are as follows (see Figure 21.2 "Real Defenses"):

1. Unauthorized signature (forgery) (UCC, Section 3-401(a))
2. Bankruptcy (UCC, Section 3-305(a))
3. Infancy (UCC, Section 3-305(a))
4. Fraudulent alteration (UCC, Section 3-407(b) and (c))
5. Duress, mental incapacity, or illegality that renders the obligation void (UCC, Section 3-305(a))
6. Fraud in the execution (UCC, Section 3-305(a))
7. Discharge of which the holder has notice when he takes the instrument (UCC, Section 3-601)

Figure 21.2 Real Defenses



Analysis of the Real Defenses

Though most of these concepts are pretty clear, a few comments by way of analysis are appropriate.

Forgery

Forgery is a real defense to an action by an HDC. As we have noted, though, negligence in the making or handling of a negotiable instrument may cut off this defense against an HDC—as, for example, when a drawer who uses a rubber signature stamp carelessly leaves it unattended. And notice, too, that Section 3-308 of the UCC provides that signatures are presumed valid unless their validity is specifically denied, at which time the burden shifts to the person claiming validity. These issues are discussed in *Triffin v. Somerset Valley Bank*, in Section 21.3 "Cases" of this chapter.

Bankruptcy

Drawers, makers, and subsequent indorsers are not liable to an HDC if they have been discharged in bankruptcy. If they were, bankruptcy would not serve much purpose.

Infancy

Whether an infant's signature on a negotiable instrument is a valid defense depends on the law of the state. In some states, for instance, an infant who misrepresents his age is estopped from asserting infancy as a defense to a breach of contract. In those states, infancy would not be available as a defense against the effort of an HDC to collect.

Fraudulent Alteration

Under Section 3-407 of the UCC, "fraudulent alteration" means either (1) an unauthorized change in an instrument that purports to modify in any respect the obligation of a party or (2) an unauthorized addition of words or numbers or other change to an incomplete instrument relating to the obligation of a party. An alteration fraudulently made discharges a party whose obligation is affected by the alteration unless that party assents or is precluded from asserting the alteration. But a nonfraudulent alteration—for

example, filling in an omitted date or giving the obligor the benefit of a lower interest rate—does not discharge the obligor. In any case, the person paying or taking the instrument may pay or collect "according to its original terms, or in the case of an incomplete instrument that is altered by unauthorized completion, according to its terms as completed. If blanks are filled or an incomplete instrument is otherwise completed, subsection (c) places the loss upon the party who left the instrument incomplete by permitting enforcement in its completed form. This result is intended even though the instrument was stolen from the issuer and completed after the theft." A moral here: don't leave instruments lying around with blanks that could be filled in.

Void Contract

A void contract is distinguished from a voidable contract; only the former is a real defense.

Fraud in the Execution

You may recall that this is the rather unusual situation in which a person is tricked into signing a document. Able holds out a piece of paper for her boss and points to the signature line, saying, "This is a receipt for goods we received a little while ago." Baker signs it. It is not a receipt; it's the signature line on a promissory note. Able has committed fraud in the execution, and the note is void.

Discharge of Which the Holder Has Notice

If the holder knows that the paper—a note, say—has already been paid, she cannot enforce it. That's a good reason to take back any note you have made from the person who presents it to you for payment.

Consumer Transactions and Holders in Due Course

The holder-in-due-course doctrine often worked considerable hardship on the consumer, usually as the maker of an installment note.

For example, a number of students are approached by a gym owner who induces them to sign one-year promissory notes for $150 for a one-year gym membership. The owner says, "I know that right now the equipment in the gym is pretty rudimentary, but then, too, $150 is about half what you'd pay at the YMCA

or Gold's Gym. And the thing is, as we get more customers signing up, we're going to use the money to invest in new equipment. So within several months we'll have a fully equipped facility for your use." Several students sign the notes, which the owner sells to a **factor** (one that lends money to another, taking back a negotiable instrument as security, usually at about a 20 percent discount). The factor takes as an apparent HDC, but the gym idea doesn't work and the owner declares bankruptcy. If this were a commercial transaction, the makers (the students) would still owe on the notes even if there was, as here, a complete failure of consideration (called "paying on a dead horse"). But the students don't have to pay.

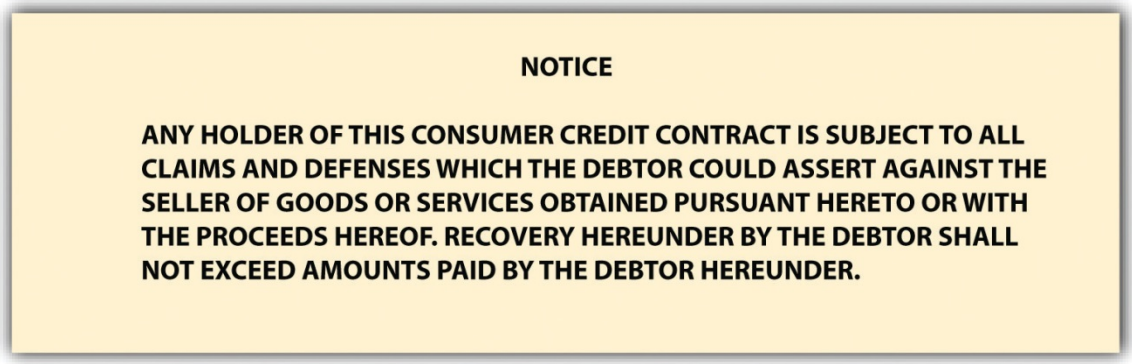
Whether the gym owner here committed fraud is uncertain, but the holder-in-due-course doctrine did often work to promote fraud. Courts frequently saw cases brought by credit companies (factors) against consumers who bought machines that did not work and services that did not live up to their promises. The ancient concept of an HDC did not square with the realities of modern commerce, in which instruments by the millions are negotiated for uncompleted transactions. The finance company that bought such commercial paper could never have honestly claimed (in the sociological sense) to be wholly ignorant that many makers will have claims against their payees (though they could and did make the claim in the legal sense).

Acting to curb abuses, the Federal Trade Commission (FTC) in 1976 promulgated a trade regulation rule that in effect abolished the holder-in-due-course rule for consumer credit transactions. Under the FTC rule titled "Preservation of Consumers' Claims and Defenses," [3] the creditor becomes a mere holder and stands in the shoes of the seller, subject to all claims and defenses that the debtor could assert against the seller. Specifically, the rule requires the seller to provide notice in any consumer credit contract that the debtor is entitled to raise defenses against any subsequent purchaser of the paper. It also bars the seller from accepting any outside financing unless the loan contract between the consumer and the outside finance company contains a similar notice. (The required notice, to be printed in no less than ten-point, boldface type, is set out in Figure 21.3 "Notice of Defense".) The effect of the rule is to ensure that a consumer's claim against the seller will not be defeated by a transfer of the paper. The FTC rule has this effect because the paragraph to be inserted in the consumer credit contract gives the holder notice sufficient to prevent him from becoming an HDC.

The rule applies only to consumer credit transactions. A **consumer transaction** is defined as a purchase of goods or services by a natural person, not a corporation or partnership, for personal, family, or household use from a seller in the ordinary course of business.[4] Purchases of goods or services for commercial purposes and purchases of interests in real property, commodities, or securities are not affected. The rule applies to any credit extended by the seller himself (except for credit card transactions) or to any "purchase money loan." This type of loan is defined as a cash advance to the consumer applied in whole or substantial part to a purchase of goods or services from a seller who either (a) refers consumers to the creditor or (b) is affiliated with the creditor. The purpose of this definition is to prevent the seller from making an end run around the rule by arranging a loan for the consumer through an outside finance company. The rule does not apply to a loan that the consumer arranges with an independent finance company entirely on his own.

The net effect of the FTC rule is this: the holder-in-due-course doctrine is virtually dead in consumer credit contracts. It remains alive and flourishing as a legal doctrine in all other business transactions.

Figure 21.3 *Notice of Defense*



KEY TAKEAWAY

The privileged position of the HDC stands up against the so-called personal defenses, which are—more or less—the same as typical defenses to obligation on any contract, *not including*, however, the real defenses. Real defenses are good against any holder, including an HDC. These are infancy, void obligations, fraud in the execution, bankruptcy, discharge of which holder has notice, unauthorized signatures, and fraudulent

alterations. While a payee may be an HDC, his or her rights as such are limited to avoiding defenses of persons the payee did not deal with. The shelter rule says that the transferee of an instrument takes the same rights that the transferor had. The Federal Trade Commission has abrogated the holder-in-due-course doctrine for consumer transactions.

EXERCISES

1. What purpose does the holder-in-due-course doctrine serve?
2. What defenses is an HDC not subject to? What defenses is an HDC subject to?
3. What is the Shelter Rule, and what purpose does it serve?
4. For what transactions has the FTC abolished the holder-in-due-course doctrine and why?
5. Under what circumstances is a forged signature valid?

---

[1] Uniform Commercial Code, Section 3-305, Comment 1.

[2] James White and Robert Summers, Uniform Commercial Code, 2/e, 575 (1980).

[3] 16 *Code of Federal Regulations*, Section 433.

[4] Uniform Commercial Code, Section 2-201(11).

21.3 Cases

Executory Promise as Satisfying "Value"

Carter & Grimsley v. Omni Trading, Inc.

716 N.E.2d 320 (Ill. App. 1999)

Lytton, J.

Facts

CC BY NC SA

Omni purchased some grain from Country Grain, and on February 2, 1996, it issued two checks, totaling $75,000, to Country Grain. Country Grain, in turn, endorsed the checks over to Carter as a retainer for future legal services. Carter deposited the checks on February 5; Country Grain failed the next day. On February 8, Carter was notified that Omni had stopped payment on the checks. Carter subsequently filed a complaint against Omni...alleging that it was entitled to the proceeds of the checks, plus pre-judgment interest, as a holder in due course....[Carter moved for summary judgment; the motion was denied.]

Discussion

Carter argues that its motion for summary judgment should have been granted because, as a holder in due course, it has the right to recover on the checks from the drawer, Omni.

The Illinois Uniform Commercial Code (UCC) defines a holder in due course as:

> *"the holder of an instrument if:*
>
> *(1) the instrument when issued does not bear such apparent evidence of forgery or alteration or is not otherwise so irregular or incomplete as to call into question its authenticity, and (2) the holder took the instrument (i) for value,...*

Section 3-303(a) of the UCC also states that:

> *(a) "An instrument is issued or transferred for value if: (1) the instrument is issued or transferred for a promise of performance,* ***to the extent that the promise has been performed*** ** * *." (emphasis added)*

Carter contends that in Illinois a contract for future legal services should be treated differently than other executory contracts. It contends that when the attorney-client relationship is created by payment of a fee

or retainer, the contract is no longer executory. Thus, Carter would achieve holder in due course status. We are not persuaded.

A retainer is the act of a client employing an attorney; it also denotes the fee paid by the client when he retains the attorney to act for him. [Citation] We have found no Illinois cases construing section 3-303(a) as it relates to a promise to perform future legal services under a retainer. The general rule, however, is that "an executory promise is not value." [Citation] "[T]he promise does not rise to the level of 'value' in the commercial paper market until it is actually performed." [Citation]

The UCC comment to section 303 gives the following example:

"Case # 2. X issues a check to Y in consideration of Y's promise to perform services in the future. Although the executory promise is consideration for issuance of the check it is value only to the extent the promise is performed.

We have found no exceptions to these principles for retainers. Indeed, courts in other jurisdictions interpreting similar language under section 3-303 have held that attorneys may be holders in due course only to the extent that they have actually performed legal services prior to acquiring a negotiable instrument. See [Citations: Pennsylvania, Florida, Massachusetts]. We agree.

This retainer was a contract for future legal services. Under section 3-303(a)(1), it was a "promise of performance," not yet performed. Thus, no value was received, and Carter is not a holder in due course.

Furthermore, in this case, no evidence was presented in the trial court that Carter performed any legal services for Country Grain prior to receiving the checks. Without an evidentiary basis for finding that Carter received the checks for services performed, the trial court correctly found that Carter failed to prove that it was a holder in due course. [Citations]

Conclusion

Because we have decided that Carter did not take the checks for value under section 3-303(a) of the UCC, we need not address its other arguments.

The judgment of the circuit court of Peoria County is affirmed.

Holdridge, J., dissenting.

I respectfully dissent. In a contractual relationship between attorney and client, the payment of a fee or retainer creates the relationship, and once that relationship is created the contract is no longer executory. [Citation] Carter's agreement to enter into an attorney-client relationship with Country Grain was the value exchanged for the checks endorsed over to the firm. Thus, the general rule cited by the majority that "an executory promise is not value" does not apply to the case at bar. On that basis I would hold that the trial court erred in determining that Carter was not entitled to the check proceeds and I therefore dissent.

CASE QUESTIONS

1. How did Carter & Grimsley obtain the two checks drawn by Omni?
2. Why—apparently—did Omni stop payments on the checks?
3. Why did the court determine that Carter was not an HDC?
4. Who is it that must have performed here in order for Carter to have been an HDC, Country Grain or Carter?
5. How could making a retainer payment to an attorney be considered anything other than payment on an executory contract, as the dissent argues?

The "Good Faith and Reasonable Commercial Standards" Requirement

Buckeye Check Cashing, Inc. v. Camp

825 N.E.2d 644 (Ohio App. 2005)

Donovan, J.

Defendant-appellant Shawn Sheth appeals from a judgment of the Xenia Municipal Court in favor of plaintiff-appellee Buckeye Check Cashing, Inc. ("Buckeye"). Sheth contends that the trial court erred in finding that Buckeye was a holder in due course of a postdated check drawn by Sheth and therefore was entitled to payment on the instrument despite the fact that Sheth had issued a stop-payment order to his bank.

In support of this assertion, Sheth argues that the trial court did not use the correct legal standard in granting holder-in-due-course status to Buckeye. In particular, Sheth asserts that the trial court used the pre-1990 Uniform Commercial Code ("UCC") definition of "good faith" as it pertains to holder-in-due-course status, which defined it as "honesty in fact." The definition of "good faith" was extended by the authors of the UCC in 1990 to also mean "the observance of reasonable commercial standards of fair dealing." The post-1990 definition was adopted by the Ohio legislature in 1994.

Sheth argues that while Buckeye would prevail under the pre-1990, "honesty in fact" definition of "good faith," it failed to act in a commercially reasonable manner when it chose to cash the postdated check drawn by Sheth. The lower court...adjudged Buckeye to be a holder in due course and, therefore, entitled to payment. We conclude that the trial court used the incorrect "good faith" standard when it granted holder-in-due-course status to Buckeye because Buckeye did not act in a commercially reasonable manner when it cashed the postdated check drawn by Sheth. Because we accept Sheth's sole assignment of error, the judgment of the trial court is reversed.

On or about October 12, 2003, Sheth entered into negotiations with James A. Camp for Camp to provide certain services to Sheth by October 15, 2003. To that end, Sheth issued Camp a check for $1,300. The check was postdated to October 15, 2003.

On October 13, 2003, Camp negotiated the check to Buckeye and received a payment of $1,261.31. Apparently fearing that Camp did not intend to fulfill his end of the contract, Sheth contacted his bank on October 14, 2003, and issued a stop-payment order on the check. Unaware of the stop-payment order, Buckeye deposited the check with its own bank on October 14, 2003, believing that the check would reach

Sheth's bank by October 15, 2003. Because the stop-payment order was in effect, the check was ultimately dishonored by Sheth's bank. After an unsuccessful attempt to obtain payment directly from Sheth, Buckeye brought suit.

Sheth's sole assignment of error is as follows:

"The trial court erred by applying the incorrect legal standard in granting holder in due course status to the plaintiff-appellee because the plaintiff-appellee failed to follow commercially reasonable standards in electing to cash the check that gives rise to this dispute."

[UCC 3-302] outlines the elements required to receive holder-in-due-course status. The statute states:

...'holder in due course' means the holder of an instrument if both of the following apply:

> *"(1) The instrument when issued or negotiated to the holder does not bear evidence of forgery or alteration that is so apparent, or is otherwise so irregular or incomplete as to call into question its authenticity;*
> *"(2) The holder took the instrument under all of the following circumstances:*
> *(a) For value;*
> *(b)* ***In good faith****;*
> *(c) Without notice that the instrument is overdue or has been dishonored or that there is an uncured default with respect to payment of another instrument issued as part of the same series;*
> *(d) Without notice that the instrument contains an unauthorized signature or has been altered;*
> *(e) Without notice of any claim to the instrument as described in [3-306];*
> *(f) Without notice that any party has a defense or claim in recoupment described in [UCC 3-305(a); emphasis added].*

At issue in the instant appeal is whether Buckeye acted in "good faith" when it chose to honor the postdated check originally drawn by Sheth....UCC 1-201, defines "good faith" as "honesty in fact and the observance of reasonable commercial standards of fair dealing." Before the Ohio legislature amended

UCC 1-201 in 1994, that section did not define "good faith"; the definition of "good faith" as "honesty in fact" in UCC 1-201 was the definition that applied[.]...

"Honesty in fact" is defined as the absence of bad faith or dishonesty with respect to a party's conduct within a commercial transaction. [Citation] Under that standard, absent fraudulent behavior, an otherwise innocent party was assumed to have acted in good faith. The "honesty in fact" requirement, also known as the "pure heart and empty head" doctrine, is a subjective test under which a holder had to subjectively believe he was negotiating an instrument in good faith for him to become a holder in due course. Maine [Citation, 1999].

In 1994, however, the Ohio legislature amended the definition of "good faith" to include not only the subjective "honesty in fact" test, but also an objective test: "the observance of reasonable commercial standards of fair dealing." Ohio UCC 1-201(20). A holder in due course must now satisfy both a subjective and an objective test of good faith. What constitutes "reasonable commercial standards of fair dealing" for parties claiming holder-in-due-course status, however, has not heretofore been defined in the state of Ohio.

In support of his contention that Buckeye is not a holder in due course, Sheth cites a decision from the Supreme Court of Maine, [referred to above] in which the court provided clarification with respect to the objective prong of the "good faith" analysis:

> *"The fact finder must therefore determine, first, whether the conduct of the holder comported with industry or 'commercial' standards applicable to the transaction and second, whether those standards were reasonable standards intended to result in fair dealing. Each of those determinations must be made in the context of the specific transaction at hand. If the fact finder's conclusion on each point is 'yes,' the holder will be determined to have acted in good faith even if, in the individual transaction at issue, the result appears unreasonable. Thus, a holder may be accorded holder in due course where it acts pursuant to those reasonable commercial standards of fair dealing—even if it is negligent—but may lose that status, even where it complies with*

commercial standards, if those standards are not reasonably related to achieving fair dealing." *[Citation]*

Check cashing is an unlicensed and unregulated business in Ohio. [Citation] Thus, there are no concrete commercial standards by which check-cashing businesses must operate. Moreover, Buckeye argues that its own internal operating policies do not require that it verify the availability of funds, nor does Buckeye apparently have any guidelines with respect to the acceptance of postdated checks. Buckeye asserts that cashing a postdated check does not prevent a holder from obtaining holder-in-due-course status and cites several cases in support of this contention. All of the cases cited by Buckeye, however, were decided prior to the UCC's addition of the objective prong to the definition of "good faith."

Under a purely subjective "honesty in fact" analysis, it is clear that Buckeye accepted the check from Camp in good faith and would therefore achieve holder-in-due-course status. When the objective prong of the good faith test is applied, however, we find that Buckeye did not conduct itself in a commercially reasonable manner. While not going so far as to say that cashing a postdated check prevents a holder from obtaining holder-in-due-course status in every instance, the presentation of a postdated check should put the check cashing entity on notice that the check might not be good. Buckeye accepted the postdated check at its own peril. Some attempt at verification should be made before a check-cashing business cashes a postdated check. Such a failure to act does not constitute taking an instrument in good faith under the current objective test of "reasonable commercial standards" enunciated in [the UCC].

We conclude that in deciding to amend the good faith requirement to include an objective component of "reasonable commercial standards," the Ohio legislature intended to place a duty on the holders of certain instruments to act in a responsible manner in order to obtain holder-in-due-course status. When Buckeye decided to cash the postdated check presented by Camp, it did so without making any attempt to verify its validity. This court in no way seeks to curtail the free negotiability of commercial instruments. However, the nature of certain instruments, such as the postdated check in this case, renders it necessary for appellee Buckeye to take minimal steps to protect its interests. That was not done. Buckeye was put on notice that the check was not good until October 15, 2003. "Good faith," as it is defined in the UCC and the

Ohio Revised Code, requires that a holder demonstrate not only honesty in fact but also that the holder act in a commercially reasonable manner. Without taking any steps to discover whether the postdated check issued by Sheth was valid, Buckeye failed to act in a commercially reasonable manner and therefore was not a holder in due course.

Based upon the foregoing, Sheth's single assignment of error is sustained, the judgment of the Xenia Municipal Court is reversed, and this matter is remanded to that court for further proceedings in accordance with law and consistent with this opinion.

Judgment reversed, and cause remanded.

CASE QUESTIONS

1. Who was Camp? Why did Sheth give him a check? Why is the case titled *Buckeye v. Camp*?
2. How does giving someone a postdated check offer the drawer any protection? How does it give rise to any "notice that the check might not be good"?
3. If Camp had taken the check to Sheth's bank to cash it, what would have happened?
4. What difference did the court discern between the pre-1990 UCC Article 3 and the post-1990 Article 3 (that Ohio adopted in 1994)?

The Shelter Rule

Triffin v. Somerset Valley Bank

777 A.2d 993 (N.J. Ct. App. 2001)

Cuff, J.

This case concerns the enforceability of dishonored checks against the issuer of the checks under Article 3 of the Uniform Commercial Code (UCC), as implemented in New Jersey[.]

Plaintiff [Robert J. Triffin] purchased, through assignment agreements with check cashing companies, eighteen dishonored checks, issued by defendant Hauser Contracting Company (Hauser Co.). Plaintiff then filed suit...to enforce Hauser Co.'s liability on the checks. The trial court granted plaintiff's motion for summary judgment. Hauser Co. appeals the grant of summary judgment....We affirm.

In October 1998, Alfred M. Hauser, president of Hauser Co., was notified by Edwards Food Store in Raritan and the Somerset Valley Bank (the Bank), that several individuals were cashing what appeared to be Hauser Co. payroll checks. Mr. Hauser reviewed the checks, ascertained that the checks were counterfeits and contacted the Raritan Borough and Hillsborough Police Departments. Mr. Hauser concluded that the checks were counterfeits because none of the payees were employees of Hauser Co., and because he did not write the checks or authorize anyone to sign those checks on his behalf. At that time, Hauser Co. employed Automatic Data Processing, Inc. (ADP) to provide payroll services and a facsimile signature was utilized on all Hauser Co. payroll checks.

Mr. Hauser executed affidavits of stolen and forged checks at the Bank, stopping payment on the checks at issue. Subsequently, the Bank received more than eighty similar checks valued at $25,000 all drawn on Hauser Co.'s account.

Plaintiff is in the business of purchasing dishonored negotiable instruments. In February and March 1999, plaintiff purchased eighteen dishonored checks from four different check cashing agencies, specifying Hauser Co. as the drawer. The checks totaled $8,826.42. Pursuant to assignment agreements executed by plaintiff, each agency stated that it cashed the checks for value, in good faith, without notice of any claims or defenses to the checks, without knowledge that any of the signatures were unauthorized or forged, and with the expectation that the checks would be paid upon presentment to the bank upon which the checks were drawn. All eighteen checks bore a red and green facsimile drawer's signature stamp in the name of Alfred M. Hauser. All eighteen checks were marked by the Bank as "stolen check" and stamped with the warning, "do not present again."...

Plaintiff then filed this action against the Bank, Hauser Co.,...Plaintiff contended that Hauser Co. was negligent in failing to safeguard both its payroll checks and its authorized drawer's facsimile stamp, and was liable for payment of the checks.

The trial court granted plaintiff's summary judgment motion, concluding that no genuine issue of fact existed as to the authenticity of the eighteen checks at issue. Judge Hoens concluded that because the check cashing companies took the checks in good faith, plaintiff was a holder in due course as assignee. Judge Hoens also found that because the checks appeared to be genuine, Hauser Co. was required, but had failed, to show that plaintiff's assignor had any notice that the checks were not validly drawn....

Hauser Co. argues that summary judgment was improperly granted because the court failed to properly address Hauser Co.'s defense that the checks at issue were invalid negotiable instruments and therefore erred in finding plaintiff was a holder in due course.

As a threshold matter, it is evident that the eighteen checks meet the definition of a negotiable instrument [UCC 3-104]. Each check is payable to a bearer for a fixed amount, on demand, and does not state any other undertaking by the person promising payment, aside from the payment of money. In addition, each check appears to have been signed by Mr. Hauser, through the use of a facsimile stamp, permitted by the UCC to take the place of a manual signature. [Section 3-401(b) of the UCC] provides that a "signature may be made manually or by means of a device or machine...with present intention to authenticate a writing." It is uncontroverted by Hauser Co. that the facsimile signature stamp on the checks is identical to Hauser Co.'s authorized stamp.

Hauser Co., however, contends that the checks are not negotiable instruments because Mr. Hauser did not sign the checks, did not authorize their signing, and its payroll service, ADP, did not produce the checks. Lack of authorization, however, is a separate issue from whether the checks are negotiable instruments. Consequently, given that the checks are negotiable instruments, the next issue is whether the checks are unenforceable by a holder in due course, because the signature on the checks was forged or unauthorized.

[Sections 3-203 and 3-302 of the UCC] discuss the rights of a holder in due course and the rights of a transferee of a holder in due course. Section 3-302 establishes that a person is a holder in due course if:

> *(1) the instrument when issued or negotiated to the holder does not bear such apparent evidence of forgery or alteration or is not otherwise so irregular or incomplete as to call into question its authenticity; and*
> *(2) the holder took the instrument for value, in good faith, without notice that the instrument is overdue or has been dishonored or that there is an uncured default with respect to payment of another instrument issued as part of the same series, without notice that the instrument contains an unauthorized signature or has been altered, without notice of any claim to the instrument described in 3-306, and without notice that any party has a defense or claim in recoupment described in subsection a. of 3-305.*

Section 3-203 deals with transfer of instruments and provides:

> *a. An instrument is transferred when it is delivered by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument.*
> *b. Transfer of an instrument, whether or not the transfer is a negotiation, vests in the transferee any right of the transferor to enforce the instrument, including any right as a holder in due course, but the transferee cannot acquire rights of a holder in due course by a transfer, directly or indirectly, from a holder in due course if the transferee engaged in fraud or illegality affecting the instrument....*

Under subsection (b) a holder in due course that transfers an instrument transfers those rights as a holder in due course to the purchaser. The policy is to assure the holder in due course a free market for the instrument.

The record indicates that plaintiff has complied with the requirements of both sections 3-302 and 3-203. Each of the check cashing companies from whom plaintiff purchased the dishonored checks were holders in due course. In support of his summary judgment motion, plaintiff submitted an affidavit from each company; each company swore that it cashed the checks for value, in good faith, without notice of any claims or defenses by any party, without knowledge that any of the signatures on the checks were unauthorized or fraudulent, and with the expectation that the checks would be paid upon their presentment to the bank upon which the checks were drawn. Hauser Co. does not dispute any of the facts sworn to by the check cashing companies.

The checks were then transferred to plaintiff in accordance with section 3-303, vesting plaintiff with holder in due course status. Each company swore that it assigned the checks to plaintiff in exchange for consideration received from plaintiff. Plaintiff thus acquired the check cashing companies' holder in due course status when the checks were assigned to plaintiff. Moreover, pursuant to section 3-403(a)'s requirement that the transfer must have been made for the purpose of giving the transferee the right to enforce the instrument, the assignment agreements expressly provided plaintiff with that right, stating that "all payments [assignor] may receive from any of the referenced Debtors...shall be the exclusive property of [assignee]." Again, Hauser Co. does not dispute any facts relating to the assignment of the checks to plaintiff.

Hauser Co. contends, instead, that the checks are per se invalid because they were fraudulent and unauthorized. Presumably, this argument is predicated on section 3-302. This section states a person is not a holder in due course if the instrument bears "apparent evidence of forgery or alteration" or is otherwise "so irregular or incomplete as to call into question its authenticity."

In order to preclude liability from a holder in due course under section 3-302, it must be apparent on the face of the instrument that it is fraudulent. The trial court specifically found that Hauser Co. had provided no such evidence, stating that Hauser Co. had failed to show that there was anything about the appearance of the checks to place the check cashing company on notice that any check was not valid.

Specifically, with respect to Hauser Co.'s facsimile signature on the checks, the court stated that the signature was identical to Hauser Co.'s authorized facsimile signature. Moreover, each of the check cashing companies certified that they had no knowledge that the signatures on the checks were fraudulent or that there were any claims or defenses to enforcement of the checks. Hence, the trial court's conclusion that there was no apparent evidence of invalidity was not an abuse of discretion and was based on a reasonable reading of the record.

To be sure, section 3-308(a) does shift the burden of establishing the validity of the signature to the plaintiff, but only if the defendant specifically denies the signature's validity in the pleadings. The section states:

> *In an action with respect to an instrument, the authenticity of, and authority to make, each signature on the instrument is admitted unless specifically denied in the pleadings. If the validity of a signature is denied in the pleadings, the burden of establishing validity is on the person claiming validity, but the signature is presumed to be authentic and authorized unless the action is to enforce the liability of the purported signer and the signer is dead or incompetent at the time of trial of the issue of validity of the signature.*

Examination of the pleadings reveals that Hauser Co. did not specifically deny the factual assertions in plaintiff's complaint.

Hence, the trial court's conclusion that there was no apparent evidence of invalidity was not an abuse of discretion and was based on a reasonable reading of the record.

In conclusion, we hold that Judge Hoens properly granted summary judgment. There was no issue of material fact as to: (1) the status of the checks as negotiable instruments; (2) the status of the check cashing companies as holders in due course; (3) the status of plaintiff as a holder in due course; and (4) the lack of apparent evidence on the face of the checks that they were forged, altered or otherwise irregular. Moreover, Hauser Co.'s failure to submit some factual evidence indicating that the facsimile

signature was forged or otherwise unauthorized left unchallenged the UCC's rebuttable presumption that a signature on an instrument is valid. Consequently, the trial court properly held, as a matter of law, that plaintiff was a holder in due course and entitled to enforce the checks. Affirmed.

CASE QUESTIONS

1. Why did the plaintiff, Mr. Triffin, obtain possession of the dishonored checks? Regarding the plaintiff, consider this:http://caselaw.findlaw.com/nj-supreme-court/1332248.html.
2. Section 4-401 of the UCC says nobody is liable on an instrument unless the person signed it, and Section 4-403(a) provides that "an unauthorized signature is ineffective" (except as the signature of the unauthorized person), so how could Hauser Co. be liable at all? And why did the court never discuss plaintiff's contention that the defendant "was negligent in failing to safeguard both its payroll checks and its authorized drawer's facsimile stamp"?
3. Why didn't the Hauser Co. specifically deny the authenticity of the signatures?
4. Obviously, the plaintiff must have known that there was something wrong with the checks when he bought them from the check-cashing companies: they had been dishonored and were marked "Stolen, do not present again." Did he present them again?
5. While the UCC does not require that the transferee of an instrument acted in good faith in order to collect on the instrument as an HDC (though he can't have participated in any scam), it disallows a person from being an HDC if he takes an instrument with notice of dishonor. Surely the plaintiff had notice of that. What does the UCC require that transformed Mr. Triffin—via the shelter rule—into a person with the rights of an HDC?
6. If the plaintiff had not purchased the checks from the check-cashing companies, who would have taken the loss here?
7. What recourse does the defendant, Hauser Co., have now?
8. Authors' comment: How this scam unfolded is suggested in the following segment of an online guide to reducing financial transaction fraud.

   Recommendations: It is clear from this case that if a thief can get check stock that looks genuine, your company can be held liable for losses that may occur from those counterfeit

checks. Most companies buy check stock from vendors that sell the identical check stock entirely blank to other companies, totally uncontrolled, thus aiding the forgers. Many companies opt for these checks because they are less expensive than controlled, high security checks (excluding legal fees and holder in due course judgments). Forgers buy the check stock, and using a $99 scanner and Adobe Illustrator, create counterfeit checks that cannot be distinguished from the account holder's original checks. This is how legal exposure to a holder in due course claim can be and is created. Companies should use checks uniquely designed and manufactured for them, or buy from vendors such as SAFEChecks (http://www.safechecks.com) that customize every company's check and never sells check stock entirely blank without it first being customized for the end user.[1]

---

[1] Frank Abagnale and Greg Litster, *Holder in Due Course and Check Fraud*, TransactionDirectory.com.

21.4 Summary and Exercises

Summary

A holder is a holder in due course (HDC) if he takes the instrument without reason to question its authenticity on account of obvious facial irregularities, for value, in good faith, and without notice that it is overdue or has been dishonored, or that it contains a forgery or alteration, or that that any person has any defense against it or claim to it. The HDC takes the paper free of most defenses; an ordinary holder takes the paper as an assignee, acquiring only the rights of the assignor.

Value is not the same as consideration; hence, a promise will not satisfy this criterion until it has been performed. The HDC must have given something of value other than a promise to give.

Good faith means (1) honesty in fact in the conduct or transaction concerned and (2) the observance of reasonable commercial standards of fair dealing. Honesty in fact is a subjective test, but the observance of reasonable commercial standards is objective.

Notice is not limited to receipt of an explicit statement of defenses; a holder may be given notice through inferences that should be drawn from the character of the instrument. Thus an incomplete instrument, one that bears marks of forgery, or one that indicates it is overdue may give notice on its face. Certain facts do not necessarily give notice of defense or claim: that the instrument is antedated or postdated, that the instrument was negotiated in return for an executory promise, that any party has signed for accommodation, that an incomplete instrument has been completed, that any person negotiating the instrument is or was a fiduciary, or that there has been default in payment of interest or principal.
A person who could not have become an HDC directly (e.g., because he had notice of a defense or claim) may become so if he takes as transferee from an HDC as long as he was not a party to any fraud or illegality affecting the instrument or had not previously been a holder with notice of a defense or claim. This is the shelter rule.

Holders in due course are not immune from all defenses. A real, as opposed to a personal, defense may be asserted against the HDC. Personal defenses include fraud in the inducement, failure of consideration, nonperformance of a condition precedent, and the like. Real defenses consist of infancy, acts that would make a contract void (such as duress), fraud in the execution, forgery, and discharge in bankruptcy. A 1976 trade regulation rule of the Federal Trade Commission abolishes the holder-in-due-course rule for consumer transactions.

EXERCISES

1. Mike signed and delivered a note for $9,000 to Paul Payee in exchange for Paul's tractor. Paul transferred the note to Hilda, who promised to pay $7,500 for it. After Hilda had paid Paul $5,000 of the promised $7,500, Hilda learned that Mike had a defense: the tractor was defective. How much, if anything, can Hilda collect from Mike on the note, and why?

2. In Exercise 1, if Hilda had paid Paul $7,500 and then learned of Mike's defense, how much—if any of the amount—could she collect from Mike?
3. Tex fraudulently sold a boat, to which he did not have title, to Sheryl for $30,000 and received, as a deposit from her, a check in the amount of $5,000. He deposited the check in his account at First Bank and immediately withdrew $3,000 of the proceeds. When Sheryl discovered that Tex had no title, she called her bank (the drawee) and stopped payment on the check. Tex, in the meantime, disappeared. First Bank now wishes to collect the $3,000 from Sheryl, but she claims it is not an HDC because it did not give value for the check in that the payment to Tex was conditional: the bank retained the right to collect from Tex if it could not collect on the check. Is Sheryl correct? Explain.
4. Corporation draws a check payable to First Bank. The check is given to an officer of Corporation (known to Bank), who is instructed to deliver it to Bank in payment of a debt owed by Corporation to Bank. Instead, the officer, intending to defraud Corporation, delivers the check to Bank in payment of his personal debt. Bank has received funds of Corporation that have been used for the personal benefit of the officer. Corporation asserts a claim to the proceeds of the check against Bank. Is Bank an HDC of the check?
5. Contractor contracted with Betty Baker to install a new furnace in Baker's business. Baker wrote a check for $8,000 (the price quoted by Contractor) payable to Furnace Co., which Contractor delivered to Furnace Co. in payment of his own debt to it. Furnace Co. knew nothing of what went on between Contractor and Baker. When Contractor did not complete the job, Baker stopped payment on the check. Furnace Co. sued Baker, who defended by claiming failure of consideration. Is this a good defense against Furnace Co.?
6. Benson purchased a double-paned, gas-filled picture window for his house from Wonder Window, making a $200 deposit and signing an installment contract, which is here set out in its entirety:

> *October 3, 2012*
>
> *I promise to pay to Wonder Window or order the sum of $1,000 in five equal installments of $200.*
>
> *[Signed] Benson*

Wonder Window negotiated the installment contract to Devon, who took the instrument for value, in good faith, without notice of any claim or defense of any party, and without

CC BY NC SA

question of the instrument's authenticity. After Benson made three payments, the window fogged up inside and was unacceptable. Benson wants his money back from Wonder Window, and he wants to discontinue further payments. Can he do that? Explain.

7. The Turmans executed a deed of trust note (a note and mortgage) dated November 12, 2012, for $100,000 payable to Ward's Home Improvement, Inc. The note was consideration for a contract: Ward was to construct a home on the Turmans' property. The same day, Ward executed a separate written assignment of the note to Robert L. Pomerantz, which specifically used the word "assigns." Ward did not endorse the note to Pomerantz or otherwise write on it. Ward did not complete the house; to do so would require the expenditure of an additional $42,000. Pomerantz maintained he is a holder in due course of the $100,000 note and demanded payment from the Turmans. Does he get paid? Explain.[1]

SELF-TEST QUESTIONS

1 Which defeats a person from being an HDC?

a. She takes the paper in return for a promise by the maker or drawer to perform a service in the future.
b. She subjectively takes it in good faith, but most people would recognize the deal as suspect.
c. The instrument contains a very clever, almost undetectable forged signature.
d. The instrument was postdated.
e. All these are grounds to defeat the HDC status.

2 Personal defenses are

a. good against all holders
b. good against holders but not HDCs
c. good against HDCs but not holders
d. not good against any holder, HDC or otherwise
e. sometimes good against HDCs, depending on the facts

3 Fraud in the inducement is a _____ defense.

a. real

b. personal

4 A person would not be an HDC if she

a. was notified that payment on the instrument had been refused

b. knew that one of the prior indorsers had been discharged

c. understood that the note was collateral for a loan

d. purchased the note at a discount

5 Rock Industries agreed to sell Contractor gravel to repair an airport drain field. Contractor was uncertain how many loads of gravel would be needed, so he drew a check made out to "Rock Industries" as the payee but left the amount blank, to be filled in on the job site when the last load of gravel was delivered. Five truckloads, each carrying ten tons of gravel, were required, with gravel priced at $20 per ton. Thus Contractor figured he'd pay for fifty tons, or $1,000, but Rock Industries had apparently filled in the amount as $1,400 and negotiated it to Fairchild Truck Repair. Fairchild took it in good faith for an antecedent debt. Contractor will

a. be liable to Fairchild, but only for $1,000

b. be liable to Fairchild for $1,400

c. not be liable to Fairchild because the check was materially altered

d. not be liable to Fairchild because it did not give "value" for it to Rock Industries

SELF-TEST ANSWERS

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

---

[1] *Turman v. Ward's Home Imp., Inc.*, 1995 WL 1055769, Va. Cir. Ct. (1995).

Chapter 22
Liability and Discharge

LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The liability of an agent who signs commercial paper
2. What contract liability is imposed when a person signs commercial paper
3. What warranty liability is imposed upon a transferor
4. What happens if there is payment or acceptance by mistake
5. How parties are discharged from liability on commercial paper

In Chapter 19 "Nature and Form of Commercial Paper", Chapter 20 "Negotiation of Commercial Paper", and Chapter 21 "Holder in Due Course and Defenses", we focused on the methods and consequences of negotiating commercial paper when all the proper steps are followed. For example, a maker gives a negotiable note to a payee, who properly negotiates the paper to a third-party holder in due course. As a result, this third party is entitled to collect from the maker, unless the latter has a real defense.

In this chapter, we begin by examining a question especially important to management: personal liability for signing company notes and checks. Then we look at the two general types of liability—contract and warranty—introduced in Chapter 20 "Negotiation of Commercial Paper". We conclude the chapter by reviewing the ways in which parties are discharged from liability.

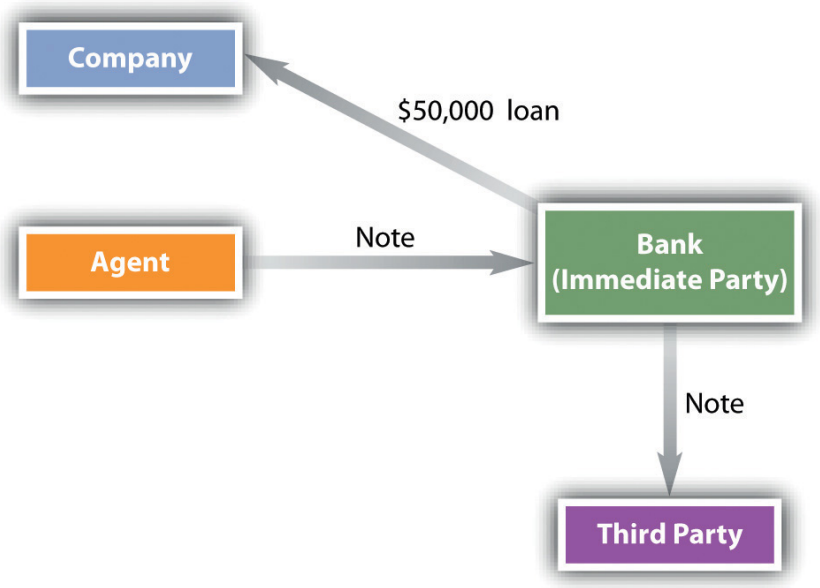
22.1 Liability Imposed by Signature: Agents, Authorized and Unauthorized

LEARNING OBJECTIVES

1. Recognize what a signature is under Article 3 of the Uniform Commercial Code.
2. Understand how a person's signature on an instrument affects liability if the person is an agent, or a purported agent, for another.

The liability of an agent who signs commercial paper is one of the most frequently litigated issues in this area of law. For example, Igor is an agent (treasurer) of Frank N. Stein, Inc. Igor signs a note showing that the corporation has borrowed $50,000 from First Bank. The company later becomes bankrupt. The question: Is Igor personally liable on the note? The unhappy treasurer might be sued by the bank—the immediate party with whom he dealt—or by a third party to whom the note was transferred (see Figure 22.1 "Signature by Representative").

Figure 22.1 Signature by Representative



There are two possibilities regarding an agent who signs commercial paper: the agent was authorized to do so, or the agent was not authorized to do so. First, though, what is a signature?

A "Signature" under the Uniform Commercial Code

Section 3-401 of the Uniform Commercial Code (UCC) provides fairly straightforwardly that "a signature can be made (i) manually or by means of a device or machine, and (ii) by the use of any name, including any trade or assumed name, or by any word, mark, or symbol executed or adopted by a person with the present intention to authenticate a writing."

Liability of an Agent Who Has Authority to Sign

Agents often sign instruments on behalf of their principals, and—of course—because a corporation's existence is a legal fiction (you can't go up and shake hands with General Motors), corporations can only act through their agents.

The General Rule

Section 3-402(a) of the UCC provides that a person acting (or purporting to act) as an agent who signs an instrument binds the principal to the same extent that the principal would be bound if the signature were on a simple contract. The drafters of the UCC here punt to the common law of agency: if, under agency

law, the principal would be bound by the act of the agent, the signature is the authorized signature of the principal. And the general rule in agency law is that the agent is not liable if he signs his own name and makes clear he is doing so as an agent. In our example, Igor should sign as follows: "Frank N. Stein, Inc., by Igor, Agent." Now it is clear under agency law that the corporation is liable and Igor is not.[1] Good job, Igor.

Incorrect Signatures

The problems arise where the agent, although authorized, signs in an incorrect way. There are three possibilities: (1) the agent signs only his own name—"Igor"; (2) the agent signs both names but without indication of any agency—"Frank N. Stein, Inc., / Igor" (the signature is ambiguous—are both parties to be liable, or is Igor merely an agent?); (3) the agent signs as agent but doesn't identify the principal—"Igor, Agent."

The UCC provides that in each case, the agent is liable to a holder in due course (HDC) who took the instrument without notice that the agent wasn't intended to be liable on the instrument. As to any other person (holder or transferee), the agent is liable unless she proves that the original parties to the instrument did not intend her to be liable on it. Section 3-402(c) says that, as to a *check*, if an agent signs his name without indicating agency status but the check has the principal's identification on it (that would be in the upper left corner), the authorized agent is not liable.

Liability of an "Agent" Who Has No Authority to Sign

A person who has no authority to sign an instrument cannot really be an "agent" because by definition an agent is a person or entity authorized to act on behalf of and under the control of another in dealing with third parties. Nevertheless, unauthorized persons not infrequently purport to act as agents: either they are mistaken or they are crooks. Are their signatures binding on the "principal"?

The General Rule

An unauthorized signature is not binding; it is—as the UCC puts it—"ineffective except as the signature of the unauthorized signer."[2] So if Crook signs a Frank N. Stein, Inc., check with the name "Igor," the only person liable on the check is Crook.

The Exceptions

There are two exceptions. Section 4-403(a) of the UCC provides that an unauthorized signature may be ratified by the principal, and Section 3-406 says that if negligence contributed to an instrument's alteration or forgery, the negligent person cannot assert lack of authority against an HDC or a person who in good faith pays or takes the instrument for value or for collection. This is the situation where Principal leaves the rubber signature stamp lying about and Crook makes mischief with it, making out a check to Payee using the stamp. But if Payee herself failed to exercise reasonable care in taking a suspicious instrument, both Principal and Payee could be liable, based on comparative negligence principles.[3]

KEY TAKEAWAY

Under the UCC, a "signature" is any writing or mark used by a person to indicate that a writing is authentic. Agents often sign on behalf of principals, and when the authorized agent makes clear that she is so signing—by naming the principal and signing her name as "agent"—the principal is liable, not the agent. But when the agent signs incorrectly, the UCC says, in general, that the agent is personally liable to an HDC who takes the paper without notice that the agent is not intended to be liable. Unauthorized signatures (forgeries) are ineffective as to the principal: they are effective as the forger's signature, unless the principal or the person paying on the instrument has been negligent in contributing to, or in failing to notice, the forgery, in which case comparative negligence principles are applied.

EXERCISES

1. Able signs his name on a note with an entirely illegible squiggle. Is that a valid signature?
2. Under what circumstances is an agent clearly not personally liable on an instrument?
3. Under what circumstances is a forgery effective as to the person whose name is forged?

[1] Uniform Commercial Code, Section 4-402(b)(1).

[2] Uniform Commercial Code, Section 3-403.

[3] Uniform Commercial Code, Section 3-406(b).

22.2 Contract Liability of Parties

LEARNING OBJECTIVE

1. Understand that a person who signs commercial paper incurs contract liability.
2. Recognize the two types of such liability: primary and secondary.
3. Know the conditions that must be met before secondary liability attaches.

Two types of liability can attach to those who deal in commercial paper: contract liability and warranty liability. Contract liability is based on a party's signature on the paper. For contract liability purposes, signing parties are divided into two categories: primary parties and secondary parties.

We discuss here the liability of various parties. You may recall the discussion in Chapter 19 "Nature and Form of Commercial Paper" about accommodation parties. An *accommodation party* signs a negotiable instrument in order to lend his name to another party to the instrument. The Uniform Commercial Code (UCC) provides that such a person "may sign the instrument as maker, drawer, acceptor, or indorser" and that in whatever capacity the person signs, he will be liable in that capacity.[1]

Liability of Primary Parties

Two parties are primarily liable: the maker of a note and the acceptor of a draft. They are required to pay by the terms of the instrument itself, and their liability is unconditional.

Maker

By signing a promissory note, the maker promises to pay the instrument—that's the maker's contract and, of course, the whole point to a note. The obligation is owed to a person entitled to enforce the note or to an indorser that paid the note.[2]

Acceptor

Recall that *acceptance* is the drawee's signed engagement to honor a draft as presented. The drawee's signature on the draft is necessary and sufficient to accept, and if that happens, the drawee as acceptor is primarily liable. The acceptance must be written on the draft by some means—any means is good. The signature is usually accompanied by some wording, such as "accepted," "good," "I accept." When a bank *certifies* a check, that is the drawee bank's acceptance, and the bank as acceptor becomes liable to the holder; the drawer and all indorsers prior to the bank's acceptance are discharged. So the holder—whether a payee or an indorsee—can look only to the bank, not to the drawer, for payment.[3] If the drawee varies the terms when accepting the draft, it is liable according to the terms as varied.[4]

Liability of Secondary Parties

Unlike primary liability, secondary liability is conditional, arising only if the primarily liable party fails to pay. The parties for whom these conditions are significant are the drawers and the indorsers. By virtue of UCC Sections 3-414 and 3-415, drawers and indorsers engage to pay the amount of an unaccepted draft to any subsequent holder or indorser who takes it up, again, *if* (this is the conditional part) the (1) the instrument is dishonored and, in some cases, (2) notice of dishonor is given to the drawer or indorser.

Drawer's Liability

If Carlos writes (more properly "draws") a check to his landlord for $700, Carlos does not expect the landlord to turn around and approach him for the money: Carlos's bank—the drawee—is supposed to pay from Carlos's account. But if the bank dishonors the check—most commonly because of insufficient funds to pay it—then Carlos is liable to pay according to the instrument's terms when he wrote the check or, if it

was incomplete when he wrote it, according to its terms when completed (subject to some limitations).[5] Under the pre-1997 UCC, Carlos's liability was conditioned not only upon dishonor but also upon notice of dishonor; however, under the revised UCC, notice is not required for the drawer to be liable unless the draft has been accepted and the acceptor is not a bank. Most commonly, if a check bounces, the person who wrote it is liable to make it good.

The drawer of a noncheck draft may disclaim her contractual liability on the instrument by drawing "without recourse."[6]

Indorser's Liability

Under UCC Section 3-415, an indorser promises to pay on the instrument according to its terms if it is dishonored or, if it was incomplete when indorsed, according to its terms when completed. The liability here is conditioned upon the indorser's receipt of *notice of dishonor* (with some exceptions, noted inSection 22.2 "Contract Liability of Parties" on contract liability of parties. Indorsers may disclaim contractual liability by indorsing "without recourse."[7]

Conditions Required for Liability

We have alluded to the point that secondary parties do not become liable unless the proper conditions are met—there are conditions precedent to liability (i.e., things have to happen before liability "ripens").

Conditions for Liability in General

The conditions are slightly different for two classes of instruments. For an unaccepted draft, the drawer's liability is conditioned on (1) presentment and (2) dishonor. For an accepted draft on a nonbank, or for an indorser, the conditions are (1) presentment, (2) dishonor, and (3) notice of dishonor.

Presentment

Presentment occurs when a person entitled to enforce the instrument (creditor) demands *payment* from the maker, drawee, or acceptor, or when a person entitled to enforce the instrument (again, the creditor) demands*acceptance* of a draft from the drawee.[8]

The common-law tort that makes a person who wrongfully takes another's property liable for that taking is **conversion**—it's the civil equivalent of theft. The UCC provides that "the law applicable to conversion of personal property applies to instruments."[9] Conversion is relevant here because if an instrument is presented for payment or acceptance and the person to whom it is presented refuses to pay, accept, or return it, the instrument is converted. An instrument is also converted if a person pays an instrument on a forged indorsement: a bank that pays a check on a forged indorsement has converted the instrument and is liable to the person whose indorsement was forged. There are various permutations on the theme of conversion; here is one example from the Official Comment:

> *A check is payable to the order of A. A indorses it to B and puts it into an envelope addressed to B. The envelope is never delivered to B. Rather, Thief steals the envelope, forges B's indorsement to the check and obtains payment. Because the check was never delivered to B, the indorsee, B has no cause of action for conversion, but A does have such an action. A is the owner of the check. B never obtained rights in the check. If A intended to negotiate the check to B in payment of an obligation, that obligation was not affected by the conduct of Thief. B can enforce that obligation. Thief stole A's property not B's.*[10]

Dishonor

Dishonor generally means failure by the obligor to pay on the instrument when presentment for payment is made (but return of an instrument because it has not been properly indorsed does not constitute dishonor). The UCC at Section 3-502 has (laborious) rules governing what constitutes dishonor and when dishonor occurs for a note, an unaccepted draft, and an unaccepted documentary draft. (A documentary draft is a draft to be presented for acceptance or payment if specified documents, certificates, statements, or the like are to be received by the drawee or other payor before acceptance or payment of the draft.)

Notice of Dishonor

Again, when acceptance or payment is refused after presentment, the instrument is said to be dishonored. The holder has a right of recourse against the drawers and indorsers, but he is usually supposed to give notice of the dishonor. Section 3-503(a) of the UCC requires the holder to give notice to a party before the party can be charged with liability, unless such notice is excused, but the UCC exempts notice in a number of circumstances (Section 3-504, discussed in Section 22.2 "Contract Liability of Parties" on contract liability). The UCC makes giving notice pretty easy: it permits any party who may be compelled to pay the instrument to notify any party who may be liable on it (but each person who is to be charged with liability must actually be notified); notice of dishonor may "be given by any commercially reasonable means including an oral, written, or electronic communication"; and no specific form of notice is required—it is "sufficient if it reasonably identifies the instrument and indicates that the instrument has been dishonored or has not been paid or accepted." [11] Section 3-503(c) sets out time limits when notice of dishonor must be given for collecting banks and for other persons. An oral notice is unwise because it might be difficult to prove. Usually, notice of dishonor is given when the instrument is returned with a stamp ("NSF"—the dreaded "nonsufficient funds"), a ticket, or a memo.

Suppose—you'll want to graph this out—Ann signs a note payable to Betty, who indorses it to Carl, who in turn indorses it to Darlene. Darlene indorses it to Earl, who presents it to Ann for payment. Ann refuses. Ann is the only primary party, so if Earl is to be paid he must give notice of dishonor to one or more of the secondary parties, in this case, the indorsers. He knows that Darlene is rich, so he notifies only Darlene. He may collect from Darlene but not from the others. If Darlene wishes to be reimbursed, she may notify Betty (the payee) and Carl (a prior indorser). If she fails to notify either of them, she will have no recourse. If she notifies both, she may recover from either. Carl in turn may collect from Betty, because Betty already will have been notified. If Darlene notifies only Carl, then she may collect only from him, but he must notify Betty or he cannot be reimbursed. Suppose Earl notified only Betty. Then Carl and Darlene are discharged. Why? Earl cannot proceed against them because he did not notify them. Betty cannot proceed against them because they indorsed subsequent to her and therefore were not contractually obligated to her. However, if, mistakenly believing that she could collect from either Carl or Darlene, Betty gave each notice within the time allowed to Earl, then he would be entitled to collect from one of them if Betty failed to pay, because they would have received notice. It is not necessary to receive notice from one

to whom you are liable; Section 3-503(b) says that notice may be given by any person, so that notice operates for the benefit of all others who have rights against the obligor.

There are some deadlines for giving notice: on an instrument taken for collection, a bank must give notice before midnight on the next banking day following the day on which it receives notice of dishonor; a nonbank must give notice within thirty days after the day it received notice; and in all other situations, the deadline is thirty days after the day dishonor occurred.[12]

Waived or Excused Conditions

Presentment and notice of dishonor have been discussed as conditions precedent for imposing liability upon secondarily liable parties (again, drawers and indorsers). But the UCC provides circumstances in which such conditions may be waived or excused.

Presentment Waived or Excused

Under UCC Section 3-504(a), presentment is excused if (1) the creditor cannot with reasonable diligence present the instrument; (2) the maker or acceptor has repudiated the obligation to pay, is dead, or is in insolvency proceedings; (3) no presentment is necessary by the instrument's terms; (4) the drawer or indorsers waived presentment; (5) the drawer instructed the drawee not to pay or accept; or (6) the drawee was not obligated to the drawer to pay the draft.

Notice of Dishonor Excused

Notice of dishonor is not required if (1) the instrument's terms do not require it or (2) the debtor waived the notice of dishonor. Moreover, a waiver of presentment is also a waiver of notice of dishonor. Delay in giving the notice is excused, too, if it is caused by circumstances beyond the control of the person giving notice and she exercised reasonable diligence when the cause of delay stopped.[13]

In fact, in real life, presentment and notice of dishonor don't happen very often, at least as to notes. Going back to presentment for a minute: the UCC provides that the "party to whom presentment is made [the debtor] may require exhibition of the instrument,...reasonable identification of the person demanding

payment,...[and] a signed receipt [from the creditor (among other things)]" (Section 3-501). This all makes sense: for example, certainly the prudent contractor paying on a note for his bulldozer wants to make sure the creditor actually still has the note (hasn't negotiated it to a third party) and is the correct person to pay, and getting a signed receipt when you pay for something is always a good idea. "Presentment" here is listed as a condition of liability, but in fact, most of the time there is no presentment at all:

> *[I]t's a fantasy. Every month millions of homeowners make payments on the notes that they signed when they borrowed money to buy their houses. Millions of college graduates similarly make payments on their student loan notes. And millions of drivers and boaters pay down the notes that they signed when they borrowed money to purchase automobiles or vessels. [Probably] none of these borrowers sees the notes that they are paying. There is no "exhibition" of the instruments as section 3-501 [puts it]. There is no showing of identification. In some cases...there is no signing of a receipt for payment. Instead, each month, the borrowers simply mail a check to an address that they have been given.* [14]

The Official Comment to UCC Section 5-502 says about the same thing:

> *In the great majority of cases presentment and notice of dishonor are waived with respect to notes. In most cases a formal demand for payment to the maker of the note is not contemplated. Rather, the maker is expected to send payment to the holder of the note on the date or dates on which payment is due. If payment is not made when due, the holder usually makes a demand for payment, but in the normal case in which presentment is waived, demand is irrelevant and the holder can proceed against indorsers when payment is not received.*

KEY TAKEAWAY

People who sign commercial paper become liable on the instrument by contract: they contract to honor the instrument. There are two types of liability: primary and secondary. The primarily liable parties are makers of

CC BY NC SA

notes and drawees of drafts (your bank is the drawee for your check), and their liability is unconditional. The secondary parties are drawers and indorsers. Their liability is conditional: it arises if the instrument has been presented for payment or collection by the primarily liable party, the instrument has been dishonored, and notice of dishonor is provided to the secondarily liable parties. The presentment and notice of dishonor are often unnecessary to enforce contractual liability.

EXERCISES

1. What parties have primary liability on a negotiable instrument?
2. What parties have secondary liability on a negotiable instrument?
3. Secondary liability is conditional. What are the conditions precedent to liability?
4. What conditions may be waived or excused, and how?

---

[1] Uniform Commercial Code, Section 3-419.

[2] Uniform Commercial Code, Section 3-412.

[3] Uniform Commercial Code, Section 3-414(b).

[4] Uniform Commercial Code, Section 3-413(a)(iii).

[5] Uniform Commercial Code, Section 3-414.

[6] Uniform Commercial Code, Section 3-414(d).

[7] Uniform Commercial Code, Section 3-415(b).

[8] Uniform Commercial Code, Section 3-501.

[9] Uniform Commercial Code, Section 3-420.

[10] Uniform Commercial Code, Section 3-420, Official Comment 1.

[11] Uniform Commercial Code, Section 3-503(b).

[12] Uniform Commercial Code, Section 3-503(c).

[13] Uniform Commercial Code, Section 3-504.

[14] Gregory E. Maggs, "A Complaint about Payment Law Under the U.C.C.: What You See Is Often Not What You Get," *Ohio State Law Journal* 68, no. 201, no. 207 (2007),http://ssrn.com/abstract=1029647.

22.3 Warranty Liability of Parties

LEARNING OBJECTIVES

1. Understand that independent of contract liability, parties to negotiable instruments incur warranty liability.
2. Know what warranties a person makes when she transfers an instrument.
3. Know what warranties a person makes when he presents an instrument for payment or acceptance.
4. Understand what happens if a bank pays or accepts a check by mistake.

Overview of Warranty Liability

We discussed the contract liability of primary and secondary parties, which applies to those who sign the instrument. Liability arises a second way, too—by warranty. A negotiable instrument is a type of property that is sold and bought, just the way an automobile is, or a toaster. If you buy a car, you generally expect that it will, more or less, work the way cars are supposed to work—that's the implied warranty of merchantability. Similarly, when an instrument is transferred from A to B for consideration, the transferee (B) expects that the instrument will work the way such instruments are supposed to work. If A transfers to B a promissory note made by Maker, B figures that when the time is right, she can go to Maker and get paid on the note. So A makes some implied warranties to B—transfer warranties. And when B presents the instrument to Maker for payment, Maker assumes that B as the indorsee from A is entitled to payment, that the signatures are genuine, and the like. So B makes some implied warranties to Maker—presentment warranties. Usually, claims of breach of warranty arise in cases involving forged, altered, or stolen instruments, and they serve to allocate the loss to the person in the best position to have avoided the loss, putting it on the person (or bank) who dealt with the wrongdoer. We take up both transfer and presentment warranties.

Transfer Warranties

Transfer warranties are important because—as we've seen—contract liability is limited to those who have actually signed the instrument. Of course, secondary liability will provide a holder with sufficient grounds for recovery against a previous indorser who did not qualify his indorsement. But sometimes there is no indorsement, and sometimes the indorsement is qualified. Sometimes, also, the holder fails to make timely presentment or notice of dishonor, thereby discharging a previous indorsee. In such cases, the transferee-holder can still sue a prior party on one or more of the five implied warranties.

A person who receives consideration for transferring an instrument makes the five warranties listed in UCC Section 3-416. The warranty may be sued on by the immediate transferee or, if the transfer was by indorsement, by any subsequent holder who takes the instrument in good faith. The warranties thus run with the instrument. They are as follows:

1. *The transferor is entitled to enforce the instrument*. The transferor warrants that he is—or would have been if he weren't transferring it—entitled to enforce the instrument. As UCC Section 3-416, Comment 2, puts it, this "is in effect a warranty that there are no unauthorized or missing indorsements that prevent the transferor from making the transferee a person entitled to enforce the instrument." Suppose Maker makes a note payable to Payee; Thief steals the note, forges Payee's indorsement, and sells the note. Buyer is not a holder because he is not "a person in possession of an instrument drawn, issued, or indorsed to him, or to his order, or to bearer, or in blank," so he is not entitled to enforce it. "'Person entitled to enforce' means (i) the holder, (ii) a non-holder in possession of the instrument who has the rights of a holder [because of the shelter rule]" (UCC, Section 3-301). Buyer sells the note to Another Party, who can hold Buyer liable for breach of the warranty: he was not entitled to enforce it.
2. *All signatures on the instrument are authentic and authorized*. This warranty would be breached, too, in the example just presented.
3. *The instrument has not been altered*.
4. *The instrument is not subject to a defense or claim in recoupment of any party that can be asserted against the warrantor*. "Recoupment" means to hold back or deduct part of what is due to another. The

Official Comment to UCC Section 3-416 observes, "[T]he transferee does not undertake to buy an instrument that is not enforceable in whole or in part, unless there is a contrary agreement. Even if the transferee takes as a holder in due course who takes free of the defense or claim in recoupment, the warranty gives the transferee the option of proceeding against the transferor rather than litigating with the obligor on the instrument the issue of the holder-in-due-course status of the transferee."

5. *The warrantor has no knowledge of any insolvency proceeding commenced with respect to the maker or acceptor or, in the case of an unaccepted draft, the drawer*. The UCC Official Comment here provides the following: "The transferor does not warrant against difficulties of collection, impairment of the credit of the obligor or even insolvency [only knowledge of insolvency]. The transferee is expected to determine such questions before taking the obligation. If insolvency proceedings...have been instituted against the party who is expected to pay and the transferor knows it, the concealment of that fact amounts to a fraud upon the transferee, and the warranty against knowledge of such proceedings is provided accordingly."[1]

Presentment Warranties

A payor paying or accepting an instrument in effect takes the paper from the party who presents it to the payor, and that party has his hand out. In doing so, the presenter makes certain implied promises to the payor, who is about to fork over cash (or an acceptance). The UCC distinguishes between warranties made by one who presents an unaccepted draft for payment and warranties made by one who presents other instruments for payment. The warranties made by the presenter are as follows.[2]

Warranties Made by One Who Presents an Unaccepted Draft

1. *The presenter is entitled to enforce the draft or to obtain payment or acceptance*. This is "in effect a warranty that there are no unauthorized or missing indorsements."[3] Suppose Thief steals a check drawn by Drawer to Payee and forges Payee's signature, then presents it to the bank. If the bank pays it, the bank cannot charge Drawer's account because it has not followed Drawer's order in paying to the wrong person (except in the case of an imposter or fictitious payee). It can, though, go back to

Thief (fat chance it can find her) on the claim that she breached the warranty of no unauthorized indorsement.

2. *There has been no alteration of the instrument*. If Thief takes a check and changes the amount from $100 to $1,000 and the bank pays it, the bank can recover from Thief $900, the difference between the amount paid by the bank and the amount Drawer (customer) authorized the bank to pay.[4] If the drawee accepts the draft, the same rules apply.
3. *The presenter has no knowledge that the signature of the drawer is unauthorized*. If the presenter doesn't know Drawer's signature is forged and the drawee pays out on a forged signature, the drawee bears the loss. (The bank would be liable for paying out over the forged drawer's signature: that's why it has the customer's signature on file.)

These rules apply—again—to warranties made by the presenter to a drawee paying out on an unaccepted draft. The most common situation would be where a person has a check made out to her and she gets it cashed at the drawer's bank.

Warranties Made by One Who Presents Something Other Than an Unaccepted Draft

In all other cases, there is only one warranty made by the presenter: that he or she is a person entitled to enforce the instrument or obtain payment on it.

This applies to the presentment of accepted drafts, to the presentment of dishonored drafts made to the drawer or an indorser, and to the presentment of notes. For example, Maker makes a note payable to Payee; Payee indorses the note to Indorsee, Indorsee indorses and negotiates the note to Subsequent Party. Subsequent Party presents the note to Maker for payment. The Subsequent Party warrants to Maker that she is entitled to obtain payment. If she is paid and is *not* entitled to payment, Maker can sue her for breach of that warranty. If the reason she isn't entitled to payment is because Payee's signature was forged by Thief, then Maker can go after Thief: the UCC says that "the person obtaining payment [Subsequent Party] and a prior transferor [Thief] warrant to the person making payment in good faith [Maker] that the warrantor [Subsequent Party] is entitled to enforce the instrument."[5] Or, again, Drawer

makes the check out to Payee; Payee attempts to cash or deposit the check, but it is dishonored. Payee presents the check to Drawer to make it good: Payee warrants he is entitled to payment on it.

Warranties cannot be disclaimed in the case of checks (because, as UCC Section 3-417, Comment 7, puts it, "it is not appropriate to allow disclaimer of warranties appearing on checks that normally will not be examined by the payor bank"—they're machine read). But a disclaimer of warranties is permitted as to other instruments, just as disclaimers of warranty are usually OK under general contract law. The reason presentment warranties 2 and 3 don't apply to makers and drawers (they apply to drawees) is because makers and drawers are going to know their own signatures and the terms of the instruments; indorsers already warranted the wholesomeness of their transfer (transfer warranties), and acceptors should examine the instruments when they accept them.

Payment by Mistake

Sometimes a drawee pays a draft (most familiarly, again, a bank pays a check) or accepts a draft by mistake. The UCC says that if the mistake was in thinking that there was no stop-payment order on it (when there was), or that the drawer's signature was authorized (when it was not), or that there were sufficient funds in the drawer's account to pay it (when there were not), "the drawee may recover the amount paid...or in the case of acceptance, may revoke the acceptance."[6] Except—and it's a big exception—such a recovery of funds does not apply "against a person who took the instrument in good faith and for value."[7] The drawee in that case would have to go after the forger, the unauthorized signer, or, in the case of insufficient funds, the drawer. Example: Able draws a check to Baker. Baker deposits the check in her bank account, and Able's bank mistakenly pays it even though Able doesn't have enough money in his account to cover it. Able's bank cannot get the money back from Baker: it has to go after Able. To rephrase, in most cases, the remedy of restitution will not be available to a bank that pays or accepts a check because the person receiving payment of the check will have given value for it in good faith.

KEY TAKEAWAY

A transferor of a negotiable instrument warrants to the transferee five things: (1) entitled to enforce, (2) authentic and authorized signatures, (3) no alteration, (4) no defenses, and (5) no knowledge of insolvency. If the transfer is by delivery, the warranties run only to the immediate transferee; if by indorsement, to any subsequent good-faith holder. Presenters who obtain payment of an instrument and all prior transferors make three presenter's warranties: (1) entitled to enforce, (2) no alteration, (3) genuineness of drawer's signature. These warranties run to any good-faith payor or acceptor. If a person pays or accepts a draft by mistake, he or she can recover the funds paid out unless the payee took the instrument for value and in good faith.

EXERCISES

1. What does it mean to say that the transferor of a negotiable instrument warrants things to the transferee, and what happens if the warranties are breached? What purpose do the warranties serve?
2. What is a presenter, and to whom does such a person make warranties?
3. Under what circumstances would suing for breach of warranties be useful compared to suing on the contract obligation represented by the instrument?
4. Why are the rules governing mistaken payment not very often useful to a bank?

---

[1] Uniform Commercial Code, Section 3-416, Official Comment 4.

[2] Uniform Commercial Code, Section 3-417.

[3] Uniform Commercial Code, Section 3-417, Comment 2.

[4] Uniform Commercial Code, Sections 3-417(2) and (b).

[5] Uniform Commercial Code, Section 3-417(d).

[6] Uniform Commercial Code, Section 3-418.

CC BY NC SA

[7] Uniform Commercial Code, Section 3-418(c).

22.4 Discharge

LEARNING OBJECTIVE

1. Understand how the obligations represented by commercial paper may be discharged.

Overview

Negotiable instruments eventually die. The obligations they represent are discharged (terminated) in two general ways: (1) according to the rules stated in Section 3-601 of the Uniform Commercial Code (UCC) or (2) by an act or agreement that would discharge an obligation to pay money under a simple contract (e.g., declaring bankruptcy).

Discharge under the Uniform Commercial Code

The UCC provides a number of ways by which an obligor on an instrument is discharged from liability, but notwithstanding these several ways, under Section 3-601, no discharge of any party provided by the

rules presented in this section operates against a subsequent holder in due course unless she has notice when she takes the instrument.

Discharge in General

Discharge by Payment

A person primarily liable discharges her liability on an instrument to the extent of payment by paying or otherwise satisfying the holder, and the discharge is good even if the payor knows that another has claim to the instrument. However, discharge does not operate if the payment is made in bad faith to one who unlawfully obtained the instrument (and UCC Section 3-602(b) lists two other exceptions).

Discharge by Tender

A person who tenders full payment to a holder on or after the date due discharges any subsequent liability to pay interest, costs, and attorneys' fees (but not liability for the face amount of the instrument). If the holder refuses to accept the tender, any party who would have had a right of recourse against the party making the tender is discharged. Mario makes a note payable to Carol, who indorses it to Ed. On the date the payment is due, Mario (the maker) tenders payment to Ed, who refuses to accept the payment; he would rather collect from Carol. Carol is discharged: had she been forced to pay as indorser in the event of Mario's refusal, she could have looked to him for recourse. Since Mario did tender, Ed can no longer look to Carol for payment.[1]

Discharge by Cancellation and Renunciation

The holder may discharge any party, even without consideration, by marking the face of the instrument or the indorsement in an unequivocal way, as, for example, by intentionally canceling the instrument or the signature by destruction or mutilation or by striking out the party's signature. The holder may also renounce his rights by delivering a signed writing to that effect or by surrendering the instrument itself.[2]

Discharge by Material and Fraudulent Alteration

Under UCC Section 3-407, if a holder materially and fraudulently alters an instrument, any party whose contract is affected by the change is discharged. A payor bank or drawee paying a fraudulently altered instrument or a person taking it for value, in good faith, and without notice of the alteration, may enforce rights with respect to the instrument according to its original terms or, if the incomplete instrument was altered by unauthorized completion, according to its terms as completed.

- Example 1: Marcus makes a note for $100 payable to Pauline. Pauline fraudulently raises the amount to $1,000 without Marcus's negligence and negotiates it to Ned, who qualifies as a holder in due course (HDC). Marcus owes Ned $100.
- Example 2: Charlene writes a check payable to Lumber Yard and gives it to Contractor to buy material for a deck replacement. Contractor fills it in for $1,200: $1,000 for the decking and $200 for his own unauthorized purposes. Lumber Yard, if innocent of any wrongdoing, could enforce the check for $1,200, and Charlene must go after Contractor for the $200.

Discharge by Certification

As we have noted, where a drawee certifies a draft for a holder, the drawer and all prior indorsers are discharged.

Discharge by Acceptance Varying a Draft

If the holder assents to an acceptance varying the terms of a draft, the obligation of the drawer and any indorsers who do not expressly assent to the acceptance is discharged.[3]

Discharge of Indorsers and Accommodation Parties

The liability of indorsers and accommodation parties is discharged under the following three circumstances.[4]

Extension of Due Date

If the holder agrees to an extension of the due date of the obligation of the obligor, the extension discharges an indorser or accommodation party having a right of recourse against the obligor to the extent

the indorser or accommodation party proves that the extension caused her loss with respect to the right of recourse.

Material Modification of Obligation

If the holder agrees to a material modification of the obligor's obligation, other than an extension of the due date, the modification discharges the obligation of an indorser or accommodation party having a right of recourse against the obligor to the extent the modification causes her loss with respect to the right of recourse.

Impairment of Collateral

If the obligor's duty to pay is secured by an interest in collateral and the holder impairs the value of the interest in collateral, the obligation of an indorser or accommodation party having a right of recourse against the obligor is discharged to the extent of the impairment.

The following explanatory paragraph from UCC Section 3-605, Official Comment 1, may be helpful:

> *Bank lends $10,000 to Borrower who signs a note under which she (in suretyship law, the "Principal Debtor") agrees to pay Bank on a date stated. But Bank insists that an accommodation party also become liable to pay the note (by signing it as a co-maker or by indorsing the note). In suretyship law, the accommodation party is a "Surety." Then Bank agrees to a modification of the rights and obligations between it and Principal Debtor, such as agreeing that she may pay the note at some date after the due date, or that she may discharge her $10,000 obligation to pay the note by paying Bank $3,000, or the Bank releases collateral she gave it to secure the note. Surety is discharged if changes like this are made by Bank (the creditor) without Surety's consent to the extent Surety suffers loss as a result. Section 3-605 is concerned with this kind of problem with Principal Debtor and Surety. But it has a wider scope: it also applies to indorsers who are not accommodation parties. Unless an indorser signs without recourse, the indorser's liability under section 3-415(a) is that of a surety. If Bank in our hypothetical case indorsed the note and*

transferred it to Second Bank, Bank has rights given to an indorser under section 3-605 if it is Second Bank that modifies rights and obligations of Borrower.

Discharge by Reacquisition

Suppose a prior party reacquires the instrument. He may—but does not automatically—cancel any indorsement unnecessary to his title and may also reissue or further negotiate the instrument. Any intervening party is thereby discharged from liability to the reacquiring party or to any subsequent holder not in due course. If an intervening party's indorsement is cancelled, she is not liable even to an HDC.[5]

Discharge by Unexcused Delay in Presentment or Notice of Dishonor

If notice of dishonor is not excused under UCC Section 3-504, failure to give it discharges drawers and indorsers.

KEY TAKEAWAY

The potential liabilities arising from commercial paper are discharged in several ways. Anything that would discharge a debt under common contract law will do so. More specifically as to commercial paper, of course, payment discharges the obligation. Other methods include tender of payment, cancellation or renunciation, material and fraudulent alteration, certification, acceptance varying a draft, reacquisition, and—in some cases—unexcused delay in giving notice of presentment or dishonor. Indorsers and accommodation parties' liability may be discharged by the same means that a surety's liability is discharged, to the extent that alterations in the agreement between the creditor and the holder would be defenses to a surety because right of recourse is impaired to the surety.

EXERCISES

1. What is the most common way that obligations represented by commercial paper are discharged?
2. Parents loan Daughter $6,000 to attend college, and she gives them a promissory note in return. At her graduation party, Parents ceremoniously tear up the note. Is Daughter's obligation terminated?

CC BY NC SA

3. Juan signs Roberta's note to Creditor as an accommodation party, agreeing to serve in that capacity for two years. At the end of that term, Roberta has not paid Creditor, who—without Juan's knowledge—gives Roberta an extra six months to pay. She fails to do so. Does Creditor still have recourse against Juan?

---

[1] Uniform Commercial Code, Section 3-603(b).

[2] Uniform Commercial Code, Section 3-604.

[3] Uniform Commercial Code, Section 3-410.

[4] Uniform Commercial Code, Section 3-605.

[5] Uniform Commercial Code, Section 3-207.

22.5 Cases

Breach of Presentment Warranties and Conduct Precluding Complaint about Such Breach

Bank of Nichols Hills v. Bank of Oklahoma

196 P.3d 984 (Okla. Civ. App. 2008)

Gabbard, J.

Plaintiff, Bank of Nichols Hills (BNH), appeals a trial court judgment for Defendant, Bank of Oklahoma (BOK), regarding payment of a forged check. The primary issue on appeal is whether BOK presented sufficient proof to support the trial court's finding that the [UCC] § 3-406 preclusion defense applied. We find that it did, and affirm.

Facts

Michael and Stacy Russell owned a mobile home in Harrah, Oklahoma. The home was insured by Oklahoma Farm Bureau Mutual Insurance Company (Farm Bureau). The insurance policy provided that

in case of loss, Farm Bureau "will pay you unless another payee is named on the Declarations page," that "Loss shall be payable to any mortgagee named in the Declarations," and that one of Farm Bureau's duties was to "protect the mortgagee's interests in the insured building." The Declarations page of the policy listed Conseco Finance as the mortgagee. Conseco had a mortgage security interest in the home.
In August 2002, a fire completely destroyed the mobile home. The Russells submitted an insurance claim to Farm Bureau. Farm Bureau then negotiated a $69,000 settlement with the Russells, issued them a check in this amount payable to them and Conseco jointly, and mailed the check to the Russells. Neither the Russells nor Farm Bureau notified Conseco of the loss, the settlement, or the mailing of the check.

The check was drawn on Farm Bureau's account at BNH. The Russells deposited the check into their account at BOK. The check contains an endorsement by both Russells, and a rubber stamp endorsement for Conseco followed by a signature of a Donna Marlatt and a phone number. It is undisputed that Conseco's endorsement was forged. Upon receipt, BOK presented the check to BNH. BNH paid the $69,000 check and notified Farm Bureau that the check had been paid from its account.

About a year later, Conseco learned about the fire and the insurance payoff. Conseco notified Farm Bureau that it was owed a mortgage balance of more than $50,000. Farm Bureau paid off the balance and notified BNH of the forgery. BNH reimbursed Farm Bureau the amount paid to Conseco. BNH then sued BOK.

Both banks relied on the Uniform Commercial Code. BNH asserted that under § 4-208, BOK had warranted that all the indorsements on the check were genuine. BOK asserted an affirmative defense under § 3-406, alleging that Farm Bureau's own negligence contributed to the forgery. After a non-jury trial, the court granted judgment to BOK, finding as follows:

- Conseco's endorsement was a forgery, accomplished by the Russells;
- Farm Bureau was negligent in the manner and method it used to process the claim and pay the settlement without providing any notice or opportunity for involvement in the process to Conseco;

- Farm Bureau's negligence substantially contributed to the Russells' conduct in forging Conseco's endorsement; and
- BOK proved its affirmative defense under § 3-406 by the greater weight of the evidence.

From this judgment, BNH appeals.

Analysis

It cannot be disputed that BOK breached its presentment warranty to BNH under § 4-208.[1] Thus the primary issue raised is whether BOK established a preclusion defense under 3-406 [that BNH is precluded from complaining about BOK's breach of presentment warranty because of its own negligence].[2] BNH asserts that the evidence fails to establish this defense because the mailing of its check to and receipt by the insured "is at most an event of opportunity and has nothing to do with the actual forgery."

Section 3-406 requires less stringent proof than the "direct and proximate cause" test for general negligence.[3] Conduct is a contributing cause of an alteration or forgery if it is a substantial factor in bringing it about, or makes it "easier for the wrongdoer to commit his wrong." The UCC Comment to § 3-406 notes that the term has the meaning as used by the Pennsylvania court in *Thompson* [Citation].

In *Thompson*, an independent logger named Albers obtained blank weighing slips, filled them out to show fictitious deliveries of logs for local timber owners, delivered the slips to the company, accepted checks made payable to the timber owners, forged the owners' signatures, and cashed the checks at the bank. When the company discovered the scheme, it sued the bank and the bank raised § 3-406 as a defense. The court specifically found that the company's negligence did not have to be the direct and proximate cause of the bank's acceptance of the forged checks. Instead, the defense applied because the company left blank logging slips readily accessible to haulers, the company had given Albers whole pads of blank slips, the slips were not consecutively numbered, haulers were allowed to deliver both the original and duplicate slips to the company's office, and the company regularly entrusted the completed checks to the haulers for delivery to the payees without the payees' consent. The court noted:

While none of these practices, in isolation, might be sufficient to charge the plaintiff [the company] with negligence within the meaning of § 3-406, the company's course of conduct, viewed in its entirety, is surely sufficient to support the trial judge's determination that it substantially contributed to the making of the unauthorized signatures....[T]hat conduct was 'no different than had the plaintiff simply given Albers a series of checks signed in blank for his unlimited, unrestrictive use.'

The UCC Comment to § 3-406 gives three examples of conduct illustrating the defense. One example involves an employer who leaves a rubber stamp and blank checks accessible to an employee who later commits forgery; another example involves a company that issues a ten dollar check but leaves a blank space after the figure which allows the payee to turn the amount into ten thousand dollars; and the third example involves an insurance company that mails a check to one policyholder whose name is the same as another policyholder who was entitled to the check. In each case, the company's negligence substantially contributed to the alterations or forgeries by making it easier for the wrongdoer to commit the malfeasance.

In the present case, we find no negligence in Farm Bureau's delivery of the check to the Russells. There is nothing in the insurance policy that prohibits the insurer from making the loss-payment check jointly payable to the Russells and Conseco. Furthermore, under § 3-420, if a check is payable to more than one payee, delivery to one of the payees is deemed to be delivery to all payees. The authority cited by BOK, in which a check was delivered to one joint payee who then forged the signature of the other, involve cases where the drawer knew or should have known that the wrongdoer was not entitled to be a payee in the first place. See [Citations].

We also find no negligence in Farm Bureau's violation of its policy provisions requiring the protection of the mortgage holder. Generally, violation of contract provisions and laxity in the conduct of the business affairs of the drawer do not per se establish negligence under this section. See [Citations].
However, evidence was presented that the contract provision merely reflected an accepted and customary commercial standard in the insurance industry. Failure to conform to the reasonable commercial

standards of one's business has been recognized by a number of courts as evidence of negligence. See, e.g., [Citations].

Here, evidence was presented that Farm Bureau did not act in a commercially reasonable manner or in accordance with reasonable commercial standards of its business when it issued the loss check to the insured without notice to the mortgagee. BOK's expert testified that it is standard practice in the industry to notify the lender of a loss this size, in order to avoid exactly the result that occurred here. Mortgagees often have a greater financial stake in an insurance policy than do the mortgagors. That was clearly true in this case. While there was opinion testimony to the contrary, the trial court was entitled to conclude that Farm Bureau did not act in a commercially reasonably manner and that this failure was negligence which substantially contributed to the forgery, as contemplated by § 3-406.

We find the trial court's judgment supported by the law and competent evidence. Accordingly, the trial court's decision is affirmed. Affirmed.

CASE QUESTIONS

1. How did BOK breach its presentment warranty to BNH?
2. What part of the UCC did BOK point to as why it should not be liable for that breach?
3. In what way was Farm Bureau Mutual Insurance Co. negligent in this case, and what was the consequence?

Presentment, Acceptance, Dishonor, and Warranties

Messing v. Bank of America

821 A.2d 22 (Md. 2003)

CC BY NC SA

At some point in time prior to 3 August 2000, Petitioner, as a holder, came into possession of a check in the amount of Nine Hundred Seventy-Six Dollars ($976.00) (the check) from Toyson J. Burruss, the drawer, doing business as Prestige Auto Detail Center. Instead of depositing the check into his account at his own bank, Petitioner elected to present the check for payment at a branch of Mr. Burruss' bank, Bank of America, the drawee.[4] On 3 August 2000, Petitioner approached a teller at Bank of America...in Baltimore City and asked to cash the check. The teller, by use of a computer, confirmed the availability of funds on deposit, and placed the check into the computer's printer slot. The computer stamped certain data on the back of the check, including the time, date, amount of the check, account number, and teller number. The computer also effected a hold on the amount of $976.00 in the customer's account. The teller gave the check back to the Petitioner, who endorsed it. The teller then asked for Petitioner's identification. Petitioner presented his driver's license and a major credit card. The teller took the indorsed check from Petitioner and manually inscribed the driver's license information and certain credit card information on the back of the check.

At some point during the transaction, the teller counted out $976.00 in cash from her drawer in anticipation of completing the transaction. She asked if the Petitioner was a customer of Bank of America. The Petitioner stated that he was not. The teller returned the check to Petitioner and requested, consistent with bank policy when cashing checks for non-customers, that Petitioner place his thumbprint on the check. [The thumbprint identification program was designed by various banking and federal agencies to reduce check fraud.] Petitioner refused and the teller informed him that she would be unable to complete the transaction without his thumbprint.

...Petitioner presented the check to the branch manager and demanded that the check be cashed notwithstanding Petitioner's refusal to place his thumbprint on the check. The branch manager examined the check and returned it to the Petitioner, informing him that, because Petitioner was a non-customer, Bank of America would not cash the check without Petitioner's thumbprint on the instrument....Petitioner left the bank with the check in his possession....

Rather than take the check to his own bank and deposit it there, or returning it to Burruss, the drawer, as dishonored and demanding payment, Petitioner,...[sued] Bank of America (the Bank)...Petitioner claimed that the Bank had violated the Maryland Uniform Commercial Code (UCC) and had violated his personal privacy when the teller asked Petitioner to place an "inkless" thumbprint on the face of the check at issue....

...[T]he Circuit Court heard oral arguments..., entered summary judgment in favor of the Bank, dismissing the Complaint with prejudice. [The special appeals court affirmed. The Court of Appeals—this court—accepted the appeal.]

[Duty of Bank on Presentment and Acceptance]

Petitioner argues that he correctly made "presentment" of the check to the Bank pursuant to § 3-111 and § 3-501(a), and demands that, as the person named on the instrument and thus entitled to enforce the check, the drawee Bank pay him....In a continuation, Petitioner contends that the teller, by placing the check in the slot of her computer, and the computer then printing certain information on the back of the check, accepted the check as defined by § 3-409(a)....Thus, according to Petitioner, because the Bank's computer printed information on the back of the check, under § 3-401(b) the Bank "signed" the check, said "signature" being sufficient to constitute acceptance under § 3-409(a).

Petitioner's remaining arguments line up like so many dominos. According to Petitioner, having established that under his reading of § 3-409(a) the Bank accepted the check, Petitioner advances that the Bank is obliged to pay him, pursuant to § 3-413(a)...Petitioner extends his line of reasoning by arguing that the actions of the Bank amounted to a conversion under § 3-420,...Petitioner argues that because the Bank accepted the check, an act which, according to Petitioner, discharged the drawer, he no longer had enforceable rights in the check and only had a right to the proceeds. Petitioner's position is that the Bank exercised unauthorized dominion and control over the proceeds of the check to the complete exclusion of the Petitioner after the Bank accepted the check and refused to distribute the proceeds, counted out by the teller, to him.

We turn to the Bank's obligations, or lack thereof, with regard to the presentment of a check by someone not its customer. Bank argues, correctly, that it had no duty to the Petitioner, a non-customer and a stranger to the Bank, and that nothing in the Code allows Petitioner to force Bank of America to act as a depository bank...

Absent a special relationship, a non-customer has no claim against a bank for refusing to honor a presented check. [Citations] This is made clear by § 3-408, which states:

> *A check or other draft does not of itself operate as an assignment of funds in the hands of the drawee available for its payment, and the drawee is not liable on the instrument until the drawee accepts it.*

Once a bank accepts a check, under § 3-409, it is obliged to pay on the check under § 3-413. Thus, the relevant question in terms of any rights Petitioner had against the Bank [regarding presentment] turns not on the reasonableness of the thumbprint identification, but rather upon whether the Bank accepted the check when presented as defined by § 3-409. As will be seen infra [below] the question of the thumbprint identification is relevant only to the issue of whether the Bank's refusal to pay the instrument constituted dishonor under § 3-502, a determination which has no impact in terms of any duty allegedly owed by the Bank to the Petitioner.

The statute clearly states that acceptance becomes effective when the presenter is notified of that fact. The facts demonstrate that at no time did the teller notify Petitioner that the Bank would pay on the check. Rather, the facts show that:

> *[T]he check was given back to [Petitioner] by the teller so that he could put his thumbprint signature on it, not to notify or give him rights on the purported acceptance. After appellant declined to put his thumbprint signature on the check, he was informed by both the teller and the branch manager that it was against bank policy to honor the check without a thumbprint signature. Indignant, [Petitioner] walked out of the bank with the check.*

As the intermediate appellate court correctly pointed out, the negotiation of the check is in the nature of a contract, and there can be no agreement until notice of acceptance is received. As a result, there was never acceptance as defined by § 3-409(a), and thus the Bank, pursuant to § 3-408 never was obligated to pay the check under § 3-413(a). Thus, the answer to Petitioner's second question [Did the lower court err in finding the Bank did not accept the...check at issue, as "acceptance" is defined in UCC Section 3-409?] is "no."

"Conversion" under § 3-420.

Because it never accepted the check, Bank of America argues that the intermediate appellate court also correctly concluded that the Bank did not convert the check or its proceeds under § 3-420. Again, we must agree. The Court of Special Appeals stated:

> *"Conversion," we have held, "requires not merely temporary interference with property rights, but the exercise of unauthorized dominion and control to the complete exclusion of the rightful possessor." [Citation] At no time did [Respondent] exercise "unauthorized dominion and control [over the check] to the complete exclusion of the rightful possessor," [Petitioner].*
>
> *[Petitioner] voluntarily gave the check to [Respondent's] teller. When [Petitioner] indicated to the teller that he was not an account holder, she gave the check back to him for a thumbprint signature in accordance with bank policy. After being informed by both [Respondent's] teller and branch manager that it was [Respondent's] policy not to cash a non-account holder's check without a thumbprint signature, [Petitioner] left the bank with the check in hand.*
>
> *Because [Petitioner] gave the check to the teller, [Respondent's] possession of that check was anything but "unauthorized," and having returned the check, within minutes of its receipt, to [Petitioner] for his thumbprint signature, [Respondent] never exercised "dominion and control*

[over it] to the complete exclusion of the rightful possessor," [Petitioner]. In short, there was no conversion.

D. "Reasonable Identification" under § 3-501(b)(2)(ii) and "Dishonor" under § 3-502

We now turn to the issue of whether the Bank's refusal to accept the check as presented constituted dishonor under § 3-501 and § 3-502 as Petitioner contends. Petitioner's argument that Bank of America dishonored the check under § 3-502(d) fails because that section applies to dishonor of an accepted draft. We have determined, supra, [above] that Bank of America never accepted the draft. Nevertheless, the question remains as to whether Bank of America dishonored the draft under § 3-502(b)...

(2) Upon demand of the person to whom presentment is made, the person making presentment must (i) exhibit the instrument, (ii) give reasonable identification...

(3) Without dishonoring the instrument, the party to whom presentment is made may (i) return the instrument for lack of a necessary indorsement, or (ii) refuse payment or acceptance for failure of the presentment to comply with the terms of the instrument, an agreement of the parties, or other applicable law or rule.

The question is whether requiring a thumbprint constitutes a request for "reasonable identification" under § 3-501(b)(2)(ii). If it is "reasonable," then under § 3-501(b)(3)(ii) the refusal of the Bank to accept the check from Petitioner did not constitute dishonor. If, however, requiring a thumbprint is not "reasonable" under § 3-501(b)(2)(ii), then the refusal to accept the check may constitute dishonor under § 3-502(b)(2). The issue of dishonor is arguably relevant because Petitioner has no cause of action against any party, including the drawer, until the check is dishonored.

Respondent Bank of America argues that its relationship with its customer is contractual, [Citations] and that in this case, its contract with its customer, the drawer, authorizes the Bank's use of the Thumbprint Signature Program as a reasonable form of identification.

According to Respondent, this contractual agreement allowed it to refuse to accept the check, without dishonoring it pursuant to § 3-501(b)(3)(ii), because the Bank's refusal was based upon the presentment failing to comply with "an agreement of the parties." The intermediate appellate court agreed. We, however, do not.

...Bank and its customer cannot through their contract define the meaning of the term "reasonable" and impose it upon parties who are not in privity with that contract. Whether requiring a thumbprint constitutes "reasonable identification" within the meaning of § 3-501(b)(2)(ii) is therefore a broader policy consideration, and not, as argued in this case, simply a matter of contract. We reiterate that the contract does not apply to Petitioner and, similarly, does not give him a cause of action against the Bank for refusing to accept the check. This also means that the Bank cannot rely on the contract as a defense against the Petitioner, on the facts presented here, to say that it did not dishonor the check.

Petitioner, as noted, argues that requiring a thumbprint violates his privacy, and further argues that a thumbprint is not a reasonable form of identification because it does not prove contemporaneously the identity of an over the counter presenter at the time presentment is made. According to Petitioner, the purpose of requiring "reasonable identification" is to allow the drawee bank to determine that the presenter is the proper person to be paid on the instrument. Because a thumbprint does not provide that information at the time presentment and payment are made, Petitioner argues that a thumbprint cannot be read to fall within the meaning of "reasonable identification" for the purposes of § 3-501(b)(2)(ii).

Bank of America argues that the requirement of a thumbprint has been upheld, in other non-criminal circumstances, not to be an invasion of privacy, and is a reasonable and necessary industry response to the growing problem of check fraud. The intermediate appellate court agreed, pointing out that the form of identification was not defined by the statute, but that the Code itself recognized a thumbprint as a form of signature, § 1-201(39), and observing that requiring thumbprint or fingerprint identification has been found to be reasonable and not to violate privacy rights in a number of non-criminal contexts....

We agree with [Petitioner] that a thumbprint cannot be used, in most instances, to confirm the identity of a non-account checkholder at the time that the check is presented for cashing, as his or her thumbprint is usually not on file with the drawee at that time. We disagree, however, with [Petitioner's] conclusion that a thumbprint signature is therefore not "reasonable identification" for purposes of § 3-501(b)(2).

Nowhere does the language of § 3-501(b)(2) suggest that "reasonable identification" is limited to information [Bank] can authenticate at the time presentment is made. Rather, all that is required is that the "person making presentment must...give reasonable identification." § 3-501(b)(2). While providing a thumbprint signature does not necessarily confirm identification of the checkholder at presentment—unless of course the drawee bank has a duplicate thumbprint signature on file—it does assist in the identification of the checkholder should the check later prove to be bad. It therefore serves as a powerful deterrent to those who might otherwise attempt to pass a bad check. That one method provides identification at the time of presentment and the other identification after the check may have been honored, does not prevent the latter from being "reasonable identification" for purposes of § 3-501(b)(2) [Citation].
[So held the lower courts.] We agree, and find this conclusion to be compelled, in fact, by our State's Commercial Law Article.

The reason has to do with warranties. The transfer of a check for consideration creates both transfer warranties (§ 3-416(a) and (c)) and presentment warranties (§ 3-417(a) and (e)) which cannot be disclaimed. The warranties include, for example, that the payee is entitled to enforce the instrument and that there are no alterations on the check. The risk to banks is that these contractual warranties may be breached, exposing the accepting bank to a loss because the bank paid over the counter on an item which was not properly payable....In such an event, the bank would then incur the expense to find the presenter, to demand repayment, and legal expenses to pursue the presenter for breach of his warranties.

In short, when a bank cashes a check over the counter, it assumes the risk that it may suffer losses for counterfeit documents, forged endorsements, or forged or altered checks. Nothing in the Commercial Law Article forces a bank to assume such risks. *See* [Citations] To the extent that banks are willing to cash

checks over the counter, with reasonable identification, such willingness expands and facilitates the commercial activities within the State....

Because the reduction of risk promotes the expansion of commercial practices, we... conclude that a bank's requirement of a thumbprint placed upon a check presented over the counter by a non-customer is reasonable. [Citations] As the intermediate appellate court well documented, the Thumbprint Program is part of an industry wide response to the growing threat of check fraud. Prohibiting banks from taking reasonable steps to protect themselves from losses could result in banks refusing to cash checks of non-customers presented over the counter at all, a result which would be counter to the direction of § 1-102(2)(b).

As a result of this conclusion, Bank of America in the present case did not dishonor the check when it refused to accept it over the counter. Under § 3-501(b)(3)(ii), Bank of America "refused payment or acceptance for failure of the presentment to comply with...other applicable law or rule." The rule not complied with by the Petitioner-presenter was § 3-502(b)(2)(ii), in that he refused to give what we have determined to be reasonable identification. Therefore, there was no dishonor of the check by Bank of America's refusal to accept it. The answer to Petitioner's third question is therefore "no," [Did Bank dishonor the check?]...

Judgment of the court of special appeals affirmed; costs to be paid by petitioner.

Eldridge, J., concurring in part and dissenting in part.

I cannot agree with the majority's holding that, after the petitioner presented his driver's license and a major credit card, it was "reasonable" to require the petitioner's thumbprint as identification.

Today, honest citizens attempting to cope in this world are constantly being required to show or give drivers' licenses, photo identification cards, social security numbers, the last four digits of social security numbers, mothers' "maiden names," 16 digit account numbers, etc. Now, the majority takes the position

that it is "reasonable" for banks and other establishments to require, in addition, thumbprints and fingerprints. Enough is enough. The most reasonable thing in this case was petitioner's "irritation with the Bank of America's Thumbprint Signature Program." Chief Judge Bell has authorized me to state that he joins this concurring and dissenting opinion.

CASE QUESTIONS

1. Petitioner claimed (a) he made a valid presentment, (b) Bank accepted the instrument, (c) Bank dishonored the acceptance, and (d) Bank converted the money and owes it to him. What did the court say about each assertion?
2. There was no dispute that there was enough money in the drawer's account to pay the check, so why didn't Petitioner just deposit it in his own account (then he wouldn't have been required to give a thumbprint)?
3. What part of UCC Article 3 became relevant to the question of whether it was reasonable for Bank to demand Petitioner's thumbprint?
4. How do the presentment and transfer warranties figure into the majority opinion?
5. What did the dissenting judges find fault with in the majority's opinion? What result would have obtained if the minority side had prevailed?

Breach of Transfer Warranties and the Bank's Obligation to Act in Good Faith

PNC Bank v. Robert L. Martin

2010 WL 3271725, U.S. Dist. Ct. (Ky. 2010)

Coffman, J.

This matter is before the court on plaintiff PNC Bank's motion for summary judgment. The court will grant the motion as to liability and damages, because the defendant, Robert L. Martin, fails to raise any genuine issue of material fact, and the evidence establishes that Martin breached his transfer warranties and account agreement with PNC....

I. Background

Martin, an attorney, received an e-mail message on August 16, 2008, from a person who called himself Roman Hidotashi. Hidotashi claimed that he was a representative of Chipang Lee Song Manufacturing Company and needed to hire a lawyer to collect millions of dollars from past-due accounts of North American customers. Martin agreed to represent the company.

On September 8, 2008, Martin received a check for $290,986.15 from a purported Chipang Lee Song Manufacturing Company customer, even though Martin had yet to commence any collections work. The check, which was drawn on First Century Bank USA, arrived in an envelope with a Canadian postmark and no return address. The check was accompanied by an undated transmittal letter. Martin endorsed the check and deposited it in his client trust account at PNC. Martin then e-mailed Hidotashi, reported that he had deposited the check, and stated that he would await further instructions.

Hidotashi responded to Martin's e-mail message on September 9, 2008. Hidotashi stated that he had an "immediate need for funds" and instructed Martin to wire $130,600 to a bank account in Tokyo. Martin went to PNC's main office in Louisville the next morning and met with representative Craig Friedman. According to Martin, Friedman advised that the check Martin deposited had cleared. Martin instructed Friedman to wire $130,600 to the Tokyo account.

Martin returned to PNC later the same day. According to Martin, Friedman accessed Martin's account information and said, "I don't understand this. The check was cleared yesterday. Let me go find out what is going on." Friedman returned with PNC vice president and branch manager Sherry Jennewein, who informed Martin that the check was fraudulent. According to Martin, Jennewein told him that she wished he had met with her instead of Friedman because she never would have authorized the wire transfer.

First Century Bank, on which the check was drawn, dishonored the check. PNC charged Martin's account for $290,986.15. PNC, however, could not recover the $130,600 the bank had wired to the Tokyo account. Martin's account, as a result, was left overdrawn by $124,313.01.

PNC commenced this action. PNC asserts one count for Martin's alleged breach of the transfer warranties provided in Kentucky's version of the Uniform Commercial Code and one count for breach of Martin's account agreement. PNC moves for summary judgment on both counts.

II. Discussion

A. Breach of transfer warranties

PNC is entitled to summary judgment on its breach-of-transfer-warranties claim because the undisputed facts establish Martin's liability.

Transfer warranties trigger when a person transfers an instrument for consideration. UCC § 3-416(a)). A transfer, for purposes of the statute, occurs when an instrument is delivered by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument. § 3-203(a). Martin transferred an instrument to PNC when he endorsed the check and deposited it in his account, thereby granting PNC the right to enforce the check. [Citation] Consideration, for purposes of the statute, need only be enough to support a simple contract. [Citation] Martin received consideration from PNC because PNC made the funds provisionally available before confirming whether First Century Bank would honor the check.

As a warrantor, Martin made a number of representations to PNC, including representations that he was entitled to enforce the check and that all signatures on the check were authentic and authorized. [UCC] § 3-416(a). Martin breached his warranties twofold. First, he was not entitled to enforce the check because the check was a counterfeit and, as a result, Martin had nothing to enforce. Second, the drawer's signature was not authentic because the check was a counterfeit.

Martin does not dispute these facts. Instead, Martin argues, summary judgment is inappropriate because Friedman and Jennewein admitted that PNC made a mistake when Friedman said that he thought the check cleared and Jennewein said that she never would have authorized the wire transfer. Friedman's and Jennewein's statements are immaterial facts. The transfer warranties placed the risk of loss on Martin, regardless of whether PNC, Martin, or both of them were at fault. [Citation] Martin, in any event, fails to

support Friedman's and Jennewein's statements with firsthand deposition testimony or affidavits, so the statements do not qualify as competent evidence. [Citation]

Martin claims that the risk of loss falls on the bank. But the cases Martin cites in support of that proposition suffer from two defects. First, all but one of the cases were decided before the Kentucky General Assembly adopted the Uniform Commercial Code. Martin fails to argue, much less demonstrate, that his cases are good law. Second, Martin's cases are inapposite even if they are good law. [UCC] § 3-416(a) addresses whether a transferor or transferee bears the risk of loss. Martin's cases address who bears the risk of loss as between other players: a drawee bank and a collecting agent [Citation]; a drawer and a drawee bank [Citation]; and an execution creditor and drawee bank [Citation—all of these cases are from 1910–1930]. The one modern case that Martin cites is also inapposite because the case involves a drawer and a drawee bank. [Citation]

In sum, the court must grant summary judgment in PNC's favor on the breach-of-transfer-warranties claim because the parties do not contest any material facts, which establish Martin's liability.

B. Breach of Contract

PNC is also entitled to summary judgment on its breach-of-contract claim because the undisputed facts establish Martin's liability.

To support its allegation that a contract existed, PNC filed copies of Martin's account agreement and Martin's accompanying signature card. Under the agreement's terms, Martin agreed to bind himself to the agreement by signing the signature card. Martin does not dispute that the account agreement was a binding contract, and he does not dispute the account agreement's terms.

Martin's account agreement authorized PNC to charge Martin's account for the value of any item returned to PNC unpaid or any item on which PNC did not receive payment. If PNC's charge-back created an overdraft, Martin was required to pay PNC the amount of the overdraft immediately.

The scam of which Martin was a victim falls squarely within the charge-back provision of the account agreement. The check was returned to PNC unpaid. PNC charged Martin's account, leaving it with an overdraft. Martin was obliged to pay PNC immediately.

As with the breach-of-transfer-warranties claim, Martin cannot defend against the breach-of-contract claim by arguing that PNC made a mistake. The account agreement authorized PNC to charge back Martin's account "even if the amount of the item has already been made available to you." The account agreement, as a result, placed the risk of loss on Martin. Any mistake on PNC's part was immaterial because PNC always had the right to charge back Martin's account. [Citation]

C. Martin's Counterclaims

Martin has asserted counterclaims for violations of various Uniform Commercial Code provisions; negligence and failure to exercise ordinary care; negligent misrepresentation; breach of contract and breach of the implied covenants of good faith and fair dealing; detrimental reliance; conversion; and negligent retention and supervision. Martin argues that "[t]o the extent that either party should be entitled to summary judgment in this case, it would be Martin with respect to his counterclaims against PNC." Martin, however, has not moved for summary judgment on his counterclaims, and the court does not address them on PNC's motion.

D. Damages

PNC's recovery under both theories of liability is contingent on PNC's demonstrating that it acted in good faith. PNC may recover for breach of the transfer warranties only if it took the check in good faith. § 3-416(b). Moreover, PNC must satisfy the implied covenant of good faith and fair dealing, which Kentucky law incorporates in the account agreement. [Citation] Good faith, under both theories, means honesty in fact and the observance of reasonable commercial standards of fair dealing. That means "contracts impose on the parties thereto a duty to do everything necessary to carry them out." [Citation]

The undisputed evidence establishes that PNC acted in good faith. PNC accepted deposit of Martin's check, attempted to present the check for payment at First Century Bank, and charged back Martin's

account when the check was dishonored. Martin cannot claim that PNC lacked good faith and fair dealing when PNC took actions permitted under the contract. [Citation] Although PNC might have had the ability to investigate the authenticity of the check before crediting Martin's account, PNC bore no such obligation because Martin warranted that the check was authentic. [UCC] § 3-416(a). Friedman's and Jennewein's statements do not impute a lack of good faith to PNC, even if Martin could support the statements with competent evidence. The Uniform Commercial Code and the account agreement place the risk of loss on Martin, even if PNC made a mistake.

Martin suggests that an insurance carrier might have already reimbursed PNC for the loss. Martin, however, presents no evidence of reimbursement, which PNC, presumably, would have disclosed in discovery.

PNC, therefore, may recover from Martin the overdraft value of $124,313.01, which is the loss PNC suffered as a result of Martin's breach of the transfer warranties and breach of contract. [UCC] § 3-416(b)...

III. Conclusion

For the foregoing reasons, IT IS ORDERED that PNC's motion for summary judgment is granted...to the extent that...PNC is permitted to recover $124,313.01 from Martin....

CASE QUESTIONS

1. How did Martin come to have an overdraft of $124,313.01 in his account?
2. Under what UCC provision did the court hold Martin liable for this amount?
3. The contract liability the court discusses was *not* incurred by Martin on account of his signature on the check (though he did indorse it); what was the contract liability?
4. If the bank had not taken the check in good faith (honesty in fact and observing reasonable commercial standards), what would the consequence have been, and why?

5. Is a reader really constrained here to say that Mr. Martin got totally scammed, or was his behavior reasonable under the circumstances?

---

[1] Section 4-208 provides as follows: "(a) If an unaccepted draft is presented [in this case, by BOK] to the drawee [BNH] for payment or acceptance and the drawee pays or accepts the draft,(i) the person obtaining payment or acceptance, at the time of presentment, and(ii) a previous transferor of the draft, at the time of transfer, warrant to the drawee that pays or accepts the draft in good faith, that:(1) The warrantor is, or was, at the time the warrantor transferred the draft, a person entitled to enforce the draft or authorized to obtain payment or acceptance of the draft on behalf of a person entitled to enforce the draft;(2) The draft has not been altered; and(3) The warrantor has no knowledge that the signature of the purported drawer of the draft is unauthorized.(b) A drawee making payment may recover from a warrantor damages for breach of warranty….(c) If a drawee asserts a claim for breach of warranty under subsection (a) of this section based on an unauthorized indorsement of the draft or an alteration of the draft, the warrantor may defend by proving that…the drawer [here, Farm Bureau] is precluded under Section 3-406 or 4-406 of this title from asserting against the drawee the unauthorized indorsement or alteration."

[2] (a) A person whose failure to exercise ordinary care substantially contributes to an alteration of an instrument or to the making of a forged signature on an instrument is precluded from asserting the alteration or the forgery against a person who, in good faith, pays the instrument or takes it for value or for collection.

[3] The parties do not address Section 3-406(b), which states that the person asserting preclusion may be held partially liable under comparative negligence principles for failing to exercise ordinary care in paying or taking the check. They also do not address any possible negligence by either bank in accepting the forged check without confirming the legitimacy of Conseco's indorsement.

[4] Petitioner's choice could be viewed as an attempt at risk shifting. Petitioner, an attorney, may have known that he could have suffered a fee charged by his own bank if he deposited a check into his own account and then the bank on which it was drawn returned it for insufficient funds, forged endorsement, alteration, or the like. Petitioner's action, viewed against that backdrop, would operate as a risk-shifting strategy, electing to avoid the risk of a returned-check fee by presenting in person the check for acceptance at the drawee bank.

22.6 Summary and Exercises

Summary

As a general rule, one who signs a note as maker or a draft as drawer is personally liable unless he or she signs in a representative capacity and either the instrument or the signature shows that the signing has been made in a representative capacity. Various rules govern the permutations of signatures when an agent and a principal are involved.

The maker of a note and the acceptor of a draft have primary contract liability on the instruments. Secondarily liable are drawers and indorsers. Conditions precedent to secondary liability are presentment, dishonor, and notice of dishonor. Under the proper circumstances, any of these conditions may be waived or excused.

Presentment is a demand for payment made on the maker, acceptor, or drawee, or a demand for acceptance on the drawee. Presentment must be made (1) at the time specified in the instrument unless no time is specified, in which case it must be at the time specified for payment, or (2) within a reasonable time if a sight instrument.

Dishonor occurs when acceptance or payment is refused after presentment, at which time a holder has the right of recourse against secondary parties if he has given proper notice of dishonor.

A seller-transferor of any commercial paper gives five implied warranties, which become valuable to a holder seeking to collect in the event that there has been no indorsement or the indorsement has been qualified. These warranties are (1) good title, (2) genuine signatures, (3) no material alteration, (4) no

defenses by other parties to the obligation to pay the transferor, and (5) no knowledge of insolvency of maker, acceptor, or drawer.

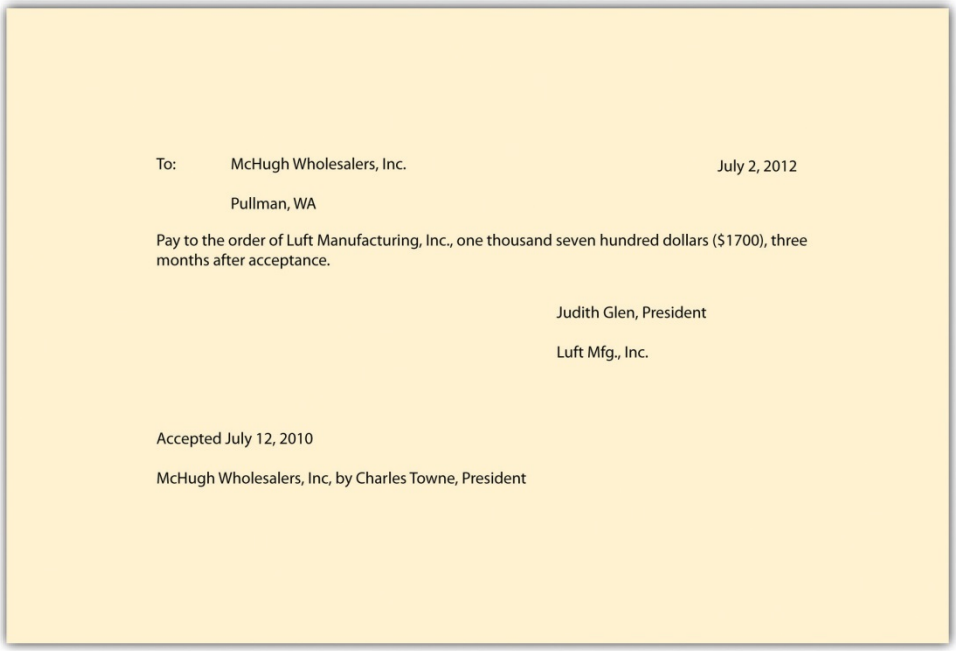
A holder on presentment makes certain warranties also: (1) entitled to enforce the instrument, (2) no knowledge that the maker's or drawer's signature is unauthorized, and (3) no material alteration.

Among the ways in which the parties may be discharged from their contract to honor the instrument are the following: (1) payment or satisfaction, (2) tender of payment, (3) cancellation and renunciation, (4) impairment of recourse or of collateral, (5) reacquisition, (6) fraudulent and material alteration, (7) certification, (8) acceptance varying a draft, and (9) unexcused delay in presentment or notice of dishonor.

EXERCISES

1 Howard Corporation has the following instrument, which it purchased in good faith and for value from Luft Manufacturing, Inc.

Figure 22.2



To: McHugh Wholesalers, Inc. July 2, 2012

Pullman, WA

Pay to the order of Luft Manufacturing, Inc., one thousand seven hundred dollars ($1700), three months after acceptance.

Judith Glen, President

Luft Mfg., Inc.

Accepted July 12, 2010

McHugh Wholesalers, Inc, by Charles Towne, President

Judith Glen indorsed the instrument on the back in her capacity as president of Luft when it was transferred to Howard on July 15, 2012.

a. Is this a note or a draft?

b. What liability do McHugh and Luft have to Howard? Explain.

2 An otherwise valid negotiable bearer note is signed with the forged signature of Darby. Archer, who believed he knew Darby's signature, bought the note in good faith from Harding, the forger. Archer transferred the note without indorsement to Barker, in partial payment of a debt. Barker then sold the note to Chase for 80 percent of its face amount and delivered it without indorsement. When Chase presented the note for payment at maturity, Darby refused to honor it, pleading forgery. Chase gave proper notice of dishonor to Barker and to Archer.

a. Can Chase hold Barker liable? Explain.

b. Can Chase hold Archer liable? Explain.

c. Can Chase hold Harding liable? Explain.

3 Marks stole one of Bloom's checks, already signed by Bloom and made payable to Duval, drawn on United Trust Company. Marks forged Duval's signature on the back of the check and cashed it at Check Cashing Company, which in turn deposited it with its bank, Town National. Town National proceeded to collect on the check from United. None of the parties was negligent. Who will bear the loss, assuming Marks cannot be found?

4 Robb stole one of Markum's blank checks, made it payable to himself, and forged Markum's signature on it. The check was drawn on the Unity Trust Company. Robb cashed the check at the Friendly Check Cashing Company, which in turn deposited it with its bank, the Farmer's National. Farmer's National proceeded to collect on the check from Unity. The theft and forgery were quickly discovered by Markum, who promptly notified Unity. None of the parties mentioned was negligent. Who will bear the loss, assuming the amount cannot be recovered from Robb? Explain.

5 Pat stole a check made out to the order of Marks, forged the name of Marks on the back, and made the instrument payable to herself. She then negotiated the check to Harrison for cash by signing her own name on the back of the instrument in Harrison's presence. Harrison was unaware of any of the facts

surrounding the theft or forged indorsement and presented the check for payment. Central County Bank, the drawee bank, paid it. Disregarding Pat, who will bear the loss? Explain.

6 American Music Industries, Inc., owed Disneyland Records over $340,000. As evidence of the debt, Irv Schwartz, American's president, issued ten promissory notes, signing them himself. There was no indication they were obligations of the corporation, American Music Industries, Inc., or that Irv Schwartz signed them in a representative capacity, but Mr. Schwartz asserted that Disneyland knew the notes were corporate obligations, not his personally. American paid four of the notes and then defaulted, and Disneyland sued him personally on the notes. He asserted he should be allowed to prove by parol evidence that he was not supposed to be liable. Is he personally liable? Explain.[1]

7 Alice Able hired Betty Baker as a bookkeeper for her seamstress shop. Baker's duties included preparing checks for Able to sign and reconciling the monthly bank statements. Baker made out several checks to herself, leaving a large space to the left of the amount written, which Able noticed when she signed the checks. Baker took the signed checks, altered the amount by adding a zero to the right of the original amount, and cashed them at First Bank, the drawee. Able discovered the fraud, Baker was sent to prison, and Able sued First Bank, claiming it was liable for paying out on altered instruments. What is the result?

8 Christina Reynolds borrowed $16,000 from First Bank to purchase a used Ford automobile. Bank took a note and a secured interest in the car (the car is collateral for the loan). It asked for further security, so Christina got her sister Juanita to sign the note as an accommodation maker. Four months later, Christina notified Bank that she wished to sell the Ford for $14,000 in order to get a four-wheel drive Jeep, and Bank released its security interest. When Christina failed to complete payment on the note for the Ford, Bank turned to Juanita. What, if anything, does Juanita owe?

SELF-TEST QUESTIONS

1 Drawers and indorsers have

a. primary contract liability

b. secondary liability

c. no liability

d. none of the above

2 Conditions(s) needed to establish secondary liability include

a. presentment

b. dishonor

c. notice of dishonor

d. all of the above

3 A demand for payment made on a maker, acceptor, or drawee is called

a. protest

b. notice

c. presentment

d. certification

4 An example of an implied warranty given by a seller of commercial paper includes a warranty

a. of good title

b. that there are no material alterations

c. that signatures are genuine

d. covering all of the above

5 Under UCC Article 3, discharge may result from

a. cancellation

b. impairment of collateral

c. fraudulent alteration

d. all of the above

SELF-TEST ANSWERS

1. b
2. d
3. c

CC BY NC SA

4. d

5. d

---

[1] *Schwartz v. Disneyland Vista Records*, 383 So.2d 1117 (Fla. App. 1980).

Chapter 23
Legal Aspects of Banking

LEARNING OBJECTIVES

CC BY NC SA

After reading this chapter, you should understand the following:

1. Banks' relationships with their customers for payment or nonpayment of checks;
2. Electronic funds transfers and how the Electronic Fund Transfer Act affects the bank-consumer relationship;
3. What a wholesale funds transfer is and the scope of Article 4A;
4. What letters of credit are and how they are used.

To this point we have examined the general law of commercial paper as found in Article 3 of the UCC. Commercial paper—notwithstanding waves of digital innovation—still passes through bank collection processes by the ton every day, and Article 3 applies to this flow. But there is also a separate article in the UCC, Article 4, "Bank Deposits and Collections." In case of conflict with Article 3 rules, those of Article 4 govern.

A discussion of government regulation of the financial services industry is beyond the scope of this book. Our focus is narrower: the laws that govern the operations of the banking system with respect to its depositors and customers. Although histories of banking dwell on the relationship between banks and the national government, the banking law that governs the daily operation of checking accounts is state based—Article 4 of the UCC. The enormous increase in noncheck banking has given rise to the Electronic Fund Transfer Act, a federal law.

23.1 Banks and Their Customers

LEARNING OBJECTIVES

1. Understand how checks move, both traditionally and electronically.
2. Know how Article 4 governs the relationship between a bank and its customers.

CC BY NC SA

The Traditional Bank Collection Process

The Traditional System in General

Once people mostly paid for things with cash: actual bills. That is obviously not very convenient or safe: a lost ten-dollar bill is almost certainly gone, and carrying around large quantities of cash is dangerous (probably only crooks do much of that). Today a person might go for weeks without reaching for a bill (except maybe to get change for coins to put in the parking meter). And while it is indisputable that electronic payment is replacing paper payment, the latter is still very significant. Here is an excerpt from a Federal Reserve Report on the issue:

> *In 2008, U.S. consumers had more payment instruments to choose from than ever before: four types of paper instruments—cash, check, money order, and travelers checks; three types of payment cards—debit, credit, and prepaid; and two electronic instruments—online banking bill payment (OBBP) and electronic bank account deductions (EBAD) using their bank account numbers. The average consumer had 5.1 of the nine instruments in 2008, and used 4.2 instruments in a typical month. Consumers made 52.9 percent of their monthly payments with a payment card. More consumers now have debit cards than credit cards (80.2 percent versus 78.3 percent), and consumers use debit cards more often than cash, credit cards, or checks individually. However, paper instruments are still popular and account for 36.5 percent of consumer payments. Most consumers have used newer electronic payments at some point, but these only account for 9.7 percent of consumer payments. Security and ease of use are the characteristics of payment instruments that consumers rate as most important.*[1]

Americans still wrote some thirty billion checks in 2006.[2] You can readily imagine how complex the bank collection process must be to cope with such a flood of paper. Every check written must eventually come back to the bank on which it is drawn, after first having been sent to the landlord, say, to pay rent, then to the landlord's bank, and from there through a series of intermediate banks and collection centers.

Terminology

To trace the traditional check-collection process, it is necessary to understand the terminology used. The bank upon which a check is written is the **payor bank** (the drawee bank). The **depository bank** is the one the payee deposits the check into. Two terms are used to describe the various banks that may handle the check after it is written: collecting banks and intermediary banks. All banks that handle the check—except the payor bank—are **collecting banks** (including the depository bank); **intermediary banks** are all the collecting banks except the payor and depository banks. A bank can take on more than one role: Roger in Seattle writes a check on his account at Seattle Bank and mails it to Julia in Los Angeles in payment for merchandise; Julia deposits it in her account at Bank of L.A. Bank of L.A. is a depository bank and a collecting bank. Any other bank through which the check travels (except the two banks already mentioned) is an intermediary bank.

Collection Process between Customers of the Same Bank

If the depository bank is also the payor bank (about 30% of all checks), the check is called an "on-us" item and UCC 4-215(e)(2) provides that—if the check is not dishonored—it is available by the payee "at the opening of the bank's second banking day following receipt of the item." Roger writes a check to Matthew, both of whom have accounts at Seattle Bank; Matthew deposits the check on Monday. On Wednesday the check is good for Matthew (he may have been given "provisional credit" before then, as discussed below, the bank could subtract the money from his account if Roger didn't have enough to cover the check).

Collection Process between Customers of Different Banks

Roger in Seattle writes a check on Seattle Bank payable to Julia in L.A. Julia deposits it in her account at L.A. Bank, the depository bank. L.A. Bank must somehow present the check to Seattle Bank either directly or through intermediary banks. If the collecting banks (again, all of them except Seattle Bank) act before the midnight deadline following receipt, they have acted "seasonably" according to UCC 4-202. When the payor bank—Seattle Bank—gets the check it must pay it, unless the check is dishonored or returned (UCC 4-302).

Physical Movement of Checks

The physical movement of checks—such as it still occurs—is handled by three possible systems.

The Federal Reserve System's regional branches process checks for banks holding accounts with them. The Feds charge for the service, and prior to 2004 it regularly included check collection, air transportation of checks to the Reserve Bank (hired out to private contractors) and ground transportation delivery of checks to paying banks. Reserve Banks handle about 27 percent of US checks, but the air service is decreasing with "Check 21," a federal law discussed below, that allows electronic transmission of checks.

Correspondent banks are banks that have formed "partnerships" with other banks in order to exchange checks and payments directly, bypassing the Federal Reserve and its fees. Outside banks may go through a correspondent bank to exchange checks and payments with one of its partners.

Correspondent banks may also form a **clearinghouse corporation**, in which members exchange checks and payments in bulk, instead of on a check-by-check basis, which can be inefficient considering that each bank might receive thousands of checks in a day. The clearinghouse banks save up the checks drawn on other members and exchange them on a daily basis. The net payments for these checks are often settled through Fedwire, a Federal Reserve Board electronic funds transfer (EFT) system that handles large-scale check settlement among US banks. Correspondent banks and clearinghouse corporations make up the private sector of check clearing, and together they handle about 43 percent of US checks.

The Electronic System: Check 21 Act

Rationale for the "Check Clearing for the 21st Century Act"

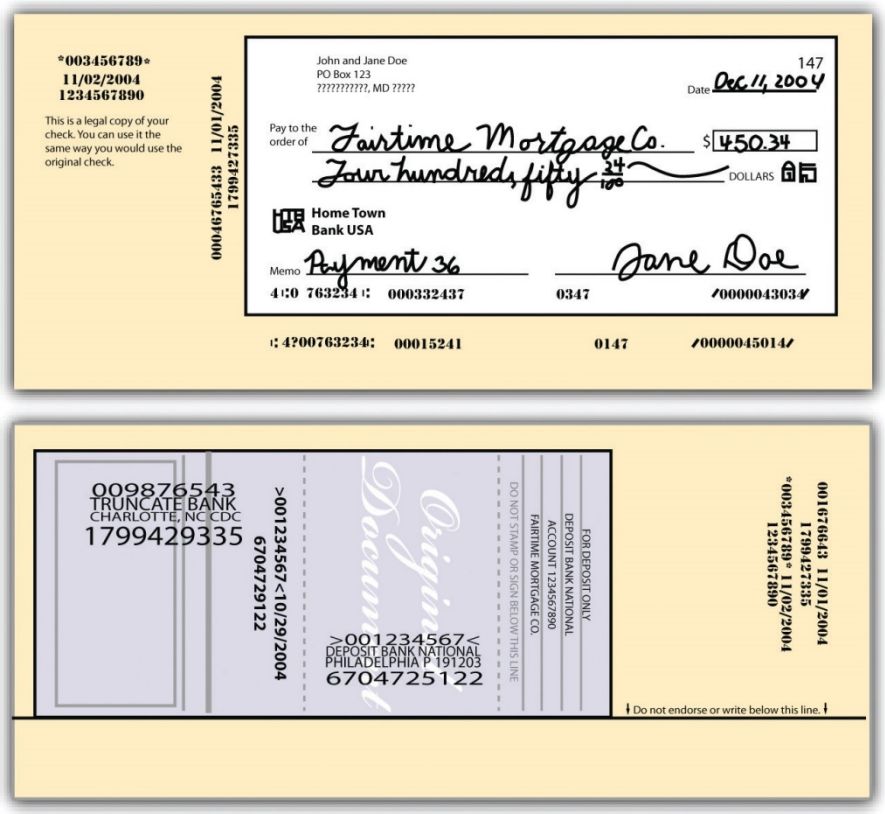
After the events of September 11, 2001, Congress felt with renewed urgency that banks needed to present and clear checks in a way not dependent upon the physical transportation of the paper instruments by air and ground, in case such transportation facilities were disrupted. The federal Check Clearing for the 21st Century Act (Public Law 108-100)—more commonly referred to as "Check 21 Act"—became effective in 2004.

Basic Idea of Check 21 Act

Check 21 Act provides the legal basis for the electronic transportation of check data. A bank scans the check. The data on the check is already encoded in electronically readable numbers and the data, now separated ("truncated") from the paper instrument (which may be destroyed), is transmitted for processing. "The Act authorizes a new negotiable instrument, called a **substitute check**, to replace the original check. A substitute check is a paper reproduction of the original check that is suitable for automated processing in the same manner as the original check. The Act permits banks to provide substitute checks in place of original checks to subsequent parties in the check processing stream....Any financial institution in the check clearing process can truncate the original check and create a substitute check.[3] However, in the check collection process it is not required that the image be converted to a substitute check: the electronic image itself may suffice.

For example, suppose Roger in Seattle writes a check on Seattle Bank payable to Julia in L.A. and mails it to her. Julia deposits it in her account at L.A. Bank, the depository bank. L.A. Bank truncates the check (again, scans it and destroys the original) and transmits the data to Seattle Bank for presentation and payment. If for any reason Roger, or any appropriate party, wants a paper version, a substitute check will be created (see Figure 23.1 "Substitute Check Front and Back"). Most often, though, that is not necessary: Roger does not receive the actual cancelled checks he wrote in his monthly statement as he did formerly. He receives instead a statement listing paid checks he's written and a picture of the check (not a substitute check) is available to him online through his bank's website. Or he may receive his monthly statement itself electronically, with pictures of the checks he wrote available with a mouse click. Roger may also dispense with mailing the check to Julia entirely, as noted in the discussion of electronic funds transfers.

Figure 23.1 Substitute Check Front and Back



Front and back of a substitute check (not actual size).

Images from Federal Reserve

Board:[*http://www.federalreserve.gov/pubs/check21/consumer_guide*](http://www.federalreserve.gov/pubs/check21/consumer_guide)

Substitute checks are legal negotiable instruments. The act provides certain warranties to protect recipients of substitute checks that are intended to protect recipients against losses associated with the check substitution process. One of these warranties provides that "[a] bank that transfers, presents, or returns a substitute check...for which it receives consideration warrants...that...[t]he substitute check meets the requirements of legal equivalence" (12 CFR § 229.52(a)(1)). The Check 21 Act does not replace existing state laws regarding such instruments. The Uniform Commercial Code still applies, and we turn to it next.

Two notable consequences of the Check 21 Act are worth mentioning. The first is that a check may be presented to the payor bank for payment very quickly, perhaps in less than an hour: the customer's "float" time is abbreviated. That means be sure you have enough money in your account to cover the checks that you write. The second consequence of Check 21 Act is that it is now possible for anybody—you at home or

the merchant from whom you are buying something—to scan a check and deposit it instantly. "Remote deposit capture" allows users to transmit a scanned image of a check for posting and clearing using a web-connected computer and a check scanner. The user clicks to send the deposit to the desired existing bank account. Many merchants are using this system: that's why if you write a check at the hardware store you may see it scanned and returned immediately to you. The digital data are transmitted, and the scanned image may be retrieved, if needed, as a "substitute check."

UCC Article 4: Aspects of Bank Operations

Reason for Article 4

Over the years, the states had begun to enact different statutes to regulate the check collection process. Eighteen states adopted the American Bankers Association Bank Collection Code; many others enacted Deferred Posting statutes. Not surprisingly, a desire for uniformity was the principal reason for the adoption of UCC Article 4. Article 4 absorbed many of the rules of the American Bankers Association Code and of the principles of the Deferred Posting statutes, as well as court decisions and common customs not previously codified.

Banks Covered

Article 4 covers three types of banks: depository banks, payor banks, and collecting banks. These terms—already mentioned earlier—are defined in UCC Section 4-105. A depositary bank is the first bank to which an item is transferred for collection. Section 4-104 defines "item" as "an instrument or a promise or order to pay money handled by a bank for collection or payment[,]...not including a credit or debit card slip." A payor bank is any bank that must pay a check because it is drawn on the bank or accepted there—the drawee bank (a depositary bank may also be a payor bank). A collecting bank is any bank except the payor bank that handles the item for collection.

Technical Rules

Detailed coverage of Parts 2 and 3 of Article 4, the substantive provisions, is beyond the scope of this book. However, Article 4 answers several specific questions that bank customers most frequently ask.

1. What is the effect of a "pay any bank" indorsement? The moment these words are indorsed on a check, only a bank may acquire the rights of a holder. This restriction can be lifted whenever (a) the check has been returned to the customer initiating collection or (b) the bank specially indorses the check to a person who is not a bank (4-201).
2. May a depositary bank supply a missing indorsement? It may supply any indorsement of the customer necessary to title unless the check contains words such as "payee's indorsement required." If the customer fails to indorse a check when depositing it in his account, the bank's notation that the check was deposited by a customer or credited to his account takes effect as the customer's indorsement. (Section 4-205(1)).
3. Are any warranties given in the collection process? Yes. They are identical to those provided in Article 3, except that they apply only to customers and collecting banks (4-207(a)). The customer or collecting bank that transfers an item and receives a settlement or other consideration warrants (1) he is entitled to enforce the item; (2) all signatures are authorized authentic; (3) the item has not been altered; (4) the item is not subject to a defense or claim in recoupment; (5) he has no knowledge of insolvency proceedings regarding the maker or acceptor or in the case of an unaccepted draft, the drawer. These warranties cannot be disclaimed as to checks.
4. Does the bank have the right to a charge-back against a customer's account, or refund? The answer turns on whether the settlement was provisional or final. A settlement is the proper crediting of the amount ordered to be paid by the instrument. Someone writes you a check for $1,000 drawn on First Bank, and you deposit it in Second Bank. Second Bank will make a "provisional settlement" with you—that is, it will provisionally credit your account with $1,000, and that settlement will be final when First Bank debits the check writer's account and credits Second Bank with the funds. Under Section 4-212(1), as long as the settlement was still provisional, a collecting bank has the right to a "charge-back" or refund if the check "bounces" (is dishonored). However, if settlement was final, the bank cannot claim a refund.

What determines whether settlement is provisional or final? Section 4-213(1) spells out four events (whichever comes first) that will convert a payor bank's provisional settlement into final settlement: When it (a) pays the item in cash; (b) settles without reserving a right to revoke and without having a right

under statute, clearinghouse rule, or agreement with the customer; finishes posting the item to the appropriate account; or (d) makes provisional settlement and fails to revoke the settlement in the time and manner permitted by statute, clearinghouse rule, or agreement. All clearinghouses have rules permitting revocation of settlement within certain time periods. For example an item cleared before 10 a.m. may be returned and the settlement revoked before 2 p.m. From this section it should be apparent that a bank generally can prevent a settlement from becoming final if it chooses to do so.

Relationship with Customers

The relationship between a bank and its customers is governed by UCC Article 4. However, Section 4-103(1) permits the bank to vary its terms, except that no bank can disclaim responsibility for failing to act in good faith or to exercise ordinary care. Most disputes between bank and customer arise when the bank either pays or refuses to pay a check. Under several provisions of Article 4, the bank is entitled to pay, even though the payment may be adverse to the customer's interest.

Common Issues Arising between Banks and Their Customers

Payment of Overdrafts

Suppose a customer writes a check for a sum greater than the amount in her account. May the bank pay the check and charge the customer's account? Under Section 4-401(1), it may. Moreover, it may pay on an altered check and charge the customer's account for the original tenor of the check, and if a check was completed it may pay the completed amount and charge the customer's account, assuming the bank acted in good faith without knowledge that the completion was improper.

Payment of Stale Checks

Section 4-404 permits a bank to refuse to pay a check that was drawn more than six months before being presented. Banks ordinarily consider such checks to be "stale" and will refuse to pay them, but the same section gives them the option to pay if they choose. A corporate dividend check, for example, will be presumed to be good more than six months later. The only exception to this rule is for certified checks, which must be paid whenever presented, since the customer's account was charged when the check was certified.

Payment of Deceased's or Incompetent's Checks

Suppose a customer dies or is adjudged to be incompetent. May the bank honor her checks? Section 4-405 permits banks to accept, pay, and collect an item as long as it has no notice of the death or declaration of incompetence, and has no reasonable opportunity to act on it. Even after notice of death, a bank has ten days to payor certify checks drawn on or prior to the date of death unless someone claiming an interest in the account orders it to refrain from doing so.

Stop Payment Orders

Section 4-403 expressly permits the customer to order the bank to "stop payment" on any check payable for her account, assuming the stop order arrives in enough time to reasonably permit the bank to act on it. An oral stop order is effective for fourteen days; a follow-up written confirmation within that time is effective for six months and can be renewed in writing. But if a stop order is not renewed, the bank will not be liable for paying the check, even one that is quite stale (e.g., *Granite Equipment Leasing Corp. v. Hempstead Bank*, 326 N.Y.S. 2d 881 (1971)).

Wrongful Dishonor

If a bank wrongfully dishonors an item, it is liable to the customer for all damages that are a direct consequence of ("proximately caused by") the dishonor. The bank's liability is limited to the damages actually proved; these may include damages for arrest and prosecution. See Section 23.4 "Cases" under "Bank's Liability for Paying over Customer's 'Stop Payment' Order" (*Meade v. National Bank of Adams County*).

Customers' Duties

In order to hold a bank liable for paying out an altered check, the customer has certain duties under Section 4-406. Primarily, the customer must act promptly in examining her statement of account and must notify the bank if any check has been altered or her signature has been forged. If the customer fails

to do so, she cannot recover from the bank for an altered signature or other term if the bank can show that it suffered a loss because of the customer's slowness. Recovery may also be denied when there has been a series of forgeries and the customer did not notify the bank within two weeks after receiving the first forged item. See Section 23.4 "Cases" under "Customer's Duty to Inspect Bank Statements" (the *Planters Bank v. Rogers* case).

These rules apply to a payment made with ordinary care by the bank. If the customer can show that the bank negligently paid the item, then the customer may recover from the bank, regardless of how dilatory the customer was in notifying the bank—with two exceptions: (1) from the time she first sees the statement and item, the customer has one year to tell the bank that her signature was unauthorized or that a term was altered, and (2) she has three years to report an unauthorized indorsement.

The Expedited Funds Availability Act

In General

In addition to UCC Article 4 (again, state law), the federal Expedited Funds Availability Act—also referred to as "Regulation CC" after the Federal Reserve regulation that implements it—addresses an aspect of the relationship between a bank and its customers. It was enacted in 1988 in response to complaints by consumer groups about long delays before customers were allowed access to funds represented by checks they had deposited. It has nothing to do with electronic transfers, although the increasing use of electronic transfers does speed up the system and make it easier for banks to comply with Regulation CC.

The Act's Provisions

The act provides that when a customer deposits a cashier's check, certified check, or a check written on an account in the same bank, the funds must be available by the next business day. Funds from other local checks (drawn on institutions within the same Federal Reserve region) must be available within two working days, while there is a maximum five-day wait for funds from out-of-town checks. In order for these time limits to be effective, the customer must endorse the check in a designated space on the back side. The FDIC sets out the law at its website: http://www.fdic.gov/regulations/laws/rules/6500-3210.html.

KEY TAKEAWAY

The bank collection process is the method by which checks written on one bank are transferred by the collecting bank to a clearing house. Traditionally this has been a process of physical transfer by air and ground transportation from the depository bank to various intermediary banks to the payor bank where the check is presented. Since 2004 the Check 21 Act has encouraged a trend away from the physical transportation of checks to the electronic transportation of the check's data, which is truncated (stripped) from the paper instrument and transmitted. However, if a paper instrument is required, a "substitute check" will recreate it. The UCC's Article 4 deals generally with aspects of the bank-customer relationship, including warranties on payment or collection of checks, payment of overdrafts, stop orders, and customers' duties to detect irregularities. The Expedited Funds Availability Act is a federal law governing customer's access to funds in their accounts from deposited checks.

EXERCISES

1. Describe the traditional check-collection process from the drawing of the check to its presentation for payment to the drawee (payor) bank
2. Describe how the Check 21 Act has changed the check-collection process.
3. Why was Article 4 developed, and what is its scope of coverage?

---

[1] Kevin Foster, et al., *The 2008 Survey of Consumer Payment Choice*, Federal Reserve Bank of Boston, Public Policy Discussion Paper No. 09-10, p. 2 (April 2010),http://www.bos.frb.org/economic/ppdp/2009/ppdp0910.pdf.

[2] Scott Schuh, *Overview of the Survey of Consumer Payment Choice (SCPC) Program*, Federal Reserve Bank of Boston, p. 5 (May 2010).http://www.bos.frb.org/economic/cprc/presentations/2010/Schuh050610.pdf.

[3] United States Treasury, *The Check Clearing for the 21st Century Act: Frequently Asked Questions*, October 2004,http://www.justice.gov/ust/eo/private_trustee/library/chapter07/docs/check21/Check21FAQs-final.pdf.

23.2 Electronic Funds Transfers

LEARNING OBJECTIVES

1. Understand why electronic fund transfers have become prevalent.
2. Recognize some typical examples of EFTs.
3. Know that the EFT Act of 1978 protects consumers, and recognize what some of those protections—and liabilities—are.
4. Understand when financial institutions will be liable for violating the act, and some of the circumstances when the institutions will not be liable.

Background to Electronic Fund Transfers

In General

Drowning in the yearly flood of billions of checks, eager to eliminate the "float" that a bank customer gets by using her money between the time she writes a check and the time it clears, and recognizing that better customer service might be possible, financial institutions sought a way to computerize the check collection process. What has developed is electronic fund transfer (EFT), a system that has changed how customers interact with banks, credit unions, and other financial institutions. Paper checks have their advantages, but their use is decreasing in favor of EFT.

In simplest terms, EFT is a method of paying by substituting an electronic signal for checks. A "debit card," inserted in the appropriate terminal, will authorize automatically the transfer of funds from your checking account, say, to the account of a store whose goods you are buying.

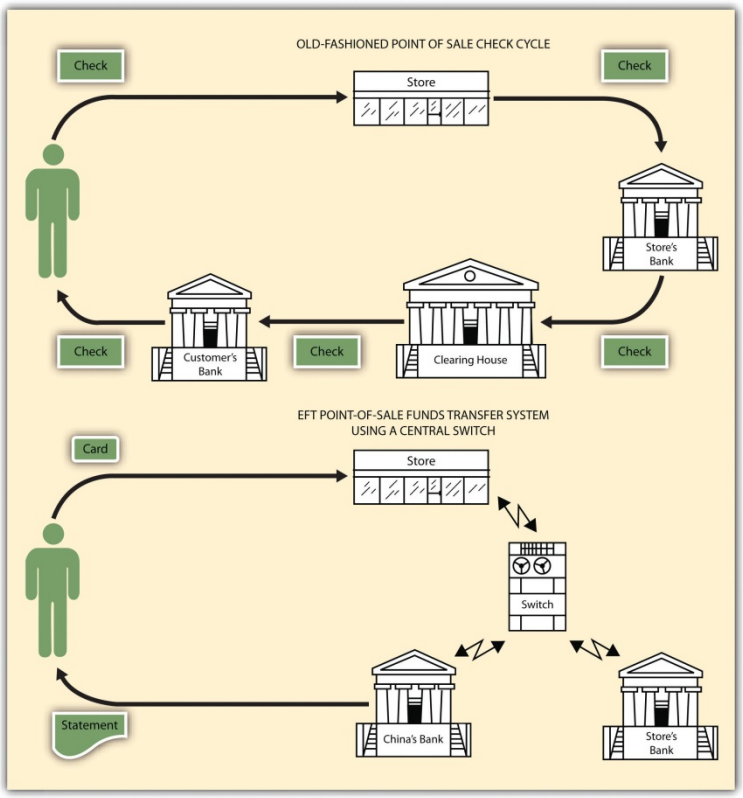
Types of EFT

You are of course familiar with some forms of EFT:

- The automated teller machine (ATM) permits you to electronically transfer funds between checking and savings accounts at your bank with a plastic ID card and a personal identification number (PIN), and to obtain cash from the machine.
- Telephone transfers or computerized transfers allow customers to access the bank's computer system and direct it to pay bills owed to a third party or to transfer funds from one account to another.
- Point of sale terminals located in stores let customers instantly debit their bank accounts and credit the merchant's account.
- Preauthorized payment plans permit direct electronic deposit of paychecks, Social Security checks, and dividend checks.
- Preauthorized withdrawals from customers' bank accounts or credit card accounts allow paperless payment of insurance premiums, utility bills, automobile or mortgage payments, and property tax payments.

The "short circuit" that EFT permits in the check processing cycle is illustrated in Figure 23.2 "How EFT Replaces Checks".

Figure 23.2 How EFT Replaces Checks



Unlike the old-fashioned check collection process, EFT is virtually instantaneous: at one instant a customer has a sum of money in her account; in the next, after insertion of a plastic card in a machine or the transmission of a coded message by telephone or computer, an electronic signal automatically debits her bank checking account and posts the amount to the bank account of the store where she is making a purchase. No checks change hands; no paper is written on. It is quiet, odorless, smudge proof. But errors are harder to trace than when a paper trail exists, and when the system fails ("our computer is down") the financial mess can be colossal. Obviously some sort of law is necessary to regulate EFT systems.

Electronic Fund Transfer Act of 1978

Purpose

CC BY NC SA

Because EFT is a technology consisting of several discrete types of machines with differing purposes, its growth has not been guided by any single law or even set of laws. The most important law governing consumer transactions is the **Electronic Fund Transfer Act of 1978**,[1] whose purpose is "to provide a basic framework establishing the rights, liabilities, and responsibilities of participants in electronic fund transfer systems. The primary objective of [the statute], however, is the provision of individual consumer rights." This federal statute has been implemented and supplemented by the Federal Reserve Board's Regulation E, Comptroller of the Currency guidelines on EFT, and regulations of the Federal Home Loan Bank Board. (Wholesale transactions are governed by UCC Article 4A, which is discussed later in this chapter.)

The EFT Act of 1978 is primarily designed to disclose the terms and conditions of electronic funds transfers so the customer knows the rights, costs and liabilities associated with EFT, but it does not embrace every type of EFT system. Included are "point-of-sale transfers, automated teller machine transactions, direct deposits or withdrawal of funds, and transfers initiated by telephone or computer" (EFT Act Section 903(6)). Not included are such transactions as wire transfer services, automatic transfers between a customer's different accounts at the same financial institution, and "payments made by check, draft, or similar paper instrument at electronic terminals" (Reg. E, Section 205.2(g)).

Consumer Protections Afforded by the Act

Four questions present themselves to the mildly wary consumer facing the advent of EFT systems: (1) What record will I have of my transaction? (2) How can I correct errors? (3) What recourse do I have if a thief steals from my account? (4) Can I be required to use EFT? The EFT Act, as implemented by Regulation E, answers these questions as follows.

1. Proof of transaction. The electronic terminal itself must be equipped to provide a receipt of transfer, showing date, amount, account number, and certain other information. Perhaps more importantly, the bank or other financial institution must provide you with a monthly statement listing all electronic transfers to and from the account, including transactions made over the computer or telephone, and must show to whom payment has been made.

2. Correcting errors. You must call or write the financial institution whenever you believe an error has been made in your statement. You have sixty days to do so. If you call, the financial institution may require you to send in written information within ten days. The financial institution has forty-five days to investigate and correct the error. If it takes longer than ten days, however, it must credit you with the amount in dispute so that you can use the funds while it is investigating. The financial institution must either correct the error promptly or explain why it believes no error was made. You are entitled to copies of documents relied on in the investigation.
3. Recourse for loss or theft. If you notify the issuer of your EFT card within two business days after learning that your card (or code number) is missing or stolen, your liability is limited to $50. If you fail to notify the issuer in this time, your liability can go as high as $500. More daunting is the prospect of loss if you fail within sixty days to notify the financial institution of an unauthorized transfer noted on your statement: after sixty days of receipt, your liability is unlimited. In other words, a thief thereafter could withdraw all your funds and use up your line of credit and you would have no recourse against the financial institution for funds withdrawn after the sixtieth day, if you failed to notify it of the unauthorized transfer.
4. Mandatory use of EFT. Your employer or a government agency can compel you to accept a salary payment or government benefit by electronic transfer. But no creditor can insist that you repay outstanding loans or pay off other extensions of credit electronically. The act prohibits a financial institution from sending you an EFT card "valid for use" unless you specifically request one or it is replacing or renewing an expired card. The act also requires the financial institution to provide you with specific information concerning your rights and responsibilities (including how to report losses and thefts, resolve errors, and stop payment of preauthorized transfers). A financial institution may send you a card that is "not valid for use" and that you alone have the power to validate if you choose to do so, after the institution has verified that you are the person for whom the card was intended.

Liability of the Financial Institution

The financial institution's failure to make an electronic fund transfer, in accordance with the terms and conditions of an account, in the correct amount or in a timely manner when properly instructed to do so by the consumer makes it liable for all damages proximately caused to the consumer, except where

1) the consumer's account has insufficient funds;

2) the funds are subject to legal process or other encumbrance restricting such transfer;

3) such transfer would exceed an established credit limit;

4) an electronic terminal has insufficient cash to complete the transaction; or

5) a circumstance beyond its control, where it exercised reasonable care to prevent such an occurrence, or exercised such diligence as the circumstances required.

Enforcement of the Act

A host of federal regulatory agencies oversees enforcement of the act. These include the Comptroller of the Currency (national banks), Federal Reserve District Bank (state member banks), Federal Deposit Insurance Corporation regional director (nonmember insured banks), Federal Home Loan Bank Board supervisory agent (members of the FHLB system and savings institutions insured by the Federal Savings & Loan Insurance Corporation), National Credit Union Administration (federal credit unions), Securities & Exchange Commission (brokers and dealers), and the Federal Trade Commission (retail and department stores) consumer finance companies, all nonbank debit card issuers, and certain other financial institutions. Additionally, consumers are empowered to sue (individually or as a class) for actual damages caused by any EFT system, plus penalties ranging from $100 to $1,000. Section 23.4 "Cases", under "Customer's Duty to Inspect Bank Statements" (*Commerce Bank v. Brown*), discusses the bank's liability under the act.

KEY TAKEAWAY

Eager to reduce paperwork for both themselves and for customers, and to speed up the check collection process, financial institutions have for thirty years been moving away from paper checks and toward electronic fund transfers. These EFTs are ubiquitous, including ATMs, point-of-sale systems, direct deposits and withdrawals and online banking of various kinds. Responding to the need for consumer protection, Congress adopted the Electronic Fund Transfers Act, effective in 1978. The act addresses many common concerns consumers have about using electronic fund transfer systems, sets out liability for financial institutions and customers, and provides an enforcement mechanism.

EXERCISES

1. Why have EFTs become very common?
2. What major issues are addressed by the EFTA?
3. If you lose your credit card, what is your liability for unauthorized charges?

---

[1] FDIC, "Electronic Fund Transfer Act of 1978,"http://www.fdic.gov/regulations/laws/rules/6500-1350.html.

23.3 Wholesale Transactions and Letters of Credit

LEARNING OBJECTIVES

CC BY NC SA

1. Understand what a "wholesale transaction" is; recognize that UCC Article 4A governs such transactions, and recognize how the Article addresses three common issues.
2. Know what a "letter of credit" (LC) is, the source of law regarding LCs, and how such instruments are used.

Wholesale Funds Transfers

Another way that money is transferred is by commercial fund transfers or **wholesale funds transfers**, which is by far the largest segment of the US payment system measured in amounts of money transferred. It is trillions of dollars a day. Wholesale transactions are the transfers of funds between businesses or financial institutions.

Background and Coverage

It was in the development of commercial "wholesale wire transfers" of money in the nineteeth and early twentieth centuries that businesses developed the processes enabling the creation of today's consumer electronic funds transfers. Professor Jane Kaufman Winn described the development of uniform law governing commercial funds transfers:

> *Although funds transfers conducted over funds transfer facilities maintained by the Federal Reserve Banks were subject to the regulation of the Federal Reserve Board, many funds transfers took place over private systems, such as the Clearing House for Interbank Payment Systems ("CHIPS"). The entire wholesale funds transfer system was not governed by a clear body of law until U.C.C. Article 4A was promulgated in 1989 and adopted by the states shortly thereafter. The Article 4A drafting process resulted in many innovations, even though it drew heavily on the practices that had developed among banks and their customers during the 15 years before the drafting committee was established. While a consensus was not easy to achieve, the community of interests shared by both the banks and their customers permitted the drafting process to find workable compromises on many thorny issues.*[1]

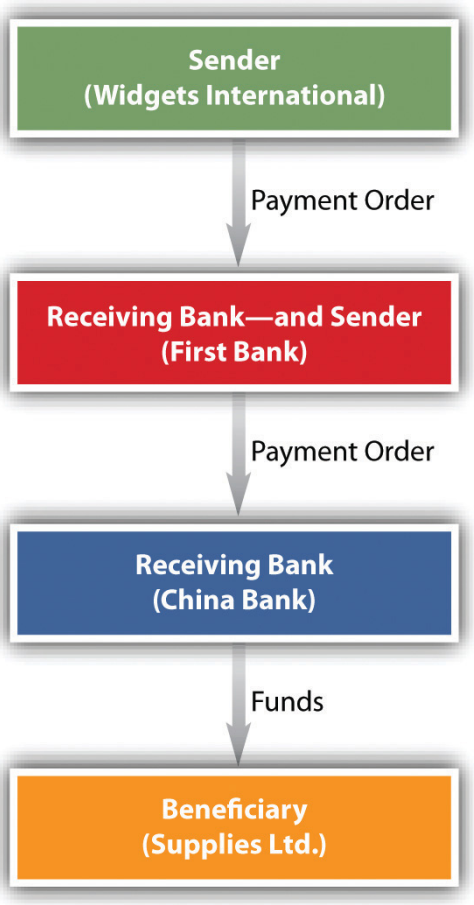
All states and US territories have adopted Article 4A. Consistent with other UCC provisions, the rights and obligations under Article 4A may be varied by agreement of the parties. Article 4A does not apply if any step of the transaction is governed by the Electronic Fund Transfer Act. Although the implication may be otherwise, the rules in Article 4A apply to any funds transfer, not just electronic ones (i.e., transfers by mail are covered, too). Certainly, however, electronic transfers are most common, and—as the Preface to Article 4A notes—a number of characteristics of them influenced the Code's rules. These transactions are characterized by large amounts of money—multimillions of dollars; the parties are sophisticated businesses or financial institutions; funds transfers are completed in one day, they are highly efficient substitutes for paper delivery; they are usually low cost—a few dollars for the funds transfer charged by the sender's bank.

Operation of Article 4A

The UCC "Prefatory Note" to Article 4A observes that "the funds transfer that is covered by Article 4A is not a complex transaction." To illustrate the operation of Article 4A, assume that Widgets International has an account with First Bank. In order to pay a supplier, Supplies Ltd., in China, Widgets instructs First Bank to pay $6 million to the account of Supplies Ltd. in China Bank. In the terminology of Article 4A, Widgets' instruction to its bank is a "payment order." Widgets is the "sender" of the payment order, First Bank is the "receiving bank," and Supplies Ltd. is the "beneficiary" of the order.

When First Bank performs the purchase order by instructing China Bank to credit the account of Supplies Limited, First Bank becomes a sender of a payment order, China Bank becomes a receiving bank, and Supplies Ltd. is still the beneficiary. This transaction is depicted in Figure 23.3 "Funds Transfer". In some transactions there may also be one or more "intermediary banks" between First and Second Bank.

Figure 23.3 Funds Transfer



Frequently Occurring Legal Issues in Funds Transfers

Three legal issues that frequently arise in funds transfer litigation are addressed in Article 4A and might be mentioned here.

Responsibility for Unauthorized Payments

First, who is responsible for unauthorized payment orders? The usual practice is for banks and their customers to agree to security procedures for the verification of payment orders. If a bank establishes a commercially reasonable procedure, complies with that procedure, and acts in good faith and according to its agreement with the customer, the customer is bound by an unauthorized payment order. There is, however, an important exception to this rule. A customer will not be liable when the order is from a person unrelated to its business operations.

Error by Sender

Second, who is responsible when the sender makes a mistake—for instance, in instructing payment greater than what was intended? The general rule is that the sender is bound by its own error. But in cases where the error would have been discovered had the bank complied with its security procedure, the receiving bank is liable for the excess over the amount intended by the sender, although the bank is allowed to recover this amount from the beneficiary.

Bank Mistake in Transferring Funds

Third, what are the consequences when the bank makes a mistake in transferring funds? Suppose, for example, that Widgets (in the previous situation) instructed payment of $2 million but First Bank in turn instructed payment of $20 million. First Bank would be entitled to only $2 million from Widgets and would then attempt to recover the remaining $18 million from Supplies Ltd. If First Bank had instructed payment to the wrong beneficiary, Widgets would have no liability and the bank would be responsible for recovering the entire payment. Unless the parties agree otherwise, however, a bank that improperly executes a payment order is not liable for consequential damages.

Letters of Credit

Because international trade involves risks not usually encountered in domestic trade—government control of exports, imports, and currency; problems in verifying goods' quality and quantity; disruptions caused by adverse weather, war; and so on—merchants have over the years devised means to minimize these risks, most notably the letter of credit ("LC"). Here are discussed the definition of letters of credit, the source of law governing them, how they work as payments for exports and as payments for imports.

Definition

A **letter of credit** is a statement by a bank (or other financial institution) that it will pay a specified sum of money to specific persons if certain conditions are met. Or, to rephrase, it is a letter issued by a bank authorizing the bearer to draw a stated amount of money from the issuing bank (or its branches, or other associated banks or agencies). Originally, a letter of credit was quite literally that—a letter addressed by the buyer's bank to the seller's bank stating that the former could vouch for their good customer, the

buyer, and that it would pay the seller in case of the buyer's default. An LC is issued by a bank on behalf of its creditworthy customers, whose application for the credit has been approved by that bank.

Source of Law

Letters of credit are governed by both international and US domestic law.

International Law

Many countries (including the United States) have bodies of law governing letters of credit. Sophisticated traders will agree among themselves by which body of law they choose to be governed. They can agree to be bound by the UCC, or they may decide they prefer to be governed by the Uniform Customs and Practice for Commercial Documentary Credits (UCP), a private code devised by the Congress of the International Chamber of Commerce. Suppose the parties do not stipulate a body of law for the agreement, and the various bodies of law conflict, what then? Julius is in New York and Rochelle is in Paris; does French law or New York law govern? The answer will depend on the particulars of the dispute. An American court must determine under the applicable principles of the law of "conflicts of law" whether New York or French law applies.

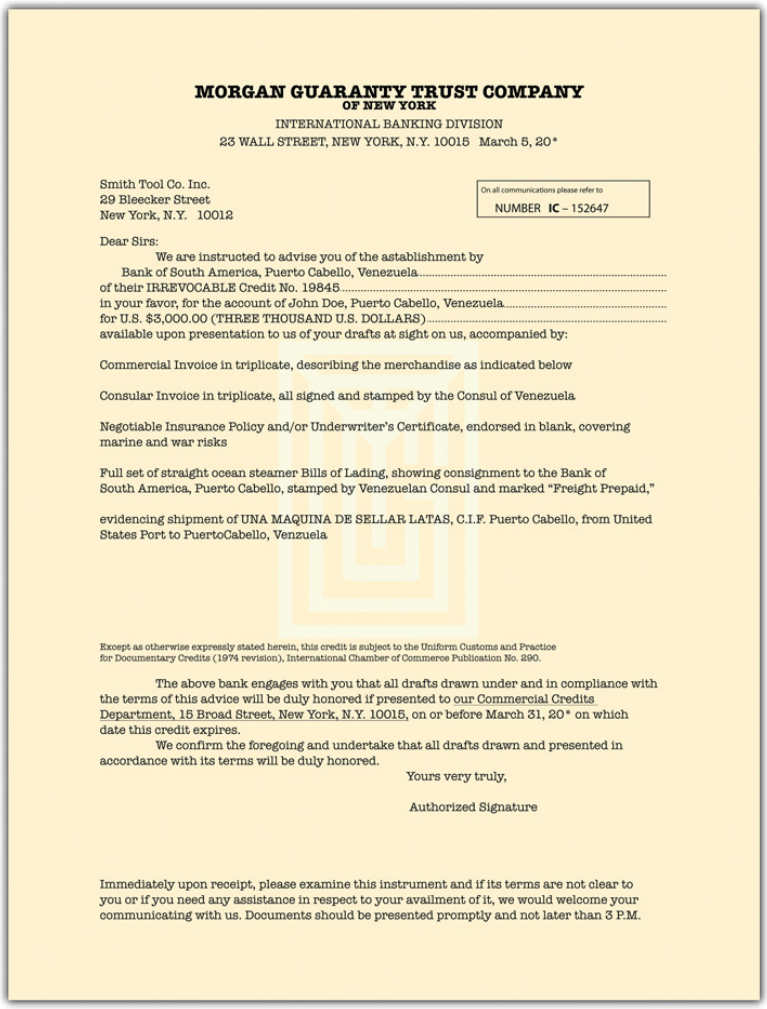
Domestic Law

The principal body of law applicable to the letter of credit in the United States is Article 5 of the UCC. Section 5-103 declares that Article 5 "applies to letters of credit and to certain rights and obligations arising out of transactions involving letters of credit." The Official Comment to 5-101 observes, "A letter of credit is an idiosyncratic form of undertaking that supports performance of an obligation incurred in a separate financial, mercantile, or other transaction or arrangement." And—as is the case in other parts of the Code—parties may, within some limits, agree to "variation by agreement in order to respond to and accommodate developments in custom and usage that are not inconsistent with the essential definitions and mandates of the statute." Although detailed consideration of Article 5 is beyond the scope of this book, a distinction between guarantees and letters of credit should be noted: Article 5 applies to the latter and not the former.

Letters of Credit as Payment for Exports

The following discussion presents how letters of credit work as payment for exports, and a sample letter of credit is presented at Figure 23.4 "A Letter of Credit".

Figure 23.4 A Letter of Credit



MORGAN GUARANTY TRUST COMPANY
OF NEW YORK
INTERNATIONAL BANKING DIVISION
23 WALL STREET, NEW YORK, N.Y. 10015 March 5, 20*

Smith Tool Co. Inc.
29 Bleecker Street
New York, N.Y. 10012

On all communications please refer to
NUMBER IC – 152647

Dear Sirs:

We are instructed to advise you of the establishment by
Bank of South America, Puerto Cabello, Venezuela
of their IRREVOCABLE Credit No. 19845
in your favor, for the account of John Doe, Puerto Cabello, Venezuela
for U.S. $3,000.00 (THREE THOUSAND U.S. DOLLARS)
available upon presentation to us of your drafts at sight on us, accompanied by:

Commercial Invoice in triplicate, describing the merchandise as indicated below

Consular Invoice in triplicate, all signed and stamped by the Consul of Venezuela

Negotiable Insurance Policy and/or Underwriter's Certificate, endorsed in blank, covering marine and war risks

Full set of straight ocean steamer Bills of Lading, showing consignment to the Bank of South America, Puerto Cabello, stamped by Venezuelan Consul and marked "Freight Prepaid,"

evidencing shipment of UNA MAQUINA DE SELLAR LATAS, C.I.F. Puerto Cabello, from United States Port to PuertoCabello, Venzuela

Except as otherwise expressly stated herein, this credit is subject to the Uniform Customs and Practice for Documentary Credits (1974 revision), International Chamber of Commerce Publication No. 290.

The above bank engages with you that all drafts drawn under and in compliance with the terms of this advice will be duly honored if presented to our Commercial Credits Department, 16 Broad Street, New York, N.Y. 10015, on or before March 31, 20* on which date this credit expires.

We confirm the foregoing and undertake that all drafts drawn and presented in accordance with its terms will be duly honored.

Yours very truly,

Authorized Signature

Immediately upon receipt, please examine this instrument and if its terms are not clear to you or if you need any assistance in respect to your availment of it, we would welcome your communicating with us. Documents should be presented promptly and not later than 3 P.M.

Julius desires to sell fine quality magic wands and other stage props to Rochelle's Gallery in Paris. Rochelle agrees to pay by letter of credit—she will, in effect, get her bank to inform Julius that he will get paid if the goods are right. She does so by "opening" a letter of credit at her bank—the issuing bank—the Banque de Rue de Houdini where she has funds in her account, or good credit. She tells the bank the terms of sale, the nature and quantity of the goods, the amount to be paid, the documents she will require as proof of shipment, and an expiration date. Banque de Rue de Houdini then directs its correspondent bank in the United States, First Excelsior Bank, to inform Julius that the letter of credit has been opened:

Rochelle is good for it. For Julius to have the strongest guarantee that he will be paid, Banque de Rou de Houdini can ask First Excelsior to confirm the letter of credit, thus binding both Banque de Rue de Houdini and Excelsior to pay according to the terms of the letter.

Once Julius is informed that the letter of credit has been issued and confirmed, he can proceed to ship the goods and draw a draft to present (along with the required documents such as commercial invoice, bill of lading, and insurance policy) to First Excelsior, which is bound to follow exactly its instructions from Banque de Rue de Houdini. Julius can present the draft and documents directly, through correspondent banks, or by a representative at the port from which he is shipping the goods. On presentation, First Excelsior may forward the documents to Banque de Rue de Houdini for approval and when First Excelsior is satisfied it will take the draft and pay Julius immediately on a sight draft or will stamp the draft "accepted" if it is a time draft (payable in thirty, sixty, or ninety days). Julius can discount an accepted time draft or hold it until it matures and cash it in for the full amount. First Excelsior will then forward the draft through international banking channels to Banque de Rue de Houdini to debit Rochelle's account.

As Payment for Imports

US importers—buyers—also can use the letter of credit to pay for goods bought from abroad. The importer's bank may require that the buyer put up collateral to guarantee it will be reimbursed for payment of the draft when it is presented by the seller's agents. Since the letter of credit ordinarily will be irrevocable, the bank will be bound to pay the draft when presented (assuming the proper documents are attached), regardless of deficiencies ultimately found in the goods. The bank will hold the bill of lading and other documents and could hold up transfer of the goods until the importer pays, but that would saddle the bank with the burden of disposing of the goods if the importer failed to pay. If the importer's credit rating is sufficient, the bank could issue a trust receipt. The goods are handed over to the importer before they are paid for, but the importer then becomes trustee of the goods for the bank and must hold the proceeds for the bank up to the amount owed

KEY TAKEAWAY

Wholesale funds transfers are a mechanism by which businesses and financial institutions can transmit large sums of money—millions of dollars—between each other, usually electronically, from and to their clients' accounts. Article 4A of the UCC governs these transactions. A letter of credit is a promise by a buyer's bank that upon presentation of the proper paperwork it will pay a specified sum to the identified seller. Letters of credit are governed by domestic and international law.

---

[1] Jane Kaufman Winn, *Clash of the Titans: Regulating the Competition between Established and Emerging Electronic Payment Systems*,http://www.law.washington.edu/Directory/docs/Winn/Clash%20of%20the%20Titans.htm.

23.4 Cases

Bank's Liability for Paying over Customer's "Stop Payment" Order

Meade v. National Bank of Adams County

2002 WL 31379858 (Ohio App. 2002)

Kline, J.

CC BY NC SA

The National Bank of Adams County appeals the Adams County Court's judgment finding that it improperly paid a check written by Denton Meade, and that Meade incurred $3,800 in damages as a result of that improper payment....

I.

Denton Meade maintained a checking account at the Bank. In 2001, Meade entered into an agreement with the Adams County Lumber Company to purchase a yard barn for $2,784 and paid half the cost as a deposit. On the date of delivery, Friday, March 9, 2001, Meade issued a check to the Lumber Company for the remaining amount he owed on the barn, $1,406.79.

Meade was not satisfied with the barn. Therefore, at 5:55 p.m. on March 9, 2001, Meade called the Bank to place a stop payment order on his check. Jacqueline Evans took the stop payment order from Meade. She received all the information and authorization needed to stop payment on the check at that time.

Bank employees are supposed to enter stop payments into the computer immediately after taking them. However, Evans did not immediately enter the stop payment order into the computer because it was 6:00 p.m. on Friday, and the Bank closes at 6:00 p.m. on Fridays. Furthermore, the Bank's policy provides that any matters that are received after 2:00 p.m. on a Friday are treated as being received on the next business day, which was Monday, March 12, 2001 in this instance.

On the morning of Saturday, March 10, 2001, Greg Scott, an officer of the Lumber Company, presented the check in question for payment at the Bank. The Bank paid the check. On Monday, the Bank entered Meade's stop payment into the computer and charged Meade a $15 stop payment fee. Upon realizing that it already paid the check, on Tuesday the Bank credited the $15 stop payment fee back to Meade's account. On Thursday, the Bank deducted the amount of the check, $1,406.79, from Meade's account.

In the meanwhile, Meade contacted Greg Scott at the Lumber Company regarding his dissatisfaction with the barn. Scott sent workers to repair the barn on Saturday, March 10 and on Monday, March 12. However, Meade still was not satisfied. In particular, he was unhappy with the runners supporting the barn. Although his order with the Lumber Company specifically provided for 4 x 6" runner boards, the

Lumber Company used 2 x 6" boards. The Lumber Company "laminated" the two by six-inch boards to make them stronger. However, carpenter Dennis Baker inspected the boards and determined that the boards were not laminated properly.

Meade hired Baker to repair the barn. Baker charged Meade approximately three hundred dollars to make the necessary repairs. Baker testified that properly laminated two by six-inch boards are just as strong as four by six-inch boards.

Meade filed suit against the Bank in the trial court seeking $5,000 in damages. The Bank filed a motion for summary judgment, which the trial court denied. At the subsequent jury trial the court permitted Meade to testify, over the Bank's objections, to the amount of his court costs, attorney fees, and deposition costs associated with this case. The Bank filed motions for directed verdict at the close of Meade's case and at the close of evidence, which the trial court denied.

The jury returned a general verdict finding the Bank liable to Meade in the amount of $3,800. The Bank filed motions for a new trial and for judgment notwithstanding the verdict, which the trial court denied. The Bank now appeals, asserting the following five assignments of error....

II.

In its first assignment of error, the Bank contends that the trial court erred in denying its motion for summary judgment. Specifically, the Bank asserts that Meade did not issue the stop payment order within a reasonable time for the Bank to act upon it, and therefore that the trial court should have granted summary judgment in favor of the Bank.

Summary judgment is appropriate only when it has been established: (1) that there is no genuine issue as to any material fact; (2) that the moving party is entitled to judgment as a matter of law; and (3) that reasonable minds can come to only one conclusion, and that conclusion is adverse to the nonmoving party. [Citation]

[UCC 4-403(A)] provides that a customer may stop payment on any item drawn on the customer's account by issuing an order to the bank that describes the item with reasonable certainty and is received by the bank "at a time and in a manner that affords the bank a reasonable opportunity to act on it before any action by the bank with respect to the item." What constitutes a reasonable time depends upon the facts of the case. See *Chute v. Bank One of Akron*, (1983) [Citation]

In *Chute*, Bank One alleged that its customer, Mr. Chute, did not give it a reasonable opportunity to act upon his stop payment order when he gave an oral stop payment at one Bank One branch office, and a different Bank One branch office paid the check the following day. In ruling that Bank One had a reasonable opportunity to act upon Mr. Chute's order before it paid the check, the court considered the teller's testimony that stop payment orders are entered onto the computer upon receipt, where they are virtually immediately accessible to all Bank One tellers.

In this case, as in *Chute*, Meade gave notice one day, and the Bank paid the check the following day. Additionally, in this case, the same branch that took the stop payment order also paid the check. Moreover, Evans testified that the Bank's policy for stop payment orders is to enter them into the computer immediately, and that Meade's stop payment order may have shown up on the computer on Saturday if she had entered it on Friday. Based on this information, and construing the facts in the light most favorable to Meade, reasonable minds could conclude that Meade provided the Bank with the stop payment order within time for the Bank to act upon the stop payment order. Accordingly, we overrule the Bank's first assignment of error.

III.

In its second assignment of error, the Bank contends that the trial court erred in permitting Meade to testify regarding the amount he spent on court costs, attorney fees, and taking depositions. Meade contends that because he incurred these costs as a result of the Bank paying his check over a valid stop payment order, the costs are properly recoverable.

As a general rule, the costs and expenses of litigation, other than court costs, are not recoverable in an action for damages. [Citations]

In this case, the statute providing for damages, [UCC 4-403(c)], provides that a customer's recoverable loss for a bank's failure to honor a valid stop payment order "may include damages for dishonor of subsequent items * * *." The statute does not provide for recouping attorney fees and costs. Meade did not allege that the Bank acted in bad faith or that he is entitled to punitive damages. Additionally, although Meade argues that the Bank caused him to lose his bargaining power with the Lumber Company, Meade did not present any evidence that he incurred attorney fees or costs by engaging in litigation with the Lumber Company.

Absent statutory authority or an allegation of bad faith, attorney fees are improper in a compensatory damage award....Therefore, the trial court erred in permitting the jury to hear evidence regarding Meade's expenditures for his attorney fees and costs. Accordingly, we sustain the Bank's second assignment of error....

IV.

In its third assignment of error, the Bank contends that the trial court erred when it overruled the Bank's motion for a directed verdict. The Bank moved for a directed verdict both at the conclusion of Meade's case and at the close of evidence.

The Bank first asserts that the record does not contain sufficient evidence to show that Meade issued a stop payment order that provided it with a reasonable opportunity to act as required by [the UCC]. Meade presented evidence that he gave the Bank his stop payment order prior to 6:00 p.m. on Friday, and that the Bank paid the check the following day....We find that this constitutes sufficient evidence that Meade

communicated the stop payment order to the Bank in time to allow the Bank a reasonable opportunity to act upon it.

The Bank also asserts that the record does not contain sufficient evidence that Meade incurred some loss resulting from its payment of the check. Pursuant to [UCC 4-403(c)] "[t]he burden of establishing the fact and amount of loss resulting from the payment of an item contrary to a stop payment order or order to close an account is on the customer." Establishing the fact and amount of loss, "the customer must show some loss other than the mere debiting of the customer's account." [Citation]

...Baker testified that he charged Meade between two hundred-eighty and three hundred dollars to properly laminate the runners and support the barn. Based upon these facts, we find that the record contains sufficient evidence that Meade sustained some loss beyond the mere debiting of his account as a result of the Bank paying his check. Accordingly, we overrule the Bank's third assignment of error.

V.

...In its final assignment of error, the Bank contends that the trial court erred in denying its motions for judgment notwithstanding the verdict and for a new trial....
[U]nlike our consideration of the Bank's motions for a directed verdict, in considering the Bank's motion for judgment notwithstanding the verdict, we also must consider whether the amount of the jury's award is supported by sufficient evidence. The Bank contends the jury's general verdict, awarding Meade $3,800, is not supported by evidence in the record.

A bank customer seeking damages for the improper payment of a check over a valid stop payment order carries the burden of proving "the fact and amount of loss." [UCC 4-403(C).] To protect banks and prevent unjust enrichment to customers, the mere debiting of the customer's account does not constitute a loss. [Citation]

In this case, the Bank's payment of Meade's $1,406.79 check to the Lumber Company discharged Meade's debt to the Lumber Company in the same amount. Therefore, the mere debiting of $1,406.79 from Meade's account does not constitute a loss.

Meade presented evidence that he incurred $300 in repair costs to make the barn satisfactory. Meade also notes that he never got the four by six-inch runners he wanted. However, Meade's carpenter, Baker, testified that since he properly laminated the two by six-inch runners, they are just as strong or stronger than the four by six-inch runners would have been.

Meade also presented evidence of his costs and fees. However, as we determined in our review of the Bank's second assignment of error, only the court may award costs and fees, and therefore this evidence was improperly admitted. Thus, the evidence cannot support the damage award. Meade did not present any other evidence of loss incurred by the Bank's payment of his check....Therefore, we find that the trial court erred in declining to enter a judgment notwithstanding the verdict on the issue of damages. Upon remand, the trial court should grant in part the Bank's motion for judgment notwithstanding the verdict as it relates to damages and consider the Bank's motion for a new trial only on the issue of damages[....] Accordingly, we sustain the Banks fourth and fifth assignments of error in part.

VI.

In conclusion, we find that the trial court did not err in denying the Bank's motions for summary judgment and for directed verdict. However, we find that the trial court erred in permitting Meade to testify as to his court costs, attorney fees and deposition costs. Additionally, we find that the trial court erred in totally denying the Bank's motion for judgment notwithstanding the verdict, as the amount of damages awarded by the jury is not supported by sufficient evidence in the record. Accordingly, we affirm the judgment of the trial court as to liability, but reverse the judgment of the trial court as to the issue of damages, and remand this cause for further proceedings consistent with this opinion.

CASE QUESTIONS

1. What did the bank do wrong here?
2. Why did the court deny Meade damages for his attorneys' fees?
3. Why did the court conclude that the jury-awarded damages were not supported by evidence presented at trial? What damages did the evidence support?

Customer's Duty to Inspect Bank Statements

Union Planters Bank, Nat. Ass'n v. Rogers

912 So.2d 116 (Miss. 2005)

Waller, J.

This appeal involves an issue of first impression in Mississippi—the interpretation of [Mississippi's UCC 4-406], which imposes duties on banks and their customers insofar as forgeries are concerned.

Facts

Neal D. and Helen K. Rogers maintained four checking accounts with the Union Planters Bank in Greenville, Washington County, Mississippi....The Rogers were both in their eighties when the events which gave rise to this lawsuit took place.[1] After Neal became bedridden, Helen hired Jackie Reese to help her take care of Neal and to do chores and errands.

In September of 2000, Reese began writing checks on the Rogers' four accounts and forged Helen's name on the signature line. Some of the checks were made out to "cash," some to "Helen K. Rogers," and some to "Jackie Reese." The following chart summarizes the forgeries to each account:

Account Number	Beginning	Ending	Number of Checks	Amount of Checks
54282309	11/27/2000	6/18/2001	46	$16,635.00
0039289441	9/27/2000	1/25/2001	10	$2,701.00

Account Number	Beginning	Ending	Number of Checks	Amount of Checks
6100110922	11/29/2000	8/13/2001	29	$9,297.00
6404000343	11/20/2000	8/16/2001	83	$29,765.00
Total			168	$58,398.00

Neal died in late May of 2001. Shortly thereafter, the Rogers' son, Neal, Jr., began helping Helen with financial matters. Together they discovered that many bank statements were missing and that there was not as much money in the accounts as they had thought. In June of 2001, they contacted Union Planters and asked for copies of the missing bank statements. In September of 2001, Helen was advised by Union Planters to contact the police due to forgeries made on her accounts. More specific dates and facts leading up to the discovery of the forgeries are not found in the record.

Subsequently, criminal charges were brought against Reese. (The record does not reveal the disposition of the criminal proceedings against Reese.) In the meantime, Helen filed suit against Union Planters, alleging conversion (unlawful payment of forged checks) and negligence. After a trial, the jury awarded Helen $29,595 in damages, and the circuit court entered judgment accordingly. From this judgment, Union Planters appeals.

Discussion

...II. Whether Rogers' Delay in Detecting the Forgeries Barred Suit against Union Planters.

The relationship between Rogers and Union Planters is governed by Article 4 of the Uniform Commercial Code. [UCC] 4-406(a) and (c) provide that a bank customer has a duty to discover and report "unauthorized signatures"; i.e., forgeries. [The section] reflects an underlying policy decision that furthers the UCC's "objective of promoting certainty and predictability in commercial transactions." The UCC facilitates financial transactions, benefiting both consumers and financial institutions, by allocating responsibility among the parties according to whomever is best able to prevent a loss. Because the customer is more familiar with his own signature, and should know whether or not he authorized a particular withdrawal or check, he can prevent further unauthorized activity better than a financial

institution which may process thousands of transactions in a single day....The customer's duty to exercise this care is triggered when the bank satisfies its burden to provide sufficient information to the customer. As a result, if the bank provides sufficient information, the customer bears the loss when he fails to detect and notify the bank about unauthorized transactions. [Citation]

A. Union Planters' Duty to Provide Information under 4-406(a).

The court admitted into evidence copies of all Union Planters statements sent to Rogers during the relevant time period. Enclosed with the bank statements were either the cancelled checks themselves or copies of the checks relating to the period of time of each statement. The evidence shows that all bank statements and cancelled checks were sent, via United States Mail, postage prepaid, to all customers at their "designated address" each month. Rogers introduced no evidence to the contrary. We therefore find that the bank fulfilled its duty of making the statements available to Rogers and that the remaining provisions of 4-406 are applicable to the case at bar....

In defense of her failure to inspect the bank statements, Rogers claims that she never received the bank statements and cancelled checks. Even if this allegation is true,[2] it does not excuse Rogers from failing to fulfill her duties under 4-406(a) & (c) because the statute clearly states a bank discharges its duty in providing the necessary information to a customer when it "sends...to a customer a statement of account showing payment of items."...The word "receive" is absent. The customer's duty to inspect and report does not arise when the statement is received, as Rogers claims; the customer's duty to inspect and report arises when the bank sends the statement to the customer's address. A reasonable person who has not received a monthly statement from the bank would promptly ask the bank for a copy of the statement. Here, Rogers claims that she did not receive numerous statements. We find that she failed to act reasonably when she failed to take any action to replace the missing statements.

B. Rogers' Duty to Report the Forgeries under 4-406(d).

[Under UCC 4-406] a customer who has not promptly notified a bank of an irregularity may be precluded from bringing certain claims against the bank:

> *"(d) If the bank proves that the customer failed, with respect to an item, to comply with the duties imposed on the customer by subsection (c), the customer is precluded from asserting against the bank:*
>
> *(1) The customer's unauthorized signature...on the item,...*

Also, when there is a series of forgeries, 406(d)(2) places additional duties on the customer, [who is precluded from asserting against the bank]:

> *(2) The customer's unauthorized signature...by the same wrongdoer on any other item paid in good faith by the bank if the payment was made before the bank received notice from the customer of the unauthorized signature...and after the customer had been afforded a reasonable period of time, not exceeding thirty (30) days, in which to examine the item or statement of account and notify the bank.*

Although there is no mention of a specific date, Rogers testified that she and her son began looking for the statements in late May or early June of 2001, after her husband had died....When they discovered that statements were missing, they notified Union Planters in June of 2001 to replace the statements. At this time, no mention of possible forgery was made, even though Neal, Jr., thought that "something was wrong." In fact, Neal, Jr., had felt that something was wrong as far back as December of 2000, but failed to do anything. Neal, Jr., testified that neither he nor his mother knew that Reese had been forging checks until September of 2001.[3]

Rogers is therefore precluded from making claims against Union Planters because (1) under 4-406(a), Union Planters provided the statements to Rogers, and (2) under 4-406(d)(2), Rogers failed to notify Union Planters of the forgeries within 30 days of the date she should have reasonably discovered the forgeries....

Conclusion

The circuit court erred in denying Union Planters' motion for JNOV because, under 4-406, Rogers is precluded from recovering amounts paid by Union Planters on any of the forged checks because she failed

to timely detect and notify the bank of the unauthorized transactions and because she failed to show that Union Planters failed to use ordinary care in its processing of the forged checks. Therefore, we reverse the circuit court's judgment and render judgment here that Rogers take nothing and that the complaint and this action are finally dismissed with prejudice. Reversed.

CASE QUESTIONS

1. If a bank pays out over a forged drawer's signature one time, and the customer (drawer) reports the forgery to the bank within thirty days, why does the bank take the loss?
2. Who forged the checks?
3. Why did Mrs. Rogers think she should not be liable for the forgeries?
4. In the end, who probably really suffered the loss here?

Customer's Duty to Inspect Bank Statements

Commerce Bank of Delaware v. Brown

2007 WL 1207171 (Del. Com. Pl. 2007)

I. Procedural Posture

Plaintiff, Commerce Bank/Delaware North America ("Commerce") initially filed a civil complaint against defendant Natasha J. Brown ("Brown") on October 28, 2005. Commerce seeks judgment in the amount of $4.020.11 plus costs and interest and alleges that Brown maintained a checking account with Commerce and has been unjustly enriched by $4,020.11....

The defendant, Brown...denied all allegations of the complaint. As an affirmative defense Brown claims the transaction for which plaintiff seeks to recover a money judgment were made by means of an ATM Machine using a debit card issued by the defendant. On January 16, 2005 Brown asserts that she became aware of the fraudulent transactions and timely informed the plaintiff of the facts on January 16, 2005. Brown asserts that she also requested Commerce in her answer to investigate the matter and to close her account. Based upon these facts, Brown asserts a maximum liability on her own part from $50.00 to $500.00 in accordance with the Electronic Fund Transfer Act ("EFTA") 15 U.S.C. § 1693(g) and regulation

(e), 12 CFR 205.6. [Commerce Bank withdrew its complaint at trial, leaving only the defendant's counter-claim in issue.]

Defendant Brown asserts [that] defendant failed to investigate and violated EFTA and is therefore liable to the plaintiff for money damages citing [EFTA].

II. The Facts

Brown was the only witness called at trial. Brown is twenty-seven years old and has been employed by Wilmington Trust as an Administrative Assistant for the past three years. Brown previously opened a checking account with Commerce and was issued a debit/ATM card by Commerce which was in her possession in December 2004. Brown, on or about January 14, 2005 went to Commerce to charge a $5.00 debit to the card at her lunch-break was informed that there was a deficiency balance in the checking account. Brown went to the Talleyville branch of Commerce Bank and spoke with "Carla" who agreed to investigate these unauthorized charges, as well as honor her request to close the account. Defendant's Exhibit No.: 1 is a Commerce Bank electronic filing and/or e-mail which details a visit by defendant on January 16, 2005 to report her card loss. The "Description of Claim" indicates as follows:

> *Customer came into speak with a CSR "Carla Bernard" on January 16, 2005 to report her card loss. At this time her account was only showing a negative $50.00 balance. She told Ms. Bernard that this was not her transaction and to please close this account. Ms. Bernard said that she would do this and that there would be an investigation on the unauthorized transactions. It was at this time also that she had Ms. Bernard change her address. In the meantime, several transactions posted to the account causing a balance of negative $3,948.11 and this amount has since been charged off on 1/27/05. Natasha Brown never received any notification of this until she received a letter from one of our collection agencies. She is now here to get this resolved.*

On the back of defendant's Exhibit No.: 1 were 26 separate unauthorized transactions at different mercantile establishments detailing debits with the pin number used on Brown's debit card charged to Commerce Bank. The first charge was $501.75 on January 13, 2005....Brown asserts at trial that she

therefore timely gave notice to Commerce to investigate and requested Commerce to close the debit checking account on January 16, 2005.

At trial Brown also testified she "never heard" from Commerce again until she received a letter in December 2005 citing a $4,000.00 deficiency balance....

On cross-examination Brown testified she received a PIN number from Commerce and "gave the PIN number to no other person." In December 2004 she resided with Charles Williams, who is now her husband. Brown testified on cross-examination that she was the only person authorized as a PIN user and no one else knew of the card, 'used the card,' or was provided orally or in writing of the PIN number. Brown spoke with Carla Bernard at the Commerce Bank at the Talleyville branch. Although Brown did not initially fill out a formal report, she did visit Commerce on January 16, 2005 the Talleyville branch and changed her address with Carla. Brown does not recall the last time she ever received a statement from Commerce Bank on her checking account. Brown made no further purchases with the account and she was unaware of all the "incidents of unauthorized debit charges on her checking account" until she was actually sued by Commerce Bank in the Court of Common Pleas.

III. The Law

15 U.S.C. § 1693(g). Consumer Liability:

> *(a) Unauthorized electronic fund transfers; limit. A consumer shall be liable for any unauthorized electronic fund transfer....In no event, however, shall a consumer's liability for an unauthorized transfer exceed the lesser of—*
> *(1) $ 50; or*
> *(2) the amount of money or value of property or services obtained in such unauthorized electronic fund transfer prior to the time the financial institution is notified of, or otherwise becomes aware of, circumstances which lead to the reasonable belief that an unauthorized electronic fund transfer involving the consumer's account has been or may be affected. Notice under this paragraph is sufficient when such steps have been taken as may be reasonably*

required in the ordinary course of business to provide the financial institution with the pertinent information, whether or not any particular officer, employee, or agent of the financial institution does in fact receive such information.

15 U.S.C. § 1693(m) Civil Liability:

(a) [A]ction for damages; amount of award....[A]ny person who fails to comply with any provision of this title with respect to any consumer, except for an error resolved in accordance with section 908, is liable to such consumer in an amount equal to the sum of—
(1) any actual damage sustained by such consumer as a result of such failure;
(2) in the case of an individual action, an amount not less than $ 100 nor greater than $ 1,000; or...
(3) in the case of any successful action to enforce the foregoing liability, the costs of the action, together with a reasonable attorney's fee as determined by the court.

12 C.F.R. § 205.6 Liability of consumer for unauthorized transfers.

(b) Limitations on amount of liability. A consumer's liability for an unauthorized electronic fund transfer or a series of related unauthorized transfers shall be determined as follows:
(1) Timely notice given. If the consumer notifies the financial institution within two business days after learning of the loss or theft of the access device, the consumer's liability shall not exceed the lesser of $ 50 or the amount of unauthorized transfers that occur before notice to the financial institution.
(2) Timely notice not given. If the consumer fails to notify the financial institution within two business days after learning of the loss or theft of the access device, the consumer's liability shall not exceed the lesser of $ 500 or the sum of:
(i) $ 50 or the amount of unauthorized transfers that occur within the two business days, whichever is less; and

(ii) The amount of unauthorized transfers that occur after the close of two business days and before notice to the institution, provided the institution establishes that these transfers would not have occurred had the consumer notified the institution within that two-day period.

IV. Opinion and Order

The Court finds based upon the testimony presented herein that defendant in her counter-claim has proven by a preponderance of evidence damages in the amount of $1,000.00 plus an award of attorney's fees. Clearly, Commerce failed to investigate the unauthorized charges pursuant to 15 U.S.C. § 1693(h). Nor did Commerce close the account as detailed in Defendant's Exhibit No. 1. Instead, Commerce sued Brown and then withdrew its claim at trial. The Court finds $50.00 is the appropriate liability for Brown for the monies charged on her account as set forth within the above statute because she timely notified, in person, Commerce on January 16, 2005. Brown also requested Commerce to close her checking account. Based upon the trial record, defendant has proven by a preponderance of the evidence damages of $1,000.00 as set forth in the above statute, 15 U.S.C. § 1693(m).

CASE QUESTIONS

1. Why—apparently—did the bank withdraw its complaint against Brown at the time of trial?
2. Why does the court mention Ms. Brown's occupation, and that she was at the time of the incident living with the man who was—at the time of trial—her husband?
3. What is the difference between the United States Code (USC) and the *Code of Federal Regulations* (CFR), both of which are cited by the court?
4. What did the bank do wrong here?
5. What damages did Ms. Brown suffer for which she was awarded $1,000? What else did she get by way of an award that is probably more important?

[1] Neal Rogers died prior to the institution of this lawsuit. Helen Rogers died after Union Planters filed this appeal. We have substituted Helen's estate as appellee.

[2] Since there was a series of forged checks, it is reasonable to assume that Reese intercepted the bank statements before Rogers could inspect them. However, Union Planters cannot be held liable for Reese's fraudulent concealment.

[3] Actually, it was Union Planters that notified Rogers that there had been forgeries, as opposed to Rogers' discovering the forgeries herself.

23.5 Summary and Exercises

Summary

Traditionally when a customer wrote a check (on the payor bank) and the payee deposited it into his account (at the depository bank), the check was physically routed by means of ground and air transportation to the various intermediary banks until it was physically presented to the payor bank for final settlement. The federal Check 21 Act (2004) promotes changes in this process by allowing banks to process electronic images of customers' checks instead of the actual paper instrument: the data on the check is truncated (stripped) from the instrument and the data are transmitted. The original check can be digitally recreated by the making of a "substitute check." Merchants—indeed, anyone with a check scanner and a computer—can also process electronic data from checks to debit the writer's account and credit the merchant's instantly.

In addition to Check 21 Act, the Electronic Fund Transfer Act of 1978 also facilitates electronic banking. It primarily addresses the uses of credit and debit cards. Under this law, the electronic terminal must provide a receipt of transfer. The financial institution must follow certain procedures on being notified of errors, the customer's liability is limited to $50 if a card or code number is wrongfully used and the institution has been notified, and an employer or government agency can compel acceptance of salary or government benefits by EFT.

Article 4 of the UCC—state law, of course—governs a bank's relationship with its customers. It permits a bank to pay an overdraft, to pay an altered check (charging the customer's account for the original tenor of the check), to refuse to pay a six-month-old check, to pay or collect an item of a deceased person (if it has no notice of death) and obligates it to honor stop payment orders. A bank is liable to the customer for damages if it wrongfully dishonors an item. The customer also has duties; primarily, the customer must inspect each statement of account and notify the bank promptly if the checks have been altered or signatures forged. The federal Expedited Funds Availability Act requires that, within some limits, banks make customers' funds available quickly.

Wholesale funds transactions, involving tens of millions of dollars, were originally made by telegraph ("wire transfers"). The modern law governing such transactions is, in the United States, UCC Article 4A.

A letter of credit is a statement by a bank or other financial institution that it will pay a specified sum of money to specified persons when certain conditions are met. Its purpose is to facilitate nonlocal sales transactions by ensuring that the buyer will not get access to the goods until the seller has proper access to the buyer's money. In the US letters of credit are governed by UCC Article 5, and in international transactions they may be covered by a different internationally recognized law.

EXERCISES

1. On March 20, Al gave Betty a check for $1,000. On March 25, Al gave Carl a check for $1,000, which Carl immediately had certified. On October 24, when Al had $1,100 in his account, Betty presented her check for payment and the bank paid her $1,000. On October 25, Carl presented his check for payment and the bank refused to pay because of insufficient funds. Were the bank's actions proper?
2. Winifred had a balance of $100 in her checking account at First Bank. She wrote a check payable to her landlord in the amount of $400. First Bank cashed the check and then attempted to charge her account. May it? Why?

3. Assume in Exercise 2 that Winifred had deposited $4,000 in her account a month before writing the check to her landlord. Her landlord altered the check by changing the amount from $400 to $4,000 and then cashed the check at First Bank. May the bank charge Winifred's account for the check? Why?
4. Assume in Exercise 2 that Winifred had deposited $5,000 in her account a month before writing the check but the bank misdirected her deposit, with the result that her account showed a balance of $100. Believing the landlord's check to be an overdraft, the bank refused to pay it. Was the refusal justified? Why?
5. Assume in Exercise 2 that, after sending the check to the landlord, Winifred decided to stop payment because she wanted to use the $300 in her account as a down payment on a stereo. She called First Bank and ordered the bank to stop payment. Four days later the bank mistakenly paid the check. Is the bank liable to Winifred? Why?
6. Assume in Exercise 5 that the landlord negotiated the check to a holder in due course, who presented the check to the bank for payment. Is the bank required to pay the holder in due course after the stop payment order? Why?
7. On Wednesday, August 4, Able wrote a $1,000 check on his account at First Bank. On Saturday, August 7, the check was cashed, but the Saturday activity was not recorded by the bank until Monday, August 9. On that day at 8:00 a.m., Able called in a stop payment order on the check and he was told the check had not cleared; at 9:00 he went to the bank and obtained a printed notice confirming the stop payment, but shortly thereafter the Saturday activity was recorded—Able's account had been debited. He wants the $1,000 recredited. Was the stop payment order effective? Explain.
8. Alice wrote a check to Carl's Contracting for $190 on April 23, 2011. Alice was not satisfied with Carl's work. She called, leaving a message for him to return the call to discuss the matter with her. He did not do so, but when she reconciled her checks upon receipt of her bank statement, she noticed the check to Carl did not appear on the April statement. Several months went by. She figured Carl just tore the check up instead of bothering to resolve any dispute with her. The check was presented to Alice's bank for payment on March 20, 2012, and Alice's bank paid it. May she recover from the bank?
9. Fitting wrote a check in the amount of $800. Afterwards, she had second thoughts about the check and contacted the bank about stopping payment. A bank employee told her a stop payment order could not be submitted until the bank opened the next day. She discussed with the employee what would happen if she withdrew enough money from her account that when the $800 check was presented, there would be

insufficient funds to cover it. The employee told her that in such a case the bank would not pay the check. Fitting did withdraw enough money to make the $800 an overdraft, but the bank paid it anyway, and then sued her for the amount of the overdraft. Who wins and why? *Continental Bank v. Fitting*, 559 P.2d 218 (1977).

10. Plaintiff's executive secretary forged plaintiff's name on number checks by signing his name and by using a rubber facsimile stamp of his signature: of fourteen checks that were drawn on her employer's account, thirteen were deposited in her son's account at the defendant bank, and one was deposited elsewhere. Evidence at trial was presented that the bank's system of comparing its customer's signature to the signature on checks was the same as other banks in the area. Plaintiff sued the bank to refund the amount of the checks paid out over a forged drawer's signature. Who wins and why?*Read v. South Carolina National Bank*, 335 S.E.2d 359 (S.C., 1965).

11. On Tuesday morning, Reggie discovered his credit card was not in his wallet. He realized he had not used it since the previous Thursday when he'd bought groceries. He checked his online credit card account register and saw that some $1,700 had been charged around the county on his card. He immediately notified his credit union of the lost card and unauthorized charges. For how much is Reggie liable?

SELF-TEST QUESTIONS

1 Article 4 of the UCC permits a bank to pay

a. an overdraft
b. an altered check
c. an item of a deceased person if it has no notice of death
d. all of the above

2 The type of banks covered by Article 4 include

a. depository banks
b. payor banks
c. both of the above
d. none of the above

3 A bank may

a. refuse to pay a check drawn more than six months before being presented

b. refuse to pay a check drawn more than sixty days before being presented

c. not refuse to pay a check drawn more than six months before being presented

d. do none of the above

4 Forms of electronic fund transfer include

a. automated teller machines

b. point of sale terminals

c. preauthorized payment plans

d. all of the above

SELF-TEST ANSWERS

1. d
2. c
3. a
4. d

CC BY NC SA

Chapter 24
Consumer Credit Transactions

LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. How consumers enter into credit transactions and what protections they are afforded when they do
2. What rights consumers have after they have entered into a consumer transaction
3. What debt collection practices third-party collectors may pursue

This chapter and the three that follow are devoted to debtor-creditor relations. In this chapter, we focus on the consumer credit transaction. Chapter 25 "Secured Transactions and Suretyship" and Chapter 26 "Mortgages and Nonconsensual Liens" explore different types of security that a creditor might require. Chapter 27 "Bankruptcy" examines debtors' and creditors' rights under bankruptcy law.

The amount of consumer debt, or **household debt**, owed by Americans to mortgage lenders, stores, automobile dealers, and other merchants who sell on credit is difficult to ascertain. One reads that the average household *credit card* debt (not including mortgages, auto loans, and student loans) in 2009 was almost $16,000.[1] Or maybe it was $10,000.[2] Or maybe it was $7,300.[3] But probably focusing on the *average* household debt is not very helpful: 55 percent of households have no credit card debt at all, and the *median* debt is $1,900.[4]

In 2007, the total household debt owed by Americans was $13.3 trillion, according to the Federal Reserve Board. That is really an incomprehensible number: suffice it to say, then, that the availability of credit is an important factor in the US economy, and not surprisingly, a number of statutes have been enacted over the years to protect consumers both before and after signing credit agreements.

The statutes tend to fall within three broad categories. First, several statutes are especially important when a consumer enters into a credit transaction. These include laws that regulate credit costs, the credit application, and the applicant's right to check a credit record. Second, after a consumer has contracted for credit, certain statutes give a consumer the right to cancel the contract and correct billing mistakes. Third, if the consumer fails to pay a debt, the creditor has several traditional debt collection remedies that today are tightly regulated by the government.

---

[1] Ben Woolsey and Matt Schulz, *Credit Card Statistics, Industry Statistics, Debt Statistics,*August 24, 2010, http://www.creditcards.com/credit-card-news/credit-card-industry-facts-personal-debt-statistics-1276.php. This is "calculated by dividing the total revolving debt in the U.S. ($852.6 billion as of March 2010 data, as listed in the Federal Reserve's May 2010 report on consumer credit) by the estimated number of households carrying credit card debt (54 million)."

[2] Deborah Fowles, "Your Monthly Credit Card Minimum Payments May Double," About.com Financial Planning,http://financialplan.about.com/od/creditcarddebt/a/CCMinimums.htm.

[3] Index Credit Cards, *Credit Card Debt*, February 9, 2010,http://www.indexcreditcards.com/creditcarddebt.

[4] Liz Pulliam Weston, "The Big Lie about Credit Card Debt," *MSN Money*, July 30, 2007.

24.1 Entering into a Credit Transaction

LEARNING OBJECTIVES

1. Understand what statutes regulate the cost of credit, and the exceptions.
2. Know how the cost of credit is expressed in the Truth in Lending Act.
3. Recognize that there are laws prohibiting discrimination in credit granting.
4. Understand how consumers' credit records are maintained and may be corrected.

The Cost of Credit

Lenders, whether banks or retailers, are not free to charge whatever they wish for credit. **Usury** laws establish a maximum rate of lawful interest. The penalties for violating usury laws vary from state to state. The heaviest penalties are loss of both principal and interest, or loss of a multiple of the interest the creditor charged. The courts often interpret these laws stringently, so that even if the impetus for a usurious loan comes from the borrower, the contract can be avoided, as demonstrated in *Matter of Dane's Estate* (Section 24.3 "Cases").

Some states have eliminated interest rate limits altogether. In other states, usury law is riddled with exceptions, and indeed, in many cases, the exceptions have pretty much eaten up the general rule. Here are some common exceptions:

- Business loans. In many states, businesses may be charged any interest rate, although some states limit this exception to incorporated businesses.
- Mortgage loans. Mortgage loans are often subject to special usury laws. The allowable interest rates vary, depending on whether a first mortgage or a subordinate mortgage is given, or whether the loan is insured or provided by a federal agency, among other variables.
- Second mortgages and home equity loans by licensed consumer loan companies.
- Credit card and other retail installment debt. The interest rate for these is governed by the law of the state where the credit card company does business. (That's why the giant Citibank, otherwise headquartered in New York City, runs its credit card division out of South Dakota, which has no usury laws for credit cards.)
- Consumer leasing.

- "Small loans" such as payday loans and pawnshop loans.
- Lease-purchases on personal property. This is the lease-to-own concept.
- Certain financing of mobile homes that have become real property or where financing is insured by the federal government.
- Loans a person takes from her tax-qualified retirement plan.
- Certain loans from stockbrokers and dealers.
- Interest and penalties on delinquent property taxes.
- Deferred payment of purchase price (layaway loans).
- Statutory interest on judgments.

And there are others. Moreover, certain charges are not considered interest, such as fees to record documents in a public office and charges for services such as title examinations, deed preparation, credit reports, appraisals, and loan processing. But a creditor may not use these devices to cloak what is in fact a usurious bargain; it is not the form but the substance of the agreement that controls.

As suggested, part of the difficulty here is that governments at all levels have for a generation attempted to promote consumption to promote production; production is required to maintain politically acceptable levels of employment. If consumers can get what they want on credit, consumerism increases. Also, certainly, tight limits on interest rates cause creditors to deny credit to the less creditworthy, which may not be helpful to the lower classes. That's the rationale for the usury exceptions related to pawnshop and payday loans.

Disclosure of Credit Costs

Setting limits on what credit costs—as usury laws do—is one thing. Disclosing the cost of credit is another.

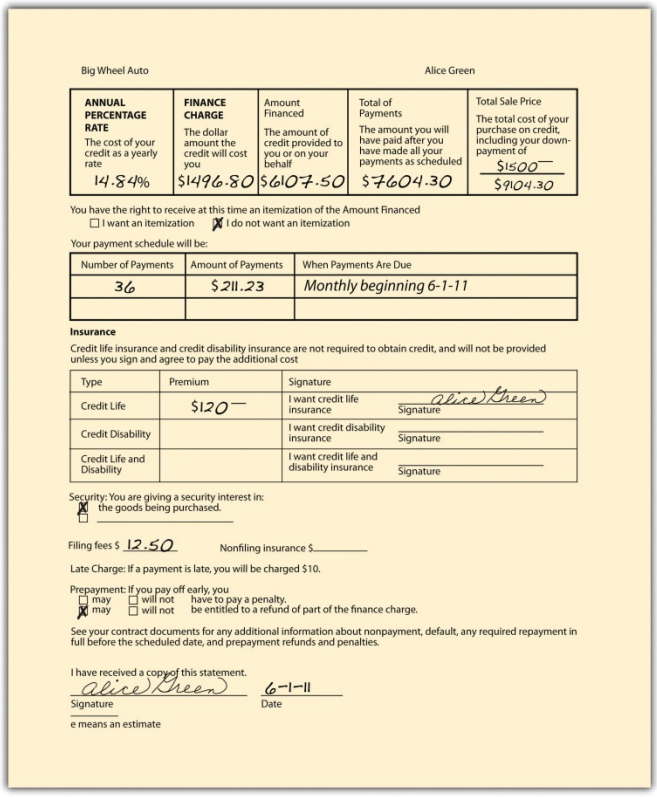
The Truth in Lending Act

Until 1969, lenders were generally free to disclose the cost of money loaned or credit extended in any way they saw fit—and they did. Financing and credit terms varied widely, and it was difficult and sometimes

impossible to understand what the true cost was of a particular loan, much less to comparison shop. After years of failure, consumer interests finally persuaded Congress to pass a national law requiring disclosure of credit costs in 1968. Officially called the Consumer Credit Protection Act, Title I of the law is more popularly known as the **Truth in Lending Act** (TILA). The act only applies to *consumer* credit transactions, and it only protects natural-person debtors—it does not protect business organization debtors.

The act provides what its name implies: lenders must inform borrowers about significant terms of the credit transaction. The TILA does not establish maximum interest rates; these continue to be governed by state law. The two key terms that must be disclosed are the finance charge and the annual percentage rate. To see why, consider two simple loans of $1,000, each carrying interest of 10 percent, one payable at the end of twelve months and the other in twelve equal installments. Although the actual charge in each is the same—$100—the interest rate is not. Why? Because with the first loan you will have the use of the full $1,000 for the entire year; with the second, for much less than the year because you must begin repaying part of the principal within a month. In fact, with the second loan you will have use of only about half the money for the entire year, and so the actual rate of interest is closer to 15 percent. Things become more complex when interest is compounded and stated as a monthly figure, when different rates apply to various portions of the loan, and when processing charges and other fees are stated separately. The act regulates open-end credit (revolving credit, like charge cards) and closed-end credit (like a car loan—extending for a specific period), and—as amended later—it regulates consumer leases and credit card transactions, too.

Figure 24.1 *Credit Disclosure Form*



Big Wheel Auto — Alice Green

ANNUAL PERCENTAGE RATE The cost of your credit as a yearly rate	FINANCE CHARGE The dollar amount the credit will cost you	Amount Financed The amount of credit provided to you or on your behalf	Total of Payments The amount you will have paid after you have made all your payments as scheduled	Total Sale Price The total cost of your purchase on credit, including your down-payment of
14.84%	$1496.80	$6107.50	$7604.30	$1500 $9104.30

You have the right to receive at this time an itemization of the Amount Financed
☐ I want an itemization ☒ I do not want an itemization

Your payment schedule will be:

Number of Payments	Amount of Payments	When Payments Are Due
36	$211.23	Monthly beginning 6-1-11

Insurance

Credit life insurance and credit disability insurance are not required to obtain credit, and will not be provided unless you sign and agree to pay the additional cost

Type	Premium	Signature
Credit Life	$120	I want credit life insurance — Signature: Alice Green
Credit Disability		I want credit disability insurance — Signature
Credit Life and Disability		I want credit life and disability insurance — Signature

Security: You are giving a security interest in:
☒ the goods being purchased.
☐

Filing fees $ 12.50 Nonfiling insurance $

Late Charge: If a payment is late, you will be charged $10.

Prepayment: If you pay off early, you
☐ may ☐ will not have to pay a penalty.
☒ may ☐ will not be entitled to a refund of part of the finance charge.

See your contract documents for any additional information about nonpayment, default, any required repayment in full before the scheduled date, and prepayment refunds and penalties.

I have received a copy of this statement.
Alice Green — Signature
6-1-11 — Date

e means an estimate

By requiring that the finance charge and the annual percentage rate be disclosed on a uniform basis, the TILA makes understanding and comparison of loans much easier. The **finance charge** is the total of all money paid for credit; it includes the interest paid over the life of the loan and all processing charges. The annual percentage rate is the true rate of interest for money or credit actually available to the borrower. The annual percentage rate must be calculated using the total finance charge (including all extra fees). See Figure 24.1 "Credit Disclosure Form" for an example of a disclosure form used by creditors.

Consumer Leasing Act of 1988

The Consumer Leasing Act (CLA) amends the TILA to provide similar full disclosure for consumers who lease automobiles or other goods from firms whose business it is to lease such goods, if the goods are valued at $25,000 or less and the lease is for four months or more. All material terms of the lease must be disclosed in writing.

Fair Credit and Charge Card Disclosure

In 1989, the Fair Credit and Charge Card Disclosure Act went into effect. This amends the TILA by requiring credit card issuers to disclose in a uniform manner the annual percentage rate, annual fees, grace period, and other information on credit card applications.

Credit Card Accountability, Responsibility, and Disclosure Act of 2009

The 1989 act did make it possible for consumers to know the costs associated with credit card use, but the card companies' behavior over 20 years convinced Congress that more regulation was required. In 2009, Congress passed and President Obama signed the Credit Card Accountability, Responsibility, and Disclosure Act of 2009 (the Credit Card Act). It is a further amendment of the TILA. Some of the salient parts of the act are as follows:

- Restricts all interest rate increases during the first year, with some exceptions. The purpose is to abolish "teaser" rates.
- Increases notice for rate increase on future purchases to 45 days.
- Preserves the ability to pay off on the old terms, with some exceptions.
- Limits fees and penalty interest and requires statements to clearly state the required due date and late payment penalty.
- Requires fair application of payments. Amounts in excess of the minimum payment must be applied to the highest interest rate (with some exceptions).
- Provides sensible due dates and time to pay.
- Protects young consumers. Before issuing a card to a person under the age of twenty-one, the card issuer must obtain an application that contains either the signature of a cosigner over the age of twenty-one or information indicating an independent means of repaying any credit extended.
- Restricts card issuers from providing tangible gifts to students on college campuses in exchange for filling out a credit card application.
- Requires colleges to publicly disclose any marketing contracts made with a card issuer.
- Requires enhanced disclosures.
- Requires issuers to disclose the period of time and the total interest it will take to pay off the card balance if only minimum monthly payments are made.

- Establishes gift card protections.[1]

The Federal Reserve Board is to issue implementing rules.

Creditors who violate the TILA are subject to both criminal and civil sanctions. Of these, the most important are the civil remedies open to consumers. If a creditor fails to disclose the required information, a customer may sue to recover twice the finance charge, plus court costs and reasonable attorneys' fees, with some limitations. As to the Credit Card Act of 2009, the issuing companies were not happy with the reforms. Before the law went into effect, the companies—as one commentator put it—unleashed a "frenzy of retaliation,"[2] by repricing customer accounts, changing fixed rates to variable rates, lowering credit limits, and increasing fees.

State Credit Disclosure Laws

The federal TILA is not the only statute dealing with credit disclosures. A uniform state act, the Uniform Consumer Credit Code, as amended in 1974, is now on the books in twelve US jurisdictions,[3] though its effect on the development of modern consumer credit law has been significant beyond the number of states adopting it. It is designed to protect consumers who buy goods and services on credit by simplifying, clarifying, and updating legislation governing consumer credit and usury.

Getting Credit

Disclosure of credit costs is a good thing. After discovering how much credit will cost, a person might decide to go for it: get a loan or a credit card. The potential creditor, of course, should want to know if the applicant is a good risk; that requires a credit check. And somebody who knows another person's creditworthiness has what is usually considered confidential information, the possession of which is subject to abuse, and thus regulation.

Equal Credit Opportunity Act

Through the 1960s, banks and other lending and credit-granting institutions regularly discriminated against women. Banks told single women to find a cosigner for loans. Divorced women discovered that

they could not open store charge accounts because they lacked a prior credit history, even though they had contributed to the family income on which previous accounts had been based. Married couples found that the wife's earnings were not counted when they sought credit; indeed, families planning to buy homes were occasionally even told that the bank would grant a mortgage if the wife would submit to a hysterectomy! In all these cases, the premise of the refusal to treat women equally was the unstated—and usually false—belief that women would quit work to have children or simply to stay home.

By the 1970s, as women became a major factor in the labor force, Congress reacted to the manifest unfairness of the discrimination by enacting (as part of the Consumer Credit Protection Act) the Equal Credit Opportunity Act (ECOA) of 1974. The act prohibits any creditor from discriminating "against any applicant on the basis of sex or marital status with respect to any aspect of a credit transaction." In 1976, Congress broadened the law to bar discrimination (1) on the basis of race, color, religion, national origin, and age; (2) because all or a part of an applicant's income is from a public assistance program; or (3) because an applicant has exercised his or her rights under the Consumer Credit Protection Act.

Under the ECOA, a creditor may not ask a credit applicant to state sex, race, national origin, or religion. And unless the applicant is seeking a joint loan or account or lives in a community-property state, the creditor may not ask for a statement of marital status or, if you have voluntarily disclosed that you are married, for information about your spouse, nor may one spouse be required to cosign if the other is deemed independently creditworthy. All questions concerning plans for children are improper. In assessing the creditworthiness of an applicant, the creditor must consider all sources of income, including regularly received alimony and child support payments. And if credit is refused, the creditor must, on demand, tell you the specific reasons for rejection. See *Rosa v. Park West Bank & Trust Co.* in Section 24.3 "Cases" for a case involving the ECOA.

The Home Mortgage Disclosure Act, 1975, and the Community Reinvestment Act (CRA), 1977, get at another type of discrimination: redlining. This is the practice by a financial institution of refusing to grant home loans or home-improvement loans to people living in low-income neighborhoods. The act requires that financial institutions within its purview report annually by transmitting information from their Loan

Application Registers to a federal agency. From these reports it is possible to determine what is happening to home prices in a particular area, whether investment in one neighborhood lags compared with that in others, if the racial or economic composition of borrowers changed over time, whether minorities or women had trouble accessing mortgage credit, in what kinds of neighborhoods subprime loans are concentrated, and what types of borrowers are most likely to receive subprime loans, among others. "Armed with hard facts, users of all types can better execute their work: Advocates can launch consumer education campaigns in neighborhoods being targeted by subprime lenders, planners can better tailor housing policy to market conditions, affordable housing developers can identify gentrifying neighborhoods, and activists can confront banks with poor lending records in low income communities." [4] Under the CRA, federal regulatory agencies examine banking institutions for CRA compliance and take this information into consideration when approving applications for new bank branches or for mergers or acquisitions.

Fair Credit Reporting Act of 1970: Checking the Applicant's Credit Record

It is in the interests of all consumers that people who would be bad credit risks not get credit: if they do and they default (fail to pay their debts), the rest of us end up paying for their improvidence. Because credit is such a big business, a number of support industries have grown up around it. One of the most important is the credit-reporting industry, which addresses this issue of checking creditworthiness. Certain companies—**credit bureaus**—collect information about borrowers, holders of credit cards, store accounts, and installment purchasers. For a fee, this information—currently held on tens of millions of Americans—is sold to companies anxious to know whether applicants are creditworthy. If the information is inaccurate, it can lead to rejection of a credit application that should be approved, and it can wind up in other files where it can live to do more damage. In 1970, Congress enacted, as part of the Consumer Credit Protection Act, the Fair Credit Reporting Act (FCRA) to give consumers access to their credit files in order to correct errors.

Under this statute, an applicant denied credit has the right to be told the name and address of the credit bureau (called "consumer reporting agency" in the act) that prepared the report on which the denial was based. (The law covers reports used to screen insurance and job applicants as well as to determine

creditworthiness.) The agency must list the nature and substance of the information (except medical information) and its sources (unless they contributed to an investigative-type report). A credit report lists such information as name, address, employer, salary history, loans outstanding, and the like. An investigative-type report is one that results from personal interviews and may contain nonfinancial information, like drinking and other personal habits, character, or participation in dangerous sports. Since the investigators rely on talks with neighbors and coworkers, their reports are usually subjective and can often be misleading and inaccurate.

The agency must furnish the consumer the information free if requested within thirty days of rejection and must also specify the name and address of anyone who has received the report within the preceding six months (two years if furnished for employment purposes).

If the information turns out to be inaccurate, the agency must correct its records; if investigative material cannot be verified, it must be removed from the file. Those to whom it was distributed must be notified of the changes. When the agency and the consumer disagree about the validity of the information, the consumer's version must be placed in the file and included in future distributions of the report. After seven years, any adverse information must be removed (ten years in the case of bankruptcy). A person is entitled to one free copy of his or her credit report from each of the three main national credit bureaus every twelve months. If a reporting agency fails to correct inaccurate information in a reasonable time, it is liable to the consumer for $1,000 plus attorneys' fees.

Under the FCRA, any person who obtains information from a credit agency under false pretenses is subject to criminal and civil penalties. The act is enforced by the Federal Trade Commission. See *Rodgers v. McCullough* inSection 24.3 "Cases" for a case involving use of information from a credit report.

KEY TAKEAWAY

Credit is an important part of the US economy, and there are various laws regulating its availability and disclosure. Usury laws prohibit charging excessive interest rates, though the laws are riddled with exceptions.

The disclosure of credit costs is regulated by the Truth in Lending Act of 1969, the Consumer Leasing Act of 1988, the Fair Credit and Charge Card Disclosure Act of 1989, and the Credit Card Accountability, Responsibility, and Disclosure Act of 2009 (these latter three are amendments to the TILA). Some states have adopted the Uniform Consumer Credit Code as well. Two major laws prohibit invidious discrimination in the granting of credit: the Equal Credit Opportunity Act of 1974 and the Home Mortgage Disclosure Act of 1975 (addressing the problem of redlining). The Fair Credit Reporting Act of 1970 governs the collection and use of consumer credit information held by credit bureaus.

EXERCISES

1. The penalty for usury varies from state to state. What are the two typical penalties?
2. What has the TILA done to the use of *interest* as a term to describe how much credit costs, and why?
3. What is redlining?
4. What does the Fair Credit Reporting Act do, in general?

---

[1] Consumers Union, "Upcoming Credit Card Protections,"http://www.creditcardreform.org/pdf/dodd-summary-509.pdf.

[2] Liz Pulliam Weston, "Credit Card Lenders Go on a Rampage," *MSN Money*, November 25, 2009.

[3] States adopting the Uniform Consumer Credit Code are the following: Colorado, Idaho, Indiana, Iowa, Kansas, Maine, Oklahoma, South Carolina, Utah, Wisconsin, Wyoming, and Guam. Cornell University Law School, "Uniform Laws."http://www.law.cornell.edu/uniform/vol7.html#concc.

[4] Kathryn L.S. Pettit and Audrey E. Droesch, "A Guide to Home Mortgage Disclosure Act Data," The Urban Institute, December 2008,http://www.urban.org/uploadedpdf/1001247_hdma.pdf.

24.2 Consumer Protection Laws and Debt Collection Practices

LEARNING OBJECTIVES

CC BY NC SA

1. Understand that consumers have the right to cancel some purchases made on credit.
2. Know how billing mistakes may be corrected.
3. Recognize that professional debt collectors are governed by some laws restricting certain practices.

Cancellation Rights

Ordinarily, a contract is binding when signed. But consumer protection laws sometimes provide an escape valve. For example, a Federal Trade Commission (FTC) regulation gives consumers three days to cancel contracts made with door-to-door salespersons. Under this cooling-off provision, the cancellation is effective if made by midnight of the third business day after the date of the purchase agreement. The salesperson must notify consumers of this right and supply them with two copies of a cancellation form, and the sales agreement must contain a statement explaining the right. The purchaser cancels by returning one copy of the cancellation form to the seller, who is obligated either to pick up the goods or to pay shipping costs. The three-day cancellation privilege applies only to sales of twenty-five dollars or more made either in the home or away from the seller's place of business; it does not apply to sales made by mail or telephone, to emergency repairs and certain other home repairs, or to real estate, insurance, or securities sales.

The Truth in Lending Act (TILA) protects consumers in a similar way. For certain big-ticket purchases (such as installations made in the course of major home improvements), sellers sometimes require a mortgage (which is subordinate to any preexisting mortgages) on the home. The law gives such customers three days to rescind the contract. Many states have laws similar to the FTC's three-day cooling-off period, and these may apply to transactions not covered by the federal rule (e.g., to purchases of less than twenty-five dollars and even to certain contracts made at the seller's place of business).

Correcting Billing Mistakes

Billing Mistakes

In 1975, Congress enacted the **Fair Credit Billing Act** as an amendment to the Consumer Credit Protection Act. It was intended to put to an end the phenomenon, by then a standard part of any comedian's repertoire, of the many ways a computer could insist that you pay a bill, despite errors and despite letters you might have written to complain. The act, which applies only to open-end credit and not to installment sales, sets out a procedure that creditors and customers must follow to rectify claimed errors. The customer has sixty days to notify the creditor of the nature of the error and the amount. Errors can include charges not incurred or those billed with the wrong description, charges for goods never delivered, accounting or arithmetic errors, failure to credit payments or returns, and even charges for which you simply request additional information, including proof of sale. During the time the creditor is replying, you need not pay the questioned item or any finance charge on the disputed amount.

The creditor has thirty days to respond and ninety days to correct your account or explain why your belief that an error has been committed is incorrect. If you do turn out to be wrong, the creditor is entitled to all back finance charges and to prompt payment of the disputed amount. If you persist in disagreeing and notify the creditor within ten days, it is obligated to tell all credit bureaus to whom it sends notices of delinquency that the bill continues to be disputed and to tell you to whom such reports have been sent; when the dispute has been settled, the creditor must notify the credit bureaus of this fact. Failure of the creditor to follow the rules, an explanation of which must be provided to each customer every six months and when a dispute arises, bars it from collecting the first fifty dollars in dispute, plus finance charges, even if the creditor turns out to be correct.

Disputes about the Quality of Goods or Services Purchased

While disputes over the quality of goods are not "billing errors," the act does apply to unsatisfactory goods or services purchased by credit card (except for store credit cards); the customer may assert against the credit card company any claims or defenses he or she may have against the seller. This means that under certain circumstances, the customer may withhold payments without incurring additional finance charges. However, this right is subject to three limitations: (1) the value of the goods or services charged must be in excess of fifty dollars, (2) the goods or services must have been purchased either in the home state or within one hundred miles of the customer's current mailing address, and (3) the consumer must

make a good-faith effort to resolve the dispute before refusing to pay. If the consumer does refuse to pay, the credit card company would acquiesce: it would credit her account for the disputed amount, pass the loss down to the merchant's bank, and that bank would debit the merchant's account. The merchant would then have to deal with the consumer directly.

Debt Collection Practices

Banks, financial institutions, and retailers have different incentives for extending credit—for some, a loan is simply a means of making money, and for others, it is an inducement to buyers. But in either case, credit is a risk because the consumer may default; the creditor needs a means of collecting when the customer fails to pay. Open-end credit is usually given without collateral. The creditor can, of course, sue, but if the consumer has no assets, collection can be troublesome. Historically, three different means of recovering the debt have evolved: garnishment, wage assignment, and confession of judgment.

Garnishment

Garnishment is a legal process by which a creditor obtains a court order directing the debtor's employer (or any party who owes money to the debtor) to pay directly to the creditor a certain portion of the employee's wages until the debt is paid. Until 1970, garnishment was regulated by state law, and its effects could be devastating—in some cases, even leading to suicide. In 1970, Title III of the Consumer Credit Protection Act asserted federal control over garnishment proceedings for the first time. The federal wage-garnishment law limits the amount of employee earnings that may be withheld in any one pay date to the lesser of 25 percent of disposable (after-tax) earnings or the amount by which disposable weekly earnings exceed thirty times the highest current federal minimum wage. The federal law covers everyone who receives personal earnings, including wages, salaries, commissions, bonuses, and retirement income (though not tips), but it allows courts to garnish above the federal maximum in cases involving support payments (e.g., alimony), in personal bankruptcy cases, and in cases where the debt owed is for state or federal tax.

The federal wage-garnishment law also prohibits an employer from firing any worker solely because the worker's pay has been garnished for one debt (multiple garnishments may be grounds for discharge). The penalty for violating this provision is a $1,000 fine, one-year imprisonment, or both. But the law does not say that an employee fired for having one debt garnished may sue the employer for damages. In a 1980 case, the Fifth Circuit Court of Appeals denied an employee the right to sue, holding that the statute places enforcement exclusively in the hands of the federal secretary of labor.[1]

The l970 federal statute is not the only limitation on the garnishment process. Note that the states can also still regulate garnishment so long as the state regulation is not in conflict with federal law: North Carolina, Pennsylvania, South Carolina, and Texas prohibit most garnishments, unless it is the government doing the garnishment. And there is an important constitutional limitation as well. Many states once permitted a creditor to garnish the employee's wage even before the case came to court: a simple form from the clerk of the court was enough to freeze a debtor's wages, often before the debtor knew a suit had been brought. In 1969, the US Supreme Court held that this prejudgment garnishment procedure was unconstitutional.[2]

Wage Assignment

A **wage assignment** is an agreement by an employee that a creditor may take future wages as security for a loan or to pay an existing debt. With a wage assignment, the creditor can collect directly from the employer. However, in some states, wage assignments are unlawful, and an employer need not honor the agreement (indeed, it would be liable to the employee if it did). Other states regulate wage assignments in various ways—for example, by requiring that the assignment be a separate instrument, not part of the loan agreement, and by specifying that no wage assignment is valid beyond a certain period of time (two or three years).

Confession of Judgment

Because suing is at best nettlesome, many creditors have developed forms that allow them to sidestep the courthouse when debtors have defaulted. As part of the original credit agreement, the consumer or borrower waives his right to defend himself in court by signing a **confession of judgment**. This written

instrument recites the debtor's agreement that a court order be automatically entered against him in the event of default. The creditor's lawyer simply takes the confession of judgment to the clerk of the court, who enters it in the judgment book of the court without ever consulting a judge. Entry of the judgment entitles the creditor to attach the debtor's assets to satisfy the debt. Like prejudgment garnishment, a confession of judgment gives the consumer no right to be heard, and it has been banned by statute or court decisions in many states.

Fair Debt Collection Practices Act of 1977

Many stores, hospitals, and other organizations attempt on their own to collect unpaid bills, but thousands of merchants, professionals, and small businesses rely on collection agencies to recover accounts receivable. The debt collection business employed some 216,000 people in 2007 and collected over $40 billion in debt.[3] For decades, some of these collectors used harassing tactics: posing as government agents or attorneys, calling at the debtor's workplace, threatening physical harm or loss of property or imprisonment, using abusive language, publishing a deadbeats list, misrepresenting the size of the debt, and telling friends and neighbors about the debt. To provide a remedy for these abuses, Congress enacted, as part of the Consumer Credit Protection Act, the Fair Debt Collection Practices Act (FDCPA) in 1977.

This law regulates the manner by which third-party collection agencies conduct their business. It covers collection of all personal, family, and household debts by collection agencies. It does not deal with collection by creditors themselves; the consumer's remedy for abusive debt collection by the creditor is in tort law.

Under the FDCPA, the third-party collector may contact the debtor only during reasonable hours and not at work if the debtor's employer prohibits it. The debtor may write the collector to cease contact, in which case the agency is prohibited from further contact (except to confirm that there will be no further contact). A written denial that money is owed stops the bill collector for thirty days, and he can resume again only after the debtor is sent proof of the debt. Collectors may no longer file suit in remote places, hoping for default judgments; any suit must be filed in a court where the debtor lives or where the underlying

contract was signed. The use of harassing and abusive tactics, including false and misleading representations to the debtor and others (e.g., claiming that the collector is an attorney or that the debtor is about to be sued when that is not true), is prohibited. Unless the debtor has given the creditor her cell phone number, calls to cell phones (but not to landlines) are not allowed.[4] In any mailings sent to the debtor, the return address cannot indicate that it is from a debt collection agency (so as to avoid embarrassment from a conspicuous name on the envelope that might be read by third parties).

Communication with third parties about the debt is not allowed, except when the collector may need to talk to others to trace the debtor's whereabouts (though the collector may not tell them that the inquiry concerns a debt) or when the collector contacts a debtor's attorney, if the debtor has an attorney. The federal statute gives debtors the right to sue the collector for damages for violating the statute and for causing such injuries as job loss or harm to reputation.

KEY TAKEAWAY

Several laws regulate practices after consumer credit transactions. The FTC provides consumers with a three-day cooling-off period for some in-home sales, during which time the consumer-purchaser may cancel the sale. The TILA and some state laws also have some cancellation provisions. Billing errors are addressed by the Fair Credit Billing Act, which gives consumers certain rights. Debt collection practices such as garnishment, wage assignments, and confessions of judgment are regulated (and in some states prohibited) by federal and state law. Debt collection practices for third-party debt collectors are constrained by the Fair Debt Collection Practices Act.

EXERCISES

1. Under what circumstances may a consumer have three days to avoid a contract?
2. How does the Fair Credit Billing Act resolve the problem that occurs when a consumer disputes a bill and "argues" with a computer about it?
3. What is the constitutional problem with garnishment as it was often practiced before 1969?

4. If Joe of Joe's Garage wants to collect on his own the debts he is owed, he is not constrained by the FDCPA. What limits are there on his debt collection practices?

---

[1] *Smith v. Cotton Brothers Baking Co., Inc.*, 609 F.2d 738 (5th Cir. 1980).

[2] *Sniadach v. Family Finance Corp.*, 395 U.S. 337 (1969).

[3] PricewaterhouseCoopers LLP, *Value of Third-Party Debt Collection to the U.S. Economy in 2007: Survey And Analysis*, June 2008, http://www.acainternational.org/files.aspx?p=/images/12546/pwc2007-final.pdf.

[4] Federal Communications Commission, "In the Matter of Rules and Regulations Implementing the Telephone Consumer Protection Act of 1991,"http://fjallfoss.fcc.gov/edocs_public/attachmatch/FCC-07-232A1.txt. (This document shows up best with Adobe Acrobat.)

24.3 Cases

Usury

Matter of Dane's Estate

390 N.Y.S.2d 249 (N.Y.A.D. 1976)

MAHONEY, J.

On December 17, 1968, after repeated requests by decedent [Leland Dane] that appellant [James Rossi] loan him $10,500 [about $64,000 in 2010 dollars] the latter drew a demand note in that amount and with decedent's consent fixed the interest rate at 7 1/2% Per annum, the then maximum annual interest permitted being 7 1/4%. Decedent executed the note and appellant gave him the full amount of the note in cash....[The estate] moved for summary judgment voiding the note on the ground that it was a usurious loan, the note having been previously rejected as a claim against the estate. The [lower court] granted the motion, voided the note and enjoined any prosecution on it thereafter. Appellant's cross motion to enforce the claim was denied.

New York's usury laws are harsh, and courts have been reluctant to extend them beyond cases that fall squarely under the statutes [Citation]. [New York law] makes any note for which more than the legal rate of interests is 'reserved or taken' or 'agreed to be reserved or taken' void. [The law] commands cancellation of a note in violation of [its provisions]. Here, since both sides concede that the note evidences the complete agreement between the parties, we cannot aid appellant by reliance upon the presumption that he did not make the loan at a usurious rate [Citation]. The terms of the loan are not in dispute. Thus, the note itself establishes, on its face, clear evidence of usury. There is no requirement of a specific intent to violate the usury statute. A general intent to charge more than the legal rate as evidenced by the note, is all that is needed. If the lender intends to take and receive a rate in excess of the legal percentage at the time the note is made, the statute condemns the act and mandates its cancellation [Citation]. The showing, as here, that the note reserves to the lender an illegal rate of interest satisfies respondents' burden of proving a usurious loan.

Next, where the rate of interest on the face of a note is in excess of the legal rate, it cannot be argued that such a loan may be saved because the borrower prompted the loan or even set the rate. The usury statutes are for the protection of the borrower and [their] purpose would be thwarted if the lender could avoid its consequences by asking the borrower to set the rate. Since the respondents herein asserted the defense of usury, it cannot be said that the decedent waived the defense by setting or agreeing to the 7 1/2% Rate of interest.

Finally, equitable considerations cannot be indulged when, as here, a statute specifically condemns an act. The statute fixes the law, and it must be followed.

The order should be affirmed, without costs.

CASE QUESTIONS

CC BY NC SA

1. What is the consequence to the lender of charging usurious rates in New York?
2. The rate charged here was one-half of one percent in excess of the allowable limit. Who made the note, the borrower or the lender? That makes no difference, but should it?
3. What "equitable considerations" were apparently raised by the creditor?

Discrimination under the ECOA

Rosa v. Park West Bank & Trust Co.

214 F.3d 213, C.A.1 (Mass. 2000)

Lynch, J.

Lucas Rosa sued the Park West Bank & Trust Co. under the Equal Credit Opportunity Act (ECOA), 15 U.S.C. §§ 1691–1691f, and various state laws. He alleged that the Bank refused to provide him with a loan application because he did not come dressed in masculine attire and that the Bank's refusal amounted to sex discrimination under the Act. The district court granted the Bank's motion to dismiss the ECOA claim...

I.

According to the complaint, which we take to be true for the purpose of this appeal, on July 21, 1998, Mr. Lucas Rosa came to the Bank to apply for a loan. A biological male, he was dressed in traditionally feminine attire. He requested a loan application from Norma Brunelle, a bank employee. Brunelle asked Rosa for identification. Rosa produced three forms of photo identification: (1) a Massachusetts Department of Public Welfare Card; (2) a Massachusetts Identification Card; and (3) a Money Stop Check Cashing ID Card. Brunelle looked at the identification cards and told Rosa that she would not provide him with a loan application until he "went home and changed." She said that he had to be dressed like one of the identification cards in which he appeared in more traditionally male attire before she would provide him with a loan application and process his loan request.

II.

Rosa sued the Bank for violations of the ECOA and various Massachusetts antidiscrimination statutes. Rosa charged that "[b]y requiring [him] to conform to sex stereotypes before proceeding with the credit transaction, [the Bank] unlawfully discriminated against [him] with respect to an aspect of a credit transaction on the basis of sex." He claims to have suffered emotional distress, including anxiety, depression, humiliation, and extreme embarrassment. Rosa seeks damages, attorney's fees, and injunctive relief.

Without filing an answer to the complaint, the Bank moved to dismiss....The district court granted the Bank's motion. The court stated:

> *[T]he issue in this case is not [Rosa's] sex, but rather how he chose to dress when applying for a loan. Because the Act does not prohibit discrimination based on the manner in which someone dresses, Park West's requirement that Rosa change his clothes does not give rise to claims of illegal discrimination. Further, even if Park West's statement or action were based upon Rosa's sexual orientation or perceived sexual orientation, the Act does not prohibit such discrimination.*

Price Waterhouse v. Hopkins (U.S. Supreme Court, 1988), which Rosa relied on, was not to the contrary, according to the district court, because that case "neither holds, nor even suggests, that discrimination based merely on a person's attire is impermissible."

On appeal, Rosa says that the district court "fundamentally misconceived the law as applicable to the Plaintiff's claim by concluding that there may be no relationship, as a matter of law, between telling a bank customer what to wear and sex discrimination." ...The Bank says that Rosa loses for two reasons. First, citing cases pertaining to gays and transsexuals, it says that the ECOA does not apply to crossdressers. Second, the Bank says that its employee genuinely could not identify Rosa, which is why she asked him to go home and change.

III.

...In interpreting the ECOA, this court looks to Title VII case law, that is, to federal employment discrimination law....The Bank itself refers us to Title VII case law to interpret the ECOA.

The ECOA prohibits discrimination, "with respect to any aspect of a credit transaction[,] on the basis of race, color, religion, national origin, sex or marital status, or age." 15 U.S.C. § 1691(a). Thus to prevail, the alleged discrimination against Rosa must have been "on the basis of...sex." See [Citation.] The ECOA's sex discrimination prohibition "protects men as well as women."

While the district court was correct in saying that the prohibited bases of discrimination under the ECOA do not include style of dress or sexual orientation, that is not the discrimination alleged. It is alleged that the Bank's actions were taken, in whole or in part, "on the basis of... [the appellant's] sex." The Bank, by seeking dismissal under Rule 12(b)(6), subjected itself to rigorous standards. We may affirm dismissal "only if it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations." [Citations] Whatever facts emerge, and they may turn out to have nothing to do with sex-based discrimination, we cannot say at this point that the plaintiff has no viable theory of sex discrimination consistent with the facts alleged.

The evidence is not yet developed, and thus it is not yet clear why Brunelle told Rosa to go home and change. It may be that this case involves an instance of disparate treatment based on sex in the denial of credit. See [Citation]; ("'Disparate treatment'...is the most easily understood type of discrimination. The employer simply treats some people less favorably than others because of their...sex."); [Citation] (invalidating airline's policy of weight limitations for female "flight hostesses" but not for similarly situated male "directors of passenger services" as impermissible disparate treatment); [Citation] (invalidating policy that female employees wear uniforms but that similarly situated male employees need wear only business dress as impermissible disparate treatment); [Citation] (invalidating rule requiring abandonment upon marriage of surname that was applied to women, but not to men). It is reasonable to infer that Brunelle told Rosa to go home and change because she thought that Rosa's attire did not accord with his male gender: in other words, that Rosa did not receive the loan application because he was a

man, whereas a similarly situated woman would have received the loan application. That is, the Bank may treat, for credit purposes, a woman who dresses like a man differently than a man who dresses like a woman. If so, the Bank concedes, Rosa may have a claim. Indeed, under *Price Waterhouse*, "stereotyped remarks [including statements about dressing more 'femininely'] can certainly be evidence that gender played a part." [Citation.] It is also reasonable to infer, though, that Brunelle refused to give Rosa the loan application because she thought he was gay, confusing sexual orientation with cross-dressing. If so, Rosa concedes, our precedents dictate that he would have no recourse under the federal Act. See [Citation]. It is reasonable to infer, as well, that Brunelle simply could not ascertain whether the person shown in the identification card photographs was the same person that appeared before her that day. If this were the case, Rosa again would be out of luck. It is reasonable to infer, finally, that Brunelle may have had mixed motives, some of which fall into the prohibited category.

It is too early to say what the facts will show; it is apparent, however, that, under some set of facts within the bounds of the allegations and non-conclusory facts in the complaint, Rosa may be able to prove a claim under the ECOA....

We reverse and remand for further proceedings in accordance with this opinion.

CASE QUESTIONS

1. Could the bank have denied Mr. Rosa a loan because he was gay?
2. If a woman had applied for loan materials dressed in traditionally masculine attire, could the bank have denied her the materials?
3. The Court offers up at least three possible reasons why Rosa was denied the loan application. What were those possible reasons, and which of them would have been valid reasons to deny him the application?
4. To what federal law does the court look in interpreting the application of the ECOA?
5. Why did the court rule in Mr. Rosa's favor when the facts as to why he was denied the loan application could have been interpreted in several different ways?

Uses of Credit Reports under the FCRA

Rodgers v. McCullough

296 F.Supp.2d 895 (W.D. Tenn. 2003)

Background

This case concerns Defendants' receipt and use of Christine Rodgers' consumer report. The material facts do not seem to be disputed. The parties agree that Ms. Rodgers gave birth to a daughter, Meghan, on May 4, 2001. Meghan's father is Raymond Anthony. Barbara McCullough, an attorney, represented Mr. Anthony in a child custody suit against Ms. Rodgers in which Mr. Anthony sought to obtain custody and child support from Ms. Rodgers. Ms. McCullough received, reviewed, and used Ms. Rodgers' consumer report in connection with the child custody case.

On September 25, 2001, Ms. McCullough instructed Gloria Christian, her secretary, to obtain Ms. Rodgers' consumer report. Ms. McCullough received the report on September 27 or 28 of 2001. She reviewed the report in preparation for her examination of Ms. Rodgers during a hearing to be held in juvenile court on October 23, 2001. She also used the report during the hearing, including attempting to move the document into evidence and possibly handing it to the presiding judge.

The dispute in this case centers around whether Ms. McCullough obtained and used Ms. Rodgers' consumer report for a purpose permitted under the Fair Credit Reporting Act (the "FCRA"). Plaintiff contends that Ms. McCullough, as well as her law firm, Wilkes, McCullough & Wagner, a partnership, and her partners, Calvin J. McCullough and John C. Wagner, are liable for the unlawful receipt and use of Ms. Rodgers' consumer report in violation 15 U.S.C. §§ 1681 *o*(negligent failure to comply with the FCRA) and 1681n (willful failure to comply with the FCRA or obtaining a consumer report under false pretenses). Plaintiff has also sued Defendants for the state law tort of unlawful invasion of privacy....

Analysis

Plaintiff has moved for summary judgment on the questions of whether Defendants failed to comply with the FCRA (i.e. whether Defendants had a permissible purpose to obtain Ms. Rodgers' credit report), whether Defendants' alleged failure to comply was willful, and whether Defendants' actions constituted unlawful invasion of privacy. The Court will address the FCRA claims followed by the state law claim for unlawful invasion of privacy.

A. Permissible Purpose under the FCRA

Pursuant to the FCRA, "A person shall not use or obtain a consumer report for any purpose unless (1) the consumer report is obtained for a purpose for which the consumer report is authorized to be furnished under this section...." [Citation.] Defendants do not dispute that Ms. McCullough obtained and used Ms. Rodgers' consumer report.

[The act] provides a list of permissible purposes for the receipt and use of a consumer report, of which the following subsection is at issue in this case:

[A]ny consumer reporting agency may furnish a consumer report under the following circumstances and no other:...

> *(3) To a person which it has reason to believe-*
> *(A) intends to use the information in connection with a credit transaction involving the consumer on whom the information is to be furnished and involving the extension of credit to, or review or collection of an account of, the consumer...*

[Citation.] Defendants concede that Ms. McCullough's receipt and use of Ms. Rodgers' consumer report does not fall within any of the other permissible purposes enumerated in [the act].

Ms. Rodgers requests summary judgment in her favor on this point, relying on the plain text of the statute, because she was not in arrears on any child support obligation at the time Ms. McCullough requested the consumer report, nor did she owe Ms. McCullough's client any debt. She notes that Mr.

CC BY NC SA

Anthony did not have custody of Meghan Rodgers and that an award of child support had not even been set at the time Ms. McCullough obtained her consumer report.

Defendants maintain that Ms. McCullough obtained Ms. Rodgers' consumer report for a permissible purpose, namely to locate Ms. Rodgers' residence and set and collect child support obligations. Defendants argue that 15 U.S.C. § 1681b(a)(3)(A) permits the use of a credit report in connection with "collection of an account" and, therefore, Ms. McCullough was permitted to use Ms. Rodgers' credit report in connection with the collection of child support.[1]

The cases Defendants have cited in response to the motion for summary judgment are inapplicable to the present facts. In each case cited by Defendants, the person who obtained a credit report did so in order to collect on an *outstanding* judgment or an *outstanding* debt. *See, e.g.*, [Citation] (finding that collection of a judgment of arrears in child support is a permissible purpose under [the act]; [Citation] (holding that defendant had a permissible purpose for obtaining a consumer report where plaintiff owed an outstanding debt to the company).

However, no such outstanding debt or judgment existed in this case. At the time Ms. McCullough obtained Ms. Rodgers' consumer report, Ms. Rodgers' did not owe money to either Ms. McCullough or her client, Mr. Anthony. Defendants have provided no evidence showing that Ms. McCullough believed Ms. Rodgers owed money to Mr. Anthony at the time she requested the credit report. Indeed, Mr. Anthony had not even been awarded custody of Meghan Rodgers at the time Ms. McCullough obtained and used the credit report. Ms. McCullough acknowledged each of the facts during her deposition. Moreover, in response to Plaintiff's request for admissions, Ms. McCullough admitted that she did not receive the credit report for the purpose of collecting on an account from Ms. Rodgers.

The evidence before the Court makes clear that Ms. McCullough was actually attempting, on behalf of Mr. Anthony, to secure custody of Meghan Rodgers and obtain a future award of child support payments from Ms. Rodgers by portraying Ms. Rodgers as irresponsible to the court. These are not listed as permissible purposes under [FCRA]. Defendants have offered the Court no reason to depart from the plain language

of the statute, which clearly does not permit an individual to obtain a consumer report for the purposes of obtaining child custody and instituting child support payments. Moreover, the fact that the Juvenile Court later awarded custody and child support to Mr. Anthony does not retroactively provide Ms. McCullough with a permissible purpose for obtaining Ms. Rodgers' consumer report. Therefore, the Court GRANTS Plaintiff's motion for partial summary judgment on the question of whether Defendants had a permissible purpose to obtain Ms. Rodgers' credit report.

B. Willful Failure to Comply with the FCRA

Pursuant to [the FCRA], "Any person who willfully fails to comply with any requirement imposed under this subchapter with respect to any consumer is liable to that consumer" for the specified damages.

"To show willful noncompliance with the FCRA, [the plaintiff] must show that [the defendant] 'knowingly and intentionally committed an act in conscious disregard for the rights of others,' but need not show 'malice or evil motive.'" [Citation.] "Under this formulation the defendant must commit the act that violates the Fair Credit Reporting Act with knowledge that he is committing the act and with intent to do so, and he must also be conscious that his act impinges on the rights of others." "The statute's use of the word 'willfully' imports the requirement that the defendant know his or her conduct is unlawful." [Citation.] A defendant can not be held civilly liable under [the act] if he or she obtained the plaintiff's credit report "under what is believed to be a proper purpose under the statute but which a court...later rules to be impermissible legally under [Citation].

Ms. McCullough is an attorney who signed multiple service contracts with Memphis Consumer Credit Association indicating that the primary purpose for which credit information would be ordered was "to collect judgments." Ms. McCullough also agreed in these service contracts to comply with the FCRA. Her deposition testimony indicates that she had never previously ordered a consumer report for purposes of calculating child support. This evidence may give rise to an inference that Ms. McCullough was aware that she did not order Ms. Rodgers' consumer report for a purpose permitted under the FCRA.

Defendants argue in their responsive memorandum that if Ms. McCullough had suspected that she had obtained Ms. Rodgers' credit report in violation of the FCRA, it is unlikely that she would have attempted to present the report to the Juvenile Court as evidence during the custody hearing for Meghan Rodgers. Ms. McCullough also testified that she believed she had a permissible purpose for obtaining Ms. Rodgers' consumer report (i.e. to set and collect child support obligations).

Viewing the evidence in the light most favorable to the nonmoving party, Defendants have made a sufficient showing that Ms. McCullough may not have understood that she lacked a permissible purpose under the FCRA to obtain and use Ms. Rodgers' credit report.

If Ms. McCullough was not aware that her actions might violate the FCRA at the time she obtained and used Ms. Rodgers' credit report, she would not have willfully failed to comply with the FCRA. The question of Ms. McCullough's state of mind at the time she obtained and used Ms. Rodgers' credit report is an issue best left to a jury. [Citation] ("state of mind is typically not a proper issue for resolution on summary judgment"). The Court DENIES Plaintiff's motion for summary judgment on the question of willfulness under [the act].

C. Obtaining a Consumer Report under False Pretenses or Knowingly without a Permissible Purpose

...For the same reasons the Court denied Plaintiff's motion for summary judgment on the question of willfulness, the Court also DENIES Plaintiff's motion for summary judgment on the question of whether Ms. McCullough obtained and used Ms. Rodgers' credit report under false pretenses or knowingly without a permissible purpose.

[Discussion of the invasion of privacy claim omitted.]

Conclusion

For the foregoing reasons, the Court GRANTS Plaintiff's Motion for Partial Summary Judgment Regarding Defendants' Failure to Comply with the Fair Credit Reporting Act [having no permissible purpose]. The Court DENIES Plaintiff's remaining motions for partial summary judgment.

CASE QUESTIONS

1. Why did the defendant, McCullough, order her secretary to obtain Ms. Rodgers's credit report? If Ms. McCullough is found liable, why would her law firm partners also be liable?
2. What "permissible purpose" did the defendants contend they had for obtaining the credit report? Why did the court determine that purpose was not permissible?
3. Why did the court deny the plaintiff's motion for summary judgment on the question of whether the defendant "willfully" failed to comply with the act? Is the plaintiff out of luck on that question, or can it be litigated further?

---

[1] Defendants also admit that Ms. McCullough used the credit report to portray Ms. Rodgers as irresponsible, financially unstable, and untruthful about her residence and employment history to the Juvenile Court. Defendants do not allege that these constitute permissible purposes under the FCRA.

24.4 Summary and Exercises

Summary

Consumers who are granted credit have long received protection through usury laws (laws that establish a maximum interest rate). The rise in consumer debt in recent years has been matched by an increase in federal regulation of consumer credit transactions. The Truth in Lending Act requires disclosure of credit terms; the Equal Credit Opportunity Act prohibits certain types of discrimination in the granting of credit; the Fair Credit Reporting Act gives consumers access to their credit dossiers and prohibits unapproved use of credit-rating information. After entering into a credit transaction, a consumer has certain

cancellation rights and may use a procedure prescribed by the Fair Credit Billing Act to correct billing errors. Traditional debt collection practices—garnishment, wage assignments, and confession of judgment clauses—are now subject to federal regulation, as are the practices of collection agencies under the Fair Debt Collection Practices Act.

EXERCISES

1. Carlene Consumer entered into an agreement with Rent to Buy, Inc., to rent a computer for $20 per week. The agreement also provided that if Carlene chose to rent the computer for fifty consecutive weeks, she would own it. She then asserted that the agreement was not a lease but a sale on credit subject to the Truth in Lending Act, and that Rent to Buy, Inc., violated the act by failing to state the annual percentage rate. Is Carlene correct?
2. Carlos, a resident of Chicago, was on a road trip to California when he heard a noise under the hood of his car. He took the car to a mechanic for repair. The mechanic overhauled the power steering unit and billed Carlos $600, which he charged on his credit card. Later that day—Carlos having driven about fifty miles—the car made the same noise, and Carlos took it to another mechanic, who diagnosed the problem as a loose exhaust pipe connection at the manifold. Carlos was billed $300 for this repair, with which he was satisfied. Carlos returned to Chicago and examined his credit card statement. What rights has he as to the $600 charge on his card?
3. Ken was the owner of Scrimshaw, a company that manufactured and sold carvings made on fossilized ivory. He applied for a loan from Bank. Bank found him creditworthy, but seeking additional security for repayment, it required his wife, Linda, to sign a guaranty as well. During a subsequent recession, demand for scrimshaw fell, and Ken's business went under. Bank filed suit against both Ken and Linda. What defense has Linda?
4. The FCRA requires that credit-reporting agencies "follow reasonable procedures to assure maximum possible accuracy of the information." In October of 1989, Renie Guimond became aware of, and notified the credit bureau Trans Union about, inaccuracies in her credit report: that she was married (and it listed a Social Security number for this nonexistent spouse), that she was also known as Ruth Guimond, and that she had a Saks Fifth Avenue credit card. About a month later, Trans Union responded to Guimond's letter,

stating that the erroneous information had been removed. But in March of 1990, Trans Union again published the erroneous information it purportedly had removed. Guimond then requested the source of the erroneous information, to which Trans Union responded that it could not disclose the identity of the source because it did not know its source. The disputed information was eventually removed from Guimond's file in October 1990. When Guimond sued, Trans Union defended that she had no claim because no credit was denied to her as a result of the inaccuracies in her credit file. The lower court dismissed her case; she appealed. To what damages, if any, is Guimond entitled?

5. Plaintiff incurred a medical debt of $160. She received two or three telephone calls from Defendant, the collection agency; each time she denied any money owing. Subsequently she received this letter:

> *You have shown that you are unwilling to work out a friendly settlement with us to clear the above debt. Our field investigator has now been instructed to make an investigation in your neighborhood and to personally call on your employer.*
>
> *The immediate payment of the full amount, or a personal visit to this office, will spare you this embarrassment.*

The top of the letter notes the creditor's name and the amount of the alleged debt. The letter was signed by a "collection agent." The envelope containing that letter presented a return address that included Defendant's full name: "Collection Accounts Terminal, Inc." What violations of the Fair Debt Collection Practices Act are here presented?

6. Eric and Sharaveen Rush filed a claim alleging violations of the Fair Credit Reporting Act arising out of an allegedly erroneous credit report prepared by a credit bureau from information, in part, from Macy's, the department store. The error causes the Rushes to be denied credit. Macy's filed a motion to dismiss. Is Macy's liable? Discuss.

SELF-TEST QUESTIONS

1 An example of a loan that is a common exception to usury law is

a. a business loan

b. a mortgage loan

c. an installment loan

d. all of the above

2 Under the Fair Credit Reporting Act, an applicant denied credit

a. has a right to a hearing

b. has the right to be told the name and address of the credit bureau that prepared the credit report upon which denial was based

c. always must pay a fee for information regarding credit denial

d. none of the above

3 Garnishment of wages

a. is limited by federal law

b. involves special rules for support cases

c. is a legal process where a creditor obtains a court order directing the debtor's employer to pay a portion of the debtor's wages directly to the creditor

d. involves all of the above

4 A wage assignment is

a. an example of garnishment

b. an example of confession of judgment

c. an exception to usury law

d. an agreement that a creditor may take future wages as security for a loan

5 The Truth-in-Truth in Lending Act requires disclosure of

a. the annual percentage rate

b. the borrower's race

c. both of the above

d. neither of the above

SELF-TEST ANSWERS

1. d

CC BY NC SA

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

Chapter 25
Secured Transactions and Suretyship

LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The basic concepts of secured transactions
2. The property subject to the security interest
3. Creation and perfection of the security interest
4. Priorities for claims on the security interest
5. Rights of creditors on default
6. The basic concepts of suretyship
7. The relationship between surety and principal
8. Rights among cosureties

25.1 Introduction to Secured Transactions

LEARNING OBJECTIVES

CC BY NC SA

1. Recognize, most generally, the two methods by which debtors' obligations may be secured.
2. Know the source of law for personal property security.
3. Understand the meaning of *security interest* and other terminology necessary to discuss the issues.
4. Know what property is subject to the security interest.
5. Understand how the security interest is created—"attached"—and perfected.

The Problem of Security

Creditors want assurances that they will be repaid by the debtor. An oral promise to pay is no security at all, and—as it is oral—it is difficult to prove. A **signature loan** is merely a written promise by the debtor to repay, but the creditor stuck holding a promissory note with a signature loan only—while he may sue a defaulting debtor—will get nothing if the debtor is insolvent. Again, that's no security at all. Real security for the creditor comes in two forms: by agreement with the debtor or by operation of law without an agreement.

By Agreement with the Debtor

Security obtained through agreement comes in three major types: (1) personal property security (the most common form of security); (2) suretyship—the willingness of a third party to pay if the primarily obligated party does not; and (3) mortgage of real estate.

By Operation of Law

Security obtained through operation of law is known as a **lien**. Derived from the French for "string" or "tie," a *lien* is the legal hold that a creditor has over the property of another in order to secure payment or discharge an obligation.

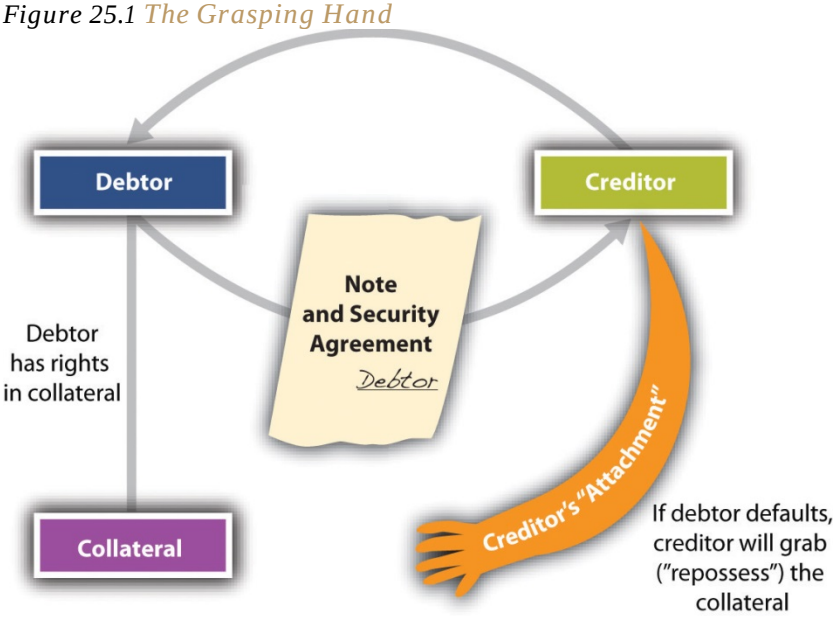
In this chapter, we take up security interests in personal property and suretyship. In the next chapter, we look at mortgages and nonconsensual liens.

Basics of Secured Transactions

The law of secured transactions consists of five principal components: (1) the nature of property that can be the subject of a security interest; (2) the methods of creating the security interest; (3) the perfection of the security interest against claims of others; (4) priorities among secured and unsecured creditors—that is, who will be entitled to the secured property if more than one person asserts a legal right to it; and (5) the rights of creditors when the debtor defaults. After considering the source of the law and some key terminology, we examine each of these components in turn.

Here is the simplest (and most common) scenario: Debtor borrows money or obtains credit from Creditor, signs a note and security agreement putting up collateral, and promises to pay the debt or, upon Debtor's default, let Creditor (secured party) take possession of (repossess) the collateral and sell it. Figure 25.1 "The Grasping Hand" illustrates this scenario—the grasping *hand* is Creditor's reach for the collateral, but the hand will not close around the collateral and take it (repossess) unless Debtor defaults.

Figure 25.1 *The Grasping Hand*



Source of Law and Definitions

Source of Law

Article 9 of the Uniform Commercial Code (UCC) governs security interests in personal property. The UCC defines the scope of the article (here slightly truncated):[1]

> *This chapter applies to the following:*
>
> 1. *A transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract;*
> 2. *An agricultural lien;*
> 3. *A sale of accounts, chattel paper, payment intangibles, or promissory notes;*
> 4. *A consignment...*

Definitions

As always, it is necessary to review some definitions so that communication on the topic at hand is possible. The secured transaction always involves a debtor, a secured party, a security agreement, a security interest, and collateral.

Article 9 applies to any transaction "that creates a security interest." The UCC in Section 1-201(35) defines **security interest** as "an interest in personal property or fixtures which secures payment or performance of an obligation."

Security agreement is "an agreement that creates or provides for a security interest." It is the contract that sets up the debtor's duties and the creditor's rights in event the debtor defaults.[2]

Collateral "means the property subject to a security interest or agricultural lien."[3]

Purchase-money security interest (PMSI) is the simplest form of security interest. Section 9-103(a) of the UCC defines "purchase-money collateral" as "goods or software that secures a purchase-money obligation with respect to that collateral." A PMSI arises where the debtor gets credit to buy goods and the creditor takes a secured interest in those goods. Suppose you want to buy a big hardbound textbook on credit at your college bookstore. The manager refuses to extend you credit outright but says she will take

back a PMSI. In other words, she will retain a security interest in the book itself, and if you don't pay, you'll have to return the book; it will be repossessed. Contrast this situation with a counteroffer you might make: because she tells you not to mark up the book (in the event that she has to repossess it if you default), you would rather give her some other collateral to hold—for example, your gold college signet ring. Her security interest in the ring is not a PMSI but a pledge; a PMSI must be an interest in the particular goods purchased. A PMSI would also be created if you borrowed money to buy the book and gave the lender a security interest in the book.

Whether a transaction is a lease or a PMSI is an issue that frequently arises. The answer depends on the facts of each case. However, a security interest is created if (1) the lessee is obligated to continue payments for the term of the lease; (2) the lessee cannot terminate the obligation; and (3) one of several economic tests, which are listed in UCC Section 1-201 (37), is met. For example, one of the economic tests is that "the lessee has an option to become owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement."

The issue of lease versus security interest gets litigated because of the requirements of Article 9 that a security interest be perfected in certain ways (as we will see). If the transaction turns out to be a security interest, a lessor who fails to meet these requirements runs the risk of losing his property to a third party. And consider this example. Ferrous Brothers Iron Works "leases" a $25,000 punch press to Millie's Machine Shop. Under the terms of the lease, Millie's must pay a yearly rental of $5,000 for five years, after which time Millie's may take title to the machine outright for the payment of $1. During the period of the rental, title remains in Ferrous Brothers. Is this "lease" really a security interest? Since ownership comes at nominal charge when the entire lease is satisfied, the transaction would be construed as one creating a security interest. What difference does this make? Suppose Millie's goes bankrupt in the third year of the lease, and the trustee in bankruptcy wishes to sell the punch press to satisfy debts of the machine shop. If it were a true lease, Ferrous Brothers would be entitled to reclaim the machine (unless the trustee assumed the lease). But if the lease is really intended as a device to create a security interest, then Ferrous Brothers can recover its collateral only if it has otherwise complied with the obligations of Article 9—for example, by recording its security interest, as we will see.

Now we return to definitions.

Debtor is "a person (1) having an interest in the collateral other than a security interest or a lien; (2) a seller of accounts, chattel paper, payment intangibles, or promissory notes; or (3) a consignee." [4]
Obligor is "a person that, with respect to an obligation secured by a security interest in or an agricultural lien on the collateral, (i) owes payment or other performance of the obligation, (ii) has provided property other than the collateral to secure payment or other performance of the obligation, or (iii) is otherwise accountable in whole or in part for payment or other performance of the obligation." [5] Here is example 1 from the Official Comment to UCC Section 9-102: "Behnfeldt borrows money and grants a security interest in her Miata to secure the debt. Behnfeldt is a debtor and an obligor."

Behnfeldt is a debtor because she has an interest in the car—she owns it. She is an obligor because she owes payment to the creditor. Usually the debtor is the obligor.

A *secondary obligor* is "an obligor to the extent that: (A) [the] obligation is secondary; or (b) [the person] has a right of recourse with respect to an obligation secured by collateral against the debtor, another obligor, or property of either." [6] The secondary obligor is a guarantor (surety) of the debt, obligated to perform if the primary obligor defaults. Consider example 2 from the Official Comment to Section 9-102: "Behnfeldt borrows money and grants a security interest in her Miata to secure the debt. Bruno cosigns a negotiable note as maker. As before, Behnfeldt is the debtor and an obligor. As an accommodation party, Bruno is a secondary obligor. Bruno has this status even if the note states that her obligation is a primary obligation and that she waives all suretyship defenses."

Again, usually the debtor is the obligor, but consider example 3 from the same Official Comment: "Behnfeldt borrows money on an unsecured basis. Bruno cosigns the note and grants a security interest in her Honda to secure her [Behnfeldt's] obligation. Inasmuch as Behnfeldt does not have a property interest in the Honda, Behnfeldt is not a debtor. Having granted the security interest, Bruno is the debtor. Because Behnfeldt is a principal obligor, she is not a secondary obligor. Whatever the outcome of enforcement of

the security interest against the Honda or Bruno's secondary obligation, Bruno will look to Behnfeldt for her losses. The enforcement will not affect Behnfeldt's aggregate obligations."

Secured party is "a person in whose favor a security interest is created or provided for under a security agreement," and it includes people to whom accounts, chattel paper, payment intangibles, or promissory notes have been sold; consignors; and others under Section 9-102(a)(72).

Chattel mortgage means "a debt secured against items of personal property rather than against land, buildings and fixtures." [7]

Property Subject to the Security Interest

Now we examine what property may be put up as security—collateral. Collateral is—again—property that is subject to the security interest. It can be divided into four broad categories: goods, intangible property, indispensable paper, and other types of collateral.

Goods

Tangible property as collateral is goods. *Goods* means "all things that are movable when a security interest attaches. The term includes (i) fixtures, (ii) standing timber that is to be cut and removed under a conveyance or contract for sale, (iii) the unborn young of animals, (iv) crops grown, growing, or to be grown, even if the crops are produced on trees, vines, or bushes, and (v) manufactured homes. The term also includes a computer program embedded in goods." [8] Goods are divided into several subcategories; six are taken up here.

Consumer Goods

These are "goods used or bought primarily for personal, family, or household purposes." [9]

Inventory

"Goods, other than farm products, held by a person for sale or lease or consisting of raw materials, works in progress, or material consumed in a business." [10]

Farm Products

"Crops, livestock, or other supplies produced or used in farming operations," including aquatic goods produced in aquaculture.[11]

Equipment

This is the residual category, defined as "goods other than inventory, farm products, or consumer goods."[12]

Fixtures

These are "goods that have become so related to particular real property that an interest in them arises under real property law."[13] Examples would be windows, furnaces, central air conditioning, and plumbing fixtures—items that, if removed, would be a cause for significant reconstruction.

Accession

These are "goods that are physically united with other goods in such a manner that the identity of the original goods is lost."[14] A new engine installed in an old automobile is an accession.

Intangible Property

Two types of collateral are neither goods nor indispensible paper: accounts and general intangibles.

Accounts

This type of intangible property includes accounts receivable (the right to payment of money), insurance policy proceeds, energy provided or to be provided, winnings in a lottery, health-care-insurance receivables, promissory notes, securities, letters of credit, and interests in business entities.[15] Often there is something in writing to show the existence of the right—such as a right to receive the proceeds of somebody else's insurance payout—but the writing is merely evidence of the right. The paper itself doesn't have to be delivered for the transfer of the right to be effective; that's done by assignment.

General Intangibles

General intangibles refers to "any personal property, including things in action, other than accounts, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction." General intangibles include payment intangibles and software.[16]

Indispensable Paper

This oddly named category is the middle ground between goods—stuff you can touch—and intangible property. It's called "indispensable" because although the right to the value—such as a warehouse receipt—is embodied in a written paper, the paper itself is indispensable for the transferee to access the value. For example, suppose Deborah Debtor borrows $3,000 from Carl Creditor, and Carl takes a security interest in four designer chairs Deborah owns that are being stored in a warehouse. If Deborah defaults, Carl has the right to possession of the warehouse receipt: he takes it to the warehouser and is entitled to take the chairs and sell them to satisfy the obligation. The warehouser will not let Carl have the chairs without the warehouse receipt—it's indispensable paper. There are four kinds of indispensable paper.

Chattel Paper

Chattel is another word for goods. Chattel paper is a record (paper or electronic) that demonstrates both "a monetary obligation and a security interest either in certain goods or in a lease on certain goods."[17] The paper represents a valuable asset and can itself be used as collateral. For example, Creditor Car Company sells David Debtor an automobile and takes back a note and security agreement (this is a purchase-money security agreement; the note and security agreement is chattel paper). The chattel paper is not yet collateral; the automobile is. Now, though, Creditor Car Company buys a new hydraulic lift from Lift Co., and grants Lift Co. a security interest in Debtor's chattel paper to secure Creditor Car's debt to Lift Co. The chattel paper is now collateral. Chattel paper can be tangible (actual paper) or electronic.

Documents

This category includes documents of title—bills of lading and warehouse receipts are examples.

Instruments

An "instrument" here is "a negotiable instrument (checks, drafts, notes, certificates of deposit) or any other writing that evidences a right to the payment of a monetary obligation, is not itself a security agreement or lease, and is of a type that in the ordinary course of business is transferred by delivery with any necessary indorsement or assignment." "Instrument" does not include (i) investment property, (ii) letters of credit, or (iii) writings that evidence a right to payment arising out of the use of a credit or charge card or information contained on or for use with the card.[18]

Investment Property

This includes securities (stock, bonds), security accounts, commodity accounts, and commodity contracts.[19] Securities may be certified (represented by a certificate) or uncertified (not represented by a certificate).[20]

Other Types of Collateral

Among possible other types of collateral that may be used as security is the **floating lien**. This is a security interest in property that was not in the possession of the debtor when the security agreement was executed. The floating lien creates an interest that floats on the river of present and future collateral and proceeds held by—most often—the business debtor. It is especially useful in loans to businesses that sell their collateralized inventory. Without the floating lien, the lender would find its collateral steadily depleted as the borrowing business sells its products to its customers. Pretty soon, there'd be no security at all. The floating lien includes the following:

- *After-acquired property*. This is property that the debtor acquires after the original deal was set up. It allows the secured party to enhance his security as the debtor (obligor) acquires more property subject to collateralization.
- *Sale proceeds*. These are proceeds from the disposition of the collateral. Carl Creditor takes a secured interest in Deborah Debtor's sailboat. She sells the boat and buys a garden tractor. The secured interest attaches to the garden tractor.

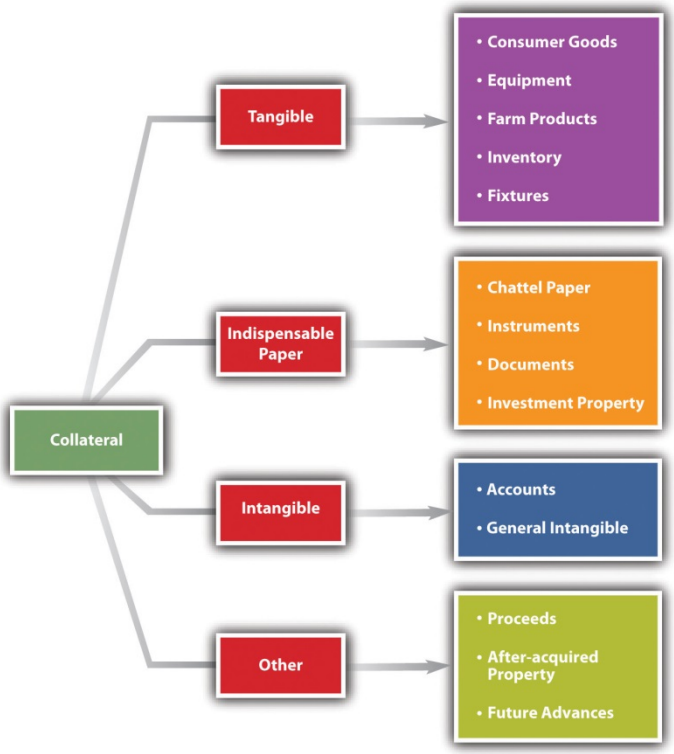
- *Future advances*. Here the security agreement calls for the collateral to stand for both present and future advances of credit without any additional paperwork.

Here are examples of future advances:

  - Example 1: A debtor enters into a security agreement with a creditor that contains a future advances clause. The agreement gives the creditor a security interest in a $700,000 inventory-picking robot to secure repayment of a loan made to the debtor. The parties contemplate that the debtor will, from time to time, borrow more money, and when the debtor does, the machine will stand as collateral to secure the further indebtedness, without new paperwork.
  - Example 2: A debtor signs a security agreement with a bank to buy a car. The security agreement contains a future advances clause. A few years later, the bank sends the debtor a credit card. Two years go by: the car is paid for, but the credit card is in default. The bank seizes the car. “Whoa!” says the debtor. “I paid for the car.” “Yes,” says the bank, “but it was collateral for all future indebtedness you ran up with us. Check out your loan agreement with us and UCC Section 9-204(c), especially Comment 5.”

See Figure 25.2 "Tangibles and Intangibles as Collateral".

Figure 25.2 Tangibles and Intangibles as Collateral



Attachment of the Security Interest

In General

Attachment is the term used to describe when a security interest becomes enforceable against the debtor with respect to the collateral. In Figure 25.1 "The Grasping Hand", "Attachment" is the outreached hand that is prepared, if the debtor defaults, to grasp the collateral.[21]

Requirements for Attachment

There are three requirements for attachment: (1) the secured party gives value; (2) the debtor has rights in the collateral or the power to transfer rights in it to the secured party; (3) the parties have a security agreement "authenticated" (signed) by the debtor, or the creditor has possession of the collateral.

Creditor Gives Value

The creditor, or secured party, must give "value" for the security interest to attach. The UCC, in Section 1-204, provides that

> *a person gives 'value' for rights if he acquires them*
>
> *(1) in return for a binding commitment to extend credit or for the extension of immediately available credit whether or not drawn upon and whether or not a charge-back is provided for in the event of difficulties in collection; or*
>
> *(2) as security for or in total or partial satisfaction of a pre-existing claim; or*
>
> *(3) by accepting delivery pursuant to a pre-existing contract for purchase; or*
>
> *(4) generally, in return for any consideration sufficient to support a simple contract.*

Suppose Deborah owes Carl $3,000. She cannot repay the sum when due, so she agrees to give Carl a security interest in her automobile to the extent of $3,000 in return for an extension of the time to pay. That is sufficient value.

Debtor's Rights in Collateral

The debtor must have rights in the collateral. Most commonly, the debtor owns the collateral (or has some ownership interest in it). The rights need not necessarily be the immediate right to possession, but they must be rights that can be conveyed.[22] A person can't put up as collateral property she doesn't own.

Security Agreement (Contract) or Possession of Collateral by Creditor

The debtor most often signs the written security agreement, or contract. The UCC says that "the debtor [must have] authenticated a security agreement that provides a description of the collateral...." "Authenticating" (or "signing," "adopting," or "accepting") means to sign or, in recognition of electronic commercial transactions, "to execute or otherwise adopt a symbol, or encrypt or similarly process a

record...with the present intent of the authenticating person to identify the person and adopt or accept a record." The "record" is the modern UCC's substitution for the term "writing." It includes information electronically stored or on paper.[23]

The "authenticating record" (the signed security agreement) is *not* required in some cases. It is not required if the debtor makes a **pledge** of the collateral—that is, delivers it to the creditor for the creditor to possess. For example, upon a creditor's request of a debtor for collateral to secure a loan of $3,000, the debtor offers up his stamp collection. The creditor says, "Fine, have it appraised (at your expense) and show me the appraisal. If it comes in at $3,000 or more, I'll take your stamp collection and lock it in my safe until you've repaid me. If you don't repay me, I'll sell it." A creditor could take possession of any goods and various kinds of paper, tangible or intangible. In commercial transactions, it would be common for the creditor to have possession of—actually or virtually—certified securities, deposit accounts, electronic chattel paper, investment property, or other such paper or electronic evidence of value.[24]

Again, Figure 25.1 "The Grasping Hand" diagrams the attachment, showing the necessary elements: the creditor gives value, the debtor has rights in collateral, and there is a security agreement signed (authenticated) by the debtor. If the debtor defaults, the creditor's "hand" will grab (repossess) the collateral.

Perfection of the Security Interest

As between the debtor and the creditor, attachment is fine: if the debtor defaults, the creditor will repossess the goods and—usually—sell them to satisfy the outstanding obligation. But unless an additional set of steps is taken, the rights of the secured party might be subordinated to the rights of other secured parties, certain lien creditors, bankruptcy trustees, and buyers who give value and who do not know of the security interest. **Perfection** is the secured party's way of announcing the security interest to the rest of the world. It is the secured party's claim on the collateral.

There are five ways a creditor may perfect a security interest: (1) by filing a financing statement, (2) by taking or retaining possession of the collateral, (3) by taking control of the collateral, (4) by taking control temporarily as specified by the UCC, or (5) by taking control automatically.

Perfection by Filing

"Except as otherwise provided...a financing statement must be filed to perfect all security agreements." [25]

The Financing Statement

A **financing statement** is a simple notice showing the creditor's general interest in the collateral. It is what's filed to establish the creditor's "dibs."

Contents of the Financing Statement

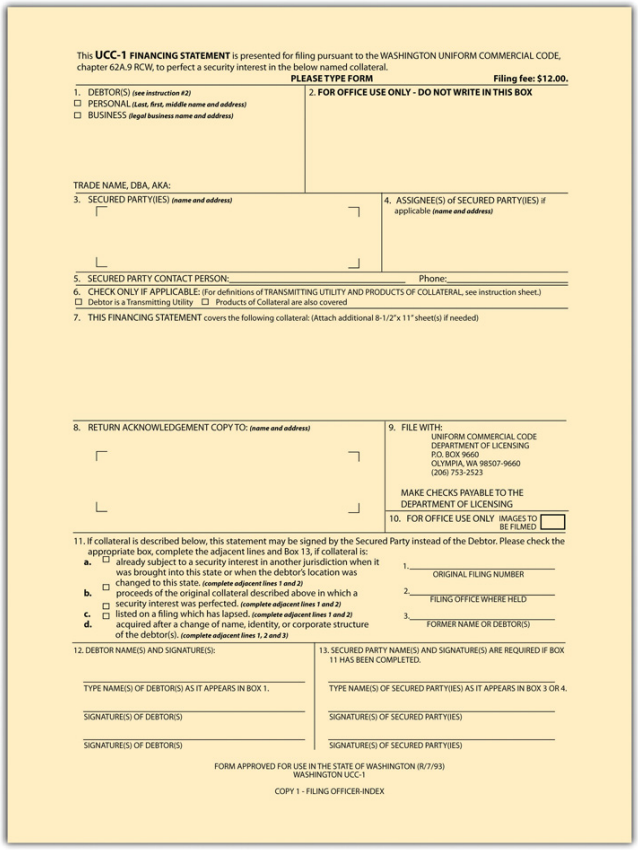
It may consist of the security agreement itself, as long as it contains the information required by the UCC, but most commonly it is much less detailed than the security agreement: it "indicates merely that a person may have a security interest in the collateral[.]...Further inquiry from the parties concerned will be necessary to disclose the full state of affairs." [26] The financing statement must provide the following information:

- The debtor's name. Financing statements are indexed under the debtor's name, so getting that correct is important. Section 9-503 of the UCC describes what is meant by "name of debtor."
- The secured party's name.
- An "indication" of what collateral is covered by the financing statement.[27] It may describe the collateral or it may "indicate that the financing statement covers all assets or all personal property" (such generic references are not acceptable in the security agreement but are OK in the financing statement).[28] If the collateral is real-property-related, covering timber to be cut or fixtures, it must include a description of the real property to which the collateral is related.[29]

The form of the financing statement may vary from state to state, but see Figure 25.3 "UCC-1 Financing Statement" for a typical financing statement. Minor errors or omissions on the form will not make it

ineffective, but the debtor's signature is required unless the creditor is authorized by the debtor to make the filing without a signature, which facilitates paperless filing.[30]

Figure 25.3 *UCC-1 Financing Statement*



This **UCC-1 FINANCING STATEMENT** is presented for filing pursuant to the WASHINGTON UNIFORM COMMERCIAL CODE, chapter 62A.9 RCW, to perfect a security interest in the below named collateral.

PLEASE TYPE FORM **Filing fee: $12.00.**

1. DEBTOR(S) *(see instruction #2)*
☐ PERSONAL *(Last, first, middle name and address)*
☐ BUSINESS *(legal business name and address)*

2. **FOR OFFICE USE ONLY - DO NOT WRITE IN THIS BOX**

TRADE NAME, DBA, AKA:

3. SECURED PARTY(IES) *(name and address)*

4. ASSIGNEE(S) of SECURED PARTY(IES) if applicable *(name and address)*

5. SECURED PARTY CONTACT PERSON:_____ Phone:_____

6. CHECK ONLY IF APPLICABLE: (For definitions of TRANSMITTING UTILITY AND PRODUCTS OF COLLATERAL, see instruction sheet.)
☐ Debtor is a Transmitting Utility ☐ Products of Collateral are also covered

7. THIS FINANCING STATEMENT covers the following collateral: (Attach additional 8-1/2"x 11" sheet(s) if needed)

8. RETURN ACKNOWLEDGEMENT COPY TO: *(name and address)*

9. FILE WITH:
UNIFORM COMMERCIAL CODE
DEPARTMENT OF LICENSING
P.O. BOX 9660
OLYMPIA, WA 98507-9660
(206) 753-2523

MAKE CHECKS PAYABLE TO THE DEPARTMENT OF LICENSING

10. FOR OFFICE USE ONLY IMAGES TO BE FILMED ☐

11. If collateral is described below, this statement may be signed by the Secured Party instead of the Debtor. Please check the appropriate box, complete the adjacent lines and Box 13, if collateral is:
a. ☐ already subject to a security interest in another jurisdiction when it was brought into this state or when the debtor's location was changed to this state. *(complete adjacent lines 1 and 2)*
b. ☐ proceeds of the original collateral described above in which a security interest was perfected. *(complete adjacent lines 1 and 2)*
c. ☐ listed on a filing which has lapsed. *(complete adjacent lines 1 and 2)*
d. acquired after a change of name, identity, or corporate structure of the debtor(s). *(complete adjacent lines 1, 2 and 3)*

1._____ ORIGINAL FILING NUMBER
2._____ FILING OFFICE WHERE HELD
3._____ FORMER NAME OR DEBTOR(S)

12. DEBTOR NAME(S) AND SIGNATURE(S):
_____ TYPE NAME(S) OF DEBTOR(S) AS IT APPEARS IN BOX 1.
_____ SIGNATURE(S) OF DEBTOR(S)
_____ SIGNATURE(S) OF DEBTOR(S)

13. SECURED PARTY NAME(S) AND SIGNATURE(S) ARE REQUIRED IF BOX 11 HAS BEEN COMPLETED.
_____ TYPE NAME(S) OF SECURED PARTY(IES) AS IT APPEARS IN BOX 3 OR 4.
_____ SIGNATURE(S) OF SECURED PARTY(IES)
_____ SIGNATURE(S) OF SECURED PARTY(IES)

FORM APPROVED FOR USE IN THE STATE OF WASHINGTON (R/7/93)
WASHINGTON UCC-1

COPY 1 - FILING OFFICER-INDEX

Duration of the Financing Statement

Generally, the financing statement is effective for five years; a **continuation statement** may be filed within six months before the five-year expiration date, and it is good for another five years.[31] Manufactured-home filings are good for thirty years. When the debtor's obligation is satisfied, the secured party files **a termination statement** if the collateral was consumer goods; otherwise—upon demand—the secured party sends the debtor a termination statement.[32]

Debtor Moves out of State

CC BY NC SA

The UCC also has rules for continued perfection of security interests when the debtor—whether an individual or an association (corporation)—moves from one state to another. Generally, an interest remains perfected until the earlier of when the perfection would have expired or for four months after the debtor moves to a new jurisdiction.[33]

Where to File the Financing Statement

For most real-estate-related filings—ore to be extracted from mines, agricultural collateral, and fixtures—the place to file is with the local office that files mortgages, typically the county auditor's office.[34] For other collateral, the filing place is as duly authorized by the state. In some states, that is the office of the Secretary of State; in others, it is the Department of Licensing; or it might be a private party that maintains the state's filing system.[35] The filing should be made in the state where the debtor has his or her primary residence for individuals, and in the state where the debtor is organized if it is a registered organization.[36] The point is, creditors need to know where to look to see if the collateral offered up is already encumbered. In any event, filing the statement in more than one place can't hurt. The filing office will provide instructions on how to file; these are available online, and electronic filing is usually available for at least some types of collateral.

Exemptions

Some transactions are exempt from the filing provision. The most important category of exempt collateral is that covered by state certificate of title laws. For example, many states require automobile owners to obtain a certificate of title from the state motor vehicle office. Most of these states provide that it is not necessary to file a financing statement in order to perfect a security interest in an automobile. The reason is that the motor vehicle regulations require any security interests to be stated on the title, so that anyone attempting to buy a car in which a security interest had been created would be on notice when he took the actual title certificate.[37]

Temporary Perfection

The UCC provides that certain types of collateral are automatically perfected but only for a while: "A security interest in certificated securities, or negotiable documents, or instruments is perfected without

filing or the taking of possession for a period of twenty days from the time it attaches to the extent that it arises for new value given under an authenticated security agreement."[38] Similar temporary perfection covers negotiable documents or goods in possession of a bailee, and when a security certificate or instrument is delivered to the debtor for sale, exchange, presentation, collection, enforcement, renewal, or registration.[39] After the twenty-day period, perfection would have to be by one of the other methods mentioned here.

Perfection by Possession

A secured party may perfect the security interest by possession where the collateral is negotiable documents, goods, instruments, money, tangible chattel paper, or certified securities.[40] This is a pledge of assets (mentioned in the example of the stamp collection). No security agreement is required for perfection by possession.

A variation on the theme of pledge is **field warehousing**. When the pawnbroker lends money, he takes possession of the goods—the watch, the ring, the camera. But when large manufacturing concerns wish to borrow against their inventory, taking physical possession is not necessarily so easy. The bank does not wish to have shipped to its Wall Street office several tons of copper mined in Colorado. Bank employees perhaps could go west to the mine and take physical control of the copper, but banks are unlikely to employ people and equipment necessary to build a warehouse on the spot. Thus this so-called field pledge is rare.

More common is the field warehouse. The field warehouse can take one of two forms. An independent company can go to the site and put up a temporary structure—for example, a fence around the copper—thus establishing physical control of the collateral. Or the independent company can lease the warehouse facilities of the debtor and post signs indicating that the goods inside are within its sale custody. Either way, the goods are within the physical possession of the field warehouse service. The field warehouse then segregates the goods secured to the particular bank or finance company and issues a warehouse receipt to the lender for those goods. The lender is thus assured of a security interest in the collateral.

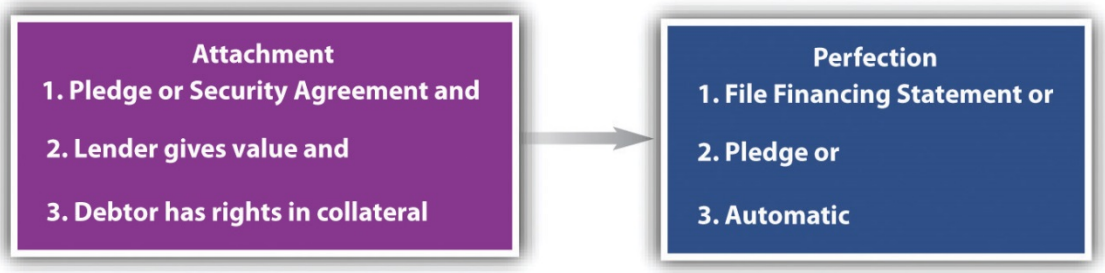
Perfection by Control

"A security interest in investment property, deposit accounts, letter-of-credit rights, or electronic chattel paper may be perfected by control of the collateral."[41] "Control" depends on what the collateral is. If it's a checking account, for example, the bank with which the deposit account is maintained has "control": the bank gets a security interest automatically because, as Official Comment 3 to UCC Section 9-104 puts it, "all actual and potential creditors of the debtor are always on notice that the bank with which the debtor's deposit account is maintained may assert a claim against the deposit account." "Control" of electronic chattel paper of investment property, and of letter-of-credit rights is detailed in Sections 9-105, 9-106, and 9-107. Obtaining "control" means that the creditor has taken whatever steps are necessary, given the manner in which the items are held, to place itself in a position where it can have the items sold, without further action by the owner.[42]

Automatic Perfection

The fifth mechanism of perfection is addressed in Section 9-309 of the UCC: there are several circumstances where a security interest is perfected upon mere attachment. The most important here is **automatic perfection** of a purchase-money security interest given in consumer goods. If a seller of consumer goods takes a PMSI in the goods sold, then perfection of the security interest is automatic. But the seller may file a financial statement and faces a risk if he fails to file and the consumer debtor sells the goods. Under Section 9-320(b), a buyer of consumer goods takes free of a security interest, even though perfected, if he buys without knowledge of the interest, pays value, and uses the goods for his personal, family, or household purposes—unless the secured party had first filed a financing statement covering the goods.

Figure 25.4 *Attachment and Perfection*



KEY TAKEAWAY

A creditor may be secured—allowed to take the debtor's property upon debtor's default—by agreement between the parties or by operation of law. The law governing agreements for personal property security is Article 9 of the UCC. The creditor's first step is to attach the security interest. This is usually accomplished when the debtor, in return for value (a loan or credit) extended from the creditor, puts up as collateral some valuable asset in which she has an interest and authenticates (signs) a security agreement (the contract) giving the creditor a security interest in collateral and allowing that the creditor may take it if the debtor defaults. The UCC lists various kinds of assets that can be collateralized, ranging from tangible property (goods), to assets only able to be manifested by paper (indispensable paper), to intangible assets (like patent rights). Sometimes no security agreement is necessary, mostly if the creditor takes possession of the collateral. After attachment, the prudent creditor will want to perfect the security interest to make sure no other creditors claim an interest in the collateral. Perfection is most often accomplished by filing a financing statement in the appropriate place to put the world on notice of the creditor's interest. Perfection can also be achieved by a pledge (possession by the secured creditor) or by "control" of certain assets (having such control over them as to be able to sell them if the debtor defaults). Perfection is automatic temporarily for some items (certified securities, instruments, and negotiable documents) but also upon mere attachment to purchase-money security interests in consumer goods.

EXERCISES

1. Why is a creditor ill-advised to be unsecured?
2. Elaine bought a computer for her use as a high school teacher, the school contributing one-third of its cost. Elaine was compelled to file for bankruptcy. The computer store claimed it had perfected its interest by mere attachment, and the bankruptcy trustee claimed the computer as an asset of Elaine's bankruptcy estate. Who wins, and why?
3. What is the general rule governing where financing statements should be filed?
4. If the purpose of perfection is to alert the world to the creditor's claim in the collateral, why is perfection accomplishable by possession alone in some cases?

5. Contractor pawned a power tool and got a $200 loan from Pawnbroker. Has there been a perfection of a security interest?

---

[1] Uniform Commercial Code, Section 9-109.

[2] Uniform Commercial Code, Section 9-102(a)(73).

[3] Uniform Commercial Code, Section 9-102(12).

[4] Uniform Commercial Code, Section 9-102(a)(28).

[5] Uniform Commercial Code, Section 9-102 (59).

[6] Uniform Commercial Code, Section 9-102(a)(71).

[7] Commercial Brokers, Inc., "Glossary of Real Estate Terms,"http://www.cbire.com/index.cfm/fuseaction/terms.list/letter/C/contentid/32302EC3-81D5-47DF-A9CBA32FAE38B22A.

[8] Uniform Commercial Code, Section 9-102(44).

[9] Uniform Commercial Code, Section 9-102(a)(48).

[10] Uniform Commercial Code, Section 9-102(a)(48).

[11] Uniform Commercial Code, Section 9-102(a)(34).

[12] Uniform Commercial Code, Section 9-102(a)(33).

[13] Uniform Commercial Code, Section 9-102(a)(41).

[14] Uniform Commercial Code, Section 9-102(a)(1).

[15] Uniform Commercial Code, Section 9-102(a)(2).

[16] Uniform Commercial Code, Section 9-102(42).

[17] Uniform Commercial Code, Section 9-102(11).

[18] Uniform Commercial Code, Section 9-102(a)(47).

[19] Uniform Commercial Code, Section 9-102(a)(49).

[20] Uniform Commercial Code, Section 8-102(a)(4) and (a)(18).

[21] Uniform Commercial Code, Section 9-203(a).

[22] Uniform Commercial Code, Section 9-203(b)(2).

[23] Uniform Commercial Code, Section 9-102, Official Comment 9. Here is a free example of a security agreement online: Docstoc, "Free Business Templates—Sample Open-Ended Security Agreement," http://www.docstoc.com/docs/271920/Free-Business-Templates—-Sample-Open-Ended-Security-Agreement.

[24] Uniform Commercial Code, Section 9-203(b)(3)(B-D).

[25] Uniform Commercial Code, Section 9-310(a).

[26] Uniform Commercial Code, Section 9-502, Official Comment 2.

[27] Uniform Commercial Code, Section 9-502(a).

[28] Uniform Commercial Code, Section 9-504.

[29] Uniform Commercial Code, Section 9-502(b).

[30] Uniform Commercial Code, Section 9-506; Uniform Commercial Code, Section, 9-502, Comment 3.

[31] Uniform Commercial Code, Section 9-515.

[32] Uniform Commercial Code, Section 9-513.

[33] Uniform Commercial Code, Section 9-316.

[34] Uniform Commercial Code, Section 9-501.

[35] Uniform Commercial Code, Section 9-501(a)(2).

[36] Uniform Commercial Code, Section 9-307(b).

[37] Uniform Commercial Code, Section 9-303.

[38] Uniform Commercial Code, Section 9-312(e).

[39] Uniform Commercial Code, Section 9-312(f) and (g).

[40] Uniform Commercial Code, Section 9-313.

[41] Uniform Commercial Code, Section 9-314.

[42] Uniform Commercial Code, Section 8-106, Official Comment 1.

25.2 Priorities

LEARNING OBJECTIVES

CC BY NC SA

1. Understand the general rule regarding who gets priority among competing secured parties.
2. Know the immediate exceptions to the general rule—all involving PMSIs.
3. Understand the basic ideas behind the other exceptions to the general rule.

Priorities: this is the money question. Who gets what when a debtor defaults? Depending on how the priorities in the collateral were established, even a secured creditor may walk away with the collateral or with nothing. Here we take up the general rule and the exceptions.

General Rule

The general rule regarding priorities is, to use a quotation attributed to a Southern Civil War general, the one who wins "gets there firstest with the mostest." The first to do the best job of perfecting wins. The Uniform Commercial Code (UCC) creates a race of diligence among competitors.

Application of the Rule

If both parties have perfected, the first to perfect wins. If one has perfected and one attached, the perfected party wins. If both have attached without perfection, the first to attach wins. If neither has attached, they are unsecured creditors. Let's test this general rule against the following situations:

1. Rosemary, without having yet lent money, files a financing statement on February 1 covering certain collateral owned by Susan—Susan's fur coat. Under UCC Article 9, a filing may be made before the security interest attaches. On March 1, Erika files a similar statement, also without having lent any money. On April 1, Erika loans Susan $1,000, the loan being secured by the fur coat described in the statement she filed on March 1. On May 1, Rosemary also loans Susan $1,000, with the same fur coat as security. Who has priority? Rosemary does, since she filed first, even though Erika actually first extended the loan, which was perfected when made (because she had already filed). This result is dictated by the rule even though Rosemary may have known of Erika's interest when she subsequently made her loan.

2. Susan cajoles both Rosemary and Erika, each unknown to the other, to loan her $1,000 secured by the fur coat, which she already owns and which hangs in her coat closet. Erika gives Susan the money a week after Rosemary, but Rosemary has not perfected and Erika does not either. A week later, they find out they have each made a loan against the same coat. Who has priority? Whoever perfects first: the rule creates a race to the filing office or to Susan's closet. Whoever can submit the financing statement or actually take possession of the coat first will have priority, and the outcome does not depend on knowledge or lack of knowledge that someone else is claiming a security interest in the same collateral. But what of the rule that in the absence of perfection, whichever security interest first attached has priority? This is "thought to be of merely theoretical interest," says the UCC commentary, "since it is hard to imagine a situation where the case would come into litigation without [either party] having perfected his interest." And if the debtor filed a petition in bankruptcy, neither unperfected security interest could prevail against the bankruptcy trustee.

To rephrase: An attached security interest prevails over other unsecured creditors (unsecured creditors lose to secured creditors, perfected or unperfected). If both parties are secured (have attached the interest), the first to perfect wins.[1] If both parties have perfected, the first to have perfected wins.[2]

Exceptions to the General Rule

There are three immediate exceptions to the general rule, and several other exceptions, all of which—actually—make some straightforward sense even if it sounds a little complicated to explain them.

Immediate Exceptions

We call the following three exceptions "immediate" ones because they allow junior filers immediate priority to take their collateral before the debtor's other creditors get it. They all involve purchase-money security interests (PMSIs), so if the debtor defaults, the creditor repossesses the very goods the creditor had sold the debtor.

(1) *Purchase-money security interest in goods (other than inventory or livestock).* The UCC provides that "a perfected purchase-money security interest in goods other than inventory or livestock has priority over

CC BY NC SA

a conflicting security interest in the same goods...if the purchase-money security interest is perfected when debtor receives possession of the collateral or within 20 days thereafter."[3] The Official Comment to this UCC section observes that "in most cases, priority will be over a security interest asserted under an after-acquired property clause."

Suppose Susan manufactures fur coats. On February 1, Rosemary advances her $10,000 under a security agreement covering all Susan's machinery and containing an after-acquired property clause. Rosemary files a financing statement that same day. On March 1, Susan buys a new machine from Erika for $5,000 and gives her a security interest in the machine; Erika files a financing statement within twenty days of the time that the machine is delivered to Susan. Who has priority if Susan defaults on her loan payments? Under the PMSI rule, Erika has priority, because she had a PMSI. Suppose, however, that Susan had not bought the machine from Erika but had merely given her a security interest in it. Then Rosemary would have priority, because her filing was prior to Erika's.

What would happen if this kind of PMSI in noninventory goods (here, equipment) did not get priority status? A prudent Erika would not extend credit to Susan at all, and if the new machine is necessary for Susan's business, she would soon be out of business. That certainly would not inure to the benefit of Rosemary. It is, mostly, to Rosemary's advantage that Susan gets the machine: it enhances Susan's ability to make money to pay Rosemary.

(2) *Purchase-money security interest in inventory*. The UCC provides that a perfected PMSI in inventory has priority over conflicting interests in the same inventory, provided that the PMSI is perfected when the debtor receives possession of the inventory, the PMSI-secured party sends an authenticated notification to the holder of the conflicting interest and that person receives the notice within five years before the debtor receives possession of the inventory, and the notice states that the person sending it has or expects to acquire a PMSI in the inventory and describes the inventory.[4] The notice requirement is aimed at protecting a secured party in the typical situation in which incoming inventory is subject to a prior agreement to make advances against it. If the original creditor gets notice that new inventory is subject to a PMSI, he will be forewarned against making an advance on it; if he does not receive notice, he will have

priority. It is usually to the earlier creditor's advantage that her debtor is able to get credit to "floor" (provide) inventory, without selling which, of course, the debtor cannot pay back the earlier creditor.

(3) *Purchase-money security interest in fixtures.* Under UCC Section 9-334(e), a perfected security in fixtures has priority over a mortgage if the security interest is a PMSI and the security interest is perfected by a fixture filing before the goods become fixtures or within twenty days after. A mortgagee is usually a bank (the mortgagor is the owner of the real estate, subject to the mortgagee's interest). The bank's mortgage covers the real estate and fixtures, even fixtures added after the date of the mortgage (after-acquired property clause). In accord with the general rule, then, the mortgagee/bank would normally have priority if the mortgage is recorded first, as would a fixture filing if made before the mortgage was recorded. But with the exception noted, the bank's interest is subordinate to the fixture-seller's later-perfected PMSI. Example: Susan buys a new furnace from Heating Co. to put in her house. Susan gave a bank a thirty-year mortgage on the house ten years before. Heating Co. takes back a PMSI and files the appropriate financing statement before or within twenty days of installation. If Susan defaults on her loan to the bank, Heating Co. would take priority over the bank. And why not? The mortgagee has, in the long run, benefited from the improvement and modernization of the real estate. (Again, there are further nuances in Section 9-334 beyond our scope here.) A non-PMSI in fixtures or PMSIs perfected more than twenty days after goods become a fixture loses out to prior recorded interests in the realty.

Other Exceptions

We have noted the three immediate exceptions to the general rule that "the firstest with the mostest" prevails. There are some other exceptions.

Think about how these other exceptions might arise: who might want to take property subject to a security agreement (not including thieves)? That is, Debtor gives Creditor a security interest in, say, goods, while retaining possession. First, *buyers* of various sorts might want the goods if they paid for them; they usually win. Second, *lien creditors* might want the goods (a **lien creditor** is one whose claim is based on operation of law—involuntarily against Debtor, and including a trustee in bankruptcy—as opposed to one whose claim is based on agreement); lien creditors may be statutory (landlords, mechanics, bailees) or

judicial. Third, a *bankruptcy trustee* representing Debtor's creditors (independent of the trustee's role as a lien creditor) might want to take the goods to sell and satisfy Debtor's obligations to the creditors. Fourth, unsecured creditors; fifth, secured creditors; and sixth, secured and perfected creditors. We will examine some of the possible permutations but are compelled to observe that this area of law has many fine nuances, not all of which can be taken up here.

First we look at buyers who take priority over, or free of, unperfected security interests. Buyers who take delivery of many types of collateral covered by an*unperfected* security interest win out over the hapless secured party who failed to perfect if they give value and don't know of the security interest or agricultural lien.[5] A buyer who doesn't give value or who knows of the security interest will not win out, nor will a buyer prevail if the seller's creditor files a financing statement before or within twenty days after the debtor receives delivery of the collateral.

Now we look at buyers who take priority over *perfected* security interests. Sometimes people who buy things even covered by a perfected security interest win out (the perfected secured party loses).

- *Buyers in the ordinary course of business*. "A buyer in the ordinary course of business, other than [one buying farm products from somebody engaged in farming] takes free of a security interest created by the buyer's seller, even if the security interest is perfected and the buyer knows [it]."[6] Here the buyer is usually purchasing inventory collateral, and it's OK if he knows the inventory is covered by a security interest, but it's not OK if he knows "that the sale violates a term in an agreement with the secured party."[7] It would not be conducive to faith in commercial transactions if buyers of inventory generally had to worry whether their seller's creditors were going to repossess the things the buyers had purchased in good faith. For example (based on example 1 to the same comment, UCC 9-320, Official Comment 3), Manufacturer makes appliances and owns manufacturing equipment covered by a perfected security agreement in favor of Lender. Manufacturer sells the equipment to Dealer, whose business is buying and selling used equipment; Dealer, in turn, sells the stuff to Buyer, a buyer in the ordinary course. Does Buyer take free of the security interest? No, because Dealer didn't create it; Manufacturer did.

CC BY NC SA

- Buyers of consumer goods purchased for personal, family, or household use take free of security interests, even if perfected, so long as they buy without knowledge of the security interest, for value, for their own consumer uses, and before the filing of a financing statement covering the goods. This—again—is the rub when a seller of consumer goods perfects by "mere attachment" (automatic perfection) and the buyer of the goods turns around and sells them. For example, Tom buys a new refrigerator from Sears, which perfects by mere attachment. Tom has cash flow problems and sells the fridge to Ned, his neighbor. Ned doesn't know about Sears's security interest and pays a reasonable amount for it. He puts it in his kitchen for home use. Sears cannot repossess the fridge from Ned. If it wanted to protect itself fully, Sears would have filed a financing statement; then Ned would be out the fridge when the repo men came.[8] The "value" issue is interestingly presented in the *Nicolosi* case (Section 25.5 "Cases").
- *Buyers of farm products*. The UCC itself does not protect buyers of farm products from security interests created by "the person engaged in farming operations who is in the business of selling farm products," and the result was that sometimes the buyer had to pay twice: once to the farmer and again to the lender whom the farmer didn't pay. As a result, Congress included in its 1985 Farm Security Act, 7 USC 1631, Section 1324, this language: "A buyer who in the ordinary course of business buys a farm product from a seller engaged in farming operations shall take free of a security interest created by the seller, even though the security interest is perfected; and the buyer knows of the existence of such interest."

There are some other exceptions, beyond our scope here.

Lien Creditors

Persons (including bankruptcy trustees) who become lien creditors *before* the security interest is perfected win out—the unperfected security interest is subordinate to lien creditors. Persons who become lien creditors *after* the security interest is perfected lose (subject to some nuances in situations where the lien arises between attachment by the creditor and the filing, and depending upon the type of security interest and the type of collateral).[9] More straightforwardly, perhaps, a lien securing payment or performance of an obligation for services or materials furnished with respect to goods by a person in the

ordinary course of business has priority over other security interests (unless a statute provides otherwise).[10] This is the bailee or "material man" (one who supplies materials, as to build a house) with a lien situation. Garage Mechanic repairs a car in which Owner has previously given a perfected security interest to Bank. Owner doesn't pay Bank. Bank seeks to repossess the car from Mechanic. It will have to pay the Mechanic first. And why not? If the car was not running, Bank would have to have it repaired anyway.

Bankruptcy Trustee

To what extent can the bankruptcy trustee take property previously encumbered by a security interest? It depends. If the security interest was not perfected at the time of filing for bankruptcy, the trustee can take the collateral.[11] If it was perfected, the trustee can't take it, subject to rules on preferential transfers: the Bankruptcy Act provides that the trustee can avoid a transfer of an interest of the debtor in property—including a security interest—(1) to or for the benefit of a creditor, (2) on or account of an antecedent debt, (3) made while the debtor was insolvent, (4) within ninety days of the bankruptcy petition date (or one year, for "insiders"—like relatives or business partners), (5) which enables the creditor to receive more than it would have in the bankruptcy.[12]There are further bankruptcy details beyond our scope here, but the short of it is that sometimes creditors who think they have a valid, enforceable security interest find out that the bankruptcy trustee has snatched the collateral away from them.

Deposit accounts perfected by control. A security interest in a deposit account (checking account, savings account, money-market account, certificate of deposit) takes priority over security interests in the account perfected by other means, and under UCC Section 9-327(3), a bank with which the deposit is made takes priority over all other conflicting security agreements.[13] For example, a debtor enters into a security agreement with his sailboat as collateral. The creditor perfects. The debtor sells the sailboat and deposits the proceeds in his account with a bank; normally, the creditor's interest would attach to the proceeds. The debtor next borrows money from the bank, and the bank takes a security interest in the debtor's account by control. The debtor defaults. Who gets the money representing the sailboat's proceeds? The bank does. The rationale: "this...enables banks to extend credit to their depositors without the need to

examine [records] to determine whether another party might have a security interest in the deposit account." [14]

KEY TAKEAWAY

Who among competing creditors gets the collateral if the debtor defaults? The general rule on priorities is that the first to secure most completely wins: if all competitors have perfected, the first to do so wins. If one has perfected and the others have not, the one who perfects wins. If all have attached, the first to attach wins. If none have attached, they're all unsecured creditors. To this general rule there are a number of exceptions. Purchase-money security interests in goods and inventory prevail over previously perfected secured parties in the same goods and inventory (subject to some requirements); fixture financers who file properly have priority over previously perfected mortgagees. Buyers in the ordinary course of business take free of a security interest created by their seller, so long as they don't know their purchase violates a security agreement. Buyers of consumer goods perfected by mere attachment win out over the creditor who declined to file. Buyers in the ordinary course of business of farm products prevail over the farmer's creditors (under federal law, not the UCC). Lien creditors who become such before perfection win out; those who become such after perfection usually lose. Bailees in possession and material men have priority over previous perfected claimants. Bankruptcy trustees win out over unperfected security interests and over perfected ones if they are considered voidable transfers from the debtor to the secured party. Deposit accounts perfected by control prevail over previously perfected secured parties in the same deposit accounts.

EXERCISES

1. What is the general rule regarding priorities for the right to repossess goods encumbered by a security interest when there are competing creditors clamoring for that right?
2. Why does it make good sense to allow purchase-money security creditors in (1) inventory, (2) equipment, and (3) fixtures priority over creditors who perfected before the PMSI was perfected?
3. A buyer in the ordinary course of business is usually one buying inventory. Why does it make sense that such a buyer should take free of a security interest created by his seller?

[1] Uniform Commercial Code, Section 9-322(a)(2).

[2] Uniform Commercial Code, Section 9-322(a)(1).

[3] Uniform Commercial Code, Section 9-324(a).

[4] Uniform Commercial Code, Section 9-324(b).

[5] Uniform Commercial Code, Section 9-317(b).

[6] Uniform Commercial Code, Section 9-320(a).

[7] Uniform Commercial Code, Section 9-320, Comment 3.

[8] Uniform Commercial Code, Section 9-320(b).

[9] Uniform Commercial Code, Section 9-317(a)(2)(B) and 9-317(e).

[10] Uniform Commercial Code, Section 9-333.

[11] 11 United States Code, Section 544 (Bankruptcy Act).

[12] United States Code, Section 547.

[13] Uniform Commercial Code, Section 9-327(1).

[14] Uniform Commercial Code, Section 9-328, Official Comment 3 and 4.

25.3 Rights of Creditor on Default and Disposition after Repossession

LEARNING OBJECTIVES

1. Understand that the creditor may sue to collect the debt.
2. Recognize that more commonly the creditor will realize on the collateral—repossess it.
3. Know how collateral may be disposed of upon repossession: by sale or by strict foreclosure.

Rights of Creditor on Default

Upon default, the creditor must make an election: to sue, or to repossess.

CC BY NC SA

Resort to Judicial Process

After a debtor's default (e.g., by missing payments on the debt), the creditor could ignore the security interest and bring suit on the underlying debt. But creditors rarely resort to this remedy because it is time-consuming and costly. Most creditors prefer to repossess the collateral and sell it or retain possession in satisfaction of the debt.

Repossession

Section 9-609 of the Uniform Commercial Code (UCC) permits the secured party to take possession of the collateral on default (unless the agreement specifies otherwise):

> *(a) After default, a secured party may (1) take possession of the collateral; and (2) without removal, may render equipment unusable and dispose of collateral on a debtor's premises.*
>
> *(b) A secured party may proceed under subsection (a): (1) pursuant to judicial process; or (2) without judicial process, if it proceeds without breach of the peace.*

This language has given rise to the flourishing business of professional "repo men" (and women). "Repo" companies are firms that specialize in repossession collateral. They have trained car-lock pickers, in-house locksmiths, experienced repossession teams, damage-free towing equipment, and the capacity to deliver repossessed collateral to the client's desired destination. Some firms advertise that they have 360-degree video cameras that record every aspect of the repossession. They have "skip chasers"—people whose business it is to track down those who skip out on their obligations, and they are trained not to breach the peace.[1] See *Pantoja-Cahue v. Ford Motor Credit Co.*, a case discussing repossession, in Section 25.5 "Cases".

The reference in Section 9-609(a)(2) to "render equipment unusable and dispose of collateral on a debtor's premises" gets to situations involving "heavy equipment [when] the physical removal from the debtor's plant and the storage of collateral pending disposition may be impractical or unduly expensive....Of course...all aspects of the disposition must be commercially reasonable."[2] Rendering the

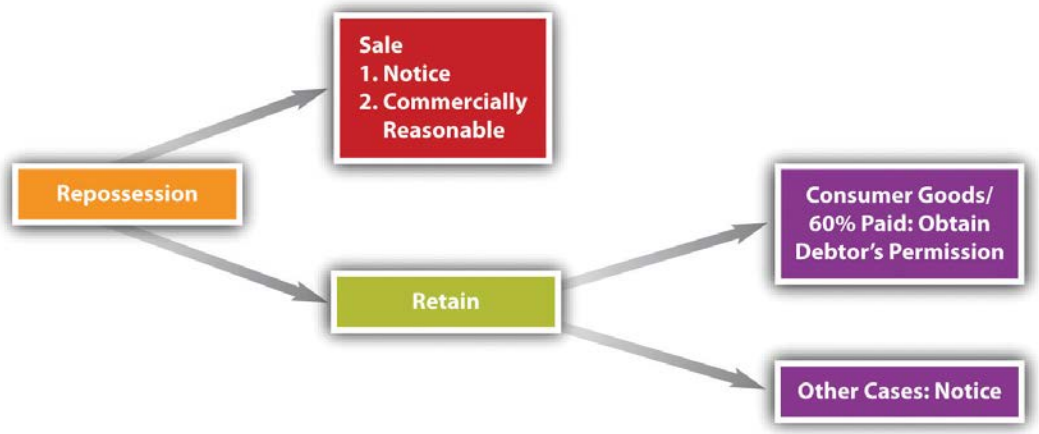
equipment unusable would mean disassembling some critical part of the machine—letting it sit there until an auction is set up on the premises.

The creditor's agents—the repo people—charge for their service, of course, and if possible the cost of repossession comes out of the collateral when it's sold. A debtor would be better off voluntarily delivering the collateral according to the creditor's instructions, but if that doesn't happen, "self-help"—repossession—is allowed because, of course, the debtor said it would be allowed in the security agreement, so long as the repossession can be accomplished without breach of peace. "Breach of peace" is language that can cover a wide variety of situations over which courts do not always agree. For example, some courts interpret a creditor's taking of the collateral despite the debtor's clear oral protest as a breach of the peace; other courts do not.

Disposition after Repossession

After repossession, the creditor has two options: sell the collateral or accept it in satisfaction of the debt (see Figure 25.5 "Disposition after Repossession").

Figure 25.5 Disposition after Repossession



Sale

Sale is the usual method of recovering the debt. Section 9-610 of the UCC permits the secured creditor to "sell, lease, license, or otherwise dispose of any or all of the collateral in its present condition or following any commercially reasonable preparation or processing." The collateral may be sold as a whole or in

parcels, at one time or at different times. Two requirements limit the creditor's power to resell: (1) it must send notice to the debtor and secondary obligor, and (unless consumer goods are sold) to other secured parties; and (2) all aspects of the sale must be "commercially reasonable."[3] Most frequently the collateral is auctioned off.

Section 9-615 of the UCC describes how the proceeds are applied: first, to the costs of the repossession, including reasonable attorney's fees and legal expenses as provided for in the security agreement (and it will provide for that!); second, to the satisfaction of the obligation owed; and third, to junior creditors. This again emphasizes the importance of promptly perfecting the security interest: failure to do so frequently subordinates the tardy creditor's interest to junior status. If there is money left over from disposing of the collateral—a surplus—the debtor gets that back. If there is still money owing—a deficiency—the debtor is liable for that. In Section 9-616, the UCC carefully explains how the surplus or deficiency is calculated; the explanation is required in a consumer goods transaction, and it has to be sent to the debtor after the disposition.

Strict Foreclosure

Because resale can be a bother (or the collateral is appreciating in value), the secured creditor may wish simply to accept the collateral in full satisfaction or partial satisfaction of the debt, as permitted in UCC Section 9-620(a). This is known as **strict foreclosure**. The debtor must consent to letting the creditor take the collateral without a sale in a "record authenticated after default," or after default the creditor can send the debtor a proposal for the creditor to accept the collateral, and the proposal is effective if not objected to within twenty days after it's sent.

The strict foreclosure provisions contain a safety feature for consumer goods debtors. If the debtor has paid at least 60 percent of the debt, then the creditor may not use strict foreclosure—unless the debtor signs a statement after default renouncing his right to bar strict foreclosure and to force a sale.[4] A consumer who refuses to sign such a statement thus forces the secured creditor to sell the collateral under Section 9-610. Should the creditor fail to sell the goods within ninety days after taking possession of the goods, he is liable to the debtor for the value of the goods in a conversion suit or may incur the liabilities

set forth in Section 9-625, which provides for minimum damages for the consumer debtor. Recall that the UCC imposes a duty to act in good faith and in a commercially reasonable manner, and in most cases with reasonable notification.[5] SeeFigure 25.5 "Disposition after Repossession".

Foreclosure on Intangible Collateral

A secured party's repossession of inventory or equipment can disrupt or even close a debtor's business. However, when the collateral is intangible—such as accounts receivable, general intangibles, chattel paper, or instruments—collection by a secured party after the debtor's default may proceed without interrupting the business. Section 9-607 of the UCC provides that on default, the secured party is entitled to notify the third party—for example, a person who owes money on an account—that payment should be made to him. The secured party is accountable to the debtor for any surplus, and the debtor is liable for any deficiency unless the parties have agreed otherwise.

As always in parsing the UCC here, some of the details and nuances are necessarily omitted because of lack of space or because a more detailed analysis is beyond this book's scope.

KEY TAKEAWAY

Upon default, the creditor may bring a lawsuit against the debtor to collect a judgment. But the whole purpose of secured transactions is to avoid this costly and time-consuming litigation. The more typical situation is that the creditor repossesses the collateral and then either auctions it off (sale) or keeps it in satisfaction of the debt (strict foreclosure). In the former situation, the creditor may then proceed against the debtor for the deficiency. In consumer cases, the creditor cannot use strict foreclosure if 60 percent of the purchase price has been paid.

EXERCISES

1. Although a creditor could sue the debtor, get a judgment against it, and collect on the judgment, usually the creditor repossesses the collateral. Why is repossession the preferred method of realizing on the security?
2. Why is repossession allowed *so long as* it can be done without a breach of the peace?
3. Under what circumstances is strict foreclosure not allowed?

---

[1] Here is an example of sophisticated online advertising for a repossession firm: SSR, "Southern & Central Coast California Repossession Services,"http://www.simonsrecovery.com/index.htm.

[2] Uniform Commercial Code, Section 9-609(a)(2), Official Comment 6.

[3] Uniform Commercial Code, Section 9-611; Uniform Commercial Code, Section 9-610.

[4] Uniform Commercial Code, 9-620(e); Uniform Commercial Code, Section 9-624.

[5] Uniform Commercial Code, Section 1-203.

25.4 Suretyship

LEARNING OBJECTIVES

1. Understand what a surety is and why sureties are used in commercial transactions.

2. Know how suretyships are created.
3. Recognize the general duty owed by the surety to the creditor, and the surety's defenses.
4. Recognize the principal obligor's duty to the surety, and the surety's rights against the surety.
5. Understand the rights among cosureties.

Definition, Types of Sureties, and Creation of the Suretyship

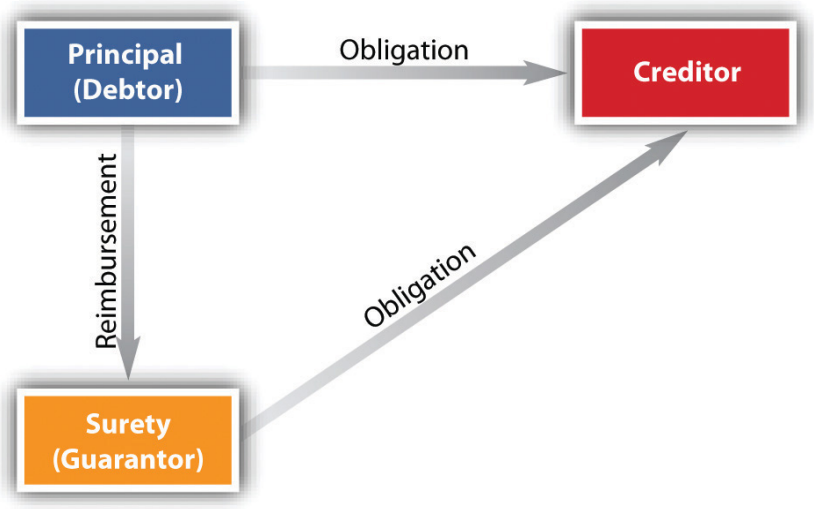
Definition

Suretyship is the second of the three major types of consensual security arrangements noted at the beginning of this chapter (personal property security, suretyship, real property security)—and a common one. Creditors frequently ask the owners of small, closely held companies to guarantee their loans to the company, and parent corporations also frequently are guarantors of their subsidiaries' debts. The earliest sureties were friends or relatives of the principal debtor who agreed—for free—to lend their guarantee. Today most sureties in commercial transaction are insurance companies (but insurance is not the same as suretyship).

A **surety** is one who promises to pay or perform an obligation owed by the **principal debtor**, and, strictly speaking, the surety is primarily liable on the debt: the creditor can demand payment from the surety when the debt is due. The creditor is the person to whom the principal debtor (and the surety, strictly speaking) owes an obligation. Very frequently, the creditor requires first that the debtor put up collateral to secure indebtedness, and—in addition—that the debtor engage a surety to make extra certain the creditor is paid or performance is made. For example, David Debtor wants Bank to loan his corporation, David Debtor, Inc., $100,000. Bank says, "Okay, Mr. Debtor, we'll loan the corporation money, but we want its computer equipment as security, and we want you personally to guarantee the debt if the corporation can't pay." Sometimes, though, the surety and the principal debtor may have no agreement between each other; the surety might have struck a deal with the creditor to act as surety without the consent or knowledge of the principal debtor.

A **guarantor** also is one who guarantees an obligation of another, and for practical purposes, therefore, *guarantor* is usually synonymous with *surety*—the terms are used pretty much interchangeably. But here's the technical difference: a surety is usually a party to the original contract and signs her (or his, or its) name to the original agreement along with the surety; the consideration for the principal's contract is the same as the surety's consideration—she is bound on the contract from the very start, and she is also expected to know of the principal debtor's default so that the creditor's failure to inform her of it does not discharge her of any liability. On the other hand, a guarantor usually does not make his agreement with the creditor at the same time the principal debtor does: it's a separate contract requiring separate consideration, and if the guarantor is not informed of the principal debtor's default, the guarantor can claim discharge on the obligation to the extent any failure to inform him prejudices him. But, again, as the terms are mostly synonymous, *surety* is used here to encompass both.

Figure 25.6 *Defenses of Principal Debtor and Surety*



Types of Suretyship

Where there is an interest, public or private, that requires protection from the possibility of a default, sureties are engaged. For example, a landlord might require that a commercial tenant not only put up a security deposit but also show evidence that it has a surety on line ready to stand for three months' rent if the tenant defaults. Often, a municipal government will want its road contractor to show it has a surety available in case, for some reason, the contractor cannot complete the project. Many states require general

contractors to have bonds, purchased from insurance companies, as a condition of getting a contractor's license; the insurance company is the surety—it will pay out if the contractor fails to complete work on the client's house. These are types of a **performance bond**. A judge will often require that a criminal defendant put up a bond guaranteeing his appearance in court—that's a type of suretyship where the bail-bonder is the surety—or that a plaintiff put up a bond indemnifying the defendant for the costs of delays caused by the lawsuit—a **judicial bond**. A bank will take out a bond on its employees in case they steal money from the bank—the bank teller, in this case, is the principal debtor (a **fidelity bond**). However, as we will see, sureties do not anticipate financial loss like insurance companies do: the surety expects, mostly, to be repaid if it has to perform. The principal debtor goes to an insurance company and buys the bond—the suretyship policy. The cost of the premium depends on the surety company, the type of bond applied for, and the applicant's financial history. A sound estimate of premium costs is 1 percent to 4 percent, but if a surety company classifies an applicant as high risk, the premium falls between 5 percent and 20 percent of the bond amount. When the purchaser of real estate agrees to assume the seller's mortgage (promises to pay the mortgage debt), the seller then becomes a surety: unless the mortgagee releases the seller (not likely), the seller has to pay if the buyer defaults.

Creation of the Suretyship

Suretyship can arise only through contract. The general principles of contract law apply to suretyship. Thus a person with the general capacity to contract has the power to become a surety. Consideration is required for a suretyship contract: if Debtor asks a friend to act as a surety to induce Creditor to make Debtor a loan, the consideration Debtor gives Creditor also acts as the consideration Friend gives. Where the suretyship arises *after* Creditor has already extended credit, new consideration would be required (absent application of the doctrine of promissory estoppel[1]). You may recall from the chapters on contracts that the promise by one person to pay or perform for the debts or defaults of another must be evidenced by a writing under the statute of frauds (subject to the "main purpose" exception).

Suretyship contracts are affected to some extent by government regulation. Under a 1985 Federal Trade Commission Credit Practices Rule, creditors are prohibited from misrepresenting a surety's liability.

Creditors must also give the surety a notice that explains the nature of the obligation and the potential liability that can arise if a person cosigns on another's debt.[2]

Duties and Rights of the Surety

Duties of the Surety

Upon the principal debtor's default, the surety is contractually obligated to perform unless the principal herself or someone on her behalf discharges the obligation. When the surety performs, it must do so in good faith. Because the principal debtor's defenses are generally limited, and because—as will be noted—the surety has the right to be reimbursed by the debtor, debtors not infrequently claim the surety acted in bad faith by doing things like failing to make an adequate investigation (to determine if the debtor really defaulted), overpaying claims, interfering with the contact between the surety and the debtor, and making unreasonable refusals to let the debtor complete the project. The case *Fidelity and Deposit Co. of Maryland v. Douglas Asphalt Co.*,in Section 25.5 "Cases", is typical.

Rights of the Surety

The surety has four main rights stemming from its obligation to answer for the debt or default of the principal debtor.

Exoneration

If, at the time a surety's obligation has matured, the principal can satisfy the obligation but refuses to do so, the surety is entitled to **exoneration**—a court order requiring the principal to perform. It would be inequitable to force the surety to perform and then to have to seek **reimbursement** from the principal if all along the principal is able to perform.

Reimbursement

If the surety must pay the creditor because the principal has defaulted, the principal is obligated to reimburse the surety. The amount required to be reimbursed includes the surety's reasonable, good-faith outlays, including interest and legal fees.

Subrogation

Suppose the principal's duty to the creditor is fully satisfied and that the surety has contributed to this satisfaction. Then the surety is entitled to be subrogated to the rights of the creditor against the principal. In other words, the surety stands in the creditor's shoes and may assert against the principal whatever rights the creditor could have asserted had the duty not been discharged. The right of **subrogation** includes the right to take secured interests that the creditor obtained from the principal to cover the duty. Sarah's Pizzeria owes Martha $5,000, and Martha has taken a security interest in Sarah's Chevrolet. Eva is surety for the debt. Sarah defaults, and Eva pays Martha the $5,000. Eva is entitled to have the security interest in the car transferred to her.

Contribution

Two or more sureties who are bound to answer for the principal's default and who should share between them the loss caused by the default are known as **cosureties**. A surety who in performing its own obligation to the creditor winds up paying more than its proportionate share is entitled to **contribution** from the cosureties.

Defenses of the Parties

The principal and the surety may have defenses to paying.

Defenses of the Principal

The principal debtor may avail itself of any standard contract defenses as against the creditor, including impossibility, illegality, incapacity, fraud, duress, insolvency, or bankruptcy discharge. However, the surety may contract with the creditor to be liable despite the principal's defenses, and a surety who has

undertaken the suretyship with knowledge of the creditor's fraud or duress remains obligated, even though the principal debtor will be discharged. When the surety turns to the principal debtor and demands reimbursement, the latter may have defenses against the surety—as noted—for acting in bad faith.

One of the main reasons creditors want the promise of a surety is to avoid the risk that the principal debtor will go bankrupt: the debtor's bankruptcy is a defense to the debtor's liability, certainly, but that defense cannot be used by the surety. The same is true of the debtor's incapacity: it is a defense available to the principal debtor but not to the surety.

Defenses of the Surety

Generally, the surety may exercise defenses on a contract that would have been available to the principal debtor (e.g., creditor's breach; impossibility or illegality of performance; fraud, duress, or misrepresentation by creditor; statute of limitations; refusal of creditor to accept tender or performance from either debtor or surety.) Beyond that, the surety has some defenses of its own. Common defenses raised by sureties include the following:

- *Release of the principal*. Whenever a creditor releases the principal, the surety is discharged, unless the surety consents to remain liable or the creditor expressly reserves her rights against the surety. The creditor's release of the surety, though, does not release the principal debtor because the debtor is liable without regard to the surety's liability.
- *Modification of the contract*. If the creditor alters the instrument sufficiently to discharge the principal, the surety is discharged as well. Likewise, when the creditor and principal modify their contract, a surety who has not consented to the modification is discharged if the surety's risk is materially increased (but not if it is decreased). Modifications include extension of the time of payment, release of collateral (this releases the surety to the extent of the impairment), change in principal debtor's duties, and assignment or delegation of the debtor's obligations to a third party. The surety may consent to modifications.

- *Creditor's failure to perfect*. A creditor who fails to file a financing statement or record a mortgage risks losing the security for the loan and might also inadvertently release a surety, but the failure of the creditor to resort first to collateral is no defense.
- *Statute of frauds*. Suretyship contracts are among those required to be evidenced by some writing under the statute of frauds, and failure to do so may discharge the surety from liability.
- *Creditor's failure to inform surety of material facts within creditor's knowledge affecting debtor's ability to perform* (e.g., that debtor has defaulted several times before).
- *General contract defenses*. The surety may raise common defenses like incapacity (infancy), lack of consideration (unless promissory estoppel can be substituted or unless no separate consideration is necessary because the surety's and debtor's obligations arise at the same time), and creditor's fraud or duress on surety. However, fraud by the principal debtor on the surety to induce the suretyship will not release the surety if the creditor extended credit in good faith; if the creditor knows of the fraud perpetrated by the debtor on the surety, the surety may avoid liability. See Figure 25.6 "Defenses of Principal Debtor and Surety".

The following are defenses of principal debtor *only:*

- Death or incapacity of principal debtor
- Bankruptcy of principal debtor
- Principal debtor's setoffs against creditor

The following are defenses of *both* principal debtor and surety:

- Material breach by creditor
- Lack of mutual assent, failure of consideration
- Creditor's fraud, duress, or misrepresentation of debtor
- Impossibility or illegality of performance
- Material and fraudulent alteration of the contract
- Statute of limitations

The following are defenses of surety *only*:

- Fraud or duress by creditor on surety
    - Illegality of suretyship contract
    - Surety's incapacity
    - Failure of consideration for surety contract (unless excused)
    - Statute of frauds
    - Acts of creditor or debtor materially affecting surety's obligations:
        - Refusal by creditor to accept tender of performance
        - Release of principal debtor without surety's consent
        - Release of surety
        - Release, surrender, destruction, or impairment of collateral
        - Extension of time on principal debtor's obligation
        - Modification of debtor's duties, place, amount, or manner of debtor's obligations

KEY TAKEAWAY

Creditors often require not only the security of collateral from the debtor but also that the debtor engage a surety. A contract of suretyship is a type of insurance policy, where the surety (insurance company) promises the creditor that if the principal debtor fails to perform, the surety will undertake good-faith performance instead. A difference between insurance and suretyship, though, is that the surety is entitled to reimbursement by the principal debtor if the surety pays out. The surety is also entitled, where appropriate, to exoneration, subrogation, and contribution. The principal debtor and the surety both have some defenses available: some are personal to the debtor, some are joint defenses, and some are personal to the surety.

EXERCISES

1. Why isn't collateral put up by the debtor sufficient security for the creditor—why is a surety often required?
2. How can it be said that sureties do not anticipate financial losses like insurance companies do? What's the difference, and how does the surety avoid losses?
3. Why does the creditor's failure to perfect a security interest discharge the surety from liability? Why doesn't failure of the creditor to resort first to perfected collateral discharge the surety?
4. What is the difference between a guarantor and a surety?

---

[1] *American Druggists' Ins. Co. v. Shoppe*, 448 N.W.2d 103, Minn. App. (1989).

[2] Here is an example of the required notice: Federal Trade Commission, "Facts for Consumers: The Credit Practices Rule,"http://www.ftc.gov/bcp/edu/pubs/consumer/credit/cre12.shtm.

25.5 Cases

Perfection by Mere Attachment; Priorities

In re NICOLOSI

4 UCC Rep. 111 (Ohio 1966)

Preliminary Statement and Issues

This matter is before the court upon a petition by the trustee to sell a diamond ring in his possession free of liens....Even though no pleadings were filed by Rike-Kumler Company, the issue from the briefs is whether or not a valid security interest was perfected in this chattel as consumer goods, superior to the statutory title and lien of the trustee in bankruptcy.

Findings of Fact

The [debtor] purchased from the Rike-Kumler Company, on July 7, 1964, the diamond ring in question, for $1237.35 [about $8,500 in 2010 dollars], as an engagement ring for his fiancée. He executed a purchase money security agreement, which was not filed. Also, no financing statement was filed. The chattel was adequately described in the security agreement.

The controversy is between the trustee in bankruptcy and the party claiming a perfected security interest in the property. The recipient of the property has terminated her relationship with the [debtor], and delivered the property to the trustee.

Conclusion of Law, Decision, and Order

If the diamond ring, purchased as an engagement ring by the bankrupt, cannot be categorized as consumer goods, and therefore exempted from the notice filing requirements of the Uniform Commercial Code as adopted in Ohio, a perfected security interest does not exist.

No judicial precedents have been cited in the briefs.
Under the commercial code, collateral is divided into tangible, intangible, and documentary categories. Certainly, a diamond ring falls into the tangible category. The classes of tangible goods are distinguished by the primary use intended. Under [the UCC] the four classes [include] "consumer goods," "equipment," "farm products" and "inventory."

The difficulty is that the code provisions use terms arising in commercial circles which have different semantical values from legal precedents. Does the fact that the purchaser bought the goods as a special gift to another person signify that it was not for his own "personal, family or household purposes"? The trustee urges that these special facts control under the express provisions of the commercial code.

By a process of exclusion, a diamond engagement ring purchased for one's fiancée is not "equipment" bought or used in business, "farm products" used in farming operations, or "inventory" held for sale, lease or service contracts. When the [debtor] purchased the ring, therefore, it could only have been "consumer

goods" bought "primarily for personal use." There could be no judicial purpose to create a special class of property in derogation of the statutory principles.

Another problem is implicit, although not covered by the briefs.

By the foregoing summary analysis, it is apparent that the diamond ring, when the interest of the debtor attached, was consumer goods since it could have been no other class of goods. Unless the fiancée had a special status under the code provision protecting a bona fide buyer, without knowledge, for value, of consumer goods, the failure to file a financing statement is not crucial. No evidence has been adduced pertinent to the scienter question.

Is a promise, as valid contractual consideration, included under the term "value"? In other words, was the ring given to his betrothed in consideration of marriage (promise for a promise)? If so, and "value" has been given, the transferee is a "buyer" under traditional concepts.
The Uniform Commercial Code definition of "value"...very definitely covers a promise for a promise. The definition reads that "a person gives 'value' for rights if he acquires them...generally in return for any consideration sufficient to support a simple contract."

It would seem unrealistic, nevertheless, to apply contract law concepts historically developed into the law of marriage relations in the context of new concepts developed for uniform commercial practices. They are not, in reality, the same juristic manifold. The purpose of uniformity of the code should not be defeated by the obsessions of the code drafters to be all inclusive for secured creditors.

Even if the trustee, in behalf of the unsecured creditors, would feel inclined to insert love, romance and morals into commercial law, he is appearing in the wrong era, and possibly the wrong court.

Ordered, that the Rike-Kumler Company holds a perfected security interest in the diamond engagement ring, and the security interest attached to the proceeds realized from the sale of the goods by the trustee in bankruptcy.

CASE QUESTIONS

1. Why didn't the jewelry store, Rike-Kumler, file a financing statement to protect its security interest in the ring?
2. How did the bankruptcy trustee get the ring?
3. What argument did the trustee make as to why he should be able to take the ring as an asset belonging to the estate of the debtor? What did the court determine on this issue?

Repossession and Breach of the Peace

Pantoja-Cahue v. Ford Motor Credit Co.

872 N.E.2d 1039 (Ill. App. 2007)

Plaintiff Mario Pantoja-Cahue filed a six-count complaint seeking damages from defendant Ford Motor Credit Company for Ford's alleged breach of the peace and "illegal activities" in repossessing plaintiff's automobile from his locked garage....

In August 2000, plaintiff purchased a 2000 Ford Explorer from auto dealer Webb Ford. Plaintiff, a native Spanish speaker, negotiated the purchase with a Spanish-speaking salesperson at Webb. Plaintiff signed what he thought was a contract for the purchase and financing of the vehicle, with monthly installment payments to be made to Ford. The contract was in English. Some years later, plaintiff discovered the contract was actually a lease, not a purchase agreement. Plaintiff brought suit against Ford and Webb on August 22, 2003, alleging fraud. Ford brought a replevin action against plaintiff asserting plaintiff was in default on his obligations under the lease. In the late night/early morning hours of March 11–12, 2004, repossession agents [from Doe Repossession Services] entered plaintiff's locked garage and removed the car...

Plaintiff sought damages for Ford and Doe's "unlawful activities surrounding the wrongful repossession of Plaintiff's vehicle." He alleged Ford and Doe's breaking into plaintiff's locked garage to effectuate the repossession and Ford's repossession of the vehicle knowing that title to the car was the subject of ongoing litigation variously violated section 2A-525(3) of the [Uniform Commercial] Code (count I against Ford), the [federal] Fair Debt Collection Practices Act (count II against Doe),...Ford's contract with plaintiff (count V against Ford) and section 2A-108 of the Code (count VI against Ford and Doe).

...

Uniform Commercial Code Section 2A-525(3)

In count I, plaintiff alleged "a breach of the peace occurred as [Ford]'s repossession agent broke into Plaintiff's locked garage in order to take the vehicle" and Ford's agent "repossessed the subject vehicle by, among other things, breaking into Plaintiff's locked garage and causing substantial damage to Plaintiff's personal property in violation of [section 2A-525(3)]":

"After a default by the lessee under the lease contract * * * or, if agreed, after other default by the lessee, the lessor has the right to take possession of the goods. * * *

The lessor *may proceed under subsection (2) without judicial process if it can be done without breach of the peace* or the lessor may proceed by action." [emphasis added.]

[U]pon a lessee's default, a lessor has the right to repossess the leased goods in one of two ways: by using the judicial process or, if repossession could be accomplished without a breach of the peace, by self-help [UCC Section 2A-525(3)]. "If a breach of the peace is likely, a properly instituted civil action is the appropriate remedy." [Citation] (interpreting the term "breach of the peace" in the context of section 9-503 of the Code, which provides for the same self-help repossession as section 2A-525 but for secured creditors rather than lessors).

Taking plaintiff's well-pleaded allegations as true, Ford resorted to self-help, by employing an agent to repossess the car and Ford's agent broke into plaintiff's locked garage to effectuate the repossession. Although plaintiff's count I allegations are minimal, they are sufficient to plead a cause of action for a violation of section 2A-525(3) if breaking into a garage to repossess a car is, as plaintiff alleged, a breach of the peace. Accordingly, the question here is whether breaking into a locked garage to effectuate a repossession is a breach of the peace in violation of section 2A-525(3).

There are no Illinois cases analyzing the meaning of the term "breach of the peace" as used in the lessor repossession context in section 2A-525(3). However, there are a few Illinois cases analyzing the term as used in section 9-503 of the Code, which contains a similar provision providing that a secured creditor may, upon default by a debtor, repossess its collateral either "(1) pursuant to judicial process; or (2) without judicial process, if it proceeds without breach of the peace." The seminal case, and the only one of any use in resolving the issue, is *Chrysler Credit Corp. v. Koontz*, 277 Ill.App.3d 1078, 214 Ill.Dec. 726, 661 N.E.2d 1171 (1996).

In *Koontz*, Chrysler, the defendant creditor, sent repossession agents to repossess the plaintiff's car after the plaintiff defaulted on his payments. The car was parked in the plaintiff's front yard. The plaintiff heard the repossession in progress and ran outside in his underwear shouting "Don't take it" to the agents. The agents did not respond and proceeded to take the car. The plaintiff argued the repossession breached the peace and he was entitled to the statutory remedy for violation of section 9-503, denial of a deficiency judgment to the secured party, Chrysler....

After a thorough analysis of the term "breach of the peace," the court concluded the term "connotes conduct which incites or is likely to incite immediate public turbulence, or which leads to or is likely to lead to an immediate loss of public order and tranquility. Violent conduct is not a necessary element. The probability of violence at the time of or immediately prior to the repossession is sufficient."...[The *Koontz* court] held the circumstances of the repossession did not amount to a breach the peace.

The court then considered the plaintiff's argument that Chrysler breached the peace by repossessing the car under circumstances constituting criminal trespass to property. Looking to cases in other jurisdictions, the court determined that, "in general, a mere trespass, standing alone, does not automatically constitute a breach of the peace." [Citation] (taking possession of car from private driveway does not, without more, constitute breach of the peace), [Citation] (no breach of the peace occurred where car repossessed from debtor's driveway without entering "any gates, doors, or other barricades to reach" car), [Citation] (no breach of the peace occurred where car was parked partially under carport and undisputed that no door, "not even one to a garage," on the debtor's premises was opened, much less broken, to repossess the car), [Citation] (although secured party may not break into or enter homes or buildings or enclosed spaces to effectuate a repossession, repossession of vehicle from parking lot of debtor's apartment building was not breach of the peace), [Citation] (repossession of car from debtor's driveway without entering any gates, doors or other barricades was accomplished without breach of the peace)....

Although the evidence showed the plaintiff notified Chrysler prior to the repossession that it was not permitted onto his property, the court held Chrysler's entry onto the property to take the car did not constitute a breach of the peace because there was no evidence Chrysler entered through a barricade or did anything other than drive the car away. [Citation] "Chrysler enjoyed a limited privilege to enter [the plaintiff's] property for the sole and exclusive purpose of effectuating the repossession. So long as the entry was limited in purpose (repossession), and so long as no gates, barricades, doors, enclosures, buildings, or chains were breached or cut, no breach of the peace occurred by virtue of the entry onto his property."

...[W]e come to essentially the same conclusion: where a repossession is effectuated by an actual breaking into the lessee/debtor's premises or breaching or cutting of chains, gates, barricades, doors or other barriers designed to exclude trespassers, the likelihood that a breach of the peace occurred is high.

Davenport v. Chrysler Credit Corp., [Citation] (Tenn.App.1991), a case analyzing Tennessee's version of section 9-503 is particularly helpful, holding that "'[a] breach of the peace is almost certain to be found if the repossession is accompanied by the unauthorized entry into a closed or locked garage.'"...This is so because "public policy favors peaceful, non-trespassory repossessions when the secured party has a free right of entry" and "forced entries onto the debtor's property or into the debtor's premises are viewed as seriously detrimental to the ordinary conduct of human affairs." *Davenport* held that the creditor's repossession of a car by entering a closed garage and cutting a chain that would have prevented it from removing the car amounted to a breach of the peace, "[d]espite the absence of violence or physical confrontation" (because the debtor was not at home when the repossession occurred).*Davenport* recognized that the secured creditors' legitimate interest in obtaining possession of collateral without having to resort to expensive and cumbersome judicial procedures must be balanced against the debtors' legitimate interest in being free from unwarranted invasions of their property and privacy interests.

"Repossession is a harsh procedure and is, essentially, a delegation of the State's exclusive prerogative to resolve disputes. Accordingly, the statutes governing the repossession of collateral should be construed in a way that prevents abuse and discourages illegal conduct which might otherwise go unchallenged because of the debtor's lack of knowledge of legally proper repossession techniques" [Citation].

We agree with [this] analysis of the term "breach of the peace" in the context of repossession and hold, with regard to section 2A-525(3) of the Code, that breaking into a locked garage to effectuate a repossession may constitute a breach of the peace.

Here, plaintiff alleges more than simply a trespass. He alleges Ford, through Doe, broke into his garage to repossess the car. Given our determination that breaking into a locked garage to repossess a car may constitute a breach of the peace, plaintiff's allegation is sufficient to state a cause of action under section 2A-525(3) of the Code. The court erred in dismissing count I of plaintiff's second amended complaint and we remand for further proceedings.

Uniform Commercial Code Section 2A-108

In count VI, plaintiff alleged the lease agreement was unconscionable because it was formed in violation of [the Illinois Consumer Fraud Statute, requiring that the customer verify that the negotiations were conducted in the consumer's native language and that the document was translated so the customer understood it.]...Plaintiff does not quote [this] or explain how the agreement violates [it]. Instead, he quotes UCC section 2A-108 of the Code, as follows:

"With respect to a consumer lease, if the court as a matter of law finds that a lease contract or any clause of a lease contract has been induced by unconscionable conduct or that unconscionable conduct has occurred in the collection of a claim arising from a lease contract, the court may grant appropriate relief.

Before making a finding of unconscionability under subsection (1) or (2), the court, on its own motion or that of a party, shall afford the parties a reasonable opportunity to present evidence as to the setting, purpose, and effect of the lease contract or clause thereof, or of the conduct."

He then, in "violation one" under count VI, alleges the lease was made in violation of [the Illinois Consumer Fraud Statute] because it was negotiated in Spanish but he was only given a copy of the contract in English; he could not read the contract and, as a result, Webb Ford was able to trick him into signing a lease, rather than a purchase agreement; such contract was induced by unconscionable conduct; and, because it was illegal, the contract was unenforceable.

This allegation is insufficient to state a cause of action against Ford under section 2A-108....First, Ford is an entirely different entity than Webb Ford and plaintiff does not assert otherwise. Nor does plaintiff assert that Webb Ford was acting as Ford's agent in inducing plaintiff to sign the lease. Plaintiff asserts no basis on which Ford can be found liable for something Webb Ford did. Second, there is no allegation as to how the contract violates [the statute], merely the legal conclusion that it does, as well as the unsupported legal conclusion that a violation of [it] is necessarily unconscionable....[Further discussion omitted.]

For the reasons stated above, we affirm the trial court's dismissal of counts IV, V and VI of plaintiff's second amended complaint. We reverse the court's dismissal of count I and remand for further proceedings. Affirmed in part and reversed in part; cause remanded.

CASE QUESTIONS

1. Under what circumstances, if any, would breaking into a locked garage to repossess a car *not* be considered a breach of the peace?
2. The court did not decide that a breach of the peace had occurred. What would determine that such a breach had occurred?
3. Why did the court dismiss the plaintiff's claim (under UCC Article 2A) that it was unconscionable of Ford to trick him into signing a lease when he thought he was signing a purchase contract? Would that section of Article 2A make breaking into his garage unconscionable?
4. What alternatives had Ford besides taking the car from the plaintiff's locked garage?
5. If it was determined on remand that a breach of the peace had occurred, what happens to Ford?

Defenses of the Principal Debtor as against Reimbursement to Surety

Fidelity and Deposit Co. of Maryland v. Douglas Asphalt Co.

338 Fed.Appx. 886, 11th Cir. Ct. (2009)

Per Curium: [1]

The Georgia Department of Transportation ("GDOT") contracted with Douglas Asphalt Company to perform work on an interstate highway. After Douglas Asphalt allegedly failed to pay its suppliers and subcontractors and failed to perform under the contract, GDOT defaulted and terminated Douglas

CC BY NC SA

Asphalt. Fidelity and Deposit Company of Maryland and Zurich American Insurance Company had executed payment and performance bonds in connection with Douglas Asphalt's work on the interstate, and after Douglas Asphalt's default, Fidelity and Zurich spent $15,424,798 remedying the default.

Fidelity and Zurich, seeking to recover their losses related to their remedy of the default, brought this suit against Douglas Asphalt, Joel Spivey, and Ronnie Spivey. The Spiveys and Douglas Asphalt had executed a General Indemnity Agreement in favor of Fidelity and Zurich.[2]
After a bench trial, the district court entered judgment in favor of Fidelity and Zurich for $16,524,798. Douglas Asphalt and the Spiveys now appeal.

Douglas Asphalt and the Spiveys argue that the district court erred in entering judgment in favor of Fidelity and Zurich because Fidelity and Zurich acted in bad faith in three ways.

First, Douglas Asphalt and the Spiveys argue that the district court erred in not finding that Fidelity and Zurich acted in bad faith because they claimed excessive costs to remedy the default. Specifically, Douglas Asphalt and the Spiveys argue that they introduced evidence that the interstate project was 98% complete, and that only approximately $3.6 million was needed to remedy any default. But, the district court found that the interstate project was only 90%–92% complete and that approximately $2 million needed to be spent to correct defective work already done by Douglas Asphalt. Douglas Asphalt and the Spiveys have not shown that the district court's finding was clearly erroneous, and accordingly, their argument that Fidelity and Zurich showed bad faith in claiming that the project was only 90% complete and therefore required over $15 million to remedy the default fails.

Second, Douglas Asphalt and the Spiveys argue that Fidelity and Zurich acted in bad faith by failing to contest the default. However, the district court concluded that the indemnity agreement required Douglas Asphalt and the Spiveys to request a contest of the default, and to post collateral security to pay any judgment rendered in the course of contesting the default. The court's finding that Douglas Asphalt and the Spiveys made no such request and posted no collateral security was not clearly erroneous, and the

sureties had no independent duty to investigate a default. Accordingly, Fidelity and Zurich's failure to contest the default does not show bad faith.

Finally, Douglas Asphalt and the Spiveys argue that Fidelity and Zurich's refusal to permit them to remain involved with the interstate project, either as a contractor or consultant, was evidence of bad faith. Yet, Douglas Asphalt and the Spiveys did not direct the district court or this court to any case law that holds that the refusal to permit a defaulting contractor to continue working on a project is bad faith. As the district court concluded, Fidelity and Zurich had a contractual right to take possession of all the work under the contract and arrange for its completion. Fidelity and Zurich exercised that contractual right, and, as the district court noted, the exercise of a contractual right is not evidence of bad faith.

Finding no error, we affirm the judgment of the district court.

CASE QUESTIONS

1. Why were Douglas Asphalt and the Spiveys supposed to pay the sureties nearly $15.5 million?
2. What did the plaintiffs claim the defendant sureties did wrong as relates to how much money they spent to cure the default?
3. What is a "contest of the default"?
4. Why would the sureties probably *not* want the principal involved in the project?

---

[1] Latin for "by the court." A decision of an appeals court as a whole in which no judge is identified as the specific author.

[2] They promised to reimburse the surety for its expenses and hold it harmless for further liability.

25.6 Summary and Exercises

CC BY NC SA

Summary

The law governing security interests in personal property is Article 9 of the UCC, which defines a security interest as an interest in personal property or fixtures that secures payment or performance of an obligation. Article 9 lumps together all the former types of security devices, including the pledge, chattel mortgage, and conditional sale.

Five types of tangible property may serve as collateral: (1) consumer goods, (2) equipment, (3) farm products, (4) inventory, and (5) fixtures. Five types of intangibles may serve as collateral: (1) accounts, (2) general intangibles (e.g., patents), (3) documents of title, (4) chattel paper, and (5) instruments. Article 9 expressly permits the debtor to give a security interest in after-acquired collateral.

To create an enforceable security interest, the lender and borrower must enter into an agreement establishing the interest, and the lender must follow steps to ensure that the security interest first attaches and then is perfected. There are three general requirements for attachment: (1) there must be an authenticated agreement (or the collateral must physically be in the lender's possession), (2) the lender must have given value, and (3) the debtor must have some rights in the collateral. Once the interest attaches, the lender has rights in the collateral superior to those of unsecured creditors. But others may defeat his interest unless he perfects the security interest. The three common ways of doing so are (1) filing a financing statement, (2) pledging collateral, and (3) taking a purchase-money security interest (PMSI) in consumer goods.

A financing statement is a simple notice, showing the parties' names and addresses, the signature of the debtor, and an adequate description of the collateral. The financing statement, effective for five years, must be filed in a public office; the location of the office varies among the states.

Security interests in instruments and negotiable documents can be perfected only by the secured party's taking possession, with twenty-one-day grace periods applicable under certain circumstances. Goods may also be secured through pledging, which is often done through field warehousing. If a seller of consumer goods takes a PMSI in the goods sold, then perfection is automatic and no filing is required, although the lender may file and probably should, to avoid losing seniority to a bona fide purchaser of consumer goods

without knowledge of the security interest, if the goods are used for personal, family, or household purposes.

The general priority rule is "first in time, first in right." Priority dates from the earlier of two events: (1) filing a financing statement covering the collateral or (2) other perfection of the security interest. Several exceptions to this rule arise when creditors take a PMSI, among them, when a buyer in the ordinary course of business takes free of a security interest created by the seller.

On default, a creditor may repossess the collateral. For the most part, self-help private repossession continues to be lawful but risky. After repossession, the lender may sell the collateral or accept it in satisfaction of the debt. Any excess in the selling price above the debt amount must go to the debtor.

Suretyship is a legal relationship that is created when one person contracts to be responsible for the proper fulfillment of another's obligation, in case the latter (the principal debtor) fails to fulfill it. The surety may avail itself of the principal's contract defenses, but under various circumstances, defenses may be available to the one that are not available to the other. One general defense often raised by sureties is alteration of the contract. If the surety is required to perform, it has rights for reimbursement against the principal, including interest and legal fees; and if there is more than one surety, each standing for part of the obligation, one who pays a disproportionate part may seek contribution from the others.

EXERCISES

1 Kathy Knittle borrowed $20,000 from Bank to buy inventory to sell in her knit shop and signed a security agreement listing as collateral the entire present and future inventory in the shop, including proceeds from the sale of inventory. Bank filed no financing statement. A month later, Knittle borrowed $5,000 from Creditor, who was aware of Bank's security interest. Knittle then declared bankruptcy. Who has priority, Bank or Creditor?

2 Assume the same facts as in Exercise 1, except Creditor—again, aware of Bank's security interest—filed a financing statement to perfect its interest. Who has priority, Bank or Creditor?

3 Harold and Wilma are married. First Bank has a mortgage on their house, and it covers after-acquired property. Because Harold has a new job requiring travel to neighboring cities, they purchase a second car for Wilma's normal household use, financed by Second Bank. They sign a security agreement; Second Bank files nothing. If they were to default on their house payments, First Bank could repossess the house; could it repossess the car, too?

4

a. Kathy Knittle borrowed $20,000 from Bank to buy inventory to sell in her knit shop and signed a security agreement listing her collateral—present and future—as security for the loan. Carlene Customer bought yarn and a tabletop loom from Knittle. Shortly thereafter, Knittle declared bankruptcy. Can Bank get the loom from Customer?
b. Assume that the facts are similar to those in Exercise 4a, except that the loom that Knittle sold had been purchased from Larry Loomaker, who had himself given a secured interest in it (and the other looms he manufactured) from Fine Lumber Company (FLC) to finance the purchase of the lumber to make the looms. Customer bought the loom from Knittle (unaware of Loomaker's situation); Loomaker failed to pay FLC. Why can FLC repossess the loom from Customer?
c. What recourse does Customer have now?

5 Creditor loaned Debtor $30,000 with the provision that the loan was callable by Creditor with sixty days' notice to Debtor. Debtor, having been called for repayment, asked for a ninety-day extension, which Creditor assented to, provided that Debtor would put up a surety to secure repayment. Surety agreed to serve as surety. When Debtor defaulted, Creditor turned to Surety for payment. Surety asserted that Creditor had given no consideration for Surety's promise, and therefore Surety was not bound. Is Surety correct?

6

a. Mrs. Ace said to University Bookstore: "Sell the books to my daughter. I'll pay for them." When University Bookstore presented Mrs. Ace a statement for $900, she refused to pay, denying she'd ever promised to do so, and she raised the statute of frauds as a defense. Is this a good defense?
b. Defendant ran a stop sign and crashed into Plaintiff's car, causing $8,000 damage. Plaintiff's attorney orally negotiated with Defendant's insurance company, Goodhands Insurance, to settle

CC BY NC SA

the case. Subsequently, Goodhands denied liability and refused to pay, and it raised the statute of frauds as a defense, asserting that any promise by it to pay for its insured's negligence would have to be in writing to be enforceable under the statute's suretyship clause. Is Goodhands's defense valid?

7

a. First Bank has a security interest in equipment owned by Kathy Knittle in her Knit Shop. If Kathy defaults on her loan and First Bank lawfully repossesses, what are the bank's options? Explain.
b. Suppose, instead, that First Bank had a security interest in Kathy's home knitting machine, worth $10,000. She paid $6,200 on the machine and then defaulted. Now what are the bank's options?

SELF-TEST QUESTIONS

1 Creditors may obtain security

a. by agreement with the debtor
b. through operation of law
c. through both of the above
d. through neither of the above

2 Under UCC Article 9, when the debtor has pledged collateral to the creditor, what other condition is required for attachment of the security interest?

a. A written security agreement must be authenticated by the debtor.
b. There must be a financing statement filed by or for the creditor.
c. The secured party received consideration.
d. The debtor must have rights in the collateral.

3 To perfect a security interest, one may

a. file a financing statement
b. pledge collateral
c. take a purchase-money security interest in consumer goods
d. do any of the above

4 Perfection benefits the secured party by

a. keeping the collateral out of the debtor's reach

b. preventing another creditor from getting a secured interest in the collateral

c. obviating the need to file a financing statement

d. establishing who gets priority if the debtor defaults

5 Creditor filed a security interest in inventory on June 1, 2012. Creditor's interest takes priority over which of the following?

a. a purchaser in the ordinary course of business who bought on June 5

b. mechanic's lien filed on May 10

c. purchase-money security interest in after-acquired property who filed on May 15

d. judgment lien creditor who filed the judgment on June 10

SELF-TEST ANSWERS

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

Chapter 26
Mortgages and Nonconsensual Liens

LEARNING OBJECTIVES

CC BY NC SA

After reading this chapter, you should understand the following:

1. The basic concepts of mortgages
2. How the mortgage is created
3. Priorities with mortgages as security devices
4. Termination of the mortgage
5. Other methods of using real estate as security
6. Nonconsensual liens

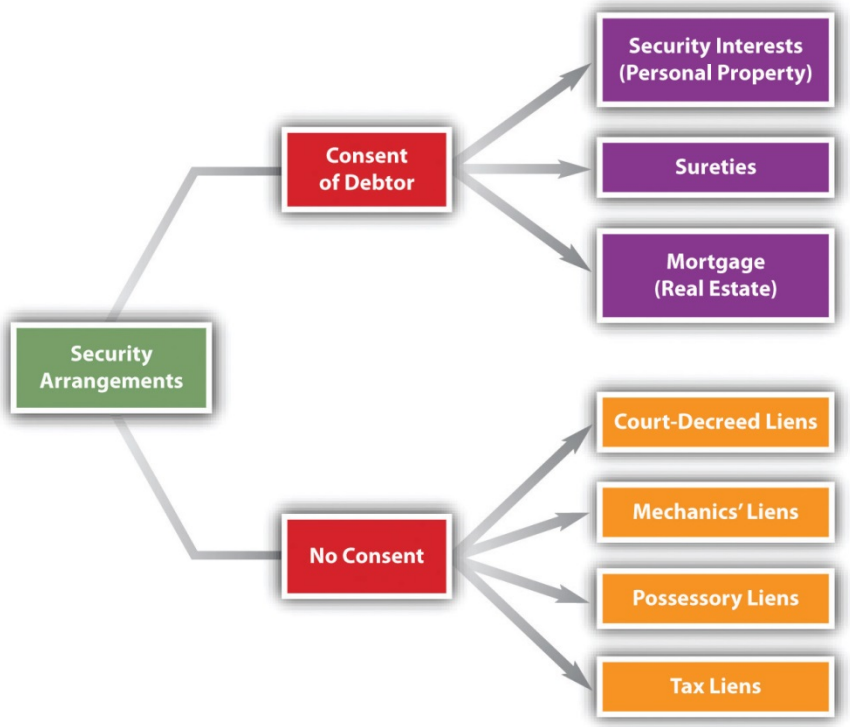
26.1 Uses, History, and Creation of Mortgages

LEARNING OBJECTIVES

1. Understand the terminology used in mortgage transactions, and how mortgages are used as security devices.
2. Know a bit about the history of mortgages.
3. Understand how the mortgage is created.

Having discussed in Chapter 25 "Secured Transactions and Suretyship" security interests in personal property and suretyship—two of the three common types of consensual security arrangements—we turn now to the third type of consensual security arrangement, the mortgage. We also discuss briefly various forms of nonconsensual liens (see Figure 26.1 "Security Arrangements").

Figure 26.1 *Security Arrangements*



Definitions

A **mortgage** is a means of securing a debt with real estate. A long time ago, the mortgage was considered an actual transfer of title, to become void if the debt was paid off. The modern view, held in most states, is that the mortgage is but a lien, giving the holder, in the event of default, the right to sell the property and repay the debt from the proceeds. The person giving the mortgage is the **mortgagor**, or borrower. In the typical home purchase, that's the buyer. The buyer needs to borrow to finance the purchase; in exchange for the money with which to pay the seller, the buyer "takes out a mortgage" with, say, a bank. The lender is the **mortgagee**, the person or institution holding the mortgage, with the right to foreclose on the property if the debt is not timely paid. Although the law of real estate mortgages is different from the set of rules in Article 9 of the Uniform Commercial Code (UCC) that we examined in Chapter 25 "Secured Transactions and Suretyship", the circumstances are the same, except that the security is real estate rather than personal property (secured transactions) or the promise of another (suretyship).

The Uses of Mortgages

Most frequently, we think of a mortgage as a device to fund a real estate purchase: for a homeowner to buy her house, or for a commercial entity to buy real estate (e.g., an office building), or for a person to purchase farmland. But the value in real estate can be mortgaged for almost any purpose (a home equity loan): a person can take out a mortgage on land to fund a vacation. Indeed, during the period leading up to the recession in 2007–08, a lot of people borrowed money on their houses to buy things: boats, new cars, furniture, and so on. Unfortunately, it turned out that some of the real estate used as collateral was overvalued: when the economy weakened and people lost income or their jobs, they couldn't make the mortgage payments. And, to make things worse, the value of the real estate sometimes sank too, so that the debtors owed more on the property than it was worth (that's called being underwater). They couldn't sell without taking a loss, and they couldn't make the payments. Some debtors just walked away, leaving the banks with a large number of houses, commercial buildings, and even shopping centers on their hands.

Short History of Mortgage Law

The mortgage has ancient roots, but the form we know evolved from the English land law in the Middle Ages. Understanding that law helps to understand modern mortgage law. In the fourteenth century, the mortgage was a deed that actually transferred title to the mortgagee. If desired, the mortgagee could move into the house, occupy the property, or rent it out. But because the mortgage obligated him to apply to the mortgage debt whatever rents he collected, he seldom ousted the mortgagor. Moreover, the mortgage set a specific date (the "law day") on which the debt was to be repaid. If the mortgagor did so, the mortgage became void and the mortgagor was entitled to recover the property. If the mortgagor failed to pay the debt, the property automatically vested in the mortgagee. No further proceedings were necessary.
This law was severe. A day's delay in paying the debt, for any reason, forfeited the land, and the courts strictly enforced the mortgage. The only possible relief was a petition to the king, who over time referred these and other kinds of petitions to the courts of equity. At first fitfully, and then as a matter of course (by the seventeenth century), the equity courts would order the mortgagee to return the land when the mortgagor stood ready to pay the debt plus interest. Thus a new right developed: the *equitable right of redemption*, known for short as the equity of redemption. In time, the courts held that this equity of

CC BY NC SA

redemption was a form of property right; it could be sold and inherited. This was a powerful right: no matter how many years later, the mortgagor could always recover his land by proffering a sum of money.

Understandably, mortgagees did not warm to this interpretation of the law, because their property rights were rendered insecure. They tried to defeat the equity of redemption by having mortgagors waive and surrender it to the mortgagees, but the courts voided waiver clauses as a violation of public policy. Hence a mortgage, once a transfer of title, became a security for debt. A mortgage as such can never be converted into a deed of title.

The law did not rest there. Mortgagees won a measure of relief in the development of the **foreclosure**. On default, the mortgagee would seek a court order giving the mortgagor a fixed time—perhaps six months or a year—within which to pay off the debt; under the court decree, failure meant that the mortgagor was forever foreclosed from asserting his right of redemption. This **strict foreclosure** gave the mortgagee outright title at the end of the time period.

In the United States today, most jurisdictions follow a somewhat different approach: the mortgagee forecloses by forcing a public sale at auction. Proceeds up to the amount of the debt are the mortgagee's to keep; surplus is paid over to the mortgagor. **Foreclosure by sale** is the usual procedure in the United States. At bottom, its theory is that a mortgage is a lien on land. (Foreclosure issues are further discussed in Section 26.2 "Priority, Termination of the Mortgage, and Other Methods of Using Real Estate as Security".)

Under statutes enacted in many states, the mortgagor has one last chance to recover his property, even after foreclosure. This statutory **right of redemption** extends the period to repay, often by one year.

Creation of the Mortgage

Statutory Regulation

The decision whether to lend money and take a mortgage is affected by several federal and state regulations.

Consumer Credit Statutes Apply

Statutes dealing with consumer credit transactions (as discussed in Chapter 24 "Consumer Credit Transactions") have a bearing on the mortgage, including state usury statutes, and the federal Truth in Lending Act and Equal Credit Opportunity Act.

Real Estate Settlement Procedures Act

Other federal statutes are directed more specifically at mortgage lending. One, enacted in 1974, is the Real Estate Settlement Procedures Act (RESPA), aimed at abuses in the settlement process—the process of obtaining the mortgage and purchasing a residence. The act covers all federally related first mortgage loans secured by residential properties for one to four families. It requires the lender to disclose information about settlement costs in advance of the closing day: it prohibits the lender from "springing" unexpected or hidden costs onto the borrower. The RESPA is a US Department of Housing and Urban Development (HUD) consumer protection statute designed to help home buyers be better shoppers in the home-buying process, and it is enforced by HUD. It also outlaws what had been a common practice of giving and accepting kickbacks and referral fees. The act prohibits lenders from requiring mortgagors to use a particular company to obtain insurance, and it limits add-on fees the lender can demand to cover future insurance and tax charges.

Redlining. Several statutes are directed to the practice of **redlining**—the refusal of lenders to make loans on property in low-income neighborhoods or impose stricter mortgage terms when they do make loans there. (The term derives from the supposition that lenders draw red lines on maps around ostensibly marginal neighborhoods.) The most important of these is the Community Reinvestment Act (CRA) of 1977.[1] The act requires the appropriate federal financial supervisory agencies to encourage regulated financial institutions to meet the credit needs of the local communities in which they are chartered, consistent with safe and sound operation. To enforce the statute, federal regulatory agencies examine banking institutions for CRA compliance and take this information into consideration when approving applications for new bank branches or for mergers or acquisitions. The information is compiled under the authority of the Home Mortgage Disclosure Act of 1975, which requires financial institutions within its

purview to report annually by transmitting information from their loan application registers to a federal agency.

The Note and the Mortgage Documents

The note and the mortgage documents are the contracts that set up the deal: the mortgagor gets credit, and the mortgagee gets the right to repossess the property in case of default.

The Note

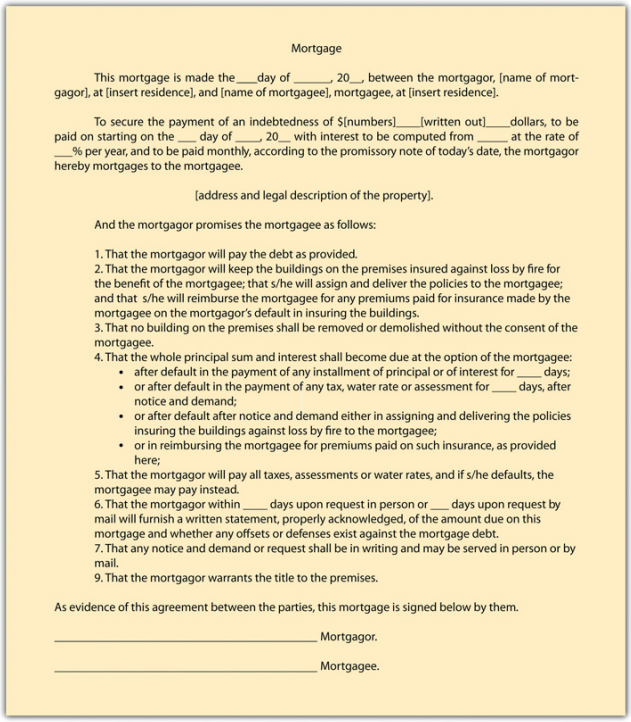
If the lender decides to grant a mortgage, the mortgagor signs two critical documents at the closing: the note and the mortgage. We cover notes in Chapter 19 "Nature and Form of Commercial Paper". It is enough here to recall that in a note (really a type of IOU), the mortgagor promises to pay a specified principal sum, plus interest, by a certain date or dates. The note is the underlying obligation for which the mortgage serves as security. Without the note, the mortgagee would have an empty document, since the mortgage would secure nothing. Without a mortgage, a note is still quite valid, evidencing the debtor's personal obligation.

One particular provision that usually appears in both mortgages and the underlying notes is the **acceleration clause**. This provides that if a debtor should default on any particular payment, the entire principal and interest will become due immediately at the lender's option. Why an acceleration clause? Without it, the lender would be powerless to foreclose the entire mortgage when the mortgagor defaulted but would have to wait until the expiration of the note's term. Although the acceleration clause is routine, it will not be enforced unless the mortgagee acts in an equitable and fair manner. The problem arises where the mortgagor's default was the result of some unconscionable conduct of the mortgagee, such as representing to the mortgagee that she might take a sixty-day "holiday" from having to make payments. In *Paul H. Cherry v. Chase Manhattan Mortgage Group* (Section 26.4 "Cases"), the equitable powers of the court were invoked to prevent acceleration.

The Mortgage

Under the statute of frauds, the mortgage itself must be evidenced by some writing to be enforceable. The mortgagor will usually make certain promises and warranties to the mortgagee and state the amount and terms of the debt and the mortgagor's duties concerning taxes, insurance, and repairs. A sample mortgage form is presented in Figure 26.2 "Sample Mortgage Form".

Figure 26.2 Sample Mortgage Form



Mortgage

This mortgage is made the ___day of _____, 20__, between the mortgagor, [name of mortgagor], at [insert residence], and [name of mortgagee], mortgagee, at [insert residence].

To secure the payment of an indebtedness of $[numbers]____[written out]____dollars, to be paid on starting on the ___ day of ____, 20__ with interest to be computed from _____ at the rate of ___% per year, and to be paid monthly, according to the promissory note of today's date, the mortgagor hereby mortgages to the mortgagee.

[address and legal description of the property].

And the mortgagor promises the mortgagee as follows:

1. That the mortgagor will pay the debt as provided.
2. That the mortgagor will keep the buildings on the premises insured against loss by fire for the benefit of the mortgagee; that s/he will assign and deliver the policies to the mortgagee; and that s/he will reimburse the mortgagee for any premiums paid for insurance made by the mortgagee on the mortgagor's default in insuring the buildings.
3. That no building on the premises shall be removed or demolished without the consent of the mortgagee.
4. That the whole principal sum and interest shall become due at the option of the mortgagee:
   - after default in the payment of any installment of principal or of interest for ____ days;
   - or after default in the payment of any tax, water rate or assessment for ____ days, after notice and demand;
   - or after default after notice and demand either in assigning and delivering the policies insuring the buildings against loss by fire to the mortgagee;
   - or in reimbursing the mortgagee for premiums paid on such insurance, as provided here;
5. That the mortgagor will pay all taxes, assessments or water rates, and if s/he defaults, the mortgagee may pay instead.
6. That the mortgagor within ____ days upon request in person or ___ days upon request by mail will furnish a written statement, properly acknowledged, of the amount due on this mortgage and whether any offsets or defenses exist against the mortgage debt.
7. That any notice and demand or request shall be in writing and may be served in person or by mail.
9. That the mortgagor warrants the title to the premises.

As evidence of this agreement between the parties, this mortgage is signed below by them.

_____ Mortgagor.

_____ Mortgagee.

KEY TAKEAWAY

As a mechanism of security, a mortgage is a promise by the debtor (mortgagor) to repay the creditor (mortgagee) for the amount borrowed or credit extended, with real estate put up as security. If the mortgagor doesn't pay as promised, the mortgagee may repossess the real estate. Mortgage law has ancient roots and brings with it various permutations on the theme that even if the mortgagor defaults, she may nevertheless have the right to get the property back or at least be reimbursed for any value above that necessary to pay the debt and the expenses of foreclosure. Mortgage law is regulated by state and federal statute.

EXERCISES

CC BY NC SA

1. What role did the right of redemption play in courts of equity changing the substance of a mortgage from an actual transfer of title to the mortgagee to a mere lien on the property?
2. What abuses did the federal RESPA address?
3. What are the two documents most commonly associated with mortgage transactions?

---

[1] 12 United States Code, Section 2901.

26.2 Priority, Termination of the Mortgage, and Other Methods of Using Real Estate as Security

LEARNING OBJECTIVES

1. Understand why it is important that the mortgagee (creditor) record her interest in the debtor's real estate.
2. Know the basic rule of priority—who gets an interest in the property first in case of default—and the exceptions to the rule.
3. Recognize the three ways mortgages can be terminated: payment, assumption, and foreclosure.
4. Be familiar with other methods (besides mortgages) by which real property can be used as security for a creditor.

CC BY NC SA

Priorities in Real Property Security

You may recall from Chapter 25 "Secured Transactions and Suretyship" how important it is for a creditor to perfect its secured interest in the goods put up as collateral. Absent perfection, the creditor stands a chance of losing out to another creditor who took its interest in the goods subsequent to the first creditor. The same problem is presented in real property security: the mortgagee wants to make sure it has first claim on the property in case the mortgagor (debtor) defaults.

The General Rule of Priorities

The general rule of priority is the same for real property security as for personal property security: the first in time to give notice of the secured interest is first in right. For real property, the notice is by **recording** the mortgage. Recording is the act of giving public notice of changes in interests in real estate. Recording was created by statute; it did not exist at common law. The typical recording statute calls for a transfer of title or mortgage to be placed in a particular county office, usually the auditor, recorder, or register of deeds.

A mortgage is valid between the parties whether or not it is recorded, but a mortgagee might lose to a third party—another mortgagee or a good-faith purchaser of the property—unless the mortgage is recorded.

Exceptions to the General Rule

There are exceptions to the general rule; two are taken up here.

Fixture Filing

The fixture-filing provision in Article 9 of the UCC is one exception to the general rule. As noted in Chapter 25 "Secured Transactions and Suretyship", the UCC gives priority to purchase-money security interests in fixtures if certain requirements are met.

Future Advances

A bank might make advances to the debtor after accepting the mortgage. If the future advances are obligatory, then the first-in-time rule applies. For example: Bank accepts Debtor's mortgage (and records

it) and extends a line of credit on which Debtor draws, up to a certain limit. (Or, as in the construction industry, Bank might make periodic advances to the contractors as work progresses, backed by the mortgage.) Second Creditor loans Debtor money—secured by the same property—before Debtor began to draw against the first line of credit. Bank has priority: by searching the mortgage records, Second Creditor should have been on notice that the first mortgage was intended as security for the entire line of credit, although the line was doled out over time.

However, if the future advances are not obligatory, then priority is determined by notice. For example, a bank might take a mortgage as security for an original loan and for any future loans that the bank chooses to make. A later creditor can achieve priority by notifying the bank with the first mortgage that it is making an advance. Suppose Jimmy mortgages his property to a wealthy dowager, Mrs. Calabash, in return for an immediate loan of $20,000 and they agree that the mortgage will serve as security for future loans to be arranged. The mortgage is recorded. A month later, before Mrs. Calabash loans him any more money, Jimmy gives a second mortgage to Louella in return for a loan of $10,000. Louella notifies Mrs. Calabash that she is loaning Jimmy the money. A month later, Mrs. Calabash loans Jimmy another $20,000. Jimmy then defaults, and the property turns out to be worth only $40,000. Whose claims will be honored and in what order? Mrs. Calabash will collect her original $20,000, because it was recited in the mortgage and the mortgage was recorded. Louella will collect her $10,000 next, because she notified the first mortgage holder of the advance. That leaves Mrs. Calabash in third position to collect what she can of her second advance. Mrs. Calabash could have protected herself by refusing the second loan.

Termination of the Mortgage

The mortgagor's liability can terminate in three ways: payment, assumption (with a novation), or foreclosure.

Payment

Unless they live in the home for twenty-five or thirty years, the mortgagors usually pay off the mortgage when the property is sold. Occasionally, mortgages are paid off in order to refinance. If the mortgage was taken out at a time of high interest rates and rates later drop, the homeowner might want to obtain a new

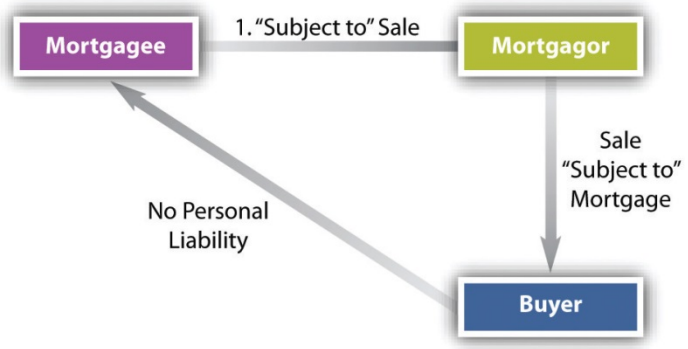
mortgage at the lower rates. In many mortgages, however, this entails extra closing costs and penalties for prepaying the original mortgage. Whatever the reason, when a mortgage is paid off, the discharge should be recorded. This is accomplished by giving the mortgagor a copy of, and filing a copy of, a Satisfaction of Mortgage document. In the *Paul H. Cherry v. Chase Manhattan Mortgage Group* case (Section 26.4 "Cases"), the bank *mistakenly* filed the Satisfaction of Mortgage document, later discovered its mistake, retracted the satisfaction, accelerated the loan because the mortgagor stopped making payments (the bank, seeing no record of an outstanding mortgage, refused to accept payments), and then tried to foreclose on the mortgage, meanwhile having lost the note and mortgage besides.

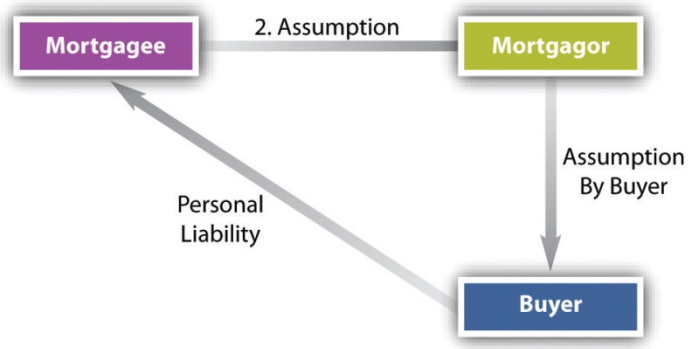
Assumption

The property can be sold without paying off the mortgage if the mortgage is assumed by the new buyer, who agrees to pay the seller's (the original mortgagor's) debt. This is a novation *if*, in approving the assumption, the bank releases the old mortgagor and substitutes the buyer as the new debtor.

The buyer need not assume the mortgage. If the buyer purchases the property without agreeing to be personally liable, this is a sale "subject to" the mortgage (see Figure 26.3 ""Subject to" Sales versus Assumption"). In the event of the seller's subsequent default, the bank can foreclose the mortgage and sell the property that the buyer has purchased, but the buyer is not liable for any deficiency.

Figure 26.3 "Subject to" Sales versus Assumption





What if mortgage rates are high? Can buyers assume an existing low-rate mortgage from the seller rather than be forced to obtain a new mortgage at substantially higher rates? Banks, of course, would prefer not to allow that when interest rates are rising, so they often include in the mortgage a **due-on-sale clause**, by which the entire principal and interest become due when the property is sold, thus forcing the purchaser to get financing at the higher rates. The clause is a device for preventing subsequent purchasers from assuming loans with lower-than-market interest rates. Although many state courts at one time refused to enforce the due-on-sale clause, Congress reversed this trend when it enacted the Garn–St. Germain Depository Institutions Act in 1982.[1] The act preempts state laws and upholds the validity of due-on-sale clauses. When interest rates are low, banks have no interest in enforcing such clauses, and there are ways to work around the due-on-sale clause.

Foreclosure

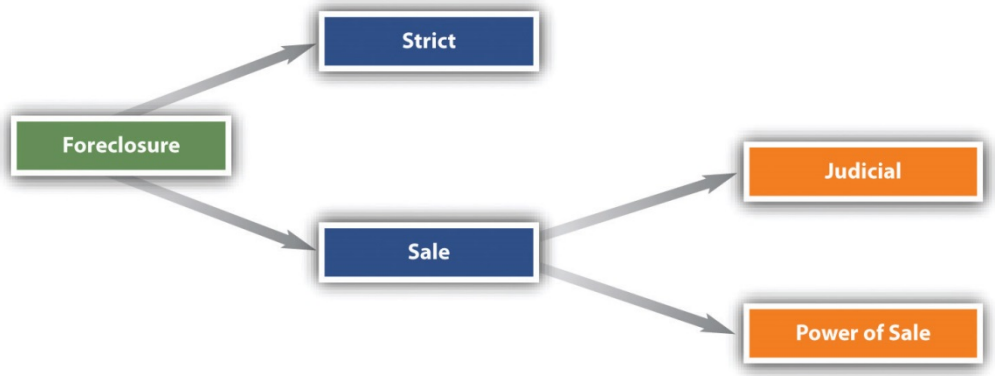
The third method of terminating the mortgage is by foreclosure when a mortgagor defaults. Even after default, the mortgagor has the right to exercise his equity of redemption—that is, to redeem the property

CC BY NC SA

by paying the principal and interest in full. If he does not, the mortgagee may foreclose the equity of redemption. Although strict foreclosure is used occasionally, in most cases the mortgagee forecloses by one of two types of sale (see Figure 26.4 "Foreclosure").

The first type is **judicial sale**. The mortgagee seeks a court order authorizing the sale to be conducted by a public official, usually the sheriff. The mortgagor is entitled to be notified of the proceeding and to a hearing. The second type of sale is that conducted under a clause called a **power of sale**, which many lenders insist be contained in the mortgage. This clause permits the mortgagee to sell the property at public auction without first going to court—although by custom or law, the sale must be advertised, and typically a sheriff or other public official conducts the public sale or auction.

Figure 26.4 Foreclosure



Once the property has been sold, it is deeded to the new purchaser. In about half the states, the mortgagor still has the right to redeem the property by paying up within six months or a year—the statutory redemption period. Thereafter, the mortgagor has no further right to redeem. If the sale proceeds exceed the debt, the mortgagor is entitled to the excess unless he has given second and third mortgages, in which case the junior mortgagees are entitled to recover their claims before the mortgagor. If the proceeds are less than the debt, the mortgagee is entitled to recover the deficiency from the mortgagor. However, some states have statutorily abolished deficiency judgments.

Other Methods of Using Real Estate as Security

Besides the mortgage, there are other ways to use real estate as security. Here we take up two: the deed of trust and the installment or land contract.

Deed of Trust

The **deed of trust** is a device for securing a debt with real property; unlike the mortgage, it requires three parties: the borrower, the trustee, and the lender. Otherwise, it is at base identical to a mortgage. The borrower conveys the land to a third party, the trustee, to hold in trust for the lender until the borrower pays the debt. (The trustee's interest is really a kind of legal fiction: that person is expected to have no interest in the property.) The primary benefit to the deed of trust is that it simplifies the foreclosure process by containing a provision empowering the trustee to sell the property on default, thus doing away with the need for any court filings. The disinterested third party making sure things are done properly becomes the trustee, not a judge. In thirty states and the District of Columbia—more than half of US jurisdictions—the deed of trust is usually used in lieu of mortgages.[2]

But the deed of trust may have certain disadvantages as well. For example, when the debt has been fully paid, the trustee will not release the deed of trust until she sees that all notes secured by it have been marked canceled. Should the borrower have misplaced the canceled notes or failed to keep good records, he will need to procure a surety bond to protect the trustee in case of a mistake. This can be an expensive procedure. In many jurisdictions, the mortgage holder is prohibited from seeking a deficiency judgment if the holder chooses to sell the property through nonjudicial means.

Alpha Imperial Building, LLC v. Schnitzer Family Investment, LLC, Section 26.4 "Cases", discusses several issues involving deeds of trust.

Installment or Land Contract

Under the **installment contract or land contract**, the purchaser takes possession and agrees to pay the seller over a period of years. Until the final payment, title belongs to the seller. The contract will

specify the type of deed to be conveyed at closing, the terms of payment, the buyer's duty to pay taxes and insure the premises, and the seller's right to accelerate on default. The buyer's particular concern in this type of sale is whether the seller in fact has title. The buyers can protect themselves by requiring proof of title and title insurance when the contract is signed. Moreover, the buyer should record the installment contract to protect against the seller's attempt to convey title to an innocent third-party purchaser while the contract is in effect.

The benefit to the land contract is that the borrower need not bank-qualify, so the pool of available buyers is larger, and buyers who have inadequate resources at the time of contracting but who have the expectation of a rising income in the future are good candidates for the land contract. Also, the seller gets all the interest paid by the buyer, instead of the bank getting it in the usual mortgage. The obvious disadvantage from the seller's point is that she will not get a big lump sum immediately: the payments trickle in over years (unless she can sell the contract to a third party, but that would be at a discount).

KEY TAKEAWAY

The general rule on priority in real property security is that the first creditor to record its interest prevails over subsequent creditors. There are some exceptions; the most familiar is that the seller of a fixture on a purchase-money security interest has priority over a previously recorded mortgagee. The mortgage will terminate by payment, assumption by a new buyer (with a novation releasing the old buyer), and foreclosure. In a judicial-sale foreclosure, a court authorizes the property's sale; in a power-of-sale foreclosure, no court approval is required. In most states, the mortgagor whose property was foreclosed is given some period of time—six months or a year—to redeem the property; otherwise, the sale is done, but the debtor may be liable for the deficiency, if any. The deed of trust avoids any judicial involvement by having the borrower convey the land to a disinterested trustee for the benefit of the lender; the trustee sells it upon default, with the proceeds (after expenses) going to the lender. Another method of real property security is a land contract: title shifts to the buyer only at the end of the term of payments.

EXERCISES

1. A debtor borrowed $350,000 to finance the purchase of a house, and the bank recorded its interest on July 1. On July 15, the debtor bought $10,000 worth of replacement windows from Window Co.; Window Co. recorded its purchase-money security interest that day, and the windows were installed. Four years later, the debtor, in hard financial times, declared bankruptcy. As between the bank and Windows Co., who will get paid first?
2. Under what interest rate circumstances would banks insist on a due-on-sale clause? Under what interest rate circumstance would banks not object to a new person assuming the mortgage?
3. What is the primary advantage of the deed of trust? What is the primary advantage of the land contract?
4. A debtor defaulted on her house payments. Under what circumstances might a court *not* allow the bank's foreclosure on the property?

---

[1] 12 United States Code, Section 1701-j.

[2] The states using the deed of trust system are as follows: Alabama, Alaska, Arkansas, Arizona, California, Colorado, District of Columbia, Georgia, Hawaii, Idaho, Iowa, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New Hampshire, North Carolina, Oklahoma, Oregon, Rhode Island, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, West Virginia, Wisconsin, and Wyoming.

26.3 Nonconsensual Lien

LEARNING OBJECTIVES

1. Understand the nonconsensual liens issued by courts—attachment liens and judgment liens—and how they are created.
2. Recognize other types of nonconsensual liens: mechanic's lien, possessory lien, and tax lien.

CC BY NC SA

The security arrangements discussed so far—security interests, suretyship, mortgages—are all obtained by the creditor with the debtor's consent. A creditor may obtain certain liens without the debtor's consent.

Court-Decreed Liens

Some nonconsensual liens are issued by courts.

Attachment Lien

An **attachment lien** is ordered against a person's property—real or personal—to prevent him from disposing of it during a lawsuit. To obtain an attachment lien, the plaintiff must show that the defendant likely will dispose of or hide his property; if the court agrees with the plaintiff, she must post a bond and the court will issue a writ of attachment to the sheriff, directing the sheriff to seize the property. Attachments of real property should be recorded. Should the plaintiff win her suit, the court issues a writ of execution, directing the sheriff to sell the property to satisfy the judgment.

Judgment Lien

A **judgment lien** may be issued when a plaintiff wins a judgment in court if an attachment lien has not already been issued. Like the attachment lien, it provides a method by which the defendant's property may be seized and sold.

Mechanic's Lien

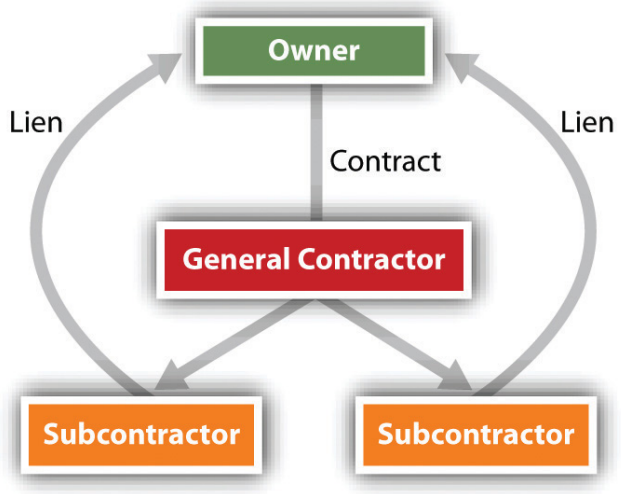
Overview

The most common nonconsensual lien on real estate is the **mechanic's lien**. A mechanic's lien can be obtained by one who furnishes labor, services, or materials to improve real estate: this is statutory, and the statute must be carefully followed. The "mechanic" here is one who works with his or her hands, not specifically one who works on machines. An automobile mechanic could not obtain a mechanic's lien on a customer's house to secure payment of work he did on her car. (The lien to which the automobile mechanic is entitled is a "possessory lien" or "artisan's lien," considered in Section 26.3.3 "Possessory

Lien") To qualify for a mechanic's lien, the claimant must file a sworn statement describing the work done, the contract made, or the materials furnished that permanently improved the real estate.

A particularly difficult problem crops up when the owner has paid the contractor, who in turn fails to pay his subcontractors. In many states, the subcontractors can file a lien on the owner's property, thus forcing the owner to pay them (see Figure 26.5 "Subcontractors' Lien")—and maybe twice. To protect themselves, owners can demand a sworn statement from general contractors listing the subcontractors used on the job, and from them, owners can obtain a waiver of lien rights before paying the general contractor.

Figure 26.5 *Subcontractors' Lien*



Procedure for Obtaining a Mechanic's Lien

Anyone claiming a lien against real estate must record a lien statement stating the amount due and the nature of the improvement. The lienor has a specified period of time (e.g., ninety days) to file from the time the work is finished. Recording as such does not give the lienor an automatic right to the property if the debt remains unpaid. All states specify a limited period of time, usually one year, within which the claimant must file suit to enforce the lien. Only if the court decides the lien is valid may the property be sold to satisfy the debt. Difficult questions sometimes arise when a lien is filed against a landlord's property as a result of improvements and services provided to a tenant, as discussed in *F & D Elec. Contractors, Inc. v. Powder Coaters, Inc.*,Section 26.4 "Cases".

Mechanic's Liens Priorities

A mechanic's lien represents a special risk to the purchaser of real estate or to lenders who wish to take a mortgage. In most states, the mechanic's lien is given priority not from the date when the lien is recorded but from an earlier date—either the date the contractor was hired or the date construction began. Thus a purchaser or lender might lose priority to a creditor with a mechanic's lien who filed after the sale or mortgage. A practical solution to this problem is to hold back part of the funds (purchase price or loan) or place them in escrow until the period for recording liens has expired.

Possessory Lien

The most common nonconsensual lien on personal property (not real estate) is the **possessory lien**. This is the right to continue to keep the goods on which work has been performed or for which materials have been supplied until the owner pays for the labor or materials. The possessory lien arises both under common law and under a variety of statutes. Because it is nonconsensual, the possessory lien is not covered by Article 9 of the UCC, which is restricted to consensual security interests. Nor is it governed by the law of mechanic's liens, which are nonpossessory and relate only to work done to improve real property.

The common-law rule is that anyone who, under an express or implied contract, adds value to another's chattel (personal property) by labor, skill, or materials has a possessory lien for the value of the services. Moreover, the lienholder may keep the chattel until her services are paid. For example, the dry cleaner shop is not going to release the wool jacket that you took in for cleaning unless you make satisfactory arrangements to pay for it, and the chain saw store won't let you take the chain saw that you brought in for a tune-up until you pay for the labor and materials for the tune-up.

Tax Lien

An important statutory lien is the federal **tax lien**. Once the government assesses a tax, the amount due constitutes a lien on the owner's property, whether real or personal. Until it is filed in the appropriate state office, others take priority, including purchasers, mechanics' lienors, judgment lien creditors, and

holders of security interests. But once filed, the tax lien takes priority over all subsequently arising liens. Federal law exempts some property from the tax lien; for example, unemployment benefits, books and tools of a trade, workers' compensation, judgments for support of minor children, minimum amounts of wages and salary, personal effects, furniture, fuel, and provisions are exempt.

Local governments also can assess liens against real estate for failure to pay real estate taxes. After some period of time, the real estate may be sold to satisfy the tax amounts owing.

KEY TAKEAWAY

There are four types of nonconsensual liens: (1) court-decreed liens are attachment liens, which prevent a person from disposing of assets pending a lawsuit, and judgment liens, which allow the prevailing party in a lawsuit to take property belonging to the debtor to satisfy the judgment; (2) mechanics' liens are authorized by statute, giving a person who has provided labor or material to a landowner the right to sell the property to get paid; (3) possessory liens on personal property allow one in possession of goods to keep them to satisfy a claim for work done or storage of them; and (4) tax liens are enforced by the government to satisfy outstanding tax liabilities and may be assessed against real or personal property.

EXERCISES

1. The mortgagor's interests are protected in a judicial foreclosure by a court's oversight of the process; how is the mortgagor's interest protected when a deed of trust is used?
2. Why is the deed of trust becoming increasingly popular?
3. What is the rationale for the common-law possessory lien?
4. Mike Mechanic repaired Alice Ace's automobile in his shop, but Alice didn't have enough money to pay for the repairs. May Mike have a mechanic's lien on the car? A possessory lien?
5. Why does federal law exempt unemployment benefits, books and tools of a trade, workers' compensation, minimum amounts of wages and salary, personal effects, furniture, fuel, and other such items from the sweep of a tax lien?

26.4 Cases

Denial of Mortgagee's Right to Foreclose; Erroneous Filings; Lost Instruments

Paul H. Cherry v. Chase Manhattan Mortgage Group

190 F.Supp.2d 1330 (Fed. Dist. Ct. FL 2002)

Background

[Paul Cherry filed a complaint suing Chase for Fair Debt Collection Practices Act violations and slander of credit.]...Chase counter-claimed for foreclosure and reestablishment of the lost note....

...Chase held a mortgage on Cherry's home to which Cherry made timely payments until August 2000. Cherry stopped making payments on the mortgage after he received a letter from Chase acknowledging his satisfaction of the mortgage. Cherry notified Chase of the error through a customer service representative. Cherry, however, received a check dated August 15, 2000, as an escrow refund on the mortgage. Chase subsequently recorded a Satisfaction of Mortgage into the Pinellas County public records on October 19, 2000. On November 14, 2000, Chase sent Cherry a "Loan Reactivation" letter with a new loan number upon which to make the payments. During this time, Cherry was placing his mortgage payments into a bank account, which subsequently were put into an escrow account maintained by his attorney. These payments were not, and have not, been tendered to Chase. As a result of the failure to tender, Chase sent Cherry an acceleration warning on November 17, 2000, and again on March 16, 2001. Chase notified the credit bureaus as to Cherry's default status and moved for foreclosure. In a letter addressed to Cherry's attorney, dated April 24, 2001, Chase's attorney advised Cherry to make the mortgage payments to Chase. Chase recorded a "vacatur, revocation, and cancellation of satisfaction of mortgage" (vacatur) [vacatur: an announcement filed in court that something is cancelled or set aside; an annulment] in the Pinellas County public records on May 3, 2001. Chase signed the vacatur on March 21, 2001, and had it notarized on March 27, 2001. Chase has also been unable to locate the original note, dated October 15, 1997, and deems it to be lost....

Foreclosure

Chase accelerated Cherry's mortgage debt after determining he was in a default status under the mortgage provisions. Chase claims that the right to foreclose under the note and mortgage is "absolute," [Citation], and that this Court should enforce the security interest in the mortgage though Chase made an administrative error in entering a Satisfaction of Mortgage into the public records....

Mortgage

...Chase relies on the Florida Supreme Court decision in *United Service Corp. v. Vi-An Const. Corp.*, [Citation] (Fla.1955), which held that a Satisfaction of Mortgage "made through a mistake may be canceled" and a mortgage reestablished as long as no other innocent third parties have "acquired an interest in the property." Generally the court looks to the rights of any innocent third parties, and if none exist, equity will grant relief to a mortgagee who has mistakenly satisfied a mortgage before fully paid. [Citation]. Both parties agree that the mortgage was released before the debt was fully paid. Neither party has presented any facts to this Court that implies the possibility nor existence of a third party interest. Although Cherry argues under *Biggs v. Smith*, 184 So. 106, 107 (1938), that a recorded satisfaction of mortgage is "prima facie evidence of extinguishment of a mortgage lien," Biggs does not apply this standard to mortgage rights affected by a mistake in the satisfaction.

Therefore, on these facts, this Court acknowledges that a vacatur is a proper remedy for Chase to correct its unilateral mistake since "equity will grant relief to those who have through mistake released a mortgage." [Citation.] Accordingly, this Court holds that an equity action is required to make a vacatur enforceable unless the parties consent to the vacatur or a similar remedy during the mortgage negotiation....

Tender

Cherry has not made a mortgage payment to Chase since August 2000, but claims to have made these payments into an escrow account, which he claims were paid to the escrow account because Chase recorded a satisfaction of his mortgage and, therefore, no mortgage existed. Cherry also claims that representatives of Chase rejected his initial attempts to make payments because of a lack of a valid loan number. Chase, however, correctly argues that payments made to an escrow account are not a proper tender of payment.*Matthews v. Lindsay*, [Citation] (1884) (requiring tender to be made to the court). Nor did Cherry make the required mortgage payments to the court as provided by [relevant court rules], allowing for a "deposit with the court all or any part of such sum or thing, whether that party claims all or any part of the sum or thing." Further, Chase also correctly argues that Cherry's failure to tender the payments from the escrow account or make deposits with the court is more than just a "technical breach" of the mortgage and note. [Citation.]

Chase may, therefore, recover the entire amount of the mortgage indebtedness, unless the court finds a "limited circumstance" upon which the request may be denied. [Citation.] Although not presented by Chase in its discussion of this case, the Court may refuse foreclosure, notwithstanding that the defendant established a foreclosure action, if the acceleration was unconscionable and the "result would be inequitable and unjust." This Court will analyze the inequitable result test and the limited circumstances by which the court may deny foreclosure.

First, this Court does not find the mortgage acceleration unconscionable by assuming arguendo [for the purposes of argument] that the mortgage was valid during the period that the Satisfaction of Mortgage was entered into the public records. Chase did not send the first acceleration warning until November 14, 2000, the fourth month of non-payment, followed by the second acceleration letter on March 16, 2001, the eighth month of non-payment. Although Cherry could have argued that a foreclosure action was an "inequitable" and "unjust" result after the Satisfaction of Mortgage was entered on his behalf, the result does not rise to an unconscionable level since Cherry could have properly tendered the mortgage payments to the court.

Second, the following "limited circumstances" will justify a court's denial of foreclosure: 1) waiver of right to accelerate; 2) mortgagee estopped from asserting foreclosure because mortgagor reasonably assumed the mortgagee would not foreclose; 3) mortgagee failed to perform a condition precedent for acceleration; 4) payment made after default but prior to receiving intent to foreclose; or, 5) where there was intent to make to make timely payment, and it was attempted, or steps taken to accomplish it, but nevertheless the payment was not made due to a misunderstanding or excusable neglect, coupled with some conduct of the mortgagee which in a measure contributed to the failure to pay when due or within the grace period. [Citations.]

Chase fails to address this fifth circumstance in its motion, an apparent obfuscation of the case law before the court. This Court acknowledges that Cherry's facts do not satisfy the first four limited circumstances. Chase at no time advised Cherry that the acceleration right was being waived; nor is Chase estopped from asserting foreclosure on the mortgage because of the administrative error, and Cherry has not relied on this error to his detriment; and since Chase sent the acceleration letter to Cherry and a request for payment to his attorney, there can be no argument that Cherry believed Chase would not foreclose. Chase has performed all conditions precedent required by the mortgage provisions prior to notice of the acceleration; sending acceleration warnings on November 17, 2000, and March 16, 2001. Cherry also has no argument for lack of notice of intent to accelerate after default since he has not tendered a payment since July 2000, thus placing him in default of the mortgage provisions, and he admits receiving the acceleration notices.

This Court finds, however, that this claim fails squarely into the final limited circumstance regarding intent to make timely payments. Significant factual issues exist as to the intent of Cherry to make or attempt to make timely mortgage payments to Chase. Cherry claims that he attempted to make the payments, but was told by a representative of Chase that there was no mortgage loan number upon which to apply the payments. As a result, the mortgage payments were placed into an account and later into his counsel's trust account as a mortgage escrow. Although these payments should have, at a minimum, been placed with the court to ensure tender during the resolution of the mortgage dispute, Cherry did take steps to accomplish timely mortgage payments. Although Cherry, through excusable neglect or a

misunderstanding as to what his rights were after the Satisfaction of Mortgage was entered, failed to tender the payments, Chase is also not without fault; its conduct in entering a Satisfaction of Mortgage into the Pinellas County public records directly contributed to Cherry's failure to tender timely payments. Cherry's attempt at making the mortgage payments, coupled with Chase's improper satisfaction of mortgage fits squarely within the limited circumstance created to justify a court's denial of a foreclosure. Equity here requires a balancing between Chase's right to the security interest encumbered by the mortgage and Cherry's attempts to make timely payments. As such, these limited circumstances exist to ensure that a foreclosure remains an action in equity. In applying this analysis, this Court finds that equity requires that Chase's request for foreclosure be denied at this juncture....

Reestablishment of the Lost Note and Mortgage

Chase also requests, as part of the foreclosure counterclaim, the reestablishment of the note initially associated with the mortgage, as it is unable to produce the original note and provide by affidavit evidence of its loss. Chase has complied with the [necessary statutory] requirements[.]...This Court holds the note to be reestablished and that Chase has the lawful right to enforce the note upon the issuance of this order.

This Court also agrees that Chase may reestablish the mortgage through a vacatur, revocation, and cancellation of satisfaction of mortgage. [Citation] (allowing the Equity Court to reestablish a mortgage that was improperly canceled due to a mistake). However, this Court will deem the vacatur effective as of the date of this order. This Court leaves the status of the vacatur during the disputed period, and specifically since May 3, 2001, to be resolved in subsequent proceedings....Accordingly, it is:

ORDERED that [Chase cannot foreclose and] the request to reestablish the note and mortgage is hereby granted and effective as of the date of this order. Cherry will tender all previously escrowed mortgage payments to the Court, unless the parties agree otherwise, within ten days of this order and shall henceforth, tender future monthly payments to Chase as set out in the reestablished note and mortgage.

CASE QUESTIONS

1. When Chase figured out that it had issued a Satisfaction of Mortgage erroneously, what did it file to rectify the error?
2. Cherry had not made any mortgage payments between the time Chase sent the erroneous Satisfaction of Mortgage notice to him and the time of the court's decision in this case. The court listed five circumstances in which a mortgagee (Chase here) might be denied the right to foreclose on a delinquent account: which one applied here? The court said Chase had engaged in "an apparent obfuscation of the case law before the court"? What obfuscation did it engage in?
3. What did Cherry do with the mortgage payments after Chase erroneously told him the mortgage was satisfied? What did the court say he should have done with the payments?

Mechanic's Lien Filed against Landlord for Payment of Tenant's Improvements

F & D Elec. Contractors, Inc. v. Powder Coaters, Inc.

567 S.E.2d 842 (S.C. 2002)

Factual/ Procedural Background

BG Holding f/k/a Colite Industries, Inc. ("BG Holding") is a one-third owner of about thirty acres of real estate in West Columbia, South Carolina. A warehouse facility is located on the property. In September 1996, Powder Coaters, Inc. ("Powder Coaters") agreed to lease a portion of the warehouse to operate its business. Powder Coaters was engaged in the business of electrostatically painting machinery parts and equipment and then placing them in an oven to cure. A signed lease was executed between Powder Coaters and BG Holding. Prior to signing the lease, Powder Coaters negotiated the terms with Mark Taylor, ("Taylor") who was the property manager for the warehouse facility and an agent of BG Holding.

The warehouse facility did not have a sufficient power supply to support Powder Coaters' machinery. Therefore, Powder Coaters contracted with F & D Electrical ("F & D") to perform electrical work which included installing two eight foot strip light fixtures and a two hundred amp load center. Powder Coaters

never paid F & D for the services. Powder Coaters was also unable to pay rent to BG Holding and was evicted in February 1997. Powder Coaters is no longer a viable company.

In January 1997, F & D filed a Notice and Certificate of Mechanic's Lien and Affidavit of Mechanic's Lien. In February 1997, F & D filed this action against BG Holding foreclosing on its mechanic's lien pursuant to S.C. [statute]....

A jury trial was held on September 2nd and 3rd, 1998. At the close of F & D's evidence, and at the close of all evidence, BG Holding made motions for directed verdicts, which were denied. The jury returned a verdict for F & D in the amount of $8,264.00. The court also awarded F & D attorneys' fees and cost in the amount of $8,264.00, for a total award of $16,528.00.

BG Holding appealed. The Court of Appeals, in a two to one decision, reversed the trial court, holding a directed verdict should have been granted to BG Holding on the grounds BG Holding did not consent to the electrical upgrade, as is required by the Mechanic's Lien Statute. This Court granted F & D's petition for certiorari, and the issue before this Court is:

> *Did the trial court err in denying BG Holding's motion for directed verdict because the record was devoid of any evidence of owner's consent to materialman's performance of work on its property as required by [the S.C. statute]?*

Law/Analysis

F & D argues the majority of the Court of Appeals erred in holding the facts of the case failed to establish that BG Holding consented to the work performed by F & D, as is required by the [South Carolina] Mechanic's Lien Statute. We agree.

...

South Carolina's Mechanic's Lien Statute provides:

CC BY NC SA

A person to whom a debt is due for labor performed or furnished or for materials furnished and actually used in the erection, alteration, or repair of a building...by virtue of an agreement with, or by consent of, the owner of the building or structure, or a person having authority from, or rightfully acting for, the owner in procuring or furnishing the labor or materials shall have a lien upon the building or structure and upon the interest of the owner of the building or structure ...to secure the payment of the debt due. [emphasis added.]

Both parties in this case concede there was no express "agreement" between F & D and BG Holding. Therefore, the issue in this appeal turns on the meaning of the word "consent" in the statute, as applied in the landlord-tenant context. This is a novel issue in South Carolina.

This Court must decide who must give the consent, who must receive consent, and what type of consent (general, specific, oral, written) must be given in order to satisfy the statute. Finally, the Court must decide whether the evidence in this case shows BG Holding gave the requisite consent.

A. Who Must Receive the Consent.

The Court of Appeals' opinion in this case contemplates the consent must be between the materialman (lien claimant) and the landlord (owner). "It is only logical...that consent under [the relevant section] must...be between the owner and the entity seeking the lien..." [Citation from Court of Appeals]. As stated previously, applying the Mechanic's Lien Statute in the landlord-tenant context presents a novel issue. We find the consent required by the statute does not have to be between the landlord/owner and the materialman, as the Court of Appeals' opinion indicates. A determination that the required consent must come from the owner to the materialman means the materialman can only succeed if he can prove an agreement with the owner. Such an interpretation would render meaningless the language of the statute that provides: "...by virtue of an agreement with, or by consent of the owner...."

Therefore, it is sufficient for the landlord/owner or his agent to give consent to his tenant. The landlord/owner should be able to delegate to his tenant the responsibility for making the requested improvements. The landlord/owner may not want to have direct involvement with the materialman or

sub-contractors, but instead may wish to allow the tenant to handle any improvements or upgrades himself. In addition, the landlord/owner may be located far away and may own many properties, making it impractical for him to have direct involvement with the materialman. We find the landlord/owner or his agent is free to enter into a lease or agreement with a tenant which allows the tenant to direct the modifications to the property which have been specifically consented to by the landlord/owner or his agent.

We hold a landlord/owner or his agent can give his consent to the lessee/tenant, as well as directly to the lien claimant, to make modifications to the leased premises.

B. What Kind of Consent Is Necessary.

This Court has already clearly held the consent required by [the relevant section] is "something more than a mere acquiescence in a state of things already in existence. It implies an agreement to that which, but for the consent, could not exist, and which the party consenting has a right to forbid." [Citations.] However, our Mechanics Lien Statute has never been applied in the landlord-tenant context where a third party is involved.

Other jurisdictions have addressed this issue. The Court of Appeals cited [a Connecticut case, 1987] in support of its holding. We agree with the Court of Appeals that the Connecticut court's reasoning is persuasive, especially since Connecticut has a similar mechanics lien statute....

The Connecticut courts have stated "the consent required from the owner or one acting under the owner's authority is more than the mere granting of permission for work to be conducted on one's property; or the mere knowledge that work was being performed on one's land." Furthermore, although the Connecticut courts have stated the statute does not require an express contract, the courts have required "consent that indicates an agreement that the owner of...the land shall be, or may be, liable for the materials or labor."...

The reasoning of [Connecticut and other states that have decided this issue] is persuasive. F & D's brief appears to argue that mere knowledge by the landowner that the work needed to be done, coupled with

the landlord's general "permission" to perform the work, is enough to establish consent under the statute. Under this interpretation, a landlord who knew a tenant needed to improve, upgrade, or add to the leased premises would be liable to any contractor and/or subcontractor who performed work on his land. Under F & D's interpretation the landlord would not be required to know the scope, cost, etc. of the work, but would only need to give the tenant general permission to perform upgrades or improvements.

Clearly, if the landlord/owner or his agent gives consent directly to the materialman, a lien can be established. Consent can also be given to the tenant, but the consent needs to be specific. The landlord/owner or his agent must know the scope of the project (for instance, as the lease provided in the instant case, the landlord could approve written plans submitted by the tenant). The consent needs to be more than "mere knowledge" that the tenant will perform work on the property. There must be some kind of express or implied agreement that the landlord may be held liable for the work or material. The landlord/owner or his agent may delegate the project or work to his tenant, but there must be an express or implied agreement about the specific work to be done. A general provision in a lease which allows tenant to make repairs or improvements is not enough.

C. Evidence There Was No Consent

- The record is clear that no contract, express or implied, existed between BG Holding and F & G. BG Holding had no knowledge F & G would be performing the work.
- F & G's supervisor, David Weatherington, and Ray Dutton, the owner of F & D, both testified they never had a conversation with anyone from BG Holding. In fact, until Powder Coaters failed to pay under the contract, F & D did not know BG Holding was the owner of the building.
- Mark Taylor, BG Holding's agent, testified he never authorized any work by F & D, nor did he see any work being performed by them on the site.
- The lease specifically provided that all work on the property was to be approved in writing by BG Holding.
- David Weatherington of F & D testified he was looking to Powder Coaters, not BG Holding, for payment.

- Powder Coaters acknowledged it was not authorized to bind BG Holding to pay for the modifications.
- The lease states, "[i]f the Lessee should make any [alterations, modification, additions, or installations], the Lessee hereby agrees to indemnify, defend, and save harmless the Lessor from any liability..."

D. Evidence There Was Consent

- Bruce Houston, owner of Powder Coaters testified that during the lease negotiations, he informed Mark Taylor, BG Holding's property manager and agent, that electrical and gas upgrading would be necessary for Powder Coaters to perform their work.
- Houston testified Mark Taylor was present at the warehouse while F & D performed their work. [However, Taylor testified he did not see F & D performing any work on the premises.]
- Houston testified he would not have entered into the lease if he was not authorized to upgrade the electrical since the existing power source was insufficient to run the machinery needed for Powder Coaters to operate.
- Houston testified Mark Taylor, BG Holding's agent, showed him the power source for the building so Taylor could understand the extent of the work that was going to be required.
- Houston testified Paragraph 5 of the addendum to the lease was specifically negotiated. He testified the following language granted him the authority to perform the electrical upfit, so that he was not required to submit the plans to BG Holding as required by a provision in the lease: "Lessor shall allow Lessee to put Office Trailer in Building. All Utilities necessary to handle Lessee's equipment shall be paid for by the Lessee including, but not limited to electricity, water, sewer, and gas." (We note that BG Holding denies this interpretation, but insists it just requires the Lessee to pay for all utility bills.)
- Powder Coaters no longer occupies the property, and BG Holding possibly benefits from the work done.

In the instant case, there is some evidence of consent. However, it does not rise to the level required under the statute....

Viewing the evidence in the light most favorable to F & D, whether BG Holding gave their consent is a close question. However, we agree with the Court of Appeals, that F & D has not presented enough evidence to show: (1) BG Holding gave anything more than general consent to make improvements (as the lease could be interpreted to allow); or (2) BG Holding had anything more that "mere knowledge" that the work was to be done. Powder Coaters asserted the lease's addendum evidenced BG Holding's consent to perform the modifications; however, there is no evidence BG Holding expressly or implicitly agreed that it might be liable for the work. In fact, the lease between Powder Coaters and BG Holding expressly provided Powder Coaters was responsible for any alterations made to the property. Even Powder Coaters acknowledged it was not authorized to bind BG Holding....Therefore, it is impossible to see how the very general provision requiring Powder Coaters to pay for water, sewer, and gas can be interpreted to authorize Powder Coaters to perform an electrical upgrade. Furthermore, we agree with the Court of Appeals that the mere presence of BG Holding's agent at the work site is not enough to establish consent.

Conclusion

We hold consent, as required by the Mechanic's Lien Statute, is something more than mere knowledge work will be or could be done on the property. The landlord/owner must do more than grant the tenant general permission to make repairs or improvements to the leased premises. The landlord/owner or his agent must give either his tenant or the materialman express or implied consent acknowledging he may be held liable for the work.

The Court of Appeals' opinion is affirmed as modified.

CASE QUESTIONS

1. Why did the lienor want to go after the landlord instead of the tenant?
2. Did the landlord here know that there were electrical upgrades needed by the tenant?
3. What kind of knowledge or acceptance did the court determine the landlord-owner needed to have or give before a material man could have a lien on the real estate?

4. What remedy has F & D (the material man) now?

Deeds of Trust; Duties of Trustee

Alpha Imperial Building, LLC v. Schnitzer Family Investment, LLC, II (SFI).

2005 WL 715940, (Wash. Ct. App. 2005)

Applewick, J.

Alpha Imperial LLC challenges the validity of a non-judicial foreclosure sale on multiple grounds. Alpha was the holder of a third deed of trust on the building sold, and contests the location of the sale and the adequacy of the sale price. Alpha also claims that the trustee had a duty to re-open the sale, had a duty to the junior lienholder, chilled the bidding, and had a conflict of interest. We find that the location of the sale was proper, the price was adequate, bidding was not chilled, and that the trustee had no duty to re-open the sale, [and] no duty to the junior lienholder....We affirm.

Facts

Mayur Sheth and another individual formed Alpha Imperial Building, LLC in 1998 for the purpose of investing in commercial real estate. In February 2000 Alpha sold the property at 1406 Fourth Avenue in Seattle (the Property) to Pioneer Northwest, LLC (Pioneer). Pioneer financed this purchase with two loans from [defendant Schnitzer Family Investment, LLC, II (SFI)].

Pioneer also took a third loan from Alpha at the time of the sale for $1.3 million. This loan from Alpha was junior to the two [other] loans[.]

Pioneer defaulted and filed for bankruptcy in 2002....In October 2002 defendant Blackstone Corporation, an entity created to act as a non-judicial foreclosure trustee, issued a Trustee's Notice of Sale. Blackstone is wholly owned by defendant Witherspoon, Kelley, Davenport & Toole (Witherspoon). Defendant Michael Currin, a shareholder at Witherspoon, was to conduct the sale on January 10, 2003. Currin and

Witherspoon represented SFI and 4th Avenue LLC. Sheth received a copy of the Notice of Sale through his attorney.

On January 10, 2003, Sheth and his son Abhi arrived at the Third Avenue entrance to the King County courthouse between 9:30 and 9:45 a.m. They waited for about ten minutes. They noticed two signs posted above the Third Avenue entrance. One sign said that construction work was occurring at the courthouse and 'all property auctions by the legal and banking communities will be moved to the 4th Avenue entrance of the King County Administration Building.' The other sign indicated that the Third Avenue entrance would remain open during construction. Sheth and Abhi asked a courthouse employee about the sign, and were told that all sales were conducted at the Administration Building.

Sheth and Abhi then walked to the Administration Building, and asked around about the sale of the Property. [He was told Michael Currin, one of the shareholders of Blackstone—the trustee—was holding the sale, and was advised] to call Currin's office in Spokane. Sheth did so, and was told that the sale was at the Third Avenue entrance. Sheth and Abhi went back to the Third Avenue entrance.

In the meantime, Currin had arrived at the Third Avenue entrance between 9:35 and 9:40 a.m. The head of SFI, Danny Schnitzer (Schnitzer), and his son were also present. Currin was surprised to notice that no other foreclosure sales were taking place, but did not ask at the information desk about it. Currin did not see the signs directing auctions to occur at the Administration Building. Currin conducted the auction, Schnitzer made the only bid, for $2.1 million, and the sale was complete. At this time, the debt owed on the first two deeds of trust totaled approximately $4.1 million. Currin then left the courthouse, but when he received a call from his assistant telling him about Sheth, he arranged to meet Sheth back at the Third Avenue entrance. When they met, Sheth told Currin that the sales were conducted at the Administration Building. Currin responded that the sale had already been conducted, and he was not required to go to the Administration Building. Currin told Sheth that the notice indicated the sale was to be at the Third Avenue entrance, and that the sale had been held at the correct location. Sheth did not ask to re-open the bidding....

Sheth filed the current lawsuit, with Alpha as the sole plaintiff, on February 14, 2003. The lawsuit asked for declaratory relief, restitution, and other damages. The trial court granted the defendants' summary judgment motion on August 8, 2003. Alpha appeals.

Location of the Sale

Alpha argues that the sale was improper because it was at the Third Avenue entrance, not the Administration Building. Alpha points to a letter from a King County employee stating that auctions are held at the Administration Building. The letter also stated that personnel were instructed to direct bidders and trustees to that location if asked. In addition, Alpha argues that the Third Avenue entrance was not a 'public' place, as required by [the statute], since auction sales were forbidden there. We disagree. Alpha has not shown that the Third Avenue entrance was an improper location. The evidence shows that the county had changed its policy as to where auctions would be held and had posted signs to that effect. However, the county did not exclude people from the Third Avenue entrance or prevent auctions from being held there. Street, who frequented sales, stated that auctions were being held in both locations. The sale was held where the Notice of Sale indicated it would be. In addition, Alpha has not introduced any evidence to show that the Third Avenue entrance was not a public place at the time of the sale. The public was free to come and go at that location, and the area was 'open and available for all to use.' Alpha relies on *Morton v. Resolution Trust* (S.D. Miss. 1995) to support its contention that the venue of the sale was improper. [But] *Morton* is not on point.

Duty to Re-Open Sale

Alpha argues that Currin should have re-opened the sale. However, it is undisputed that Sheth did not request that Currin re-open it. The evidence indicates that Currin may have known about Sheth's interest in bidding prior to the day of the sale, due to a conversation with Sheth's attorney about Sheth's desire to protect his interest in the Property. But, this knowledge did not create in Currin any affirmative duty to offer to re-open the sale.

In addition, Alpha cites no Washington authority to support the contention that Currin would have been obligated to re-open the sale if Sheth had asked him to. The decision to continue a sale appears to be fully within the discretion of the trustee: "[t]he trustee may for any cause the trustee deems advantageous, continue the sale." [Citation.] Alpha's citation to *Peterson v. Kansas City Life Ins. Co.*, Missouri (1936) to support its contention that Currin should have re-opened the sale is unavailing. In Peterson, the Notice of Sale indicated that the sale would be held at the 'front' door of the courthouse. But, the courthouse had four doors, and the customary door for sales was the east door. The sheriff, acting as the trustee, conducted the sale at the east door, and then re-opened the sale at the south door, as there had been some sales at the south door. Alpha contends this shows that Currin should have re-opened the sale when learning of the Administration Building location, akin to what the sheriff did in Peterson. However, Peterson does not indicate that the sheriff had an affirmative duty to re-sell the property at the south door. This case is not on point.

Chilled Bidding

Alpha contends that Currin chilled the bidding on the Property by telling bidders that he expected a full credit sale price and by holding the sale at the courthouse. Chilled bidding can be grounds for setting aside a sale. *Country Express Stores, Inc. v. Sims,* [Washington Court of Appeals] (1997). The*Country Express* court explained the two types of chilled bidding:

The first is intentional, occurring where there is collusion for the purpose of holding down the bids. The second consists of inadvertent and unintentional acts by the trustee that have the effect of suppressing the bidding. To establish chilled bidding, the challenger must establish the bidding was actually suppressed, which can sometimes be shown by an inadequate sale price.

We hold that there was no chilling. Alpha has not shown that Currin engaged in intentional chilling. There is no evidence that Currin knew about the signs indicating auctions were occurring at the Administration Building when he prepared the Notice of Sale, such that he intentionally held the sale at a location from which he knew bidders would be absent. Additionally, Currin's statement to [an interested person who might bid on the property] that a full credit sale price was expected and that the opening bid would be

$4.1 million did not constitute intentional chilling. SFI was owed $4.1 million on the Property. SFI could thus bid up to that amount at no cost to itself, as the proceeds would go back to SFI. Currin confirmed that SFI was prepared to make a full-credit bid. [It is common for trustees to] disclose the full-credit bid amount to potential third party bidders, and for investors to lose interest when they learn of the amount of indebtedness on property. It was therefore not a misrepresentation for Currin to state $4.1 million as the opening bid, due to the indebtedness on the Property. Currin's statements had no chilling effect—they merely informed [interested persons] of the minimum amount necessary to prevail against SFI. Thus, Currin did not intentionally chill the bidding by giving Street that information.

Alpha also argues that the chilled bidding could have been unintended by Currin.... [But the evidence is that] Currin's actions did not intentionally or unintentionally chill the bidding, and the sale will not be set aside.

Adequacy of the Sale Price

Alpha claims that the sale price was 'greatly inadequate' and that the sale should thus be set aside. Alpha submitted evidence that the property had an 'as is' value of $4.35 million in December 2002, and an estimated 2004 value of $5.2 million. The debt owed to SFI on the property was $4.1 million. SFI bought the property for $2.1 million. These facts do not suggest that the sale must be set aside.

Washington case law suggests that the price the property is sold for must be 'grossly inadequate' for a trustee's sale to be set aside on those grounds alone. In *Cox* [Citation, 1985], the property was worth between $200,000 and $300,000, and was sold to the beneficiary for $11,873. The Court held that amount to be grossly inadequate In *Steward* [Citation, 1988] the property had been purchased for approximately $64,000, and then was sold to a third party at a foreclosure sale for $4,870. This court held that $4,870 was not grossly inadequate. In *Miebach* [Citation] (1984), the Court noted that a sale for less than two percent of the property's fair market value was grossly inadequate. The Court in *Miebach* also noted prior cases where the sale had been voided due to grossly inadequate purchase price; the properties in those cases had been sold for less than four percent of the value and less than three percent of the value. In addition, the Restatement indicates that gross inadequacy only exists when

the sale price is less than 20 percent of the fair market value—without other defects, sale prices over 20 percent will not be set aside. [Citation.] The Property was sold for between 40 and 48 percent of its value. These facts do not support a grossly inadequate purchase price.

Alpha cites *Miebach* for the proposition that 'where the inadequacy of price is great the sale will be set aside with slight indications of fraud or unfairness,' arguing that such indications existed here. However, the cases cited by the Court in *Miebach* to support this proposition involved properties sold for less than three and four percent of their value. Alpha has not demonstrated the slightest indication of fraud, nor shown that a property that sold for 40 to 48 percent of its value sold for a greatly inadequate price.

Duty to a Junior Lienholder

Alpha claims that Currin owed a duty to Alpha, the junior lienholder. Alpha cites no case law for this proposition, and, indeed, there is none—Division Two specifically declined to decide this issue in *Country Express* [Citation]. Alpha acknowledges the lack of language in RCW 61.24 (the deed of trust statute) regarding fiduciary duties of trustees to junior lienholders. But Alpha argues that since RCW 61.24 requires that the trustee follow certain procedures in conducting the sale, and allows for sales to be restrained by anyone with an interest, a substantive duty from the trustee to a junior lienholder can be inferred.

Alpha's arguments are unavailing. The procedural requirements in RCW 61.24 do not create implied substantive duties. The structure of the deed of trust sale illustrates that no duty is owed to the junior lienholder. The trustee and the junior lienholder have no relationship with each other. The sale is pursuant to a contract between the grantor, the beneficiary and the trustee. The junior lienholder is not a party to that contract. The case law indicates only that the trustee owes a fiduciary duty to the debtor and beneficiary: "a trustee of a deed of trust is a fiduciary for both the mortgagee and mortgagor and must act impartially between them." *Cox* [Citation]. The fact that a sale in accordance with that contract can extinguish the junior lienholder's interest further shows that the grantor's and beneficiary's interest in the deed of trust being foreclosed is adverse to the junior lienholder. We conclude the trustee, while having

duties as fiduciary for the grantor and beneficiary, does not have duties to another whose interest is adverse to the grantor or beneficiary. Thus, Alpha's claim of a special duty to a junior lienholder fails....

Attorney Fees

...Defendants claim they are entitled to attorney fees for opposing a frivolous claim, pursuant to [the Washington statute]. An appeal is frivolous 'if there are no debatable issues upon which reasonable minds might differ and it is so totally devoid of merit that there was no reasonable possibility of reversal.' [Citation] Alpha has presented several issues not so clearly resolved by case law as to be frivolous, although Alpha's arguments ultimately fail. Thus, Respondents' request for attorney fees under [state law] is denied.

Affirmed.

CASE QUESTIONS

1. Why did the plaintiff (Alpha) think the sale should have been set aside because of the location problems?
2. Why did the court decide the trustee had no duty to reopen bidding?
3. What is meant by "chilling bidding"? What argument did the plaintiff make to support its contention that bidding was chilled?
4. The court notes precedent to the effect that a "grossly inadequate" bid price has some definition. What is the definition? What percentage of the real estate's value in this case was the winning bid?
5. A trustee is one who owes a fiduciary duty of the utmost loyalty and good faith to another, the beneficiary. Who was the beneficiary here? What duty is owed to the junior lienholder (Alpha here)—any duty?
6. Why did the defendants not get the attorneys' fee award they wanted?

26.5 Summary and Exercises

Summary

CC BY NC SA

A mortgage is a means of securing a debt with real estate. The mortgagor, or borrower, gives the mortgage. The lender is the mortgagee, who holds the mortgage. On default, the mortgagee may foreclose the mortgage, convening the security interest into title. In many states, the mortgagor has a statutory right of redemption after foreclosure.

Various statutes regulate the mortgage business, including the Truth in Lending Act, the Equal Credit Opportunity Act, the Real Estate Settlement Procedures Act, and the Home Mortgage Disclosure Act, which together prescribe a code of fair practices and require various disclosures to be made before the mortgage is created.

The mortgagor signs both a note and the mortgage at the closing. Without the note, the mortgage would secure nothing. Most notes and mortgages contain an acceleration clause, which calls for the entire principal and interest to be due, at the mortgagee's option, if the debtor defaults on any payment.

In most states, mortgages must be recorded for the mortgagee to be entitled to priority over third parties who might also claim an interest in the land. The general rule is "First in time, first in right," although there are exceptions for fixture filings and nonobligatory future advances. Mortgages are terminated by repayment, novation, or foreclosure, either through judicial sale or under a power-of-sale clause.

Real estate may also be used as security under a deed of trust, which permits a trustee to sell the land automatically on default, without recourse to a court of law.

Nonconsensual liens are security interests created by law. These include court-decreed liens, such as attachment liens and judgment liens. Other liens are mechanic's liens (for labor, services, or materials furnished in connection with someone's real property), possessory liens (for artisans working with someone else's personal properly), and tax liens.

EXERCISES

1 Able bought a duplex from Carr, who had borrowed from First Bank for its purchase. Able took title subject to Carr's mortgage. Able did not make mortgage payments to First Bank; the bank foreclosed and sold the property, leaving a deficiency. Which is correct?

a. Carr alone is liable for the deficiency.

b. Able alone is liable for the deficiency because he assumed the mortgage.

c. First Bank may pursue either Able or Carr.

d. Only if Carr fails to pay will Able be liable.

2 Harry borrowed $175,000 from Judith, giving her a note for that amount and a mortgage on his condo. Judith did not record the mortgage. After Harry defaulted on his payments, Judith began foreclosure proceedings. Harry argued that the mortgage was invalid because Judith had failed to record it. Judith counterargues that because a mortgage is not an interest in real estate, recording is not necessary. Who is correct? Explain.

3 Assume in Exercise 2 that the documents did not contain an acceleration clause and that Harry missed three consecutive payments. Could Judith foreclose? Explain.

4 Rupert, an automobile mechanic, does carpentry work on weekends. He built a detached garage for Clyde for $20,000. While he was constructing the garage, he agreed to tune up Clyde's car for an additional $200. When the work was completed, Clyde failed to pay him the $20,200, and Rupert claimed a mechanic's lien on the garage and car. What problems, if any, might Rupert encounter in enforcing his lien? Explain.

5 In Exercise 4, assume that Clyde had borrowed $50,000 from First Bank and had given the bank a mortgage on the property two weeks after Rupert commenced work on the garage but several weeks before he filed the lien. Assuming that the bank immediately recorded its mortgage and that Rupert's lien is valid, does the mortgage take priority over the lien? Why?

6 Defendant purchased a house from Seller and assumed the mortgage indebtedness to Plaintiff. All monthly payments were made on time until March 25, 1948, when no more were made. On October 8, 1948, Plaintiff sued to foreclose and accelerate the note. In February of 1948, Plaintiff asked to obtain a loan elsewhere and pay him off; he offered a discount if she would do so, three times, increasing the amount offered each time. Plaintiff understood that Defendant was getting a loan from the Federal Housing Administration (FHA), but she was confronted with a number of requirements, including

significant property improvements, which—because they were neighbors—Plaintiff knew were ongoing. While the improvements were being made, in June or July, he said to her, "Just let the payments go and we'll settle everything up at the same time," meaning she need not make monthly payments until the FHA was consummated, and he'd be paid from the proceeds. But then "he changed his tune" and sought foreclosure. Should the court order it?

SELF-TEST QUESTIONS

1 The person or institution holding a mortgage is called

a. the mortgagor

b. the mortgagee

c. the debtor

d. none of the above

2 Mortgages are regulated by

a. the Truth in Lending Act

b. the Equal Credit Opportunity Act

c. the Real Estate Settlement Procedures Act

d. all of the above

3 At the closing, a mortgagor signs

a. only a mortgage

b. only a note

c. either a note or the mortgage

d. both a note and the mortgage

4 Mortgages are terminated by

a. repayment

b. novation

c. foreclosure

d. any of the above

CC BY NC SA

5 A lien ordered against a person's property to prevent its disposal during a lawsuit is called

a. a judgment lien

b. an attachment lien

c. a possessory lien

d. none of the above

SELF-TEST ANSWERS

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

Chapter 27
Bankruptcy

LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. A short history of US bankruptcy law
2. An overview of key provisions of the 2005 bankruptcy act

CC BY NC SA

3. The basic operation of Chapter 7 bankruptcy
4. The basic operation of Chapter 11 bankruptcy
5. The basic operation of Chapter 13 bankruptcy
6. What debtor's relief is available outside of bankruptcy

27.1 Introduction to Bankruptcy and Overview of the 2005 Bankruptcy Act

LEARNING OBJECTIVES

1. Understand what law governs bankruptcy in the United States.
2. Know the key provisions of the law.

The Purpose of Bankruptcy Law

Bankruptcy law governs the rights of creditors and insolvent debtors who cannot pay their debts. In broadest terms, bankruptcy deals with the seizure of the debtor's assets and their distribution to the debtor's various creditors. The term derives from the Renaissance custom of Italian traders, who did their trading from benches in town marketplaces. Creditors literally "broke the bench" of a merchant who failed to pay his debts. The term *banco rotta* (broken bench) thus came to apply to business failures.

In the Victorian era, many people in both England and the United States viewed someone who became bankrupt as a wicked person. In part, this attitude was prompted by the law itself, which to a greater degree in England and to a lesser degree in the United States treated the insolvent debtor as a sort of felon. Until the second half of the nineteenth century, British insolvents could be imprisoned; jail for insolvent debtors was abolished earlier in the United States. And the entire administration of bankruptcy

law favored the creditor, who could with a mere filing throw the financial affairs of the alleged insolvent into complete disarray.

Today a different attitude prevails. Bankruptcy is understood as an aspect of financing, a system that permits creditors to receive an equitable distribution of the bankrupt person's assets and promises new hope to debtors facing impossible financial burdens. Without such a law, we may reasonably suppose that the level of economic activity would be far less than it is, for few would be willing to risk being personally burdened forever by crushing debt. Bankruptcy gives the honest debtor a fresh start and resolves disputes among creditors.

History of the Bankruptcy System; Bankruptcy Courts and Judges

Constitutional Basis

The US Constitution prohibits the states from impairing the "obligation of a contract." This means that no state can directly provide a means for discharging a debtor unless the debt has been entirely paid. But the Constitution in Article I, Section 8, does give the federal government such a power by providing that Congress may enact a uniform bankruptcy law.

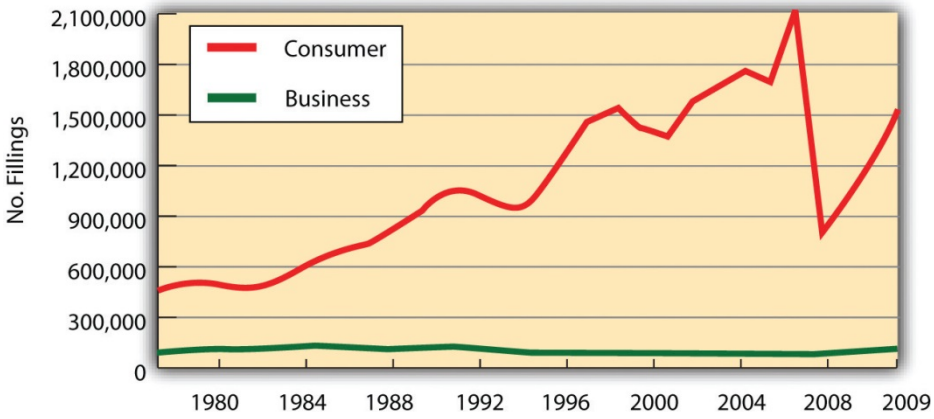
Bankruptcy Statutes

Congress passed bankruptcy laws in 1800, 1841, and 1867. These lasted only a few years each. In 1898, Congress enacted the Bankruptcy Act, which together with the Chandler Act amendments in 1938, lasted until 1978. In 1978, Congress passed the Bankruptcy Reform Act, and in 2005, it adopted the current law, the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). This law is the subject of our chapter.

At the beginning of the twentieth century, bankruptcies averaged fewer than 20,000 per year. Even in 1935, at the height of the Great Depression, bankruptcy filings in federal court climbed only to 69,000. At the end of World War II, in 1945, they stood at 13,000. From 1950 on, the statistics show a steep increase. During the decade before the 1978 changes, bankruptcy filings in court averaged 181,000 a year—reaching a high of 254,000 in 1975. They soared to over 450,000 filings per year in the 1980s and mostly

maintained that pace until just before the 2005 law took effect (see Figure 27.1 "US Bankruptcies, 1980–2009"). The 2005 act—preceded by "massive lobbying largely by banks and credit card companies"[1]—was intended by its promoters to restore personal responsibility and integrity in the bankruptcy system. The law's critics said it was simply a way for the credit card industry to extract more money from consumers before their debts were wiped away.

Figure 27.1 *US Bankruptcies, 1980–2009*



Bankruptcy Action.com,http://www.bankruptcyaction.com/USbankstats.htm, statistics from Administrative Office of the Courts.

Bankruptcy Courts, Judges, and Costs

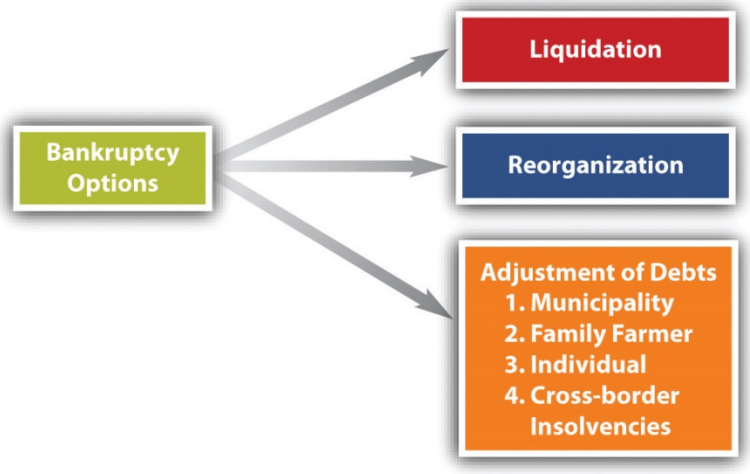
Each federal judicial district has a US Bankruptcy Court, whose judges are appointed by US Courts of Appeal. Unless both sides agree otherwise, bankruptcy judges are to hear only bankruptcy matters (called core proceedings). Bankruptcy trustees are government lawyers appointed by the US Attorney General. They have administrative responsibilities in overseeing the proceedings.

The filing fee for a bankruptcy is about $200, depending upon the type of bankruptcy, and the typical lawyer's fee for uncomplicated cases is about $1,200–$1,400.

Overview of Bankruptcy Provisions

The BAPCPA provides for six different kinds of bankruptcy proceedings. Each is covered by its own chapter in the act and is usually referred to by its chapter number (see Figure 27.2 "Bankruptcy Options").

Figure 27.2 *Bankruptcy Options*



The bankruptcy statute (as opposed to case law interpreting it) is usually referred to as the bankruptcy *code*. The types of bankruptcies are as follows:

- Chapter 7, Liquidation: applies to all debtors except railroads, insurance companies, most banks and credit unions, and homestead associations.[2] A liquidation is a "straight" bankruptcy proceeding. It entails selling the debtor's nonexempt assets for cash and distributing the cash to the creditors, thereby discharging the insolvent person or business from any further liability for the debt. About 70 percent of all bankruptcy filings are Chapter 7.
- Chapter 9, Adjustment of debts of a municipality: applies to municipalities that are insolvent and want to adjust their debts.[3] (The law does not suppose that a town, city, or county will go out of existence in the wake of insolvency.)
- Chapter 11, Reorganization: applies to anybody who could file Chapter 7, plus railroads. It is the means by which a financially troubled company can continue to operate while its financial affairs are put on a sounder basis. A business might liquidate following reorganization but will probably take on new life after negotiations with creditors on how the old debt is to be paid off. A company may voluntarily decide to seek Chapter 11 protection in court, or it may be forced involuntarily into a Chapter 11 proceeding.

- Chapter 12, Adjustment of debts of a family farmer or fisherman with regular annual income.[4] Many family farmers cannot qualify for reorganization under Chapter 13 because of the low debt ceiling, and under Chapter 11, the proceeding is often complicated and expensive. As a result, Congress created Chapter 12, which applies only to farmers whose total debts do not exceed $1.5 million.
- Chapter 13, Adjustment of debts of an individual with regular income: applies only to individuals (no corporations or partnerships) with debt not exceeding about $1.3 million.[5] This chapter permits an individual with regular income to establish a repayment plan, usually either a composition (an agreement among creditors, discussed in Section 27.5 "Alternatives to Bankruptcy", “Alternatives to Bankruptcy”) or an extension (a stretch-out of the time for paying the entire debt).
- Chapter 15, Ancillary and other cross-border cases: incorporates the United Nations’ Model Law on Cross-Border Insolvency to promote cooperation among nations involved in cross-border cases and is intended to create legal certainty for trade and investment. “Ancillary” refers to the possibility that a US debtor might have assets or obligations in a foreign country; those non-US aspects of the case are “ancillary” to the US bankruptcy case.

The BAPCPA includes three chapters that set forth the procedures to be applied to the various proceedings. Chapter 1, “General Provisions,” establishes who is eligible for relief under the act. Chapter 3, “Case Administration,” spells out the powers of the various officials involved in the bankruptcy proceedings and establishes the methods for instituting bankruptcy cases. Chapter 5, “Creditors, the Debtor, and the Estate,” deals with the debtor’s “estate”—his or her assets. It lays down ground rules for determining which property is to be included in the estate, sets out the powers of the bankruptcy trustee to “avoid” (invalidate) transactions by which the debtor sought to remove property from the estate, orders the distribution of property to creditors, and sets forth the duties and benefits that accrue to the debtor under the act.

To illustrate how these procedural chapters (especially Chapter 3 and Chapter 5) apply, we focus on the most common proceeding: liquidation (Chapter 7). Most of the principles of bankruptcy law discussed in

connection with liquidation apply to the other types of proceedings as well. However, some principles vary, and we conclude the chapter by noting special features of two other important proceedings—Chapter 13 and Chapter 11.

KEY TAKEAWAY

Bankruptcy law's purpose is to give the honest debtor a fresh start and to resolve disputes among creditors. The most recent amendments to the law were effective in 2005. Bankruptcy law provides relief to six kinds of debtors: (1) Chapter 7, straight bankruptcy—liquidation—applies to most debtors (except banks and railroads); (2) Chapter 9 applies to municipalities; (3) Chapter 11 is business reorganization; (4) Chapter 12 applies to farmers; (5) Chapter 13 is for wage earners; and (6) Chapter 15 applies to cross-border bankruptcies. The bankruptcy statutes also have several chapters that cover procedures of bankruptcy proceedings.

EXERCISES

1. Why is bankruptcy law required in a modern capitalistic society?
2. Who does the bankruptcy trustee represent?
3. The three most commonly filed bankruptcies are Chapter 7, 11, and 13. Who gets relief under those chapters?

---

[1] CCH Bankruptcy Reform Act Briefing, "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005," April 2005, http://www.cch.com/bankruptcy/bankruptcy_04-21.pdf.

[2] 11 United States Code, Section 109(b).

[3] 11 United States Code, Section 109(c).

CC BY NC SA

[4] 11 United States Code, Section 109(f).

[5] 11 United States Code, Section 109(e).

27.2 Case Administration; Creditors' Claims; Debtors' Exemptions and Dischargeable Debts; Debtor's Estate

LEARNING OBJECTIVES

1. Understand the basic procedures involved in administering a bankruptcy case.
2. Recognize the basic elements of creditors' rights under the bankruptcy code.
3. Understand the fundamentals of what property is included in the debtor's estate.
4. Identify some of the debtor's exemptions—what property can be kept by the debtor.
5. Know some of the debts that cannot be discharged in bankruptcy.
6. Know how an estate is liquidated under Chapter 7.

Case Administration (Chapter 3 of the Bankruptcy Code)

Recall that the purpose of liquidation is to convert the debtor's assets—except those exempt under the law—into cash for distribution to the creditors and thereafter to discharge the debtor from further liability. With certain exceptions, any person may voluntarily file a petition to liquidate under Chapter 7. A "person" is defined as any individual, partnership, or corporation. The exceptions are railroads and insurance companies, banks, savings and loan associations, credit unions, and the like.

For a Chapter 7 liquidation proceeding, as for bankruptcy proceedings in general, the various aspects of case administration are covered by the bankruptcy code's Chapter 3. These include the rules governing commencement of the proceedings, the effect of the petition in bankruptcy, the first meeting of the creditors, and the duties and powers of trustees.

Commencement

The bankruptcy begins with the filing of a petition in bankruptcy with the bankruptcy court.

Voluntary and Involuntary Petitions

The individual, partnership, or corporation may file a voluntary petition in bankruptcy; 99 percent of bankruptcies are voluntary petitions filed by the debtor. But involuntary bankruptcy is possible, too, under Chapter 7 or Chapter 11. To put anyone into bankruptcy involuntarily, the petitioning creditors must meet three conditions: (1) they must have claims for unsecured debt amounting to at least $13,475; (2) three creditors must join in the petition whenever twelve or more creditors have claims against the particular debtor—otherwise, one creditor may file an involuntary petition, as long as his claim is for at least $13,475; (3) there must be no bona fide dispute about the debt owing. If there is a dispute, the debtor can resist the involuntary filing, and if she wins the dispute, the creditors who pushed for the involuntary petition have to pay the associated costs. Persons owing less than $13,475, farmers, and charitable organizations cannot be forced into bankruptcy.

The Automatic Stay

The petition—voluntary or otherwise—operates as a **stay** against suits or other actions against the debtor to recover claims, enforce judgments, or create liens (but not alimony collection). In other words, once the petition is filed, the debtor is freed from worry over other proceedings affecting her finances or property. No more debt collection calls! Anyone with a claim, secured or unsecured, must seek relief in the bankruptcy court. This provision in the act can have dramatic consequences. Beset by tens of thousands of products-liability suits for damages caused by asbestos, UNR Industries and Manville Corporation, the nation's largest asbestos producers, filed (separate) voluntary bankruptcy petitions in 1982; those filings automatically stayed all pending lawsuits.

First Meeting of Creditors

Once a petition in bankruptcy is filed, the court issues an **order of relief**, which determines that the debtor's property is subject to bankruptcy court control and creates the stay. The Chapter 7 case may be dismissed by the court if, after a notice and hearing, it finds that among other things (e.g., delay,

nonpayment of required bankruptcy fees), the debts are primarily consumer debts and the debtor could pay them off—that's the 2005 act's famous "means test," discussed in Section 27.3 "Chapter 7 Liquidation".

Assuming that the order of relief has been properly issued, the creditors must meet within a reasonable time. The debtor is obligated to appear at the meeting and submit to examination under oath. The judge does not preside and, indeed, is not even entitled to attend the meeting.

When the judge issues an order for relief, an interim trustee is appointed who is authorized initially to take control of the debtor's assets. The trustee is required to collect the property, liquidate the debtor's estate, and distribute the proceeds to the creditors. The trustee may sue and be sued in the name of the estate. Under every chapter except Chapter 7, the court has sole discretion to name the trustee. Under Chapter 7, the creditors may select their own trustee as long as they do it at the first meeting of creditors and follow the procedures laid down in the act.

Trustee's Powers and Duties

The act empowers the trustee to use, sell, or lease the debtor's property in the ordinary course of business or, after notice and a hearing, even if not in the ordinary course of business. In all cases, the trustee must protect any security interests in the property. As long as the court has authorized the debtor's business to continue, the trustee may also obtain credit in the ordinary course of business. She may invest money in the estate to yield the maximum, but reasonably safe, return. Subject to the court's approval, she may employ various professionals, such as attorneys, accountants, and appraisers, and may, with some exceptions, assume or reject executory contracts and unexpired leases that the debtor has made. The trustee also has the power to avoid many prebankruptcy transactions in order to recover property of the debtor to be included in the liquidation.

Creditors' Claims, the Debtor, and the Estate (Chapter 5 of the Bankruptcy Code)

We now turn to the major matters covered in Chapter 5 of the bankruptcy act: creditors' claims, debtors' exemptions and discharge, and the property to be included in the estate. We begin with the rules governing proof of claims by creditors and the priority of their claims.

Claims and Creditors

A claim is defined as a right to payment, whether or not it is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured. A creditor is defined as a person or entity with a claim that arose no later than when the court issues the order for relief. These are very broad definitions, intended to give the debtor the broadest possible relief when finally discharged.

Proof of Claims

Before the trustee can distribute proceeds of the estate, unsecured creditors must file a **proof of claim**, prima facie evidence that they are owed some amount of money. They must do so within six months after the first date set for the first meeting of creditors. A creditor's claim is disallowed, even though it is valid, if it is not filed in a timely manner. A party in interest, such as the trustee or creditor, may object to a proof of claim, in which case the court must determine whether to allow it. In the absence of objection, the claim is "deemed allowed." The court will not allow some claims. These include unenforceable claims, claims for unmatured interest, claims that may be offset by debts the creditor owes the debtor, and unreasonable charges by an insider or an attorney. If it's a "no asset" bankruptcy—most are—creditors are in effect told by the court not to waste their time filing proof of claim.

Claims with Priority

The bankruptcy act sets out categories of claimants and establishes priorities among them. The law is complex because it sets up different orders of priorities.

First, *secured creditors* get their security interests before anyone else is satisfied, because the security interest is not part of the property that the trustee is entitled to bring into the estate. This is why being a secured creditor is important (as discussed in Chapter 25 "Secured Transactions and Suretyship"and Chapter 26 "Mortgages and Nonconsensual Liens"). To the extent that secured creditors have claims in excess of their collateral, they are considered unsecured or general creditors and are lumped in with general creditors of the appropriate class.

Second, of the six classes of claimants (see Figure 27.3 "Distribution of the Estate"), the first is known as that of "*priority claims*." It is subdivided into ten categories ranked in order of priority. The highest-priority class within the general class of priority claims must be paid off in full before the next class can share in a distribution from the estate, and so on. Within each class, members will share pro rata if there are not enough assets to satisfy everyone fully. The priority classes, from highest to lowest, are set out in the bankruptcy code (11 USC Section 507) as follows:

> *(1) Domestic support obligations ("DSO"), which are claims for support due to the spouse, former spouse, child, or child's representative, and at a lower priority within this class are any claims by a governmental unit that has rendered support assistance to the debtor's family obligations.*
>
> *(2) Administrative expenses that are required to administer the bankruptcy case itself. Under former law, administrative expenses had the highest priority, but Congress elevated domestic support obligations above administrative expenses with the passage of the BAPCPA. Actually, though, administrative expenses have a de facto priority over domestic support obligations, because such expenses are deducted before they are paid to DSO recipients. Since trustees are paid from the bankruptcy estate, the courts have allowed de facto top priority for administrative expenses because no trustee is going to administer a bankruptcy case for nothing (and no lawyer will work for long without getting paid, either).*
>
> *(3) Gap creditors. Claims made by* ***gap creditors*** *in an involuntary bankruptcy petition under Chapter 7 or Chapter 11 are those that arise between the filing of an involuntary bankruptcy petition and the order for relief issued by the court. These claims are given priority because otherwise creditors would not deal with the debtor, usually a business, when the business has declared bankruptcy but no trustee has been appointed and no order of relief issued.*
>
> *(4) Employee wages up to $10,950 for each worker, for the 180 days previous to either the bankruptcy filing or when the business ceased operations, whichever is earlier (180-day period).*

(5) Unpaid contributions to employee benefit plans during the 180-day period, but limited by what was already paid by the employer under subsection (4) above plus what was paid on behalf of the employees by the bankruptcy estate for any employment benefit plan.
(6) Any claims for grain from a grain producer or fish from a fishermanfor up to $5,400 each against a storage or processing facility.

(7) Consumer layaway deposits of up to $2,425 each.

(8) Taxes owing to federal, state, and local governments for income, property, employment and excise taxes. Outside of bankruptcy, taxes usually have a higher priority than this, which is why many times creditors—not tax creditors—file an involuntary bankruptcy petition against the debtor so that they have a higher priority in bankruptcy than they would outside it.

(9) Allowed claims based on any commitment by the debtor to a federal depository institution to maintain the capital of an insured depository institution.

(10) Claims for death or personal injury from a motor vehicle or vessel that occurred while the debtor was legally intoxicated.

Third through sixth (after secured creditors and priority claimants), other claimants are attended to, but not immediately. The bankruptcy code (perhaps somewhat awkwardly) deals with who gets paid when in more than one place. Chapter 5 sets out priority *claims* as just noted; that order applies to *all*bankruptcies. Chapter 7, dealing with liquidation (as opposed to Chapter 11 and Chapter 13, wherein the debtor pays most of her debt), then lists the order of*distribution*. Section 726 of 11 United States Code provides: “Distribution of property of the estate. (1) First, in payment of claims of the kind specified in, and in the order specified in section 507...” (again, the priority of claims just set out). Following the order specified in the bankruptcy code, our discussion of the order of distribution is taken up in Section 27.3 "Chapter 7 Liquidation".

Debtor's Duties and Exemptions

The act imposes certain duties on the debtor, and it exempts some property that the trustee can accumulate and distribute from the estate.

Debtor's Duties

The debtor, reasonably enough, is supposed to file a list of creditors, assets, liabilities, and current income, and a statement of financial affairs. The debtor must cooperate with the trustee and be an "honest debtor" in general; the failure to abide by these duties is grounds for a denial of discharge.

The individual debtor (not including partnerships or corporations) also must show evidence that he or she attended an approved nonprofit budget and counseling agency within 180 days before the filing. The counseling may be "an individual or group briefing (including a briefing conducted by telephone or on the Internet) that outline[s] the opportunities for available credit counseling and assisted such individual in performing a related budget analysis." [1] In Section 111, the 2005 act describes who can perform this counseling, and a host of regulations and enforcement mechanisms are instituted, generally applying to persons who provide goods or services related to bankruptcy work for consumer debtors whose nonexempt assets are less than $150,000, in order to improve the professionalism of attorneys and others who work with debtors in, or contemplating, bankruptcy. A debtor who is incapacitated, disabled, or on active duty in a military zone doesn't have to go through the counseling.

Debtor's Exemptions

The bankruptcy act exempts certain property of the estate of an individual debtor so that he or she will not be impoverished upon discharge. Exactly what is exempt depends on state law.

Notwithstanding the Constitution's mandate that Congress establish "uniform laws on the subject of bankruptcies," bankruptcy law is in fact not uniform because the states persuaded Congress to allow

nonuniform exemptions. The concept makes sense: what is necessary for a debtor in Maine to live a nonimpoverished postbankruptcy life might not be the same as what is necessary in southern California. The bankruptcy code describes how a person's residence is determined for claiming state exemptions: basically, where the debtor lived for 730 days immediately before filing or where she lived for 180 days immediately preceding the 730-day period. For example, if the debtor resided in the same state, without interruption, in the two years leading up to the bankruptcy, he can use that state's exemptions. If not, the location where he resided for a majority of the half-year preceding the initial two years will be used. The point here is to reduce "exemption shopping"—to reduce the incidences in which a person moves to a generous exemption state only to declare bankruptcy there.

Unless the state has opted out of the federal exemptions (a majority have), a debtor can choose which exemptions to claim.[2] There are also some exemptions not included in the bankruptcy code: veteran's, Social Security, unemployment, and disability benefits are outside the code, and alimony payments are also exempt under federal law. The federal exemptions can be doubled by a married couple filing together.

Here are the federal exemptions:[3]

Homestead:

- *Real property, including mobile homes and co-ops, or burial plots up to $20,200. Unused portion of homestead, up to $10,125, may be used for other property.*

Personal Property:

- *Motor vehicle up to $3,225.*
- *Animals, crops, clothing, appliances and furnishings, books, household goods, and musical instruments up to $525 per item, and up to $10,775 total.*
- *Jewelry up to $1,350.*
- *$1,075 of any property, and unused portion of homestead up to $10,125.*
- *Health aids.*
- *Wrongful death recovery for person you depended upon.*

CC BY NC SA

- *Personal injury recovery up to $20,200 except for pain and suffering or for pecuniary loss.*
- *Lost earnings payments.*

Pensions:

- *Tax exempt retirement accounts; IRAs and Roth IRAs up to $1,095,000 per person.*

Public Benefits:

- *Public assistance, Social Security, Veteran's benefits, Unemployment Compensation.*
- *Crime victim's compensation.*

Tools of Trade:

- *Implements, books, and tools of trade, up to $2,025.*

Alimony and Child Support:

- *Alimony and child support needed for support.*

Insurance:

- *Unmatured life insurance policy except credit insurance.*
- *Life insurance policy with loan value up to $10,775.*
- *Disability, unemployment, or illness benefits.*
- *Life insurance payments for a person you depended on, which you need for support.*

In the run-up to the 2005 changes in the bankruptcy law, there was concern that some states—especially Florida[4]—had gone too far in giving debtors' exemptions. The BAPCPA amended Section 522 to limit the amount of equity a debtor can exempt, even in a state with unlimited homestead exemptions, in certain circumstances. (Section 522(o) and (p) set out the law's changes.)

Secured Property

As already noted, secured creditors generally have priority, even above the priority claims. That's why banks and lending institutions almost always secure the debtor's obligations. But despite the general rule, the debtor can avoid certain types of security interests. Liens that attach to assets that the debtor is entitled to claim as exempt can be avoided to the extent the lien impairs the value of the exemption in both Chapter 13 and Chapter 7. To be avoidable, the lien must be a judicial lien (like a judgment or a garnishment), or a nonpossessory, non-purchase-money security interest in household goods or tools of the trade.

Tax liens (which are statutory liens, not judicial liens) aren't avoidable in Chapter 7 even if they impair exemptions; tax liens can be avoided in Chapter 13 to the extent the lien is greater than the asset's value.

Dischargeable and Nondischargeable Debts

The whole point of bankruptcy, of course, is for debtors to get relief from the press of debt that they cannot reasonably pay.

Dischargeable Debts

Once discharged, the debtor is no longer legally liable to pay any remaining unpaid debts (except nondischargeable debts) that arose before the court issued the order of relief. The discharge operates to void any money judgments already rendered against the debtor and to bar the judgment creditor from seeking to recover the judgment.

Nondischargeable Debts

Some debts are not dischargeable in bankruptcy. A bankruptcy discharge varies, depending on the type of bankruptcy the debtor files (Chapter 7, 11, 12, or 13). The most common nondischargeable debts listed in Section 523 include the following:

- All debts not listed in the bankruptcy petition
- Student loans—unless it would be an undue hardship to repay them (seeSection 27.6 "Cases", *In re Zygarewicz*)

- Taxes—federal, state, and municipal
- Fines for violating the law, including criminal fines and traffic tickets
- Alimony and child support, divorce, and other property settlements
- Debts for personal injury caused by driving, boating, or operating an aircraft while intoxicated
- Consumer debts owed to a single creditor and aggregating more than $550 for luxury goods or services incurred within ninety days before the order of relief
- Cash advances aggregating more than $825 obtained by an individual debtor within ninety days before the order for relief
- Debts incurred because of fraud or securities law violations
- Debts for willful injury to another's person or his or her property
- Debts from embezzlement

This is not an exhaustive list, and as noted in Section 27.3 "Chapter 7 Liquidation", there are some circumstances in which it is not just certain debts that aren't dischargeable: sometimes a discharge is denied entirely.

Reaffirmation

A debtor may reaffirm a debt that was discharged. Section 524 of the bankruptcy code provides important protection to the debtor intent on doing so. No **reaffirmation** is binding unless the reaffirmation was made *prior* to the granting of the discharge; the reaffirmation agreement must contain a clear and conspicuous statement that advises the debtor that the agreement is not required by bankruptcy or nonbankruptcy law and that the agreement may be rescinded by giving notice of rescission to the holder of such claim at any time prior to discharge or within sixty days after the agreement is filed with the court, whichever is later.

A written agreement to reaffirm a debt must be filed with the bankruptcy court. The attorney for the debtor must file an affidavit certifying that the agreement represents a fully informed and voluntary agreement, that the agreement does not impose an undue hardship on the debtor or a dependent of the debtor, and that the attorney has fully advised the debtor of the legal consequences of the agreement and

of a default under the agreement. Where the debtor is an individual who was not represented by an attorney during the course of negotiating the agreement, the reaffirmation agreement must be approved by the court, after disclosures to the debtor, and after the court finds that it is in the best interest of the debtor and does not cause an undue hardship on the debtor or a dependent.

Property Included in the Estate

When a bankruptcy petition is filed, a **debtor's estate** is created consisting of all the debtor's then-existing property interests, whether legal or equitable. In addition, the estate includes any bequests, inheritances, and certain other distributions of property that the debtor receives within the next 180 days. It also includes property recovered by the trustee under certain powers granted by the law. What is not exempt property will be distributed to the creditors.

The bankruptcy code confers on the trustee certain powers to recover property for the estate that the debtor transferred before bankruptcy.

One such power (in Section 544) is to act as a **hypothetical lien creditor**. This power is best explained by an example. Suppose Dennis Debtor purchases equipment on credit from Acme Supply Company. Acme fails to perfect its security interest, and a few weeks later Debtor files a bankruptcy petition. By virtue of the section conferring on the trustee the status of a hypothetical lien creditor, the trustee can act as though she had a lien on the equipment, with priority over Acme's unperfected security interest. Thus the trustee can avoid Acme's security interest, with the result that Acme would be treated as an unsecured creditor.

Another power is to avoid transactions known as **voidable preferences**—transactions highly favorable to particular creditors.[5] A transfer of property is voidable if it was made (1) to a creditor or for his benefit, (2) on account of a debt owed before the transfer was made, (3) while the debtor was insolvent, (4) on or within ninety days before the filing of the petition, and (5) to enable a creditor to receive more than he would have under Chapter 7. If the creditor was an "insider"—one who had a special relationship with the debtor, such as a relative or general partner of the debtor or a corporation that the debtor

controls or serves in as director or officer—then the trustee may void the transaction if it was made within one year of the filing of the petition, assuming that the debtor was insolvent at the time the transaction was made.

Some prebankruptcy transfers that seem to fall within these provisions do not. The most important exceptions are (1) transfers made for new value (the debtor buys a refrigerator for cash one week before filing a petition; this is an exchange for new value and the trustee may not void it); (2) a transfer that creates a purchase-money security interest securing new value if the secured party perfects within ten days after the debtor receives the goods; (3) payment of a debt incurred in the ordinary course of business, on ordinary business terms; (4) transfers totaling less than $600 by an individual whose debts are primarily consumer debts; (5) transfers totaling less than $5,475 by a debtor whose debts are not primarily consumer debts; and (6) transfers to the extent the transfer was a bona fide domestic support obligation.

A third power of the trustee is to avoid **fraudulent transfers** made within two years before the date that the bankruptcy petition was filed.[6] This provision contemplates various types of fraud. For example, while insolvent, the debtor might transfer property to a relative for less than it was worth, intending to recover it after discharge. This situation should be distinguished from the voidable preference just discussed, in which the debtor pays a favored creditor what he actually owes but in so doing cannot then pay other creditors.

KEY TAKEAWAY

A bankruptcy commences with the filing of a petition of bankruptcy. Creditors file proofs of claim and are entitled to certain priorities: domestic support obligations and the costs of administration are first. The debtor has an obligation to file full and truthful schedules and to attend a credit counseling session, if applicable. The debtor has a right to claim exemptions, federal or state, that leave her with assets sufficient to make a fresh

start: some home equity, an automobile, and clothing and personal effects, among others. The honest debtor is discharged of many debts, but some are nondischargeable, among them taxes, debt from illegal behavior (embezzlement, drunk driving), fines, student loans, and certain consumer debt. A debtor may, after proper counseling, reaffirm debt, but only before filing. The bankruptcy trustee takes over the nonexempt property of the debtor; he may act as a hypothetical lien creditor (avoiding unperfected security interests) and avoid preferential and fraudulent transfers that unfairly diminish the property of the estate.

EXERCISES

1. What is the automatic stay, and when does it arise?
2. Why are the expenses of claimants administering the bankruptcy given top priority (notwithstanding the nominal top priority of domestic support obligations)?
3. Why are debtor's exemptions not uniform? What sorts of things are exempt from being taken by the bankruptcy trustee, and why are such exemptions allowed?
4. Some debts are nondischargeable; give three examples. What is the rationale for disallowing some debts from discharge?
5. How does the law take care that the debtor is fully informed of the right *not*to reaffirm debts, and why is such care taken?
6. What is a hypothetical lien creditor? What is the difference between a preferential transfer and a fraudulent one? Why is it relevant to discuss these three things in the same paragraph?

---

[1] 11 United States Code, Section 109(h).

[2] These are the states that allow residents to chose either federal or state exemptions (the other states mandate the use of state exemptions only): Arkansas, Connecticut, District of Columbia, Hawaii, Kentucky, Massachusetts, Michigan, Minnesota, New Hampshire, New Jersey, New Mexico, Pennsylvania, Rhode Island, Texas, Vermont, Washington, and Wisconsin.

[3] 11 United States Code, Section 522.

[4] The Florida homestead exemption is "[r]eal or personal property, including mobile or modular home and condominium, to unlimited value. Property cannot exceed: 1/2 acre in a municipality, or 160 acres elsewhere." The 2005 act limits the state homestead exemptions, as noted.

[5] 11 United States Code, Section 547.

[6] 11 United States Code, Section 548.

27.3 Chapter 7 Liquidation

LEARNING OBJECTIVES

1. Recognize the grounds for a Chapter 7 case to be dismissed.
2. Be familiar with the BAPCPA's means-testing requirements before Chapter 7 discharge is granted.
3. Know under what circumstances a debtor will be denied discharge.
4. Understand the order of distribution of the debtor's estate under Chapter 7.

Trustee's Duties under Chapter 7; Grounds for Dismissal: The Means Test

Except as noted, the provisions discussed up until now apply to each type of bankruptcy proceeding. The following discussion is limited to certain provisions under Chapter 7.

Trustee's Duties

In addition to the duties already noted, the trustee has other duties under Chapter 7. He must sell the property for money, close up the estate "as expeditiously as is compatible with the best interests of parties in interest," investigate the debtor's financial affairs, examine proofs of claims, reject improper ones, oppose the discharge of the debtor where doing so is advisable in the trustee's opinion, furnish a creditor with information about the estate and his administration (unless the court orders otherwise), file tax reports if the business continues to be operated, and make a final report and file it with the court.

Conversion

Under Section 706 of the bankruptcy code, the debtor may convert a Chapter 7 case to Chapter 11, 12, or 13 at any time. The court may order a **conversion** to Chapter 11 at any time upon request of a party in interest and after notice and hearing. And, as discussed next, a case may be converted from Chapter 7 to Chapter 13 if the debtor agrees, or be dismissed if he does not, in those cases where the debtor makes too much money to be discharged without it being an "abuse" under the 2005 act.

Dismissal

The court may dismiss a case for three general reasons.

The first reason is "for cause," after notice and a hearing for cause, including (1) unreasonable delay by the debtor that prejudices creditors, (2) nonpayment of any fees required, (3) failure to file required documents and schedules.

The second reason for dismissal (or, with the debtor's permission, conversion to Chapter 11 or 13) applies to debtors whose debt is primarily consumer debt: the court may—after notice and a hearing—dismiss a case if granting relief would be "an abuse of the provisions" of the bankruptcy code.

The third reason for dismissal is really the crux of the 2005 law: under it, the court will find that granting relief under Chapter 7 to a debtor whose debt is primarily consumer debt *is* "an abuse" if the debtor makes too much money. The debtor must pass a means test: If he's poor enough, he can go Chapter 7. If he is not poor enough (or if they are not, in case of a married couple), Chapter 13—making payments to creditors—is the way to go. Here is one practitioner's explanation of the means test:

> *To apply the means test, the courts will look at the debtor's average income for the 6 months prior to filing [not the debtor's income at the time of filing, when—say—she just lost her job] and compare it to the median income for that state. For example, the median annual income for a single wage-earner in California is $42,012. If the income is below the median, then Chapter 7 remains open as an option. If the income exceeds the median, the remaining parts of the means test will be applied.*

The next step in the calculation takes monthly income less reasonable living expenses ["reasonable living expenses" are strictly calculated based on IRS standards; the figure excludes payments on the debts included in the bankruptcy], and multiplies that figure times 60. This represents the amount of income available over a 5-year period for repayment of the debt obligations.

If the income available for debt repayment over that 5-year period is $10,000 or more, then Chapter 13 will be required. In other words, anyone earning above the state median, and with at least $166.67 per month ($10,000 divided by 60) of available income, will automatically be denied Chapter 7. So for example, if the court determines that you have $200 per month income above living expenses, $200 times 60 is $12,000. Since $12,000 is above $10,000, you're stuck with Chapter 13.

What happens if you are above the median income but do NOT have at least $166.67 per month to pay toward your debts? Then the final part of the means test is applied. If the available income is less than $100 per month, then Chapter 7 again becomes an option. If the available income is between $100 and $166.66, then it is measured against the debt as a percentage, with 25% being the benchmark.

In other words, let's say your income is above the median, your debt is $50,000, and you only have $125 of available monthly income. We take $125 times 60 months (5 years), which equals $7,500 total. Since $7,500 is less than 25% of your $50,000 debt, Chapter 7 is still a possible option for you. If your debt was only $25,000, then your $7,500 of available income would exceed 25% of your debt and you would be required to file under Chapter 13.

To sum up, first figure out whether you are above or below the median income for your state—median income figures are available athttp://www.new-bankruptcy-law-info.com. Be sure to account for your spouse's income if you are a two-income family. Next, deduct your average

CC BY NC SA

monthly living expenses from your monthly income and multiply by 60. If the result is above $10,000, you're stuck with Chapter 13. If the result is below $6,000, you may still be able to file Chapter 7. If the result is between $6,000 and $10,000, compare it to 25% of your debt. Above 25%, you're looking at Chapter 13 for sure.[1]

The law also requires that attorneys sign the petition (as well as the debtor); the attorney's signature certifies that the petition is well-grounded in fact and that the attorney has no knowledge after reasonable inquiry that the schedules and calculations are incorrect. Attorneys thus have an incentive to err in favor of filing Chapter 13 instead of Chapter 7 (perhaps that was part of Congress's purpose in this section of the law).

If there's been a **dismissal**, the debtor and creditors have the same rights and remedies as they had prior to the case being commenced—as if the case had never been filed (almost). The debtor can refile immediately, unless the court orders a 120-day penalty (for failure to appear). In most cases, a debtor can file instantly for a Chapter 13 following a Chapter 7 dismissal.

Distribution of the Estate and Discharge; Denying Discharge

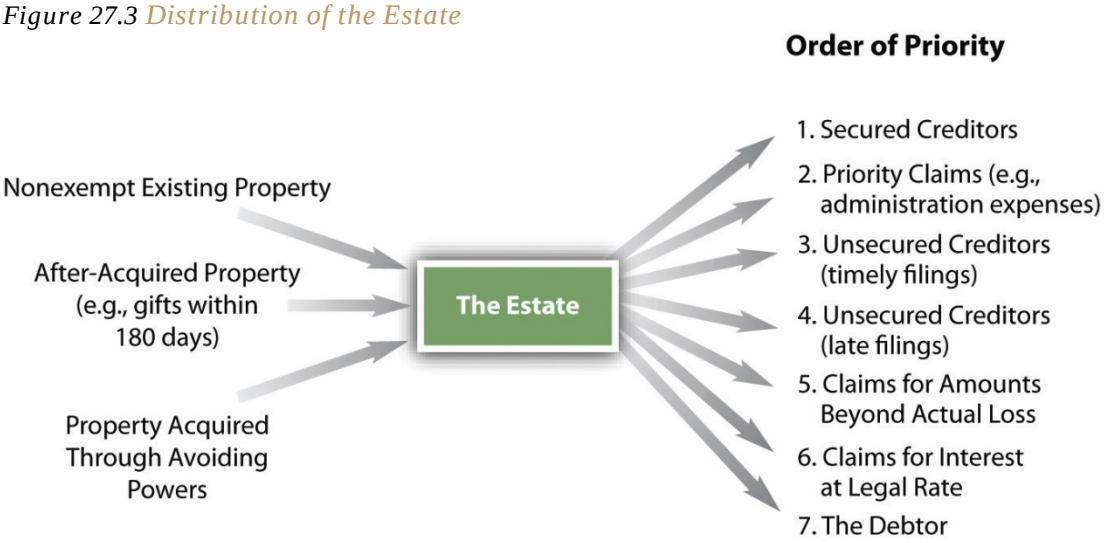
Distribution of the Estate

The estate includes all his or her assets or all their assets (in the case of a married couple) broadly defined. From the estate, the debtor removes property claimed exempt; the trustee may recapture some assets improperly removed from the estate (preferential and fraudulent transfers), and what's left is the distributable estate. It is important to note that the vast majority of Chapter 7 bankruptcies are **no-asset cases**—90–95 percent of them, according to one longtime bankruptcy trustee.[2] That means creditors get nothing. But in those cases where there are assets, the trustee must distribute the estate to the remaining classes of claimants in this order:

1. Secured creditors, paid on their security interests
2. Claims with priority
3. Unsecured creditors who filed their claims on time
4. Unsecured creditors who were tardy in filing, if they had no notice of the bankruptcy

5. Unsecured creditors who were tardy and had notice, real or constructive
6. Claims by creditors for fines, penalties, and exemplary or punitive damages
7. Interest for all creditors at the legal rate
8. The debtor

Figure 27.3 Distribution of the Estate



Discharge

Once the estate is distributed, the court will order the debtor discharged (except for nondischargeable debts) unless one of the following overall exceptions applies for denying **discharge** (i.e., relief from the debt). This list is not exhaustive:

1. The debtor is not an individual. In a Chapter 7 case, a corporation or partnership does not receive a bankruptcy discharge; instead, the entity is dissolved and its assets liquidated. The debts remain theoretically valid but uncollectible until the statute of limitations on them has run. Only an individual can receive a Chapter 7 discharge.[3]
2. The debtor has concealed or destroyed property with intent to defraud, hinder, or delay within twelve months preceding filing of the petition.
3. The debtor has concealed, destroyed, or falsified books and records
4. The debtor has lied under oath, knowingly given a false account, presented or used a false claim, given or received bribes, refused to obey court orders.

5. The debtor has failed to explain satisfactorily any loss of assets.
6. The debtor has declared Chapter 7 or Chapter 11 bankruptcy within eight years, or Chapter 13 within six years (with some exceptions).
7. The debtor failed to participate in "an instructional course concerning personal financial management" (unless that's excused).
8. An individual debtor has "abused" the bankruptcy process. A preferential transfer is not an "abuse," but it will be set aside. Making too much money to file Chapter 7 is "an abuse" that will deny discharge.

A discharge may be revoked if the debtor committed fraud during the bankruptcy proceedings, but the trustee or a creditor must apply for revocation within one year of the discharge.

Having the **discharge denied** does not affect the administration of the bankruptcy case. The trustee can (and will) continue to liquidate any nonexempt assets of the debtor and pay the creditors, but the debtor still has to pay the debts left over.

As to any consequence of discharge, bankruptcy law prohibits governmental units from discriminating against a person who has gone through bankruptcy. Debtors are also protected from discrimination by private employers; for example, a private employer may not fire a debtor because of the bankruptcy. Certainly, however, the debtor's credit rating will be affected by the bankruptcy.

KEY TAKEAWAY

A Chapter 7 bankruptcy case may be dismissed for cause or because the debtor has abused the system. The debtor is automatically considered to have abused the system if he makes too much money. With the debtor's permission, the Chapter 7 may be converted to Chapter 11, 12, or 13. The law requires that the debtor pass a means test to qualify for Chapter 7. Assuming the debtor does qualify for Chapter 7, her nonexempt assets (if there are any) are sold by the trustee and distributed to creditors according to a priority set out in the law. A discharge may be denied, in general because the debtor has behaved dishonestly or—again—has abused the system.

EXERCISES

1. What is the difference between denial of a discharge for cause and denial for abuse?
2. What is the difference between a dismissal and a denial of discharge?
3. Which creditors get satisfied first in a Chapter 7 bankruptcy?

---

[1] Charles Phelan, "The New Bankruptcy Means Test Explained in Plain English,"*Buzzle.com*, http://www.buzzle.com/editorials/1-10-2006-85999.asp.

[2] Eugene Crane, Hearing before the Subcommittee on Commercial and Administrative Law of the Committee on the Judiciary, House of Representatives, One Hundred Tenth Congress, Second Session, *Statement to the House Judiciary Sub-Committee,* September 16, 2008; http://judiciary.house.gov/hearings/printers/110th/44493.PDF.

[3] 11 United States Code, Section 727(a)(1).

27.4 Chapter 11 and Chapter 13 Bankruptcies

LEARNING OBJECTIVES

1. Understand the basic concepts of Chapter 11 bankruptcies.
2. Understand the basic concepts of Chapter 13 bankruptcies.

Reorganization: Chapter 11 Bankruptcy

Overview

Chapter 11 provides a means by which corporations, partnerships, and other businesses, including sole proprietorships, can rehabilitate themselves and continue to operate free from the burden of debts that they cannot pay.

CC BY NC SA

It is simple enough to apply for the protection of the court in Chapter 11 proceeding, and for many years, large financially ailing companies have sought shelter in Chapter 11. Well-known examples include General Motors, Texaco, K-Mart, Delta Airlines, and Northwest Airlines. An increasing number of corporations have turned to Chapter 11 even though, by conventional terms, they were solvent. Doing so enables them to negotiate with creditors to reduce debt. It also may even permit courts to snuff out lawsuits that have not yet been filed. Chapters 3 and 5, discussed in Section 27.2 "Case Administration; Creditors' Claims; Debtors' Exemptions and Dischargeable Debts; Debtor's Estate", apply to Chapter 11 proceedings also. Our discussion, therefore, is limited to special features of Chapter 11.

How It Works

Eligibility

Any person eligible for discharge in Chapter 7 proceeding (plus railroads) is eligible for a Chapter 11 proceeding, except stockbrokers and commodity brokers. Individuals filing Chapter 11 must take credit counseling; businesses do not. A company may voluntarily enter Chapter 11 or may be put there involuntarily by creditors. Individuals can file Chapter 11 particularly if they have too much debt to qualify for Chapter 13 and make too much money to qualify for Chapter 7; under the 2005 act, individuals must commit future wages to creditors, just as in Chapter 13.[1]

Operation of Business

Unless a trustee is appointed, the debtor will retain possession of the business and may continue to operate with its own management. The court may appoint a trustee on request of any party in interest after notice and a hearing. The appointment may be made for cause—such as dishonesty, incompetence, or gross mismanagement—or if it is otherwise in the best interests of the creditors. Frequently, the same incompetent management that got the business into bankruptcy is left running it—that's a criticism of Chapter 11.

Creditors' Committee

The court must appoint a committee of unsecured creditors as soon as practicable after issuing the order for relief. The committee must consist of creditors willing to serve who have the seven largest claims, unless the court decides to continue a committee formed before the filing, if the committee was fairly chosen and adequately represents the various claims. The committee has several duties, including these: (1) to investigate the debtor's financial affairs, (2) to determine whether to seek appointment of a trustee or to let the business continue to operate, and (3) to consult with the debtor or trustee throughout the case.

The Reorganization Plan

The debtor may always file its own plan, whether in a voluntary or involuntary case. If the court leaves the debtor in possession without appointing a trustee, the debtor has the exclusive right to file a reorganization plan during the first 120 days. If it does file, it will then have another 60 days to obtain the creditors' acceptances. Although its exclusivity expires at the end of 180 days, the court may lengthen or shorten the period for good cause. At the end of the exclusive period, the creditors' committee, a single creditor, or a holder of equity in the debtor's property may file a plan. If the court does appoint a trustee, any party in interest may file a plan at any time.

The Bankruptcy Reform Act specifies certain features of the plan and permits others to be included. Among other things, the plan must (1) designate classes of claims and ownership interests; (2) specify which classes or interests are impaired—a claim or ownership interest is impaired if the creditor's legal, equitable, contractual rights are altered under the plan; (3) specify the treatment of any class of claims or interests that is impaired under the plan; (4) provide the same treatment of each claim or interests of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment; and (5) provide adequate means for carrying out the plan. Basically, what the plan does is provide a process for rehabilitating the company's faltering business by relieving it from repaying part of its debt and initiating reforms so that the company can try to get back on its feet.

Acceptance of the Plan

The act requires the plan to be accepted by certain proportions of each impaired class of claims and interests. A class of claims accepts the plan if creditors representing at least two-thirds of the dollar amount of claims and more than one-half the number of allowed claims vote in favor. A class of property interests accepts the plan if creditors representing two-thirds of the dollar amount of the allowed ownership interests vote in favor. Unimpaired classes of claims and interest are deemed to have accepted the plan; it is unnecessary to solicit their acceptance.

Confirmation of the Plan

The final act necessary under Chapter 11 is confirmation by the court. Once the court confirms the plan, the plan is binding on all creditors. The rules governing confirmation are complex, but in essence, they include the following requirements:

1. The plan must have been proposed in good faith. Companies must also make a good-faith attempt to negotiate modifications in their collective bargaining agreements (labor union contracts).
2. All provisions of the act must have been complied with.
3. The court must have determined that the reorganized business will be likely to succeed and be unlikely to require further financial reorganization in the foreseeable future.
4. Impaired classes of claims and interests must have accepted the plan, unless the plan treats them in a "fair and equitable" manner, in which case consent is not required. This is sometimes referred to as the cram-down provision.
5. All members of every class must have received no less value than they would have in Chapter 7 liquidation.

Discharge, Conversion

The debtor gets discharged when all payments under the plan are completed. A Chapter 11 bankruptcy may be converted to Chapter 7, with some restrictions, if it turns out the debtor cannot make the plan work.

Adjustment of Debts of an Individual with Regular Income: Chapter 13 Bankruptcy

CC BY NC SA

In General

Anyone with a steady income who is having difficulty paying off accumulated debts may seek the protection of a bankruptcy court in Chapter 13 proceeding (often called the wage earner's plan). Under this chapter, the individual debtor presents a payment plan to creditors, and the court appoints a trustee. If the creditors wind up with more under the plan presented than they would receive in Chapter 7 proceeding, then the court is likely to approve it. In general, a Chapter 13 repayment plan extends the time to pay the debt and may reduce it so that the debtor need not pay it all. Typically, the debtor will pay a fixed sum monthly to the trustee, who will distribute it to the creditors. The previously discussed provisions of Chapters 3 and 5 apply also to this chapter; therefore, the discussion that follows focuses on some unique features of Chapter 13.

People seek Chapter 13 discharges instead of Chapter 7 for various reasons: they make too much money to pass the Chapter 7 means test; they are behind on their mortgage or car payments and want to make them up over time and reinstate the original agreement; they have debts that can't be discharged in Chapter 7; they have nonexempt property they want to keep; they have codebtors on a personal debt who would be liable if the debtor went Chapter 7; they have a real desire to pay their debts but cannot do so without getting the creditors to give them some breathing room. Chapter 7 cases may always be converted to Chapter 13.

How It Works

Eligibility

Chapter 13 is voluntary only. Anyone—sole proprietorships included—who has a regular income, unsecured debts of less than $336,000, and secured debts of less than $1,010,650 is eligible to seek its protection. The debts must be unpaid and owing at the time the debtor applies for relief. If the person has more debt than that, she will have to file Chapter 11. The debtor must attend a credit-counseling class, as in Chapter 7.

The Plan

Plans are typically extensions or compositions—that is, they extend the time to pay what is owing, or they are agreements among creditors each to accept something less than the full amount owed (so that all get

something). Under Chapter 13, the stretch-out period is three to five three years. The plan must provide for payments of all future income or a sufficient portion of it to the trustee. Priority creditors are entitled to be paid in full, although they may be paid later than required under the original indebtedness. As long as the plan is being carried out, the debtor may enjoin any creditors from suing to collect the original debt.

Confirmation

Under Section 1325 of the bankruptcy code, the court must approve the plan if it meets certain requirements. These include (1) distribution of property to unsecured creditors whose claims are allowed in an amount no less than that which they would have received had the estate been liquidated under Chapter 7; (2) acceptance by secured creditors, with some exceptions, such as when the debtor surrenders the secured property to the creditor; and (3) proposal of the plan "in good faith." If the trustee or an unsecured creditor objects to confirmation, the plan must meet additional tests. For example, a plan will be approved if all of the debtor's disposable income (as defined in Section 1325) over the commitment period (three to five years) will be used to make payments under the plan.

Discharge

Once a debtor has made all payments called for in the plan, the court will discharge him from all remaining debts except certain long-term debts and obligations to pay alimony, maintenance, and support. Under former law, Chapter 13 was so broad that it permitted the court to discharge the debtor from many debts considered nondischargeable under Chapter 7, but 1994 amendments and the 2005 act made Chapter 13 less expansive. Debts dischargeable in Chapter 13, but not in Chapter 7, include debts for willful and malicious injury to property, debts incurred to pay nondischargeable tax obligations, and debts arising from property settlements in divorce or separation proceedings. (See Section 27.6 "Cases", *In re Ryan*, for a discussion of what debts are dischargeable under Chapter 13 as compared with Chapter 7.)

Although a Chapter 13 debtor generally receives a discharge only after completing all payments required by the court-approved (i.e., "confirmed") repayment plan, there are some limited circumstances under which the debtor may request the court to grant a "hardship discharge" even though the debtor has failed to complete plan payments. Such a discharge is available only to a debtor whose failure to complete plan

payments is due to circumstances beyond the debtor's control. A Chapter 13 discharge stays on the credit record for up to ten years.

A discharge may be denied if the debtor previously went through a bankruptcy too soon before filing Chapter 13, failed to act in good faith, or—with some exceptions—failed to complete a personal financial management course.

KEY TAKEAWAY

Chapter 11—frequently referred to as "corporate reorganization"—is most often used by businesses whose value as a going concern is greater than it would be if liquidated, but, with some exceptions, anyone eligible to file Chapter 7 can file Chapter 11. The business owners, or in some cases the trustee or creditors, develop a plan to pay the firm's debts over a three- to five-year period; the plan must be approved by creditors and the court. Chapter 13—frequently called the wage-earner's plan—is a similar mechanism by which a person can discharge some debt and have longer to pay debts off than originally scheduled. Under Chapter 13, people can get certain relief from creditors that they cannot get in Chapter 7.

EXERCISES

1. David Debtor is a freelance artist with significant debt that he feels a moral obligation to pay. Why is Chapter 11 his best choice of bankruptcy chapters to file under?
2. What is the practical difference between debts arising from property settlements in divorce or separation proceedings—which can be discharged under Chapter 13—and debts owing for alimony (maintenance) and child support—which cannot be discharged under Chapter 13?
3. Why would a person want to go through the long grind of Chapter 13 instead of just declaring straight bankruptcy (Chapter 7) and being done with it?

[1] 11 United States Code, Sections 1115, 1123(a)(8), and 1129(a)(15).

27.5 Alternatives to Bankruptcy

LEARNING OBJECTIVES

1. Understand that there are nonbankruptcy alternatives for debtors who cannot pay their bills in a timely way: assignment for benefit of creditors, compositions, and receiverships.
2. Recognize the reasons why these alternatives might not work.

Alternatives to Bankruptcy: Overview

Bankruptcy is a necessary thing in a capitalist economic system. As already noted, without it, few people would be willing to take business risks, and the economy would necessarily operate at a lower level (something some people might not think so bad overall). But bankruptcy, however "enlightened" society may have become about it since Victorian days, still carries a stigma. Bankruptcy filings are public information; the lists of people and businesses who declare bankruptcy are regularly published in monthly business journals. Bankruptcy is expensive, too, and both debtors and creditors become enmeshed in significantly complex federal law. For these reasons, among others, both parties frequently determine it is in their best interest to find an alternative to bankruptcy. Here we take up briefly three common alternatives.

In other parts of this book, other nonbankruptcy creditors' rights are discussed: under the Uniform Commercial Code (UCC), creditors have rights to reclaim goods sold and delivered but not paid for; under

the UCC, too, creditors have a right to repossess personal property that has been put up as collateral for the debtor's loan or extension of credit; and mortgagees have the right to repossess real estate without judicial assistance in many circumstances. These nonbankruptcy remedies are governed mostly by state law.

The nonbankruptcy alternatives discussed here are governed by state law also.

Assignment for Benefit of Creditors; Compositions; Receivership

Assignment for Benefit of Creditors

Under a common-law **assignment for the benefit of creditors**, the debtor transfers some or all of his assets to a trustee—usually someone appointed by the adjustment bureau of a local credit managers' association—who sells the assets and apportions the proceeds in some agreed manner, usually pro rata, to the creditors. Of course, not every creditor need agree with such a distribution. Strictly speaking, the common-law assignment does not discharge the balance of the debt. Many state statutes attempt to address this problem either by prohibiting creditors who accept a partial payment of debt under an assignment from claiming the balance or by permitting debtors to demand a release from creditors who accept partial payment.

Composition

A **composition** is simply an agreement by creditors to accept less than the full amount of the debt and to discharge the debtor from further liability. As a contract, composition requires consideration; the mutual agreement among creditors to accept a pro rata share of the proceeds is held to be sufficient consideration to support the discharge. The essential difference between assignment and composition lies in the creditors' agreement: an assignment implies no agreement among the creditors, whereas a composition does. Not all creditors of the particular debtor need agree to the composition for it to be valid. A creditor who does not agree to the composition remains free to attempt to collect the full sum owed; in particular, a creditor not inclined to compose the debt could attach the debtor's assets while other creditors are bargaining over the details of the composition agreement.

One advantage of the assignment over the composition is that in the former the debtor's assets—having been assigned—are protected from attachment by hungry creditors. Also, the assignment does not require creditors' consent. However, an advantage to the debtor of the assignment (compared with the composition) is that in the composition creditors cannot go after the debtor for any deficiency (because they agreed not to).

Receivership

A creditor may petition the court to appoint a receiver; **receivership** is a long-established procedure in equity whereby the receiver takes over the debtor's property under instructions from the court. The receiver may liquidate the property, continue to operate the business, or preserve the assets without operating the business until the court finally determines how to dispose of the debtor's property.

The difficulty with most of the alternatives to bankruptcy lies in their voluntary character: a creditor who refuses to go along with an agreement to discharge the debtor can usually manage to thwart the debtor and her fellow creditors because, at the end of the day, the US Constitution forbids the states from impairing private citizens' contractual obligations. The only final protection, therefore, is to be found in the federal bankruptcy law.

KEY TAKEAWAY

Bankruptcy is expensive and frequently convoluted. Nonbankruptcy alternatives include assignment for the benefit of creditors (the debtor's assets are assigned to a trustee who manages or disposes of them for creditors), compositions (agreements by creditors to accept less than they are owed and to discharge the debtor from further liability), and receivership (a type of court-supervised assignment).

EXERCISES

1. What is an assignment for benefit of creditors?
2. What is a composition?

3. What is a receivership?
4. Why are these alternatives to bankruptcy often unsatisfactory?

27.6 Cases

Dischargeability of Student Loans under Chapter 7

In re Zygarewicz

423 B.R. 909 (Bkrtcy.E.D.Cal. 2010)

MCMANUS, BANKRUPTCY JUDGE.

Angela Zygarewicz, a chapter 7 debtor and the plaintiff in this adversary proceeding, borrowed 16 government-guaranteed student [sic] loans totaling $81,429. The loans have been assigned to Educational Credit Management Corporation ("ECMC"). By September 2009, the accrual of interest on these student loans had caused the debt to balloon to more than $146,000. The debtor asks the court to declare that these student loans were discharged in bankruptcy.

The Bankruptcy Code provides financially distressed debtors with a fresh start by discharging most of their pre-petition debts....However, under 11 U.S.C. § 523(a)(8), there is a presumption that educational loans extended by or with the aid of a governmental unit or nonprofit institution are nondischargeable unless the debtor can demonstrate that their repayment would be an undue hardship. See [Citation]. This exception to a bankruptcy discharge ensures that student loans, which are typically extended solely on the basis of the student's future earnings potential, cannot be discharged by recent graduates who then pocket all of the future benefits derived from their education. See [Citation].

The debtor bears the burden of proving by a preponderance of the evidence that she is entitled to a discharge of the student loan. See [Citation]. That is, the debtor must prove that repayment of student loans will cause an undue hardship.

The Bankruptcy Code does not define "the undue hardship." Courts interpreting section 523(a)(8), however, have concluded that undue hardship [and] is something more than "garden-variety hardship." [Citation.] Only cases involving "real and substantial" hardship merit discharges. See [Citation.]

The Ninth Circuit has adopted a three-part test to guide courts in their attempts to determine whether a debtor will suffer an undue hardship is required to repay a student loan:

- First, the debtor must establish "that she cannot maintain, based on current income and expenses, a 'minimal' standard of living for herself and her dependents if forced to repay the loans."...
- Second, the debtor must show "that additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans."...
- The third prong requires "that the debtor has made good faith efforts to repay the loans...."

(*Pena*, citing *Brunner v. N.Y. State Higher Educ. Servs. Corp.*, [Citation]).

Debtor must satisfy all three parts of the *Brunner* test before her student loans can be discharged. Failure to prove any of the three prongs will defeat a debtor's case.

When this bankruptcy case was filed in September 2005, the debtor was a single woman and had no dependents. She is 39 years old.

Schedule I reported that the debtor was unemployed. The debtor's responses to the Statement of Financial Affairs revealed that she had received $5,500 in income during 2005 prior to the filing of the petition.

Evidence at trial indicated that after the petition was filed, the debtor found work and earned a total of $9,424 in 2005. In 2004 and 2003, she earned $13,994 and $17,339, respectively.
Despite this modest income, the debtor did not immediately file an adversary proceeding to determine the dischargeability of her student loans. It was almost three years after the entry of her chapter 7 discharge 'on January 3, 2006 that the debtor reopened her chapter 7 case in order to pursue this adversary proceeding.'

In her complaint, the debtor admits that after she received a discharge, she found part-time work with a church and later took a full-time job as a speech therapist. During 2006, the debtor earned $20,009 and in 2007 she earned $37,314. Hence, while it is clear the debtor's income was very modest in the time period immediately prior to her bankruptcy petition, her financial situation improved during her bankruptcy case.

The court cannot conclude based on the evidence of the debtor's financial circumstances up to the date of the discharge, that she was unable to maintain a minimal standard of living if she was required to repay her students [sic] loans.

However, in January 2007, the debtor was injured in an automobile accident. Her injuries eventually halted the financial progress she had been making and eventually prevented her from working. She now subsists on social security disability payments.

The circumstance creating the debtor's hardship, the automobile accident, occurred after her chapter 7 petition was filed, indeed, approximately one year after her discharge was entered. The debtor is maintaining that this post-petition, post-discharge circumstance warrants a declaration that her student loans were discharged effective from the petition date.

When must the circumstances creating a debtor's hardship arise: before the bankruptcy case is filed; after the case if filed but prior to the entry of a discharge; or at anytime, including after the entry of a discharge?

The court concludes that the circumstances causing a chapter 7 debtor's financial hardship must arise prior to the entry of the discharge. If the circumstances causing a debtor's hardship arise after the entry of a discharge, those circumstances cannot form the basis of a determination that repayment of a student loan will be an undue hardship....

[T]here is nothing in the Bankruptcy Code requiring that a complaint under section 523(a)(8) [to discharge student loans] be filed at any particular point in a bankruptcy case, whether it is filed under chapter 7 or 13. [Relevant Federal Rules of Bankruptcy Procedure] permits such dischargeability complaints to be brought at any time, including after the entry of a discharge and the closing of the bankruptcy case....

While a debtor's decision to file an action to determine the dischargeability of a student loan is not temporally constrained, this does not mean that a debtor's financial hardship may arise after a discharge has been entered.

[The] *Coleman* [case, cited by debtor] deals with the ripeness of a dispute concerning the dischargeability of a student loan. [The Ninth Circuit held that it] is ripe for adjudication at any point during the case. The Ninth Circuit did not conclude, however, that a debtor could rely upon post-discharge circumstances to establish undue hardship. In fact, the court in *Coleman* made clear that the debtor could take a snapshot of the hardship warranting a discharge of a student loan any time *prior* to discharge. [*Coleman* was a Chapter 13 case.]

Here, the debtor was injured in an automobile accident on January 17, 2007, almost exactly one year after her January 3, 2006 chapter 7 discharge. Because the accident had no causal link to the misfortune prompting the debtor to seek bankruptcy relief in the first instance, the accident cannot be relied on to justify the discharge of the student loans because repayment would be an undue hardship.

To hold otherwise would mean that a bankruptcy discharge is a perpetual license to discharge student loans based on events that occur years after the bankruptcy discharge is granted. If a discharged debtor suffers later financial misfortune, that debtor must consider seeking another discharge subject to the limitations imposed by [the sections of the code stipulating how often a person can petition for bankruptcy]. In the context of a second case, the debtor could then ask that the student loan be declared dischargeable under section 523(a)(8).

In this instance, the debtor is now eligible for a discharge in a chapter 13 case. Her chapter 7 petition was filed on September 19, 2005. Section 1328(f)(1) bars a chapter 13 discharge when the debtor has received a chapter 7 discharge in a case commenced in the prior four years. She would not be eligible for a chapter 7 discharge until September 19, 2013.

This is not to say that post-discharge events are irrelevant. The second and third prongs of the *Pena* test require the court to consider whether the circumstances preventing a debtor from repaying a student loan are likely to persist, and whether the debtor has made good faith efforts to repay the student loan. Post-discharge events are relevant to these determinations because they require the court to look into the debtor's financial future.

Unfortunately for the debtor, it is unnecessary to consider the second and third prongs because she cannot satisfy the first prong.

CASE QUESTIONS

1. What is the rationale for making the bankruptcy discharge of student loans very difficult?
2. Petitioner argued that she should be able to use a postdischarge event (the auto accident) as a basis for establishing that she could not maintain a "minimal" standard of living, and thus she should get a retroactive discharge of her student loans. What benefit is there to her if she could successfully make the argument, given that she could—as the court noted—file for Chapter 13?

3. The court cites the *Coleman* case. That was a Chapter 13 proceeding. Here were the facts: Debtor had not yet completed her payments under her five-year repayment plan, and no discharge order had yet been entered; one year into the plan, she was laid off work. She had been trying to repay her student loans for several years, and she claimed she would suffer hardship in committing to the five-year repayment plan without any guarantee that her student loan obligations would be discharged, since she was required to commit all of her disposable income to payments under the plan and would likely be forced to pursue undue hardship issue pro se upon completion of the plan." In *Coleman,* the court held that Debtor could, postfiling but predischarge—one year into the five-year plan—bring up the hardship issue.

   Now, in the case here, after the auto accident, the petitioner "subsists" on Social Security disability payments, and she has almost $150,000 in debt, yet the court prohibited her from claiming a hardship discharge of student loans. Does this result really make sense? Is the court's concern that allowing this postdischarge relief would mean "that a bankruptcy discharge is a perpetual license to discharge student loans based on events that occur years after the bankruptcy discharge is granted" well founded? Suppose it is scheduled to take thirty years to pay off student loans; in year 4, the student-borrower, now Debtor, declares Chapter 7 bankruptcy, student loans not being discharged; in year 6, the person is rendered disabled. What public policy is offended if the person is allowed to "reopen" the bankruptcy and use the postbankruptcy event as a basis for claiming a hardship discharge of student loans?

4. The court suggests she file for Chapter 13. What if—because of timing—the petitioner was not eligible for Chapter 13? What would happen then?

Chapter 11 Bankruptcy

In re Johns-Manville Corp.

CC BY NC SA

36 B.R. 727 (Bkrtcy. N.Y. 1984)

Lifland, Bankruptcy Judge.

Whether an industrial enterprise in the United States is highly successful is often gauged by its "membership" in what has come to be known as the "Fortune 500". Having attained this measure of financial achievement, Johns-Manville Corp. and its affiliated companies (collectively referred to as "Manville") were deemed a paradigm of success in corporate America by the financial community. Thus, Manville's filing for protection under Chapter 11 of Title 11 of the United States Code ("the Code or the Bankruptcy Code") on August 26, 1982 ("the filing date") was greeted with great surprise and consternation on the part of some of its creditors and other corporations that were being sued along with Manville for injuries caused by asbestos exposure. As discussed at length herein, Manville submits that the sole factor necessitating its filing is the mammoth problem of uncontrolled proliferation of asbestos health suits brought against it because of its substantial use for many years of products containing asbestos which injured those who came into contact with the dust of this lethal substance. According to Manville, this current problem of approximately 16,000 lawsuits pending as of the filing date is compounded by the crushing economic burden to be suffered by Manville over the next 20–30 years by the filing of an even more staggering number of suits by those who had been exposed but who will not manifest the asbestos-related diseases until some time during this future period ("the future asbestos claimants"). Indeed, approximately 6,000 asbestos health claims are estimated to have arisen in only the first 16 months since the filing date. This burden is further compounded by the insurance industry's general disavowal of liability to Manville on policies written for this very purpose.

It is the propriety of the filing by Manville which is the subject of the instant decision. Four separate motions to dismiss the petition pursuant to Section 1112(b) of the Code have been lodged before this Court....

Preliminarily, it must be stated that there is no question that Manville is eligible to be a debtor under the Code's statutory requirements. Moreover, it should also be noted that neither Section 109 nor any other provision relating to voluntary petitions by companies contains any insolvency

requirement....Accordingly, it is abundantly clear that Manville has met all of the threshold eligibility requirements for filing a voluntary petition under the Code....

A "principal goal" of the Bankruptcy Code is to provide "open access" to the "bankruptcy process." [Citation.] The rationale behind this "open access" policy is to provide access to bankruptcy relief which is as "open" as "access to the credit economy." Thus, Congress intended that "there should be no legal barrier to voluntary petitions." Another major goal of the Code, that of "rehabilitation of debtors," requires that relief for debtors must be "timely." Congress declared that it is essential to both the "open access" and "rehabilitation" goals that

> *[i]nitiating relief should not be a death knell. The process should encourage resort to it, by debtors and creditors, that cuts short the dissipation of assets and the accumulation of debts. Belated commencement of a case may kill an opportunity for reorganization or arrangement.*

Accordingly, the drafters of the Code envisioned that a financially beleaguered debtor with real debt and real creditors should not be required to wait until the economic situation is beyond repair in order to file a reorganization petition. The "Congressional purpose" in enacting the Code was to encourage resort to the bankruptcy process. This philosophy not only comports with the elimination of an insolvency requirement, but also is a corollary of the key aim of Chapter 11 of the Code, that of avoidance of liquidation. The drafters of the Code announced this goal, declaring that reorganization is more efficient than liquidation because "assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap." [Citation.] Moreover, reorganization also fosters the goals of preservation of jobs in the threatened entity. [Citation.]

In the instant case, not only would liquidation be wasteful and inefficient in destroying the utility of valuable assets of the companies as well as jobs, but, more importantly, liquidation would preclude just compensation of some present asbestos victims and all future asbestos claimants. This unassailable reality represents all the more reason for this Court to adhere to this basic potential liquidation avoidance aim of Chapter 11 and deny the motions to dismiss. Manville must not be required to wait until its economic picture has deteriorated beyond salvation to file for reorganization.

Clearly, none of the justifications for declaring an abuse of the jurisdiction of the bankruptcy court announced by these courts [in various cases cited] are present in the *Manville* case. In *Manville*, it is undeniable that there has been no sham or hoax perpetrated on the Court in that Manville is a real business with real creditors in pressing need of economic reorganization. Indeed, the Asbestos Committee has belied its own contention that Manville has no debt and no real creditors by quantifying a benchmark settlement demand approaching one billion dollars for compensation of approximately 15,500 pre-petition asbestos claimants, during the course of negotiations pitched toward achieving a consensual plan. This huge asserted liability does not even take into account the estimated 6,000 new asbestos health claims which have arisen in only the first 16 months since the filing date. The number of post-filing claims increases each day as "future claims back into the present." ...

In short, Manville's filing did not in the appropriate sense abuse the jurisdiction of this Court and it is indeed, like the debtor in [Citation], a "once viable business supporting employees and unsecured creditors [that] has more recently been burdened with judgments [and suits] that threaten to put it out of existence." Thus, its petition must be sustained....

In sum, Manville is a financially besieged enterprise in desperate need of reorganization of its crushing real debt, both present and future. The reorganization provisions of the Code were drafted with the aim of liquidation avoidance by great access to Chapter 11. Accordingly, Manville's filing does not abuse the jurisdictional integrity of this Court, but rather presents the same kinds of reasons that were present in [Citation], for awaiting the determination of Manville's good faith until it is considered...as a prerequisite to confirmation or as a part of the cadre of motions before me which are scheduled to be heard subsequently.

[A]ll four of the motions to dismiss the Manville petition are denied in their entirety.

CASE QUESTIONS

1. What did Manville want to do here, and why?
2. How does this case demonstrate the fundamental purpose of Chapter 11 as opposed to Chapter 7 filings?
3. The historical background here is that Manville knew from at least 1930 that asbestos—used in many industrial applications—was a deadly carcinogen, and it worked diligently for decades to conceal and obfuscate the fact. What "good faith" argument was raised by the movants in this case?

Chapter 13: What Debts Are Dischargeable?

In re Ryan

389 B.R. 710 9th Cir. BAP, (Idaho, 2008)

On July 13, 1995, Ryan was convicted of possession of an unregistered firearm under 26 U.S.C. § 5861(d) in the United States District Court for the District of Alaska. Ryan was sentenced to fifty-seven months in prison followed by three years of supervised release. In addition, Ryan was ordered to pay a fine of $7,500..., costs of prosecution in the amount of $83,420, and a special assessment of $50.00. Ryan served his sentence. He also paid the $7,500 fine. The district court, following an appellate mandate, ultimately eliminated the restitution obligation.

On April 25, 2003, Ryan filed a petition for bankruptcy relief under chapter 7 in the District of Idaho. He received his chapter 7 discharge on August 11, 2003. Shortly thereafter, Ryan filed a case under chapter 13, listing as his only obligation the amount of unpaid costs of prosecution owed to the United States ("Government")....

Ryan completed payments under the plan, and an "Order of Discharge" was entered on October 5, 2006. The chapter 13 trustee's final report reflected that the Government received $2,774.89 from payments made by Ryan under his plan, but a balance of $77,088.34 on the Government's costs of prosecution claim remained unpaid. Ryan then renewed his request for determination of dischargeability. The bankruptcy court held that the unpaid portion of the Government's claim for costs of prosecution was excepted from discharge by § 1328(a)(3). Ryan appealed.

Section 1328(a)(3) provides an exception to discharge in chapter 13 for "restitution, or a criminal fine." It states, in pertinent part:

> *[A]s soon as practicable after the completion by the debtor of all payments under the plan, the court shall grant the debtor a discharge of all debts provided for by the plan or disallowed under section 502 of this title except any debt...*
>
> *(3) for restitution, or a criminal fine, included in a sentence on the debtor's conviction of a crime [.] [emphasis added].*

The essential question, then, is whether these costs of prosecution constitute a "criminal fine."

Statutory interpretation begins with a review of the particular language used by Congress in the relevant version of the law. [Citation.]

The term "criminal fine" is not defined in [Chapter 13] or anywhere else in the Bankruptcy Code. However, its use in § 1328(a)(3) implicates two important policies embedded in the Bankruptcy Code. First, in light of the objective to provide a fresh start for debtors overburdened by debts that they cannot pay, exceptions to discharge are interpreted strictly against objecting creditors and in favor of debtors. *See, e.g.* [Citations]. In chapter 13, this principle is particularly important because Congress adopted the liberal "superdischarge" provisions of § 1328 as an incentive to debtors to commit to a plan to pay their creditors all of their disposable income over a period of years rather than simply discharging their debts in a chapter 7 liquidation.

"[T]he dischargeability of debts in chapter 13 that are not dischargeable in chapter 7 represents a policy judgment that [it] is preferable for debtors to attempt to pay such debts to the best of their abilities over three years rather than for those debtors to have those debts hanging over their heads indefinitely, perhaps for the rest of their lives." [Citations.]

A second, countervailing policy consideration is a historic deference, both in the Bankruptcy Code and in the administration of prior bankruptcy law, to excepting criminal sanctions from discharge in bankruptcy. Application of this policy is consistent with a general recognition that, "[t]he principal purpose of the Bankruptcy Code is to grant a 'fresh start' to the '*honest* but unfortunate debtor.'" [Citation] (emphasis added [in original]).

The legislative history is clear that [in its 1994 amendments to the bankruptcy law] Congress intended to overrule the result in [of a 1990 Supreme Court case so that]:..."[N]o debtor with criminal restitution obligations will be able to discharge them through any bankruptcy proceeding."...

The imposition on a defendant of the costs of a special prosecutor is different from ordering a defendant to pay criminal fines. Costs are paid to the entity incurring the costs; criminal fines are generally paid to a special fund for victims' compensation and assistance in the U.S. Treasury....

To honor the principle that exceptions to discharge are to be construed narrowly in favor of debtors, particularly in chapter 13, where a broad discharge was provided by Congress as an incentive for debtors to opt for relief under that chapter rather than under chapter 7, it is not appropriate to expand the scope of the [Chapter 13] exception beyond the terms of the statute. Congress could have adopted an exception to discharge in chapter 13 that mirrored [the one in Chapter 7]. It did not do so. In contrast, under [the 2005] BAPCPA, when Congress wanted to limit the chapter 13 "superdischarge," it incorporated exceptions to discharge from [Chapter 7] wholesale....

As a bottom line matter, Ryan served his time and paid in full the criminal fine that was imposed as part of his sentence for conviction of possession of an unregistered firearm. The restitution obligation that was included as part of his sentence was voided. Ryan paid the Government a total of $6,331.66 to be applied to the costs of prosecution awarded as part of his criminal judgment, including $2,774.89 paid under his chapter 13 plan, leaving a balance of $77,088.34. We determine that the unpaid balance of the costs of prosecution award was covered by Ryan's chapter 13 discharge.

Based on the foregoing analysis, we conclude that the exception to discharge included in [Chapter 13] for "restitution, or a criminal fine, included in a sentence on the debtor's conviction of a crime" does not cover costs of prosecution included in such a sentence, and we REVERSE.

CASE QUESTIONS

1. What is the rationale for making some things dischargeable under Chapter 13 that are not dischargeable under Chapter 7?
2. What is the difference between "criminal restitution" (which in 1994 Congress said could not get discharged at all) and "the costs of prosecution"?
3. Why did the court decide that Ryan's obligation to pay "costs of prosecution" was not precluded by the limits on Chapter 13 bankruptcies imposed by Congress?

27.7 Summary and Exercises

Summary

The Constitution gives Congress the power to legislate on bankruptcy. The current law is the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which provides for six types of proceedings: (1) liquidation, Chapter 7; (2) adjustment of debts of a municipality, Chapter 9; (3) reorganization, Chapter 11; (4) family farmers with regular income, Chapter 12; (5) individuals with regular income, Chapter 13; and (6) cross-border bankruptcies, Chapter 15.

With some exceptions, any individual, partnership, or corporation seeking liquidation may file a voluntary petition in bankruptcy. An involuntary petition is also possible; creditors petitioning for that must meet certain criteria.

A petition operates as a stay against the debtor for lawsuits to recover claims or enforce judgments or liens. A judge will issue an order of relief and appoint a trustee, who takes over the debtor's property and preserves security interests. To recover monies owed, creditors must file proof of claims. The trustee has certain powers to recover property for the estate that the debtor transferred before bankruptcy. These include the power to act as a hypothetical lien creditor, to avoid fraudulent transfers and voidable preferences.

The bankruptcy act sets out categories of claimants and establishes priority among them. After secured parties take their security, the priorities are (1) domestic support obligations, (2) administrative expenses, (3) gap creditor claims, (4) employees' wages, salaries, commissions, (5) contributions to employee benefit plans, (6) grain or fish producers' claims against a storage facility, (7) consumer deposits, (8) taxes owed to governments, (9) allowed claims for personal injury or death resulting from debtor's driving or operating a vessel while intoxicated. After these priority claims are paid, the trustee must distribute the estate in this order: (a) unsecured creditors who filed timely, (b) unsecured creditors who filed late, (c) persons claiming fines and the like, (d) all other creditors, (e) the debtor. Most bankruptcies are no-asset, so creditors get nothing.

Under Chapter 7's 2005 amendments, debtors must pass a means test to be eligible for relief; if they make too much money, they must file Chapter 13.

Certain property is exempt from the estate of an individual debtor. States may opt out of the federal list of exemptions and substitute their own; most have.

Once discharged, the debtor is no longer legally liable for most debts. However, some debts are not dischargeable, and bad faith by the debtor may preclude discharge. Under some circumstances, a debtor may reaffirm a discharged debt. A Chapter 7 case may be converted to Chapter 11 or 13 voluntarily, or to Chapter 11 involuntarily.

CC BY NC SA

Chapter 11 provides for reorganization. Any person eligible for discharge in Chapter 7 is eligible for Chapter 11, except stockbrokers and commodity brokers; those who have too much debt to file Chapter 13 and surpass the means test for Chapter 7 file Chapter 11. Under Chapter 11, the debtor retains possession of the business and may continue to operate it with its own management unless the court appoints a trustee. The court may do so either for cause or if it is in the best interests of the creditors. The court must appoint a committee of unsecured creditors, who remain active throughout the proceeding. The debtor may file its own reorganization plan and has the exclusive right to do so within 120 days if it remains in possession. The plan must be accepted by certain proportions of each impaired class of claims and interests. It is binding on all creditors, and the debtor is discharged from all debts once the court confirms the plan.

Chapter 13 is for any individual with regular income who has difficulty paying debts; it is voluntary only; the debtor must get credit counseling. The debtor presents a payment plan to creditors, and the court appoints a trustee. The plan extends the time to pay and may reduce the size of the debt. If the creditors wind up with more in this proceeding than they would have in Chapter 7, the court is likely to approve the plan. The court may approve a stretch-out of five years. Some debts not dischargeable under Chapter 7 may be under Chapter 13.

Alternatives to bankruptcy are (1) composition (agreement by creditors to accept less than the face amount of the debt), (2) assignment for benefit of creditors (transfer of debtor's property to a trustee, who uses it to pay debts), and (3) receivership (a disinterested person is appointed by the court to preserve assets and distribute them at the court's direction). Because these are voluntary procedures, they are ineffective if all parties do not agree to them.

EXERCISES

1 David has debts of $18,000 and few assets. Because his debts are less than $25,000, he decides to file for bankruptcy using the state court system rather than the federal system. Briefly describe the procedure he should follow to file for bankruptcy at the state level.

2 Assume that David in Exercise 1 is irregularly employed and has developed a plan for paying off his creditors. What type of bankruptcy should he use, Chapter 7, 11, or 13? Why?

3 Assume that David owns the following unsecured property: a $3,000 oboe, a $1,000 piano, a $2,000 car, and a life insurance policy with a cash surrender value of $8,000. How much of this property is available for distribution to his creditors in a bankruptcy? Explain.

4 If David owes his ex-wife alimony (maintenance) payments and is obligated to pay $12,000 for an educational loan, what effect will his discharge have on these obligations?

5 Assume that David owns a corporation that he wants to liquidate under Chapter 7. After the corporate assets are distributed to creditors, there is still money owing to many of them. What obstacle does David face in obtaining a discharge for the corporation?

6 The famous retired professional football player—with a pension from the NFL—Orenthal James "O.J." Simpson was convicted of wrongful death in a celebrated Santa Monica, California, trial in 1997 and ordered to pay $33.5 million in damages to the families of the deceased. Mr. Simpson sold his California house, moved to Florida, and, from occasional appearances in the press, seemed to be living a high-style life with a big house, nice cars, and sharp clothing. He has never declared bankruptcy. Why hasn't he been forced into an involuntary Chapter 7 bankruptcy by his creditors?

7

a. A debtor has an automobile worth $5,000. The federal exemption applicable to her is $3,225. The trustee sells the car and gives the debtor the amount of the exemption. The debtor, exhausted by the bankruptcy proceedings, takes the $3,225 and spends it on a six-week vacation in Baja California. Is this an "abuse" of the bankruptcy system?

b. A debtor has $500 in cash beyond what is exempt in bankruptcy. She takes the cash and buys new tires for her car, which is worth about $2,000. Is this an "abuse" of the bankruptcy system?

SELF-TEST QUESTIONS

1 Alternatives to bankruptcy include

a. an assignment

b. a composition

c. receivership

d. all of the above

2 A composition is

a. a procedure where a receiver takes over the debtor's property

b. an agreement by creditors to take less than the face value of their debt

c. basically the same as an assignment

d. none of these

3 The highest-priority class set out by the 2005 act is for

a. employees' wages

b. administrative expenses

c. property settlements arising from divorce

d. domestic support obligations

4 Darlene Debtor did the following within ninety days of filing for bankruptcy. Which could be set aside as a preferential payment?

a. paid water and electricity bills

b. made a gift to the Humane Society

c. prepaid an installment loan on inventory

d. borrowed money from a bank secured by a mortgage on business property

5 Donald Debtor sold his 1957 Chevrolet to his brother for one-fifth its value sixty days before filing for bankruptcy. The trustee wishes to avoid the transaction on the basis that it was

a. a hypothetical lien

b. a lease disguised as a sale

c. a preferential payment

d. a voidable preference

6 Acme Co. filed for bankruptcy with the following debts; which is their correct priority from highest to lowest?

i. wages of $15,000 owed to employees

ii. unpaid federal taxes

iii. balance owed to a creditor who claimed its security with a $5,000 deficiency owing

a. i, ii, iii

b. ii, iii, i

c. iii, ii, i

d. i, iii, ii

SELF-TEST ANSWERS

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

CC BY NC SA