Business Law, Ethics, and Sustainability

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An OER Textbook for the University of Iowa Introduction to Law Course

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1.

LAW AND RISK MANAGEMENT

Learning Objectives

After reading this chapter, students should understand:

1. The importance of legal risk management to business strategy
2. How to assess attitude towards risk
3. A simple model for assessing legal risk
4. A preview of ways to manage and mitigate liability risks, such as through liquidated damages clauses and insurance

1.1 Introduction

Often, law for business students is taught as a sort of compressed version of law school. Subjects are taught much like they might be for law students, albeit at a simplified level. This sort of training can be useful, but it ignores a crucial difference between how lawyers and managers relate to the law: lawyers are trained to argue for specific legal conclusions on behalf of a client, while *managers make decisions to manage legal risk*. Law is rarely black and white, such as "don't do this or you'll go to jail." Rather, legal decisions often involve questions such as "Our trademark is similar to several others. Is it too similar?" Or, "Adding this statement to the label of our product might expose us to liability, but it's not prohibited by regulation. Should we proceed?" This leaves many managerial decisions involving law up to the risk tolerance of the manager. Compared to how attorneys operate, this requires a very different approach to legal reasoning. In this sense, a business-focused course on legal topics should essentially be a course on business *strategy* related to legal issues. It should equip managers with a broad overview of legal risks associated with running a business, how their decisions alter those risks, and how to minimize or otherwise use those risks to their advantage.

For these reasons, this text begins with a broad discussion of how one might evaluate risk generally. In this chapter, we will learn techniques for assessing, evaluating, and managing legal

risks. Risk management is a topic for an entire course by itself, so in this chapter we will only touch on several major points and then apply them to the law. Throughout the course, examples and exercises will relate back to these concepts.

1.2 An Approach to Evaluating Risk

Risk management will be a major focal point of business and societal decision making in the twenty-first century. Businesses face an incredible variety of risks everyday, which range both in severity and in frequency. Some risks are minor (e.g., an employee might steal paperclips), and others may entail losing the business (a pandemic arises which eliminates demand for certain services). Some risks are frequent (bad weather for a drive-in movie theater), and some are infrequent (new government regulation alters the healthcare landscape). Legal risks span these same spectrums. Some legal risks are constant (potential slip and falls in a grocery store) and some are infrequent (a major intellectual property lawsuit). Some are minor (producing a product label well within regulatory standards) and some are significant (criminal negligence results in the death of customers).

In this section, we will discuss legal risk, which is one of a variety of these risks which businesses face everyday. As business increasingly involves international management, understanding legal risk has become more important than

ever, due to the bewildering number of international norms and regulations governing the modern legal environment of business. The types of legal risk a company faces can be roughly broken down into four categories:[1]

1. **Regulatory risk.** If a company fails to have appropriate compliance methods, it risks regulatory violations which can have far-reaching civil and criminal penalties.
2. **Tort risk.** Companies that fail to take reasonable care to ensure the safety of their customers, clients, and employees will inevitably face personal injury lawsuits. Individuals injured on premises, industrial accidents, or products that harm customers may all result in litigation.
3. **Contract risk.** Contracts are the language of business, and failure to understand contractual complexities may result in harmful liability. Competitors may take advantage of ambiguous terms, damages provisions may disfavor the company, or there may be unforeseen consequences from contractual provisions.
4. **Intellectual property risk.** Modern business increasingly relies on intellectual property, rather than

1. Adapted from Matthew Whalley and Chris Guzelian, *The Legal Risk Management Handbook: An Interntional Guide to Protect Your Business from Legal Loss* (2017).

> real property, to create value. Infringing on others' intellectual property rights, or failure to protect one's own intellectual property rights, can have substantial impact on a company.

Reading a long list of potential legal harms may inspire some trepidation, particularly for someone with responsibility over these areas of company operations. If we wish to understand and use the concepts of risk and uncertainty to manage these risks, we need to be able to measure (at least roughly) these concepts' outcomes. Psychological and economic research shows that emotions such as fear, dread, ambiguity avoidance, and feelings of emotional loss represent valid risks. Such feelings are thus relevant to decision making under uncertainty. Our focus here, however, will draw more on financial metrics rather than emotional or psychological measures of risk perception.

We will discuss one particular approach to measuring risk here, which is a useful model in the legal context. We will *not* impose a mathematical framework on this model, for two reasons. First, this is a course on business law, not a course on statistics or probability models, and developing those models together would exceed the time available in this course. Second, and more foundational, assuming exact probabilities for potential legal events implies a level of certainty that will likely never exist in real life.

We also emphasize from the start that measuring risk using

the model in this chapter is a multi-step process. We must evaluate how appropriate the underlying model might be for the specific occasion. Further, we need to evaluate each question in terms of the risk level that each entity is willing to assume for the gain each hopes to receive. Firms must understand the assumptions behind worst-case or ruin scenarios, since most firms do not want to take on risks that "bet the house." To this end, knowing the severity of losses that might be expected in the future is a first step (legal consequences). However, financial decision making requires that we evaluate severity levels based upon what an individual or a firm can comfortably endure (attitudes towards risk, risk tolerance, or risk appetite).

1.3 Legal Consequences

Mismanaging legal risk can have a variety of consequences, from harm to reputation to imprisonment of company officers. These consequences range dramatically from minor to severe. Most of the consequences we will look at in this textbook are civil in nature. Civil cases involve one party suing another to seek compensation for a wrong. Damages can be compensatory (to put someone in the same position as if they had not been harmed) or punitive (intended to punish wrongdoing). If you are sued, you should also expect to spend a substantial amount on attorney fees, regardless of whether

you win or lose.[2] On the civil side, courts can also impose injunctions, which is an order to perform, or not perform, a specific action.

Lawyers may provide your management team detailed legal risk assessments.

If the financial consequences are severe enough, the firm might risk bankruptcy. 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. In bankruptcy, the firm might be liquidated or reorganized. As we will see later in the text, bankruptcy provides debtors a fresh

2. Courts will sometimes grant attorneys' fees, but this is not typical of litigation in the United States.

start, but for many firms the consequences of bankruptcy are severe enough that they will avoid actions that likely lead to bankruptcy.

1.4 Attitudes Towards Risk

Different people and companies can view the legal risks above very differently. Some individuals do not mind the prospect of personal bankruptcy, for instance, and some companies are structured to take substantial risk. Others view the prospect of being sued with trepidation. In other words, different people and firms have different attitudes toward the risk-return tradeoff. People are **risk averse** when they shy away from risks and prefer to have as much security and certainty as is reasonably affordable in order to lower their discomfort level. They would be willing to pay extra to have the security of knowing that unpleasant risks would be removed from their lives. Economists and risk management professionals consider most people to be risk averse. So, why do people invest in the stock market where they confront the possibility of losing everything? Perhaps they are also seeking the highest value possible for their pensions and savings and believe that losses may not be pervasive—very much unlike the situation in the financial crisis of 2008.

A **risk seeker**, on the other hand, is not simply the person who hopes to maximize the value of retirement investments by investing the stock market. Much like a gambler, a risk seeker

is someone who will enter into an endeavor (such as blackjack card games or slot machine gambling) as long as a positive long run return on the money is possible, however unlikely.

Finally, an entity is said to be **risk neutral** when its risk preference lies in between these two extremes. Risk neutral individuals will not pay extra to have the risk transferred to someone else, nor will they pay to engage in a risky endeavor. To them, money is money. Economists consider most widely held or publicly traded corporations as making decisions in a risk-neutral manner since their shareholders have the ability to diversify away risk—to take actions that seemingly are not related or have opposite effects, or to invest in many possible unrelated products or entities such that the impact of any one event decreases the overall risk. Risks that the corporation might choose to transfer remain for diversification.

1.5 A Model for Evaluating Legal Risk

This section combines the ideas from the prior sections to implement a simple, non-mathematical model for evaluating legal risk. A "model" is a simplified framework for evaluating a real-life situation. It will never capture all of the nuance involved in a particular choice, but it may be *useful* to decisionmakers. In particular, the model presented here is non-mathematical. It relies on simple categorization of the

likelihood of an event, the consequences of that event, and the decisionmaker's approach to evaluating risk.

First, evaluate the likelihood of the event. For instance, what are the chances of getting sued? We will categorize the likelihood as "low", "medium", or "high". Much of this course will aim to teach you how to categorize potential legal events in this framework. For example, as we study intellectual property law you will gain a sense of the likelihood of being sued based on similarity of your trademark to existing trademarks, and as we study tort law you will get a sense for which torts are common and uncommon. We won't use specific probabilities for these events in formal calculations, but you might think of a low probability event as one that rarely occurs for similar companies, a medium probability event as one that has occurred several times in the last year for similar companies, and a high probability event as one which will almost certainly result in litigation.

Next, categorize the severity of the outcome as "slight", "manageable", or "severe". Again, much of this course aims to teach you which events are which. As you did the Exercise under "Legal Consequences" above, you likely started to see some of the newsworthy severe events faced by firms in your industry. For modeling purposes, a slight outcome is one which would not harm the financial health of the company in a significant way. An example might be a somewhat frivolous lawsuit which is settled as a "nuisance suit" for a few thousand

dollars.[3] A manageable outcome is one which would generate discussion among managers about potential budgets for a loss, such as a small-business customer injured in an accident with major medical bills. This kind of outcome might worry managers, but does not risk the future of the business. A severe outcome is one which risks bankruptcy, criminal charges, or other substantial long-term consequences for the existence of the firm.

Finally, decide the correct attitude towards risk. Is the firm risk averse, risk neutral, or risk seeking? In our model, the attitude towards risk forms the shaded "danger zone" in the grid, dividing causes of little concern from significant concern. The more risk averse the individual or firm, the farther up and to the left we shift the dividing line, and the more risk-seeking the firm, the farther lower and to the right we shift the line. An extremely risk averse firm would avoid even low probability severe events (as shown in the first figure below), while an extremely risk-seeking firm might avoid only high probability severe events.

Applying this model might look something like the following. We (1) classify the likelihood of the legal event, and (2) the severity of the consequence. Then (3), we identify the risk tolerance of the firm. Finally, (4) we analyze how those

3. 3A nuisance suit is one with little legal merit, which a company will pay a small sum to settle to avoid the costs of litigation.

three interact and offer a conclusion: is this a high risk decision, in the legal danger zone, or a low risk decision, in the zone of safety?

A highly risk averse firm avoids the possibility of severe legal outcomes.

A risk seeking firm might avoid only the most likely and severe legal consequences.

For example, suppose the firm under consideration is a tech startup like Uber. The firm consistently pushes legal boundaries, such as in classifying workers as independent contractors rather than employees, as it attempts to increase

market share in a quickly growing industry.[4] Suppose also that the firm was considering whether to expand to a city that has somewhat hostile regulations for ride-sharing. At the same time, the consequences for entering the market and losing a legal challenge are simply to withdraw or pay an insubstantial fine. Let's apply the model:

1. As the new market appears hostile, the likelihood of legal challenge is probably medium or high.
2. Relative to the size of the firm, a modest fine is a relatively small consequence. We might then classify the severity of outcome as low.
3. We might classify this firm as risk seeking based on its past attitude towards the law and the potential rewards at stake.
4. Although the likelihood of legal action is moderate to high, the potential consequence is slight. This decision is likely a low-risk legal decision, in the legal safety zone for the firm.

4. They might also be classified as risk-neutral because the company simply finds it advantageous to engage in legally risky behavior.

1.6 Mitigating and Managing Legal Risk

We conclude this chapter by highlighting methods to mitigate legal risk. We will cover many of these topics in greater detail later, but it is worth noting them in abbreviated form now, both to round off this initial topic and to preview what we will study throughout the semester.

- **Insurance**. Both individuals and businesses have significant needs for various types of insurance, to provide protection for health care, for their property, and for legal claims made against them by others. Insurance allows individuals to pay a certain amount today to avoid uncertain losses in the future. Businesses face a host of risks that could result in substantial liabilities. Many types of policies are available, including policies for owners, landlords, and tenants (covering liability incurred on the premises); for manufacturers and contractors (for liability incurred on all premises); for a company's products and completed operations (for liability that results from warranties on products or injuries caused by products); for owners and contractors (protective liability for damages caused by independent contractors engaged by the insured); and for contractual liability (for failure to abide by performances required by specific contracts). Some years ago, different types of

individual and business coverage had to be purchased separately and often from different companies. Today, most insurance is available on a package basis, through single policies that cover the most important risks. These are often called multiperil policies.

- **Smart contracting**. As we will study in contract law later in this text, in order to limit risk in contracts, many contractual drafters choose to include "liquidated damages" clauses. These are statements in the contract that spell out what damages will be if the contract is broken. This makes the damages certain, which lowers risk for the contracting parties. For example, in a contract for sale of a home, a party might lose their "ready money" if they back out of the agreement without cause.
- **Regulatory review**. Many firms find it worthwhile to preemptively hire an attorney to review products for regulatory and litigation risk before launching the product. For a fee, a specialized attorney can examine the product and provide a report on potential regulatory violations and lawsuit risks. Many firms might be surprised at the substantial increased risk of litigation based on innocuous statements on packaging, for instance. We will return to this theme when we cover administrative law (the law of government regulation of business).
- **Preemptive tort defense**. The liberal use of liability

waivers, warning labels, caution signs, safety rails, handguards, and so on, can help prevent against tort litigation. Liability waivers reduce litigation risk by having individuals specifically agree they will not sue in case of injury during an activity. In other cases, often such litigation turns not on whether someone was injured from a product, but whether they were appropriately warned that such injury could occur. Physical safeguards against injury can help reduce the probability of potential negligence lawsuits by preventing injury in the first place. Businesses that practice prudent preemptive tort defense can lower their legal risks substantially.

- **Limited liability forms** When starting a new business, choosing a legal structure for the company that provides a personal liability shield substantially lowers legal risk for the proprietor. Then, performing business operations in a way that maintains that liability shield continues to lower legal risk. For corporations and franchisors, maintaining appropriate relationships with subsidiaries and franchisees provides the same benefit. For example, if a franchisor exercises excessive control over franchisee operations, it opens itself up to liability for the franchisee's actions.
- **A risk-educated board** In corporations, the board of directors has the primary legal responsibility to manage risk. If a board is risk-educated, it will incorporate legal

risk management into its overall strategy for the company. One path to strategic success is pursuing opportunities in which the corporation can manage legal risk better than competitors.[5]

- **Knowing the law**. Finally, a prime way to reduce legal risk is to simply be familiar with the law. An attorney will not always be around to consult, or it may be cost-prohibitive to use their services at times. Law is vast and complicated, but many legal concepts foundational to business are easy to understand. The more one knows about the law, the easier it is to avoid compromising legal situations, to be conversant with those that can offer legal counsel, *and* to make decisions that balance legal and ethical interests with other strategic concerns.

Key Takeaways

5. See Roger Barker et al., *Risk Management and the Board of Directors: Lessons to be Learned from USB*, in *Legal Risk Management, Governance, and Corporate Compliance* 174 (2013).

- Approaching law from a risk management approach is crucial to evaluate the legal environment of business.
- Evaluating legal risk requires understanding the likelihood of legal action, the severity of the consequences, and the risk tolerance level of the company. Even low probability legal events can be so severe that risk averse firms should take action to avoid them, while even high probability legal events may not bother risk seeking firms.
- Much of this text will offer ways to reduce legal risk associated with business decisions, such as preemptively avoiding tort liability and employing smart contracting principles. Insurance against legal claims can also reduce uncertainty, at a price.

2.

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.

2.1 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]

2.1.1 Functions of the Law

At the macro level, 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. Conversely, the law may keep peace at the expense of individual rights, maintain an ugly status quo, be used to oppress minorities, and so on. In a democracy, law ultimately reflects how society wishes to order itself, while in authoritarian governments law is used to perpetuate existing power structures. In that sense, law and politics are deeply entwined. At the micro level, law provides the "rules of the game" for how businesses operate, restricting certain kinds of conduct and encouraging others. It can be used by businesses as a shield, giving them freedom to operate, and as a sword, such as when using litigation as a strategy against their competitors.

2.1.2 Law and Politics

In the United States, legislators, judges, administrative

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

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.

Our Overworked Supreme Court, Joseph Keppler, 1838-1894, LOC

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[2] (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.

2. The basic entities that comprise the international legal system. Countries, states, and nations are all roughly synonymous. State can also be used to designate the basic units of federally united states, such as in the United States of America, which is a nation-state.

2.2 Schools of Legal Thought

Learning Objectives

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

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. There are many philosophies of law and thus many different jurisprudential views, and the two main schools are legal

positivism[3] and natural law.[4] Although there are others, these two are the most influential in how people think about the law.

2.2.1 Legal Positivism: Law as Sovereign Command

We could examine existing statutes[5]—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 city roads and conclude that the "correct" or "right" speed is no more than twenty-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 thirty-one miles per hour is generally allowed by most state troopers, but that occasionally someone gets ticketed for doing twenty-seven miles per hour in a twenty-five miles per

3. A jurisprudence that focuses on the law as it is—the command of the sovereign.
4. A jurisprudence that emphasizes a law that transcends positive laws (human laws) and points to a set of principles that are universal in application.
5. Legislative directives, having the form of general rules that are to be followed in the nation-state or its subdivisions. Statutes are controlling over judicial decisions or common law, but are inferior to (and controlled by) constitutional law.

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.

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.

2.2.2 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."[6]

Both the US Constitution and the United Nations (UN)

6. Cambridge Dictionary of Philosophy, s.v. "natural law."

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

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

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

deriving their just powers from the consent of the governed.

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

John Locke

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."[7]

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

7. Martin Luther King Jr., "Letter from Birmingham Jail." Image by Marion Trikosko, 1964, LOC.

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.

2.2.3 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. 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.[8]

Key Takeaway

Each of the various schools of legal thought has a

8. 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.

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).

2.3 Basic Concepts and Categories of US Positive Law

Learning Objectives

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

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.

2.3.1 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, but also torts, and broken promises. 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.

2.3.2 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[9] in common-law cases came into being, and a doctrine of stare decisis[10] (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

9. A prior judicial decision that is either binding or persuasive, and as such, provides a rule useful in making a decision in the case at hand.
10. Latin, for "let the decision stand." By keeping within the rule of a prior judicial decision, a court follows "precedent" by letting the prior decision govern the result in the case at hand.

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.

2.3.3 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 and intellectual property
- 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.

2.3.4 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.

Some of the basic differences between civil law[11] and criminal law[12] cases are illustrated in the table below.

11. In contrast to criminal law, the law that governs noncriminal disputes, such as in lawsuits (as opposed to prosecutions) over contract disputes and tort claims. In contrast to common law, civil law is part of the continental European tradition dating back to Roman law.
12. That body of law in any nation-state that defines offenses against society as a whole, punishable by fines, forfeitures, or imprisonment.

	Civil Cases	**Criminal Cases**
Parties	Plaintiff brings case; defendant must answer or lose by default	Prosecutor brings case; defendant may plea guilty or go to trial
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) Injunctions (equitable remedy) Specific performance (equity)	Fines, jail, and forfeitures

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.

2.3.5 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.

Fourteenth Amendment, National Archives

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.

2.4 Sources of Law and Their Priority

Learning Objectives

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

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.

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[13] (agreements between states or countries) and what is

13. Formal agreements concluded between nation-states.

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.

2.4.1 Constitutions

Constitutions[14] 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

14. The founding documents of any nation-state's legal system.

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. 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."[15]

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

2.4.2 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.

2.4.3 Delegating Legislative Powers: Rules by Administrative Agencies

Congress has found it necessary and useful to create government agencies to administer various laws. 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.

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.

2.4.4 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.

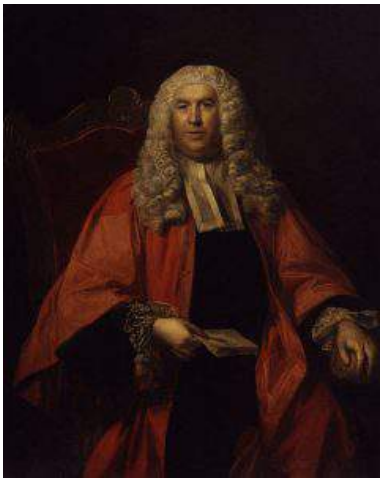
On a more local level, counties and municipal corporations or townships may be authorized under a state's constitution

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.

2.4.5 Judicial Decisions: The Common Law

Common law[16] 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.

16. Judicial decisions that do not involve interpretation of statutes, regulations, treaties, or the Constitution.



Sir William Blackstone (1723-1780) was a famous legal jurist who helped codify the 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.

2.4.6 Priority of Laws

2.4.6.1 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 later, 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.)

2.4.6.2 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.

2.4.6.3 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.

2.4.7 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.[17] The legal basis can be a Constitutional law, a statute, a regulation, or a prior judicial decision that creates a precedent to be followed. 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

17. In a complaint, a legal basis on which a claim is predicated.

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.[18] 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.

Generally speaking, to plausibly allege a cause of action, courts look to three elements: (1) did the plaintiff suffer a non-hypothetical, concrete injury? (2) Was it plausibly caused by the defendant? (3) Is the problem one a court has the capacity to redress? If each of these elements is present, the plaintiff has legal "standing" to sue. For example, if my neighbor's house was robbed, it is my neighbor, not I, that has suffered an injury. I would not have standing to sue. Often businesses can get lawsuits dismissed by arguing that no real injury has occurred.

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18. For a good example of this, see the last exercise problem at the end of this section!

For instance, if a plaintiff slipped and fell at your business with no obvious injury, but sought to recover the costs of future medical monitoring to ensure they had not been injured, one could argue they lack standing to sue. At the point an injury manifested, the plaintiff would have a stronger case.

Causes of action developed through hundreds of years of legal decisions building on each other. 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, 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.

2.5 Legal and Political Systems of the World

Learning Objectives

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

1. Describe how the common-law system differs from the civil-law system.
2. Describe what the term international law means, and what it doesn't mean.

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.

2.5.1 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.

2.5.2 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.

2.5.3 International "Law"

The term "international law" is often used, which deserves mention in this context. In the sense of a sovereign making laws discussed above, there is no "international law". No international sovereign musters an international police force to enforce a series of international statutes. There are broad principles, along natural law lines, that most nations and people agree to, and which nations or coalitions of nations may choose to use military power to enforce. This takes us more into the realm of geopolitics than law. In a looser sense, international law does exist through more informal means such as excluding nations from elements of international cooperation. In this sense, international principles or norms

of conduct can be enforced. In this sense, international law is much like canon or church law, whose enforcement mechanism is excommunication from the body of believers. We devote a chapter to international law later in the text, but even there our focus will be on United States law applied in an international context, such as how United States courts treat decisions by courts of other countries, and whether a court in the United States should rule on a dispute that occurred outside the United States.

To give practice on the principles discussed in this chapter, we conclude with an example case that illustrates the law in practice.

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.

3.

COURTS AND THE LEGAL PROCESS

Learning Objectives

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

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

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

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

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

Robinson v. Audi

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

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

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

Learning Objectives

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

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). 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.

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[1] (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

1. Subject matter jurisdiction in federal court where the plaintiff is a citizen of one state, no defendant is also a citizen of that state, and the amount in controversy exceeds $75,000.

jurisdiction[2], 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[3] 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 sometimes plaintiffs' attorneys know that removal is common and that it will move the case along faster by filing in federal court to begin with.[4] 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

2. Federal court subject matter jurisdiction based on a complaint that uses a federal statutory, regulatory, or constitutional law as a cause of action.
3. The right of a defendant to remove a case from state to federal court.
4. While this is true, most often plaintiffs' attorneys feel they will receive larger jury verdicts and settlements in state courts and file there, hoping against removal.

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.

3.1.1 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[5]—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[6]—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.

3.1.1.1 Limited Jurisdiction Courts In most large urban states and many smaller states, there are four and

5. The jurisdiction that a judge has to hear witnesses and receive evidence in a trial proceeding.
6. The jurisdiction of an appellate court to review whether the parties received a fair trial in accordance with applicable law. Appellate jurisdiction does not include hearing witnesses or receiving new evidence.

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. Most disputes that wind up in court are handled in the 18,000-plus limited jurisdiction courts, which are estimated to hear more than 80 percent of all cases.

One familiar limited jurisdiction court is the small claims court, with jurisdiction to hear civil cases involving claims for amounts ranging between $1,000 and $5,000 in about half the states and for considerably less in the other states ($500 to $1,000). In Iowa, our small claims courts hear cases claiming amounts up to $6,500. The advantage of the small claims court is that its procedures are informal, it is often located in a neighborhood outside the business district, it is usually open after business hours, and it is speedy. Lawyers are not necessary to present the case and in some states are not allowed to appear in court.

3.1.1.2 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. In Iowa, our general trial courts are referred to as District Courts, and we have one for each county.[7]

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.

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.

3.1.1.3 Appellate Courts The losing party in a general jurisdiction court can almost always appeal to either one or two higher courts. These intermediate appellate

7. For unusual historic reasons, one Iowa county, Lee, has two county seats and two county courthouses: https://www.desmoinesregister.com/story/news/local/columnists/kyle-munson/2016/10/07/iowas-lee-county-gets-another-vote-its-2-courthouses/91187556/

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[8] remains a possibility.

Optional Viewing – The Iowa Supreme Court

The Iowa Supreme Court consists of seven Justices. The finalists for an open position are chosen through a merit-based system, and then the Governor chooses from that slate to appoint a new Justice. In this video interview, Professor Dayton interviews Justice McDermott shortly after his appointment to the Iowa Supreme Court.

8. The writ issued by a higher court that grants review of the decision of a lower court. In the United States, the Supreme Court's *writ of certiorari* is highly sought by those who would have the court review a state supreme court judgment or that of a federal circuit court of appeals. Most of the cases heard by the Supreme Court are through the granting of a petitioner's appeal to have the writ issued.

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https://pressbooks.uiowa.edu/introtolaw/?p=73#oembed-1

3.1.2 The Federal Court System

3.1.2.1 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.

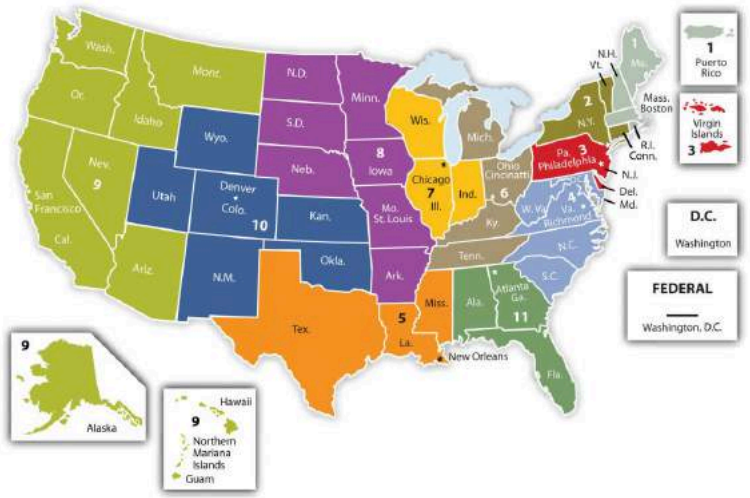
3.1.2.2 Courts of Appeal Cases from the district courts can then be appealed to the circuit courts of appeal, of which there are thirteen. Each circuit oversees the work of the district courts in several states. For example, the US Court of Appeals for the Second Circuit hears appeals from district courts 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. 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.

3.1.2.3 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.

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.



Federal Judicial Circuits

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.

Optional Listening

Justice Dana Oxley of the Iowa Supreme Court discusses the history of, and differences between, the US and Iowa Constitutions in this excellent podcast episode of *In the Balance:* https://www.iowacourts.gov/for-the-public/in-the-

balance-podcast/2022/08/30/episode-24-the-iowa-and-federal-constitutions-with-justice-dana-oxley

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3.2 The Problem of Jurisdiction

Learning Objectives

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

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[9] and the question of personal jurisdiction. We will consider the question of subject matter jurisdiction first, because judges do; if they determine, on the

9. Legal authority to hear and decide a case or controversy.

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.

3.2.1 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[10] was the system devised by the nation's founders in which power is shared between states and the federal government. This sharing requires a division of labor between the states and the federal government. It is Article III of the US Constitution that spells out the respective spheres of authority (jurisdiction) between state and federal courts.

Take a close look at Article III of the Constitution. Article III makes clear that federal courts are courts of limited power or jurisdiction. Notice that the only kinds of cases federal courts are authorized to deal with have strong federal

10. The idea, originating with the Constitution's Founding Fathers, that the United States legal and political system would be one of governance shared between the states and the federal government.

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. 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.[11]

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[12], it will be too late to refile in the correct court system. Such

11. Each court must have subject matter jurisdiction and personal jurisdiction over at least one named defendant. If the defendant is a nonresident where the lawsuit is filed, there may be constitutional issues of personal jurisdiction arising from the due process clause of the Fourteenth Amendment. One state should not claim personal jurisdiction over a nonresident unless various tests are met, such as minimum contacts and the "purposeful availment" test.
12. Each state and the federal government has legislated certain time periods beyond which plaintiffs are not allowed to file civil lawsuits. (There are some statutes of limitations for some kinds of criminal offenses, as well.)

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!)

3.2.2 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. *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.
6. *Antitrust*. Federal laws designed to protect trade and commerce from restraining monopolies, price fixing, and price discrimination.
7. *Other cases specified by federal statute*. Any other cases specified by a federal statute where Congress declares that federal courts will have exclusive jurisdiction.

3.2.3 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[13] 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.

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.

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13. When both state and federal courts have subject matter jurisdiction of a case, there is concurrent jurisdiction. Only one court will hear the case between the parties and will hear all causes of action, whether based on state or federal law.

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.

3.2.4 How a Case Proceeds

3.2.4.1 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. An agent of the court, such as a sheriff or process server, will then serve the defendant with the complaint and a summons. If the defendant is out of state, it might be possible to serve process through the mail. 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.

3.2.4.2 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).

3.2.4.3 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.

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.

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. In the 2010s, the Supreme Court established the current rules for personal jurisdiction under the Fourteenth Amendment. In a series of cases, the Court found that due process requires that personal jurisdiction arise in one of two ways: specific jurisdiction exists when the defendant's conduct in the forum state gave rise to the case, and general jurisdiction exists where the defendant is incorporated or essentially "at home."[14] This generally limits the states in which one can sue a defendant to the home of the defendant or the state in which the defendant's conduct created the facts of the case. Corporations are typically regarded as home in their state of incorporation, or the state in which the company maintains its headquarters.

3.2.5 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

14. *Walden v. Fiore*, 134 S. Ct. 1115 (2014) and *Daimler AG v. Bauman*, 571 U.S. 20 (2014).

different states, the judge may have difficulty determining which law to apply.

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.

3.3 Motions and Discovery

Learning Objectives

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

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[15] (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

15. The initial documents filed by parties in a lawsuit.

various motions[16], 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.

3.3.1 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

16. Written requests made to a presiding judge. These include motions to dismiss, motions for summary judgment, motions to direct an opposing party to divulge more in discovery, motions for a directed verdict, motions for judgment n.o.v., and many others.

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.[17] If there is no triable question of fact

17. As in a directed verdict, when a judge grants summary judgment, she has concluded that there are no matters of law or fact on which

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.

3.3.2 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

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reasonable people would disagree. Summary judgment is a final order, and it is appealable.

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.

3.4 The Pretrial and Trial Phase

Learning Objectives

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

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.

3.4.1 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; more than 90 percent of all civil cases end before trial, and more than 90 percent of criminal prosecutions end with a guilty plea.

3.4.2 Trial

At trial, the first order of business is to select a jury. (In a federal civil case claiming over $20 in damages, either party can request one, based on the Seventh 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.

The judge acts as the trial's "referee".

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[18]—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

18. At the close of one party's evidence, the other party may move for a directed verdict, or renew that motion at the close of all parties' evidence. A judge will direct a verdict if there is no real issue of fact for reasonable jurors to consider and if the law as applied to the facts in evidence clearly favors the party who requests the directed verdict.

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 verdicts have been overturned on appeal because a trial judge 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.)

3.4.3 Post-Trial 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.[19], from the Latin non obstante veredicto). A

19. Judgment "notwithstanding the verdict" may be awarded after the jury returns a verdict that the judge believes no rational jury could

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.

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 have come to. Judgment n.o.v. reverses the verdict and awards judgment to the party against whom the jury's verdict was made.

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.

3.5 Judgment, Appeal, and Execution

Learning Objectives

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

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.

3.5.1 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.

3.5.2 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.

3.5.3 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.

3.6 When Can Someone Bring a Lawsuit?

Learning Objectives

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

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.

3.6.1 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.

The "Case or Controversy" Clause in Article III, Section 2 of the Constitution

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.

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, in *California v. Texas*, a group of states and several individuals challenged the constitutionality of the Affordable Care Act's healthcare enrollment mandate. The mandate imposed a tax on individuals who were not enrolled in a health plan. Prior to the lawsuit, Congress had already reduced the tax to $0 in an attempt to effectively eliminate the mandate. Can anyone be injured by a "mandate" if the penalty for non-compliance is $0?

The individual plaintiffs claimed that, even with a $0 tax penalty, they still enrolled in a health plan because they wanted to comply with the law. Their injury, therefore, was having to enroll in a health plan when they would not have otherwise done so. The Supreme Court responded: "Their problem lies in the fact that the statutory provision, while it tells them to obtain that coverage, has no means of enforcement. With the penalty zeroed out, the IRS can no longer seek a penalty from those who fail to comply. Because of this, there is no possible Government action that is causally connected to the plaintiffs' injury."[20]

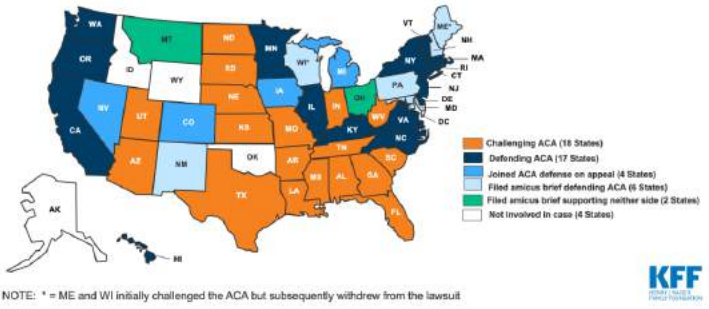
Because the states were not subject to the individual mandate, they claimed to have suffered an even more indirect injury: that the mandate had caused increased enrollment in

20. *California v. Texas*, 141 S. Ct. 2104, 2115 (2021)

state-run health plans, which in turn increased their administrative costs. "[S]etting aside that pure issue of law, we need only examine the initial factual premise of their claim to uncover another fatal weakness: The state plaintiffs have failed to show that the challenged minimum essential coverage provision [the mandate], without any prospect of penalty, will harm them by leading more individuals to enroll in these programs."[21]. Thus, the Court did not address the provision's constitutionality because none of the plaintiffs had standing to challenge it.

Figure 1

States' positions in *California v. Texas* at the Supreme Court



NOTE: * = ME and WI initially challenged the ACA but subsequently withdrew from the lawsuit

3.6.2 Class Actions

Most lawsuits concern a dispute between two people or between a person and a company or other organization. But

21. *California v. Texas*, 141 S. Ct. 2104, 2117 (2021)

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.

3.7 Relations with Lawyers

Learning Objectives

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

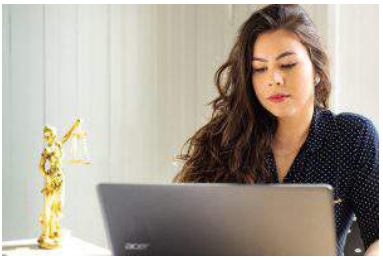
1. Understand the various ways that lawyers charge for services.
2. Describe the contingent fee system in the United States.
3. Know the difference between the American rule and the British rule with regard to who pays attorneys' fees.

3.7.1 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.

3.7.2 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.

4.

ALTERNATIVE DISPUTE RESOLUTION

4 Alternative Means of Resolving Disputes

Learning Objectives

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

1. Identify the different methods of alternative dispute resolution.
2. Decide when ADR is more appropriate than litigation to resolve a dispute.

Although this book primarily focuses on trials and litigation,

Alternative Dispute Resolution ("ADR") methods offer parties a way to settle their disputes outside the courtroom. The umbrella term ADR includes any method of resolving disputes without litigation. ADR includes a range of conflict resolution processes and techniques that occur outside of any governmental authority. This chapter will focus on three common ADR methods: negotiation, mediation, and arbitration.

4.1 Pitfalls of Litigation

Litigation has many drawbacks and should be treated by businesses as a last resort. First, litigation can be incredibly expensive for all parties involved. For example, during the Deepwater Oil Spill in 2010, over 130 million gallons of oil leaked into the Gulf of Mexico.[1] The spill caused immense harm to the environment and to individuals living nearby. BP Oil was held responsible for the spill and ultimately agreed to pay over $11 billion to injured parties. The settlement included a payment of almost $600 million in attorneys' fees to the lawyers representing the injured parties. This does not include the amount that BP Oil spent on its own attorneys, which is unknown. If the parties had resolved their disputes outside of

1. https://www.nationalgeographic.com/animals/article/how-is-wildlife-doing-now--ten-years-after-the-deepwater-horizon

court – which is admittedly unlikely in this case – hundreds of millions of additional dollars could have gone to environmental clean-up and injured parties instead of to attorneys.

Even in smaller-scale cases, attorneys' fees regularly cost tens or hundreds of thousands of dollars. The chart below shows the median litigation costs for various types of claims.[2] Based on the chart below, if an employee sues for $50,000 in lost wages, would it make more financial sense to pay the employee or to go to court? Are there any other important considerations besides the cost of attorneys?

In addition to the high costs of litigation, cases can go on for

2. Paula Hannaford-Agor, Measuring the cost of civil litigation: Findings from a survey of trial lawyers, Voir Dire 22, 26 (Spring 2013).

years and demand large amounts of a business's time. In 2011, for example, Apple accused Samsung of copying the iPhone. Seven years and a trip to the Supreme Court later, the parties finally settled the case in 2018.[3] Although major companies can afford to be tied up in litigation for years, most businesses would prefer to spend their time and money on other matters.

Finally, the adversarial nature of litigation can permanently damage relationships between the parties. This may not have mattered for two competitors like Apple and Samsung. However, what if a distributor of bicycles had a dispute with their largest supplier of bicycle tires? Even a well-intentioned lawsuit may anger the supplier and ruin the relationship between the two companies. This would leave the bicycle distributor with a short-term win in the lawsuit but a long-term problem of where to find tires. It is therefore crucial to consider the risks to a business relationship before filing a lawsuit against another party who you may work with again in the future.

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3. https://money.cnn.com/2018/06/27/technology/apple-samsung-patent-infringement-settlement/index.html#:~:text=The%20settlement%20closes%20a%20dispute,%24140%20million%20it%20owed%20Apple.

ADR methods address these issues by reducing the cost, time, and animosity in a dispute.

4.2 Negotiation

Negotiation is the preeminent mode of dispute resolution. While the two most commonly discussed forms of ADR are arbitration and mediation, negotiation is almost always attempted first to resolve a dispute. Negotiation allows the parties to meet in order to settle a disagreement. The main advantage of this form of dispute settlement is that it allows the parties themselves to control the process and the solution. Negotiation is much less formal than other types of ADRs and allows for a lot of flexibility.

Most businesses and individuals will naturally rely on negotiation as a first step in a dispute. If a warehouse fails to deliver a shipment of products on time to a store, that store's manager will likely try to solve the problem through negotiation as a first step. This could be as simple as calling the warehouse and asking why the delay occurred and whether it will happen again. Perhaps the manager would seek a discount on the late products or a guarantee that there would be no more delays. This approach would save the time, money, and animosity associated with litigation. It would also be faster and less expensive than other forms of ADR like mediation and arbitration.

What if the relationship between the store and warehouse was already strained? Maybe it had delivered a number of items late over the past year and had not kept its promises in past

negotiations. Negotiations are a great first step for resolving problems, but they rely on the ability of the two parties to reach an agreement without outside help. When this is not possible, the parties may want to rely on mediation or arbitration to resolve their disputes.

4.3 Mediation

Mediation is a slightly more formal type of ADR in which the parties rely on a neutral third person to help solve their dispute. This neutral third person – called a **mediator** – is selected by the parties. She serves as something like a referee in the disagreement. Like athletes, the parties have full control over how they "play the game" and its outcome. They can freely engage in discussion (within the scope of the agreed upon rules) and accept or reject any proposed resolutions. As the referee, the mediator's role is only to enforce the agreed upon rules. These may include the length of meetings and the general items to be addressed during them. However, the mediator has no authority to bind the parties to an agreement, even when she thinks it is in their best interests.

Mediation can be effective when parties are unable to resolve their disputes through direct negotiation. During a

contentious divorce, for example, spouses may rely on a mediator to help divide their assets before going straight to trial. They may negotiate in the presence of a mediator ("**conference mediation**") or could even sit in separate rooms and speak to each other only through the mediator ("**shuttle mediation**"). Reaching an agreement before going to trial could save the spouses thousands of dollars as well as the headache of going to court.

Mediation can be advantageous in a business setting due to its speed and affordability. For example, a jeweler sued a supplier for failing to deliver approximately $57,000 worth of jewelry. Before trial started, both parties agreed to use a mediator to try to settle the disagreement. They reached an agreement in which the supplier would pay back $39,000 and would continue to sell the jeweler items at a discounted rate. The mediation took four hours and cost each party $560.[4] If Apple and Samsung had resolved their dispute in this way, they could have saved seven years and tens of millions of dollars in legal fees.

The jeweler example demonstrates a third advantage of mediation over litigation: more room for creativity. Judges and juries are constrained in the types of remedies they may award at the end of a trial. In contrast, parties in a mediation can

4. https://effectivedisputesolutions.co.uk/mediation/case-studies/birmingham-mediation-contract-dispute

reach agreements tailored to their unique needs. The result may include monetary awards or other creative solutions like an ongoing discount on a product. Thus, creative mediation agreements can both repair a harm and serve other needs like encouraging a continued business relationship.

4.4 Arbitration

Arbitration is a type of ADR in which the parties rely on a private decision maker (an **"arbitrator"**) to resolve their disputes. Although the rules of procedure are considerably more relaxed than those that apply in the courtroom, the proceedings are closer to a trial than other forms of ADR.

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. They will typically express this preference by including an **arbitration clause** in the contract. In an arbitration clause (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. Some arbitration clauses name a specific person as the arbitrator; others identify a neutral third-party who then selects the arbitrator. In practice, most parties adopt the methods and procedures recommended by the American Arbitration Association.

Sample Arbitration Clause[5]

In the event a dispute shall arise between the parties to this [contract, lease, etc.], it is hereby agreed that the dispute shall be referred to [a named arbitrator or arbitration organization] for arbitration in accordance with [a specified set of arbitration rules or guidelines]. The arbitrator's decision shall be final and binding and judgment may be entered thereon. In the event a party fails to proceed with arbitration, unsuccessfully challenges the arbitrator's award, or fails to comply with arbitrator's award, the other party is entitled of costs of suit including a reasonable attorney's fee for having to compel arbitration or defend or enforce the award.

It is also important to familiarize yourself with state law governing arbitration clauses. For example, Missouri law requires that contracts with an arbitration clause include the following language in ten-point, capital font directly before the contract's signature line: "THIS CONTRACT

5. https://usam.com/arbitration/sample-arbitration-clauses/

CONTAINS A BINDING ARBITRATION PROVISION WHICH MAY BE ENFORCED BY THE PARTIES."[6]

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). When a contract specifies that arbitration will take place though this Association, the parties are agreeing to be bound by the Association's rules and procedures. 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.

An arbitration hearing resembles a trial in many ways. Each party will typically begin with an opening statement and will

6. Mo. Ann. Stat. § 435.460. Note that this provision only applies when the arbitration clause is outside the scope of the Federal Arbitration Act. *Duggan v. Zip Mail Servs., Inc.*, 920 S.W.2d 200, 203 (Mo. Ct. App. 1996).

then present their case to the arbitrator. Like in a trial, this presentation may include witnesses and the introduction of evidence. The parties conclude with closing arguments. An arbitrator usually reaches her decision (the **"award"**) 30 or 60 days after the hearing; the parties may also request an oral decision immediately following the hearing if that is required (a **"bench decision"**).

Arbitration has several 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. Finally, parties can keep the record from arbitration private if they desire to do so. In contrast, most records from litigation are available to the general public.

Due in part to these advantages, arbitration is used in a broad range of settings. The MLB, for instance, relies on a unique form of arbitration to settle salary disputes.[7] Players with between three and six years of MLB experience are eligible for salary arbitration. Typically, these players are still on their rookie contract but would like to

7. https://www.mlb.com/glossary/transactions/salary-arbitration

be paid more than the league's minimum salary. If the player and his team cannot agree on a salary by a deadline, they must both submit a proposed salary to a panel of arbitrators. The arbitrators then hear each side's arguments and choose one of the two proposals; they may not average the two or choose a third salary. What incentives might this create to avoid arbitration? How could it impact the proposed salary each party submits to the arbitrator?

In addition to MLB salary disagreements, arbitration is commonly relied on to resolve disputes about labor/employment, intellectual property, construction, real estate, and international business dealings.

Congress "declared a national policy favoring arbitration" when it passed the Federal Arbitration Act in 1925.[8] Under this law, parties must use arbitration to settle their disputes if their agreement contains an arbitration clause. This broadly applies to arbitration clauses in documents like supply contracts, employment agreements, and personnel policies. If a party subject to an arbitration clause tries to sue in court, the other party can seek an order compelling them to go to arbitration. Although an arbitration clause may seem like boilerplate language, it is therefore crucial for businesses to consider both whether to include one in a contract and what

8. Southland Corp. v. Keating, 465 U.S. 1, 10 (1984).

specific provisions it contains (e.g., how to choose an arbitrator, rules of arbitration, etc.).

The arbitrator's decision is final and binding, even if the arbitrator reaches an arguably incorrect legal decision, with very few exceptions (such as fraud or a decision that violates public policy). 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.

5.

CORPORATE SOCIAL RESPONSIBILITY AND BUSINESS ETHICS

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. How- ever, 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.

5.1 What Is Ethics?

Learning Objectives

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

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.

5.1.1 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.

Proposition 1 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).

Proposition 2 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.

4.1.2 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 "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.

5.2 Major Ethical Perspectives

Learning Objectives

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

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

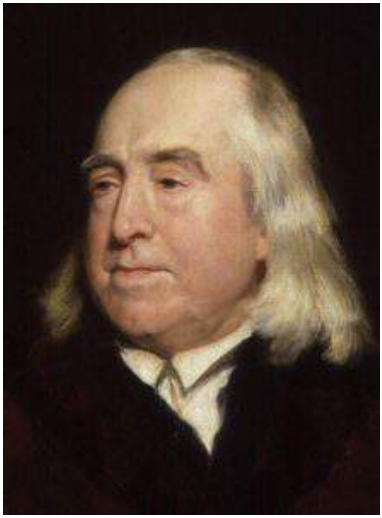
There are several well-respected ways of looking at ethical issues. Some of them have been around for centuries. It is important to know that many who think a lot about business and ethics have deeply held beliefs about which perspective is best. Others would recommend considering ethical problems from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

5.2.1 Utilitarianism (or, the Consequences Tradition)

Utilitarianism[1] 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

1. The theory that the "right" moral act is the one that produces the greatest good for society.

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. In the Four Traditions of Ethical Thought we discuss in class, utilitarianism matches most closely with the Consequences Tradition.



Jeremy Bentham

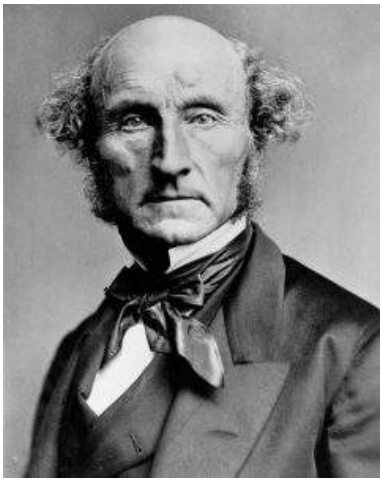
Bentham believed that the most promising way to obtain agreement on the best policies for a society would be to look at the various policies a legislature could pass and compare the good and bad consequences of each. The right course of action from an ethical point of view would be to choose the policy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

This statement describes "act utilitarianism"—which action among various options will deliver the greatest good to society? "Rule utilitarianism" is a slightly different version; it

asks, what rule or principle, if followed regularly, will create the greatest good?

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

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



John Stuart Mill

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:

- 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.
- 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.

- 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.
- Underestimating the cost or harm of a certain decision to someone else or some other group of people.
- Favoring short-term benefits, even though the long-term costs are greater.
- 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.

5.2.2 Rules and Duty: Deontology (the Standards of Conduct Tradition)

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.

Immanuel Kant

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[2] 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

2. A theory that judges the morality of choices not by results (or "goods") but by adherence to moral norms. The duty to act in accord with these norms is one that bears no relation to the expected consequences of the action.

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?").

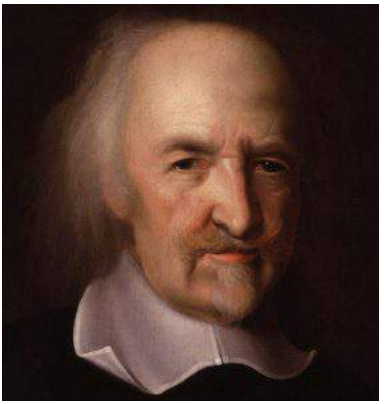
5.2.3 Social Justice Theory and Social Contract Theory (Similarities to relationships/Care Tradition)

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 giving that is not voluntary. Certain economists, such as the late Milton Friedman 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 pandemics—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[3] (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."

3. Goods that are useful to society (parks, education, national defense, highways) that would ordinarily not be produced by private enterprise. Public goods require public revenues (taxes) and political support to be adequately maintained.



Thomas Hobbes

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[4], 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!

4. The idea that people in a civil society have voluntarily given up some of their freedoms to have ordered liberty with the assistance of a government that will support that liberty. Hobbes and Locke are generally regarded as the preeminent social contract theorists.

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:

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.

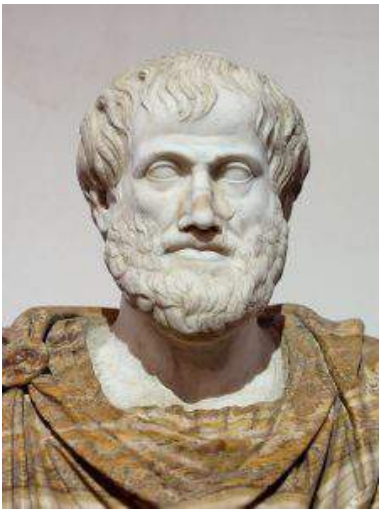
Rights and duties exist not only between people and their governments but also between individuals. Your right to be free from physical assault is protected by the law in most states, and when someone walks up to you and punches you in the nose, your rights—as set forth in the positive law of your state—have been violated. Thus other people have a duty to respect your rights and to not punch you in the nose.

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).

5.2.4 Aristotle and Virtue Theory

(Similarities to Character Tradition)



Virtue theory[5], 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,

5. Aristotle's perspective on finding happiness through the application of reason in human affairs advises continual practice to develop habits of virtuous moral character. In a modern setting, deliberating on core values and their application to individual and corporate ethical dilemmas and adhering to the recommendations of core values analysis would provide similar practice.

generosity, and high-mindedness. This pursuit is also termed "knowledge of the good" in Greek philosophy.[6]

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

6. LaRue Tone Hosmer, Moral Leadership in Business (Chicago: Irwin Professional Publishing, 1994), 72.

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.[7]

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

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

5.2.5 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[8] 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

8. Values that are generally recognized as positive ethical characteristics of an individual or a business organization. People may have strong views about other kinds of ethical values, but core values are more widely accepted.

family or in places of wor- ship 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.

5.3 An Ethical Decision Model

Learning Objectives

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

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.

5.3.1 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.

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 in- formed, 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.

5.4 Corporations and Corporate Governance

Learning Objectives

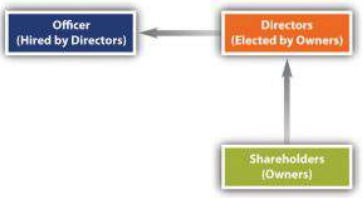
After reading this section, you should be able to do the following:

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.

5.4.1 Legal Organization of the Corporation



This figure, 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 interests; 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.

5.4.2 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.

5.4.2.1 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.

Advocates of this counterpoint might also point out two difficulties with the "maximize profit" alone approach to business strategy. First, very different decisions might be reached based on the timeframe involved in the maximization problem. Some decisions that maximize profit in the short term might be disasterous for profit in the long run. E.g., Enron. When considering long-term profit, many decisions such as investing in customer or community relations are rational, even if they have no short-term effect on profits. Second, the best way to maximize profit might be to adopt a more stakeholder-centric view of business! Nobody likes to visit a business that they feel does not appreciate them, and nobody likes to work for a company that does not value employees. In anything but the short term, considering the needs of crucial stakeholders beyond shareholders alone is almost always a sound business decision, resulting in long-term gains for shareholders as well!

5.4.2.2 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[9]) 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

9. The view that all stakeholders to a corporate decision deserve some kind of moral consideration and that corporations that keep all stakeholders in mind will, over the long term, deliver superior results to shareholders.

of its decisions on a wide range of stakeholders, not just shareholders. As the table below indicates, stakeholders have very different kinds of interests ("stakes") in the actions of a corporation.

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

Stakes of Various Stakeholders

5.4.3 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.

5.4.3.1 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.

5.4.3.2 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.[10] 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.

5.4.3.3 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

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

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.[11] When Sherron Watkins sent Ken Lay a letter warning him about Enron's accounting practices, CFO Andrew Fastow tried to fire her.[12]

5.4.3.4 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

11. John Schwartz, "An Enron Unit Chief Warned, and Was Rebuffed," New York Times, February 20, 2002.
12. Warren Bennis, "A Corporate Fear of Too Much Truth," New York Times, February 17, 2002.

company's oft-celebrated corporate response.[13] 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.[14]

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13. University of Oklahoma Department of Defense Joint Course in Communication, Case Study: The Johnson & Johnson Tylenol Crisis, accessed April 5, 2011.
14. FindLaw, Report of Investigation by the Special Investigative

5.4.3.5 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.

5.4.3.6 Managing by the Numbers If you manage by the numbers, there is a temptation to lie about those numbers,

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Committee of the Board of Directors of Enron Corp., February 1, 2002, accessed April 5, 2011.

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.[15]

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

15. Steven Pearlstein, "Debating the Enron Effect," Washington Post, February 17, 2002.

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.

5.4.4 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[16] 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.[17]

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

16. 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.
17. 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.

"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.

5.4.5 Putting it All Together

To combine our discussion of ethics and stakeholders, the following framework may be useful when approaching an ethical problem.

1. Identify stakeholders (those who influence the organization, and who are influenced by it) and

their wishes

2. Identify alternative solutions to the problem
3. Apply an ethical framework
    a. Choose an ethical framework
    b. State what that framework entails
    c. Apply the framework to the facts, considering stakeholders and alternatives
    d. Reach a conclusion for that framework
4. Repeat (3) for alternative ethical frameworks
5. Discuss differences between framework outcomes
6. Reach an overall conclusion

6.

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.[1] 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.

1. Although the common law preceded the Constitution, and remains in force, constitutional processes like creation of statutes may overrule the common law.

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[2], 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.

Local Angle

2. 62The power the Supreme Court has to say what the US Constitution means. Because the Constitution speaks in broad terms, the interpretations of the Supreme Court as to the meaning of its provisions define what the Constitution means. The Constitution can only be changed by amendment or by further interpretation by the Supreme Court.

The University of Iowa Libraries have an excellent guide to the Constitution: http://guides.lib.uiowa.edu/us_constitution.

This guide also features on-campus activities planned each year for Constitution Day in September, such as a live reading of the Constitution, and places where you can go to pick up your own pocket copy of the Constitution!

6.1 Basic Aspects of the US Constitution

Learning Objectives

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

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.

6.1.1 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.

Lewis Hine, Adolescent Girl, a Spinner, in a Carolina Cotton Mill (1908)

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 no- tably affirmed by the Supreme Court in the *Dred Scott* decision in 1857.[3] 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.[4]

3. 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.
4. Roe v. Wade, 410 US 113 (1973).

6.1.2 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. The Fourteenth Amendment is often considered the most important, as otherwise the rights guaranteed in the Constitution would apply to Congress alone, and not the states.[5]

6.1.3 Federalism

The partnership created in the Constitution between the states

5. That is, states would be free to, e.g., control speech and gun rights without considering the First or Second Amendments, subject to the restrictions in their respective state constitutions only.

and the federal government is called federalism.[6] In effect, federalism is the concept of shared governance between the states and the federal government.. 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.

6.1.4 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.[7] Thus the president retains veto power, but the House of Representatives is entrusted with the power to initiate spending bills.

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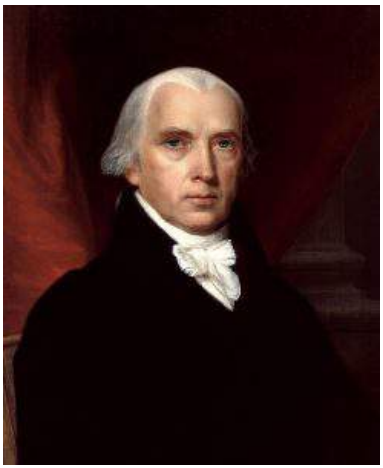
6. The idea, built into the structure of the Constitution, that states and the federal government have concurrent powers
7. In the original design of the Constitution, the executive, legislative, and judicial branches were all given powers that could modify or limit the powers of the other branches of government. For example, the president wields a veto power over congressional legislation.

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 below, which held that corporations are "persons" with "free speech rights" that include spending unlimited amounts of money in campaign donations and political advocacy. *Kimel v. Florida Board of Regents*, 528 US 62 (2000).

Because *Roe v. Wade* has been so controversial, this chapter includes a seminal case on "the right of privacy," *Griswold v. Connecticut*, below. Was the court 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 the subsection "Fifth Amendment" below). 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.

Similarly in more recent years, the Supreme Court in *Obergefell v. Hodges* found a right to same-sex marriage within the Constitution, striking provisions in many state constitutions, based on the idea that banning same-sex marriage violated the dignity of same-sex couples. The Constitution says nothing directly about privacy, dignity, family, or reproductive rights, yet the Supreme Court has used the Constitution to protect these areas.

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, or when deciding dignity rights protected same-sex marriage, the Supreme Court did not act on the basis of clear and unequivocal language in the Constitution, and it made illegal any state or federal legislative or executive action contrary to its interpretations. Only a constitutional amendment or the court's repudiation of these cases 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.

6.2 The Commerce Clause

Learning Objectives

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

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[8] 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

8. Article I, Section 8, of the US Constitution is generally regarded as the legal authority by which the federal government can make law that governs commerce among the states and with foreign nations.

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;

The Commerce Clause undergirds most federal regulation of the economy.

6.2.1 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.[9] 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

9. Hipolite Egg Co. v. United States, 220 US 45 (1911).

from the systematic enticement to, and the enslavement in prostitution and debauchery of women, and, more insistently, of girls."[10]

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."

10. Hoke v. United States, 227 US 308 (1913).

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.

6.2.2 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.

6.2.3 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.

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.[11]

11. Katzenbach v. McClung, 379 US 294 (1964).

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

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

violence. Morrison and Crawford moved to dismiss Brzonkala's suit on the ground that Section 13981's civil remedy was unconstitutional. In dismissing the complaint, the district court found that that Congress lacked authority to enact Section 13981 under either the commerce clause or the Fourteenth Amendment, which Congress had explicitly identified as the sources of federal authority for the VAWA. Ultimately, the court of appeals affirmed, as did the Supreme Court.

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

The absence of a workable judicial commerce clause touchstone remains. In 1996, California voters passed the Compassionate Use Act, legalizing marijuana for medical use. California's law conflicted with the federal Controlled

Substances Act (CSA), which banned possession of marijuana. After the Drug Enforcement Administration (DEA) seized doctor-prescribed marijuana from a patient's home, a group of medical marijuana users sued the DEA and US Attorney General John Ashcroft in federal district court.

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

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

the national marijuana market, making the regulation of intrastate use "essential" to regulating the drug's national market.

Notice how similar this reasoning is to the court's earlier reasoning in *Wickard v. Filburn*. 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.

6.3 Dormant Commerce Clause

Learning Objectives

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

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.
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.[12]

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 "Summary and Exercises", is

12. Even when the federal government does not act to make rules to govern matters of interstate commerce, the states may (using their police powers), but they may not do so in ways that unduly burden or discriminate against interstate commerce.

an example of a case where Iowa imposed an undue burden on interstate commerce by prohibiting double trailers on its highways.[13] Iowa's prohibition was judicially declared void when the Supreme Court judged it to be an undue burden.

Discrimination 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.[14] 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.

13. Kassell v. Consolidated Freightways, 450 US 662 (1981).
14. Oregon Waste Systems v. Department of Environmental Quality, 511 US 93 (1994).

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.)[15]

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.

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

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.

6.4 Preemption: The Supremacy Clause

Learning Objectives

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

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.[16]

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

16. Cippolone v. Liggett Group, 505 US 504 (1993).

> in the Constitution or Laws of any State to the Contrary notwithstanding.

The preemption[17] 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

17. Based on the supremacy clause, the preemption doctrine holds that state and federal laws that conflict must yield to the superior law, which is federal law.

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.

Federal preemption also explains much of the law one encounters in everyday life, such as in the grocery store. For example, often students who have studied some consumer law note that many juices are labeled "100% Juice" yet contain some added ingredients, such as citric acid. Here, state-based false advertising laws attorneys might bring to attack these

claims have been preempted by FDA regulations, which regulates the term "100%".[18]

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.

18. E.g., 21 CFR § 101.30.

6.5 Business and the Bill of Rights

Learning Objectives

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

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 our chapter on civil procedure, where we saw how due process limited the locations in which one could sue a defendant. 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.

6.5.1 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.[19]

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.

6.5.2 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

19. Jackson v. Metropolitan Edison Co., 419 US 345 (1974).

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 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.[20] 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."

20. Buckley v. Valeo, 424 US 1 (1976).

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* (below), 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."

6.5.3 Fourth Amendment

The Fourth Amendment says, "all persons shall be secure in their persons, houses, pa- pers, 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.

6.5.4 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[21], the takings clause[22], and substantive

21. In matters of civil or criminal procedure, the Constitution requires that both states and the federal government provide fair process (or due process) to all parties, especially defendants who are accused of a crime or, in a civil case, defendants who are served with a summons and complaint in a state other than their residence.
22. In the Fifth Amendment, the government is required to provide

due process[23]. 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.

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,

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compensation to the owner for any taking of private property. The same requirement is imposed on states through the due process clause of the Fourteenth Amendment (under selective incorporation).

23. A doctrine of the Supreme Court that negated numerous laws in the first third of the 20th century. Its use in the past 80 years is greatly diminished, but it survives in terms of protecting substantive liberties not otherwise enumerated in the Constitution.

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.[24] 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

24. Kelo v. City of New London, 545 US 469 (2005).

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*, 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.[25] 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.

6.5.5 Fourteenth Amendment: Due Process and Equal Protection

25. Cruzan v. Missouri Department of Health, 497 US 261 (1990).

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 or an issue of substantive due process. For substantive due process, consider what happened in an Alabama court not too long ago.[26]

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

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

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.

The BMW case established constitutional limitations on punitive damages.

"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).[27]

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 (or "rational basis review"): economic and social relations. Government actions are usually upheld if there is a rational basis for them.
- Intermediate scrutiny: gender. Government

27. Plessy v. Ferguson, 163 US 537 (1896).

classifications are sometimes upheld.

- Strict scrutiny: race, ethnicity, and fundamental rights. Classifications based on any of these are almost never upheld.

Under minimal scrutiny (or rational basis review) 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.)[28]

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.[29] 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

28. United States v. Virginia, 518 US 515 (1996).

29. Palmore v. Sidoti, 466 US 429 (1984).

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.[30]

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.

Optional Viewing – The Executive Branch

30. Atty. Gen. of New York v. Soto-Lopez, 476 US 898 (1986).

The US Constitution sets out the three branches of government – judicial, legislative, and executive. The Iowa Constitution does this as well. In this video interview, Professor Dayton speaks with Lieutenant Governor Adam Gregg, who is second in command in our executive branch- and also a lawyer.

One or more interactive elements has been excluded from this version of the text. You can view them online here: https://pressbooks.uiowa.edu/introtolaw/?p=139#oembed-1

7.

ADMINISTRATIVE AND ENVIRONMENTAL 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.

7.1 Administrative Agencies: Their Structure and Powers

Learning Objectives

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

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.

7.1.1 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[1]

1. Governmental units, either state or federal, that have specialized expertise and authority over some area of the economy.

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.

7.1.2 Why Regulate the Economy at All?

The market often does not work properly, as economists usually 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) can be helpful. Negative externalities must be "fixed," as well. For example, as we see in 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 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.

Other market imperfections can yield a demand for regulation. For example, there is a need to regulate frequencies for public broad- cast 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 some- thing that must be created by government. On its own, for example, the market would have difficulty completely providing public goods such as education, a highway system, a military for defense.

At the same time, government regulation can go beyond correcting externalities and market imperfections. Often government agencies are subject to "capture" by the very industry they were created to regulate, and so regulations are issued that preserve monopoly power, limit consumer choice, favor certain businesses, and so on.

7.1.3 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 with the Supreme Court's expansive interpretation of the Commerce Clause (more ability to legally regulate led to more regulatory agencies), 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.

Optional Viewing: Iowa Leaders in the Law

Secretary of Agriculture Thomas Vilsack is an Iowa lawyer, former Governor of the State of Iowa, and has served in the Cabinets of two different Presidents. In this interview, Professor Dayton discusses Sec. Vilsack's road from being an orphan to heading up one of the most important administrative agencies in the federal government.

One or more interactive elements has been excluded from this version of the text. You can view them online here:
https://pressbooks.uiowa.edu/introtolaw/?p=164#oembed-1

7.1.4 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).

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).

7.1.5 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.

The Food and Drug Administration (FDA) oversees regulation of large areas of the economy, from food labeling to prescription drugs to medical devices. For example, FDA establishes regulations for required "serving sizes" on food products. An extensive table establishes these amounts for an incredibly specific variety of foods.

Product category	Reference amount	Label statement [4]
Bakery Products:		
Bagels, toaster pastries, muffins (excluding English muffins)	110 g	_ piece(s) (_ g)
Biscuits, croissants, tortillas, soft bread sticks, soft pretzels, corn bread, hush puppies, scones, crumpets, English muffins	55 g	_ piece(s) (_ g)
Breads (excluding sweet quick type), rolls	50 g	_ piece(s) (_ g) for sliced bread and distinct pieces (e.g., rolls); 2 oz (56 g/_ inch slice) for unsliced bread
Bread sticks - see crackers		
Toaster pastries - see bagels, toaster pastries, muffins (excluding English muffins)		
Brownies	40 g	_ piece(s) (_ g) for distinct pieces; fractional slice (_ g) for bulk
Cakes, heavyweight (cheese cake; pineapple upside-down cake; fruit, nut, and vegetable cakes with more than or equal to 35 percent of the finished weight as fruit, nuts, or vegetables or any of these combinations) [5]	125 g	_ piece(s) (_ g) for distinct pieces (e.g., sliced or individually packaged products); _ fractional slice (_ g) for large discrete units

An example from the FDA's table (valid as of January 2022).

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.

7.1.6 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.[2] The concept that Congress can delegate power to an agency is known as the delegation doctrine.[3] 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

2. The legislative act that establishes an agency's authority in a particular area of the economy.
3. As a matter of constitutional law, the delegation doctrine declares that an agency can only exercise that power delegated to it by a constitutional authority.

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.[4] 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

4. Schechter Poultry Corp. v. United States, 295 US 495 (1935).

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 "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.

OSHA regulations aim to protect from workplace dangers.

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.

7.2 Controlling Administrative Agencies

Learning Objectives

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

1. Understand how the president controls administrative agencies.

2. Understand how Congress controls administrative agencies.
3. Understand how the courts can control administrative agencies.

During the course of the past seventy years, a substantial debate has been conducted, often in shrill terms, about the legitimacy of administrative lawmaking. One criticism is that agencies are "captured" by the industry they are directed to regulate. Another is that they overregulate, stifling individual initiative and the ability to compete. During the 1960s and 1970s, a massive outpouring of federal law created many new agencies and greatly strengthened the hands of existing ones. In the late 1970s during the Carter administration, Congress began to deregulate American society, and deregulation increased under the Reagan administration. But the accounting frauds of WorldCom, Enron, and others led to the Sarbanes-Oxley Act of 2002, and the financial meltdown of 2008 has led to reregulation of the financial sector. In the 2010s, the Trump administration set about a large scheme of government deregulation, citing concerns that regulation impaired business productivity.

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. 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.

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.

Major Administrative Agencies of the United States

7.2.1 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.

7.2.2 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.

7.2.3 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, often believing that the agencies are better situated to judge their own jurisdiction and are experts in rulemaking for those matters delegated to them by Congress. In a famous case referred to as *Chevron*,[5] the United States Supreme Court established the doctrine of "*Chevron* deference." This doctrine states that courts should defer to how agencies interpret statutes. If Congress did not speak clearly to an issue, courts must defer to the agency's "permissible" or "reasonable" interpretation of the statute.

Key Takeaway

5. Chevron, USA v. Natural Resources Defense Council, Inc., 467 US 837 (1984)

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.

7.3 The Administrative Procedure Act

Learning Objectives

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

- Understand why the Administrative Procedure Act was needed.
- Understand how hearings are conducted under the act.
- Understand how the act affects rulemaking by agencies.

In 1946, Congress enacted the Administrative Procedure Act (APA).[6] 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.

7.3.1 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[7] (ALJ), formerly

6. The federal act that governs all agency procedures in both hearings and rulemaking.
7. The primary hearing officer in an administrative agency, who

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 par- ties 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

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provides the initial ruling of the agency (often called an order) in any contested proceeding.

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.

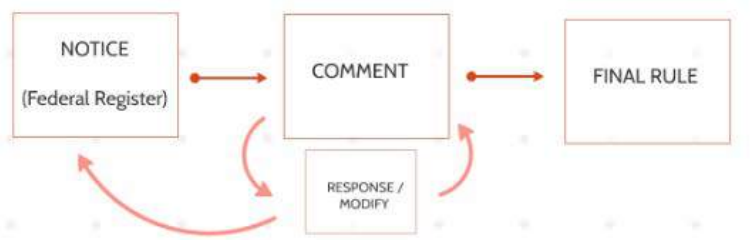
Certain types of agency actions that have a direct impact on individuals need not be filtered through a full-scale hearing. Safety and quality inspections (grading of food, inspection of airplanes) can be made on the spot by skilled inspectors. Certain licenses can be administered through tests without a hearing (a test for a driver's license), and some decisions can be made by election of those affected (labor union elections).

7.3.2 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[8] 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 administrative rulemaking process.

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

8. The Federal Register is where all proposed administrative regulations are first published, usually inviting comment from interested parties.

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)[9], 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

9. A compilation of all final agency rules. The CFR has the same legal effect as a bill passed by Congress and signed into law by the president.

Administrative Procedure Act (APA) governs both rulemaking and the agency enforcement of regulations, and it provides a process for fair hearings.

7.4 Administrative Burdens on Business Operations

Learning Objectives

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

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.

7.4.1 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.[10]

10. In re FTC Line of Business Report Litigation, 595 F.2d 685 (D.C. Cir. 1978).

In 1980, responding to cries that businesses, individuals, and state and local governments were being swamped by federal demands for paperwork, Congress enacted the Paperwork Reduction Act. It gives power to the federal Office of Management and Budget (OMB) to develop uniform policies for coordinating the gathering, storage, and transmission of all the millions of reports flowing in each year to the scores of federal departments and agencies requesting information. These reports include tax and Medicare forms, financial loan and job applications, questionnaires of all sorts, compliance reports, and tax and business records. The OMB was given the power also to determine whether new kinds of information are needed. In effect, any agency that wants to collect new information from outside must obtain the OMB's approval.

7.4.2 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.[11]

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.[12]

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

11. Marshall v. Barlow's, Inc., 436 US 307 (1978).
12. New York v. Burger, 482 US 691 (1987).

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.[13]

7.4.3 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.

13. Dow Chemical Co. v. United States Environmental Protection Agency, 476 US 227 (1986).

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 re- quest. 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 ex- emptions, 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; and
- 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.

7.5 The Scope of Judicial Review

Learning Objectives

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

- Describe the "exhaustion of remedies" requirement.
- Detail various strategies for obtaining judicial review of agency rules.
- 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.

7.5.1 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[14] 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

14. A requirement that anyone wishing to appeal an agency action must wait until the agency has taken final action.

not acting in good faith, the courts will hear an appeal without exhaustion.

7.5.2 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.

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; or
- 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.[15]

7.5.3 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?

15. Motor Vehicle Manufacturers' Assn. v. State Farm Mutual Ins., 463 US 29 (1983).

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 im- munity 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.[16]

In recent years, the Supreme Court has been stripping away the traditional immunity enjoyed by many government

16. Dalehite v. United States, 346 US 15 (1953).

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.[17] 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

17. Bivens v. Six Unknown Federal Narcotics Agents, 403 US 388 (1971).

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.[18] 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

18. Office of Personnel Management v. Richmond, 110 S. Ct. 2465 (1990).

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).

ENVIRONMENTAL LAW

Learning Objectives

1. Describe the major federal laws that govern business activities that may adversely affect air quality and water quality.
2. Describe the major federal laws that govern waste disposal and chemical hazards including pesticides.

In one sense, environmental law is very old. Medieval England had smoke control laws that established the seasons when soft coal could be burned. Nuisance laws give private individuals a limited control over polluting activities of adjacent

landowners. But a comprehensive set of US laws directed toward general protection of the environment is largely a product of the past quarter-century, with most of the legislative activity stemming from the late 1960s and later, when people began to perceive that the environment was systematically deteriorating from assaults by rapid population growth and greatly increased automobile driving, vast proliferation of factories that generate waste products, and a sharp rise in the production of toxic materials. Two of the most significant developments in environmental law came in 1970, when the National Environmental Policy Act took effect and the Environmental Protection Agency became the first of a number of new federal administrative agencies to be established during the decade.

NATIONAL ENVIRONMENTAL POLICY ACT

Signed into law by President Nixon on January 1, 1970, the National Environmental Policy Act (NEPA) declared that it shall be the policy of the federal government, in cooperation with state and local governments, "to create and maintain conditions under which man and nature can exist in productive harmony, and fulfill the social, economic, and other requirements of present and future generations of Americans.. . . The Congress recognizes that each person should enjoy a healthful environment and that each person

has a responsibility to contribute to the preservation and enhancement of the environment."

The most significant aspect of NEPA is its requirement that federal agencies prepare an environmental impact statement332 in every recommendation or report on proposals for legislation and whenever undertaking a major federal action that significantly affects environmental quality. The statement must (1) detail the environmental impact of the proposed action, (2) list any unavoidable adverse impacts should the action be taken, (3) consider alternatives to the pro- posed action, (4) compare short-term and long-term consequences, and (5) describe irreversible commitments of resources. Unless the impact statement is prepared, the project can be enjoined from proceeding. Note that NEPA does not apply to purely private activities but only to those proposed to be carried out in some manner by federal agencies.

ENVIRONMENTAL PROTECTION AGENCY

The Environmental Protection Agency (EPA) has been in the forefront of the news since its creation in 1970. Charged with monitoring environmental practices of industry, assisting the government and private business to halt environmental deterioration, promulgating regulations consistent with federal environmental policy, and policing industry for violations of the various federal environmental statutes and

regulations, the EPA has had a pervasive influence on American business. Business Week noted the following in 1977: "Cars rolling off Detroit's assembly line now have antipollution devices as standard equipment. The dense black smokestack emissions that used to symbolize industrial prosperity are rare, and illegal, sights. Plants that once blithely ran discharge water out of a pipe and into a river must apply for permits that are almost impossible to get unless the plants install expensive water treatment equipment. All told, the EPA has made a sizable dent in man-made environmental filth."[19]

The EPA is especially active in regulating water and air pollution and in overseeing the disposition of toxic wastes and chemicals. Clean Water Act Legislation governing the nation's waterways goes back a long time. The first federal water pollution statute was the Rivers and Harbors Act of 1899. Congress enacted new laws in 1948, 1956, 1965, 1966, and 1970. But the centerpiece of water pollution enforcement is the Clean Water Act of 1972 (technically, the Federal Water Pollution Control Act Amendments of 1972), as amended in 1977 and by the Water Quality Act of 1987. The Clean Water Act is designed to restore and maintain the "chemical, physical, and biological integrity of the Nation's waters."33 United States Code, Section 1251. It operates on the states,

19. [20]

20. [15]

requiring them to designate the uses of every significant body of water within their borders (e.g., for drinking water, recreation, commercial fishing) and to set water quality standards to reduce pollution to levels appropriate for each use.

CLEAN WATER ACT

Congress only has power to regulate interstate commerce, and so the Clean Water Act is applicable only to "navigable waters" of the United States. This has led to disputes over whether the act can apply, say, to an abandoned gravel pit that has no visible connection to navigable waterways, even if the gravel pit provides habitat for migratory birds. In *Solid Waste Agency of Northern Cook County v. Army Corps of Engineers*, the US Supreme Court said no.

The Clean Water Act also governs private industry and imposes stringent standards on the discharge of pollutants into waterways and publicly owned sewage systems. The act created an effluent permit system known as the National Pollutant

Discharge Elimination System. To discharge any pollutants into navigable waters from a "point source" like a pipe, ditch, ship, or container, a company must obtain a certification that it meets specified standards, which are continually being tightened. For example, until 1983, industry had to use the "best practicable technology" currently available, but after July 1, 1984, it had to use the "best available technology" economically achievable. Companies must limit certain kinds of "conventional pollutants" (such as suspended solids and acidity) by "best conventional control technology."

CLEAN AIR ACT

The centerpiece of the legislative effort to clean the atmosphere is the Clean Air Act of 1970 (amended in 1975, 1977, and 1990). Under this act, the EPA has set two levels of National Ambient Air Quality Standards (NAAQS). The primary standards limit the ambient (i.e., circulating) pollution that affects human health; secondary standards limit pollution that affects animals, plants, and property. The heart of the Clean Air Act is the requirement that subject to EPA approval, the states implement the standards that the EPA establishes. The setting of these pollutant standards was coupled with directing the states to develop state implementation plans (SIPs), applicable to appropriate industrial sources in the state, in order to achieve these standards. The act was amended in 1977 and 1990 primarily to set new goals (dates) for achieving

attainment of NAAQS since many areas of the country had failed to meet the deadlines.

Beyond the NAAQS, the EPA has established several specific standards to control different types of air pollution. One major type is pollution that mobile sources, mainly automobiles, emit. The EPA requires new cars to be equipped with catalytic converters and to use unleaded gasoline to eliminate the most noxious fumes and to keep them from escaping into the atmosphere. To minimize pollution from stationary sources, the EPA also imposes uniform standards on new industrial plants and those that have been substantially modernized. And to safeguard against emissions from older plants, states must promulgate and enforce SIPs.

The Clean Air Act is even more solicitous of air quality in certain parts of the nation, such as designated wilderness areas and national parks. For these areas, the EPA has set standards to prevent significant deterioration in order to keep the air as pristine and clear as it was centuries ago.

TOXIC WASTE

The EPA also worries about chemicals so toxic that the tiniest quantities could prove fatal or extremely hazardous to health. To control emission of substances like asbestos, beryllium, mercury, vinyl chloride, benzene, and arsenic, the EPA has established or proposed various National Emissions Standards for Hazardous Air Pollutants. Concern over acid rain and

other types of air pollution prompted Congress to add almost eight hundred pages of amendments to the Clean Air Act in 1990. (The original act was fifty pages long.) As a result of these amendments, the act was modernized in a manner that parallels other environmental laws. For instance, the amendments established a permit system that is modeled after the Clean Water Act. And the amendments provide for felony convictions for willful violations, similar to penalties incorporated into other statutes.

The amendments include certain defenses for industry. Most important, companies are protected from allegations that they are violating the law by showing that they were acting in accordance with a permit. In addition to this "permit shield," the law also contains protection for workers who unintentionally violate the law while following their employers' instructions.

Though pollution of the air by highly toxic substances like benzene or vinyl chloride may seem a problem removed from that of the ordinary person, we are all in fact polluters. Every year, the United States generates approximately 230 million tons of "trash"—about 4.6 pounds per person per day. Less than one-quarter of it is recycled; the rest is incinerated or buried in landfills. But many of the country's landfills have been closed, either because they were full or because they were contaminating groundwater. Once groundwater is contaminated, it is extremely expensive and difficult to clean it up. In the 1965 Solid Waste Disposal Act and the 1970

Resource Recovery Act, Congress sought to regulate the discharge of garbage by encouraging waste management and recycling. Federal grants were available for research and training, but the major regulatory effort was expected to come from the states and municipalities.

But shocking news prompted Congress to get tough in 1976. The plight of homeowners near Love Canal in upstate New York became a major national story as the discovery of massive underground leaks of toxic chemicals buried during the previous quarter century led to evacuation of hundreds of homes. Next came the revelation that Kepone, an exceedingly toxic pesticide, had been dumped into the James River in Virginia, causing a major human health hazard and severe damage to fisheries in the James and downstream in the Chesapeake Bay. The rarely discussed industrial dumping of hazardous wastes now became an open controversy, and Congress responded in 1976 with the Resource Conservation and Recovery Act (RCRA) and the Toxic Substances Control Act (TSCA) and in 1980 with the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA).

The RCRA expresses a "cradle-to-grave" philosophy: hazardous wastes must be regulated at every stage. The act gives the EPA power to govern their creation, storage, transport, treatment, and disposal. Any person or company that generates hazardous waste must obtain a permit (known as a "manifest") either to store it on its own site or ship it

to an EPA-approved treatment, storage, or disposal facility. No longer can hazardous substances simply be dumped at a convenient landfill. Owners and operators of such sites must show that they can pay for damage growing out of their operations, and even after the sites are closed to further dumping, they must set aside funds to monitor and maintain the sites safely.

This philosophy can be severe. In 1986, the Supreme Court ruled that bankruptcy is not a sufficient reason for a company to abandon toxic waste dumps if state regulations reasonably require protection in the interest of public health or safety. The practical effect of the ruling is that trustees of the bankrupt company must first devote assets to cleaning up a dump site, and only from remaining assets may they satisfy creditors. Another severity is RCRA's imposition of criminal liability, including fines of up to $25,000 a day and one-year prison sentences, which can be extended beyond owners to individual employees.

The CERCLA, also known as the Superfund, gives the EPA emergency powers to respond to public health or environmental dangers from faulty hazardous waste disposal, currently estimated to occur at more than seventeen thousand sites around the country. The EPA can direct immediate removal of wastes presenting imminent danger (e.g., from train wrecks, oil spills, leaking barrels, and fires). Injuries can be sudden and devastating; in 1979, for example, when a freight train derailed in Florida, ninety thousand pounds of chlorine

gas escaped from a punctured tank car, leaving 8 motorists dead and 183 others injured and forcing 3,500 residents within a 7-mile radius to be evacuated. The EPA may also carry out "planned removals" when the danger is substantial, even if immediate removal is not necessary.

The EPA prods owners who can be located to voluntarily clean up sites they have abandoned. But if the owners refuse, the EPA and the states will undertake the task, drawing on a federal trust fund financed mainly by taxes on the manufacture or import of certain chemicals and petroleum (the balance of the fund comes from general revenues). States must finance 10 percent of the cost of cleaning up private sites and 50 percent of the cost of cleaning up public facilities. The EPA and the states can then assess unwilling owners' punitive damages up to triple the cleanup costs.

Cleanup requirements are especially controversial when applied to landowners who innocently purchased contaminated property. To deal with this problem, Congress enacted the Superfund Amendment and Reauthorization Act in 1986, which protects innocent landowners who—at the time of purchase—made an "appropriate inquiry" into the prior uses of the property. The act also requires companies to publicly disclose information about hazardous chemicals they use. We now turn to other laws regulating chemical hazards.

CHEMICAL HAZARDS

Toxic Substances Control Act

Chemical substances that decades ago promised to improve the quality of life have lately shown their negative side—they have serious adverse side effects. For example, asbestos, in use for half a century, causes cancer and asbestosis, a debilitating lung disease, in workers who breathed in fibers decades ago. The result has been crippling disease and death and more than thirty thousand asbestos-related lawsuits filed nationwide. Other substances, such as polychlorinated biphenyls (PCBs) and dioxin, have caused similar tragedy. Together, the devastating effects of chemicals led to enactment of the TSCA, designed to control the manufacture, processing, commercial distribution, use, and disposal of chemicals that pose unreasonable health or environmental risks. (The TSCA does not apply to pesticides, tobacco, nuclear materials, firearms and ammunition, food, food additives, drugs, and cosmetics—all are regulated by other federal laws.)

The TSCA gives the EPA authority to screen for health and environmental risks by requiring companies to notify the EPA ninety days before manufacturing or importing new chemicals. The EPA may demand that the

companies test the substances before marketing them and may regulate them in a number of ways, such as requiring the manufacturer to label its products, to keep records on its manufacturing and disposal processes, and to document all significant adverse reactions in people exposed to the chemicals. The EPA also has authority to ban certain especially hazardous substances, and it has banned the further production of PCBs and many uses of asbestos.

Both industry groups and consumer groups have attacked the TSCA. Industry groups criticize the act because the enforcement mechanism requires mountainous paperwork and leads to widespread delay. Consumer groups complain because the EPA has been slow to act against numerous chemical substances. The debate continues.

1. "The Tricks of the Trade-off," Business Week, April 4, 1977, 72. ↵

Key Takeaways

Laws limiting the use of one's property have been around for many years; common-law restraints (e.g.,

the law of nuisance) exist as causes of action against those who would use their property to adversely affect the life or health of others or the value of their neighbors' property. Since the 1960s, extensive federal laws governing the environment have been enacted. These include laws governing air, water, and chemicals. Some laws include criminal penalties for noncompliance.

8.

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.

8.1 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.

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 traditionally was thought of as consisting 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. More and more, however, crimes are defined through "strict liability," which does not require proving a specific mental state for conviction.

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).

8.2 Types of Crimes

Learning Objectives

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

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[1] 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[2], 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," or business, crime.

8.2.1 Offenses Against the Person

7.2.1.1 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

1. A serious kind of crime, usually involving potential imprisonment of one year or more.
2. Crimes that are less serious than a felony, involving punishment of less than one year in prison.

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).

8.2.1.2 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.

8.2.2 Offenses against Property

8.2.2.1 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[3], 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

3. A form of larceny in which a person entrusted with someone else's property wrongfully takes sole possession or has the intent to take sole possession.

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[4], 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* 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

4. A form of larceny in which the rightful owner is tricked into giving up title to his or her property.

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.

8.2.2.2 Receiving Stolen Property One who engages in receiving stolen property[5] 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

5. Depending on the value of the property, if you receive property from another person, knowing that it has been stolen, you have committed either a misdemeanor or a felony.

property will turn out to have been stolen) are sufficient for conviction.

8.2.2.3 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.

8.2.2.4 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.

8.2.3 Offenses against Habitation and Other Offenses

8.2.3.1 Burglary Burglary is not a crime against property. It is defined as "the breaking and entering of the dwelling of another in the nighttime with intent to commit a felony." The intent to steal is not an issue: a man who sneaks into a woman's home intent on raping her has committed a burglary, even if he does not carry out the act. The student doing critical thinking will no doubt notice that the definition provides plenty of

room for argument. What is "breaking"? (The courts do not require actual destruction; the mere opening of a closed door, even if unlocked, is enough.) What is entry? When does night begin? What kind of intent? Whose dwelling? Can a landlord burglarize the dwelling of his tenant? (Yes.) Can a person burglarize her own home? (No.)

8.2.3.2 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.

8.2.3.3 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.

8.2.3.4 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.

8.2.4 Business Crime

Business[6] 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 business crime, but embezzlement by a teller or bank officer is. Many business 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

6. Many sources, including the FBI's website, still refer to business crime as "whitecollar crime." We prefer the term "business crime."

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 business 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.

8.2.4.1 Mail and Wire Fraud Federal law prohibits the use of the mails or any inter- state 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.[7]

7. United States v. Isaacs, 493 F.2d 1124 (7th Cir. 1974), cert. denied, 417 US 976 (1974).

8.2.4.2 Violations of Antitrust Law In Violations of Section 1 of the Sherman Act, which condemns activities in "restraint of trade" (including price fixing), are also crimes.

8.2.4.3 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. An executive can be held criminally liable even though she may have had no personal knowledge of the violation.

8.2.4.4 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.[8]

8.2.4.5 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.

8.2.4.6 Violations of the Racketeering Influenced and Corrupt Organizations Act In 1970 Congress enacted the Racketeering Influenced and Corrupt Organizations Act

8. *U.S. v. Hanousek*, 176 F.3d 1116 (9th Cir. 1999).

(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.

Optional Viewing: Iowa Leaders in the Law

State Auditor and former Assistant Attorney General Rob Sand talks to our class about embezzlement, business crime, and how he cracked the biggest lottery fraud case in Iowa history.

One or more interactive elements has been excluded from this version of the text. You can view them online here:

https://pressbooks.uiowa.edu/introtolaw/?p=188#oembed-1

Key Takeaway

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

8.3 The Nature of a Criminal Act

Learning Objectives

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

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.

8.3.1 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.

8.3.2 Impossibility

What if a defendant is accused of attempting a crime that is factually impossible? Suppose that a husband intended to poison his wife with strychnine in her coffee, but put sugar in the coffee instead? The "mens rea" or criminal intent was

there, but the act itself was not criminal (murder by poisoning requires the use of poison). States are divided on this, but thirty-seven states have ruled out factual impossibility as a defense to the crime of attempt.

Legal impossibility is different, and is usually acknowledged as a valid defense. If the defendant completes all of his intended acts, but those acts do not fulfill all the required elements of a crime, there could be a successful "impossibility" defense. If 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.

8.3.3 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."

8.3.4 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.

8.4 Responsibility

Learning Objectives

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

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.

8.4.1 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.

8.4.2 Excuses That Limit or Overcome Responsibility

8.4.2.1 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.

8.4.2.2 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[9] 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

9. When a police officer or other government agent entices people to commit crimes they were not disposed to commit without the government agent's suggestions and inducements.

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.

8.4.2.3 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.

8.4.2.4 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.

Optional Viewing: Iowa Leaders in the Law

Dr. Brian Farrell, an attorney and professor, talks about wrongful convictions and the Innocence Project in Iowa.

One or more interactive elements has been excluded from this version of the text. You can view them online here:
https://pressbooks.uiowa.edu/introtolaw/?p=188#oembed-2

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.

8.5 Procedure

Learning Objectives

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

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 formal charge that a less serious crime has been committed. (a document stating the crime of which the person being held is accused) or ask the grand jury[10] for an indictment.[11]

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

10. A group of citizens that hear the state's evidence and determine whether a reasonable basis (probable cause) exists for believing that a crime has been committed and thus that a criminal proceeding should be brought against a defendant.
11. A formal charge that a serious crime has been committed; where a grand jury is convened, an indictment may issue if probable cause is found.

to as a petit jury). The jury cannot convict unless it finds the defendant guilty beyond a reasonable doubt.[12]

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

12. The prosecutor must prove how each element of the offense charged is "beyond a reasonable doubt." This is more difficult than satisfying the "preponderance of the evidence" standard in civil cases.

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.

Optional Listening: Criminal Procedure

Serial Podcast Season 3 deals with a number of people's stories in the criminal justice system. In Episode 1, a woman is accosted and assaulted at a bar- but she ends up in jail instead of her attacker. This episode shows how the justice system does not always live up to the promises found in our Constitution. To listen and learn more: https://serialpodcast.org/season-three/1/a-bar-fight-walks-into-the-justice-center

8.6 Constitutional Rights of the Accused

Learning Objectives

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

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.

8.6.1 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. Here are some specifics:

Under the Supreme Court case *Terry v. Ohio*[13], police can briefly detain and pat down a suspect when there is "reasonable suspicion" of criminal activity.[14] Beyond that brief type of interaction, police need probable cause and a warrant to search or seize, with several important exceptions. Police do not need a warrant when, for example:

- No reasonable expectation of privacy exists, such as in garbage on the street;

13. 392 U.S. 1 (1968).
14. Reasonable suspicion means "specific and articulable facts" based on surrounding circumstances. Reasonable suspicion for detainment ("stop") and pat down ("frisk") are different.

- Responding to an emergency;
- Searching a vehicle (probable cause is still needed, but not a warrant); or
- Searching incident to an arrest.

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[15] 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.)

8.6.2 Double Jeopardy

The Fifth Amendment prohibits the government from prosecuting a person twice for the same offense. The

15. Evidence obtained in violation of constitutional rights from the Fourth, Fifth, and Sixth Amendments are generally not admissible at trial.

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 re-prosecuted for the same crime. Please note, this does not stop *two different sovereigns* from bringing similar charges. Thus, it is not double jeopardy to be tried twice, once by a state, and again by the federal government, based on the same actions.

8.6.3 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 confessions made (1) once in custody, and (2) in response to interrogation, are not 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.[16] These so-called *Miranda* warnings have prompted scores of follow-up cases that have made this branch of jurisprudence especially complex.

8.6.4 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). In Iowa, the time frame is one year. If the prosecution fails to try the case in that time, the case may be dismissed unless the defendant waives their right to a speedy trial.[17]

8.6.5 Cross-Examination

The Sixth Amendment also says that the defendant shall have

16. *Miranda v. Arizona*, 384 US 436 (1966).
17. https://www.press-citizen.com/story/news/crime-and-courts/2015/07/29/university-iowa-tailgating-kinnick-stadium-assault-dismissed/30853323/

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.

8.6.6 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.

8.6.7 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 2020, there were 2,620 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.

8.6.8 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.

9.

INTRODUCTION TO TORT LAW

Learning Objectives

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

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

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

9.1 Purpose of Tort Laws

Learning Objectives

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

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.

9.1.1 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.

The *idea* of tort law is even more ancient than the term. The ancient Greek poem The Iliad says:

> But Achilles hath wrought to fury the proud heart within him, cruel man! neither recketh he of the love of his comrades wherewith we ever honoured him amid the ships above all others—pitiless one! Lo, a man accepteth recompense from the slayer of his brother, or for his dead son; and the slayer abideth in his own land for the paying of a great price, and the

> kinsman's heart and proud spirit are restrained by the taking of recompense.[1]

Clear back to ancient Greek life, people held the idea of "recompense" for injury. After the recompense was paid, the injured party did not go to war for revenge. At heart, this system of "blood-money" is the foundation of modern tort law, taking the ancient idea of monetary recompense for injury or death into modern law.

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 dam- ages. 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

1. Book IX, Augustus Taber Murray translation (1924).

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.

9.1.2 Kinds of Torts

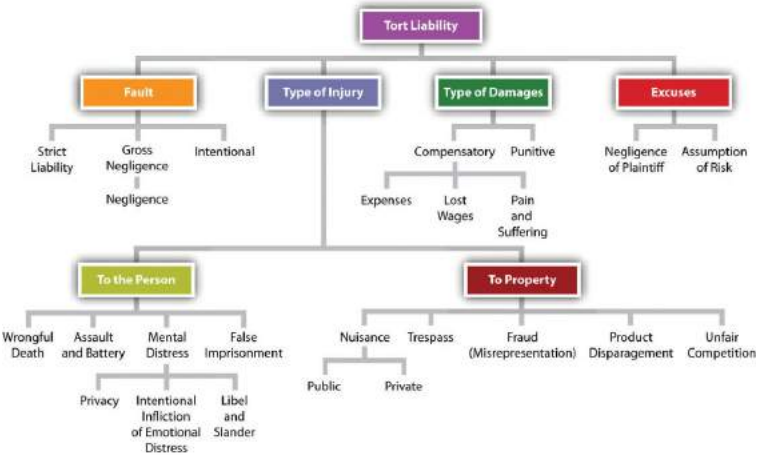
There are three kinds of torts: intentional torts, negligent torts, and strict liability torts. Intentional torts arise from intentional acts, whereas unintentional torts often result from carelessness (e.g., when a surgical team fails to remove a clamp from a patient's abdomen when the operation is 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.

9.1.3 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.



Dimensions of Tort Liability

9.1.3.1 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.[2] 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.

9.1.3.2 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,

2. Liability without fault. This may arise when the defendant engages in ultrahazardous activities or where defective product creates an unreasonable risk of injury to consumers or others.

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).

9.1.3.3 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.[3] 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.

3. A defense to a plaintiff's action in tort where the plaintiff has knowingly and voluntarily entered into a risky activity that results in injury.

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).

9.1.4 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.[4]

In certain instances, the courts will permit an award of punitive damages.[5] 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

4. An award of money damages to make the plaintiff whole, as opposed to additional damages (punitive) that punish the defendant or make an example of defendant.
5. Punitive damages are awarded in cases where the conduct of the defendant is deemed to be so outrageous that justice is only served by adding a penalty over and above compensatory damages.

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.

9.2 Intentional Torts

Learning Objectives

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

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 in 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.

9.2.1 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) intent to cause (2) the threat of immediate harm or offensive contact or (3) any intentional act that would arouse reasonable apprehension of imminent harm. Battery is intentional, unauthorized, harmful or offensive physical contact with

another person.[6] Battery is the contact, assault is the apprehension of contact.[7]

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.)

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6. A person's immediate property will count as the person, so shaking someone's glasses could count as a battery.
7. Note, apprehension is not the same thing as fear! One might not be afraid of the threat of a weak punch, but that doesn't mean its threat is not an assault.

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.

9.2.2 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.* (below) shows, the defendant must

be shown to have restrained the plaintiff in order for damages to be allowed.

9.2.3 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 overturned 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 dancer and cable access television host.[8] 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.

9.2.4 Trespass and Nuisance

Trespass is intentionally going on land that belongs to someone else or putting something on someone else's property and re- fusing 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

8. Roche v. Stern, 675 N.Y.S.2d 133 (1998).

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.[9] 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

9. Katko v. Briney, 183 N.W.2d 657 (Iowa 1971).

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.

Does a duty of care extend to trespassers?

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.

9.2.5 Trespass to Chattels and Conversion

Trespass to land covered real property, but what about personal property? The tort of trespass to chattels occurs when another intentionally acts to interfere with one's right to possession of an object or damages that object. For example, if when teaching this class I took your laptop (a piece of personal property) and locked it in my office for a week, I would be depriving you of its use, and you could sue. Or, if I intentionally damaged your laptop by scratching the screen, again trespass to chattels has occurred. If the trespass is severe

enough that the plaintiff deserves the full value of the property in compensation, such as if I destroyed the laptop, the tort becomes *conversion*. The tort of conversion is comparable to the criminal action of larceny.

9.2.6 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.

9.2.7 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.

9.2.8 Defamation

A defamatory statement published in written form is called libel.

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."[10]

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

10. Restatement (Second) of Torts, Section 559 (1965).

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.

For example, a recent defamation lawsuit centered around a single text from the artist Kesha to Lady Gaga. The text read "she was raped by the same man", referring to the producer Lukasz "Dr. Luke" Gottwald. Although the statement was only a single text to a single person, this counted as being "published."

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.

9.2.8.1 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.

9.2.8.2 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."[11] In subsequent cases, the court extended the constitutional doctrine further, applying it not merely to government officials but to public figures,[12] people who voluntarily place themselves in the public

11. Times v. Sullivan, 376 US 254 (1964).
12. Based on the First Amendment of the US Constitution, a public figure cannot recover in a defamation case unless the plaintiff's defamation was done with actual malice.

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.

9.2.9 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."

9.2.9.1 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.

9.2.9.2 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.

9.2.9.3 Public Disclosure of Embarrassing 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.

9.2.9.4 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.

9.3 Negligence

Learning Objectives

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

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.

9.3.1 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[13] 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

13. A breach of the duty of due care.

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[14], (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.

9.3.1.1 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

14. Any act that fails to meet a standard of the person's duty of due care toward others. The standard is usually described as the standard of behavior that is expected of a hypothetical "reasonable person" under the circumstances. Certain professionals, however, may be held to a higher standard than the ordinary person.

against the risk of injury that foreseeably would ensue from unreasonably dangerous conduct.

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

A "wet floor" sign is designed to protect against negligence suits.

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.

9.3.2 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.[15]

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[16], 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

15. Tarasoff v. Regents of University of California, 551 P.2d 334 (Calif. 1976).
16. An act of the defendant that violates a statute regulation or ordinance can be used to establish a breach of the duty of due care.

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.

9.3.3 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)[17] 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

17. The actual cause of negligence is sometimes called the "but for" event that is a breach of duty on the part of the defendant.

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[18]: 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* (below), 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.

9.3.4 Damages

For a plaintiff to win a tort case, she must allege and prove

18. Sometimes known as legal cause, proximate cause must be shown as well as actual cause, so that an act of the defendant will not result in liability if the consequences of the negligent act are too remote or unforeseeable.

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.

9.3.5 Problems of Proof

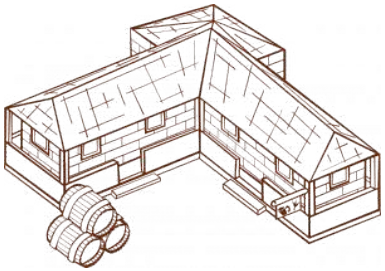
The plaintiff in a tort suit, as in any other, has the burden of proving his allegations. He must show that the defendant took the actions complained of as negligent, demonstrate the circumstances that make the actions negligent, and prove the occurrence and extent of injury. Factual issues are for the 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[19], 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[20] (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

19. Literally, "the thing speaks for itself." In tort cases, res ipsa loquitur creates a presumption that the defendant was negligent because he or she was in exclusive control of the situation and that the plaintiff would not have suffered injury but for someone's negligence. Res ipsa loquitur shifts the burden to the defendant to prove that he or she was not negligent.
20. Evidence that is not "direct" but that provides judges and juries with facts that tend to show legal liability.

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."[21]



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

21. Scott v. London & St. Katherine Docks Co., 3 H. & C. 596, 159 Eng.Rep. 665 (Q.B. 1865).

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.

9.3.6 Excuses

There are more excuses (defenses) than are listed here, but those listed here are among the principal defenses that will completely or partially excuse the negligence of the defendant.

9.3.6.1 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[22] 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

22. Actions of a plaintiff that contribute to his or her own injuries. In a few states, comparative negligence is a complete bar to the plaintiff's recovery.

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.[23] 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.

9.3.6.2 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

23. In most states, the negligence of the plaintiff is weighed against the negligence of the defendant, and where the defendant's negligence outweighs the plaintiff's, the plaintiff can recover against the defendant even though the plaintiff has caused some of his or her own injuries.

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.

9.3.6.3 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.[24]

9.3.6.4 Necessity If one is responding to an emergency situation, actions which would otherwise be tortious may be excused. For instance, trespassing on someone's property to save a drowning child would be justified under the doctrine of necessity. Proving a necessity defense requires showing that it was reasonable to assume the action was necessary to otherwise stop unavoidable damages from occurring. Of course, if one causes the emergency then the necessity defense would be unavailable.

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24. Johnson v. Kosmos Portland Cement Co., 64 F.2d 193 (6th Cir. 1933).

9.3.7 Vicarious Liability

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

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

Key Takeaway

The most common tort claim is based on the negligence of the defendant. In each negligence claim, the plaintiff must establish by a preponderance of the evidence that (1) the defendant had a duty of due care, (2) the defendant breached that duty, (3) that the breach of duty both actually and approximately has caused harm to the plaintiff, and (4) that the harm is measurable in money damages.

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

9.4 Strict Liability

Learning Objectives

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

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.

9.4.1 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 reason- ableness 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 Corp.*

9.4.2 Strict Liability for Products

Because of the importance of products liability, this text devotes an entire chapter to it. 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."[25]

Key Takeaway

Common-law courts have long held that certain

25. Pellman v. McDonald's Corp., 237 F.2d 512 (S.D.N.Y. 2003).

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.

10.

PRODUCTS LIABILITY

Learning Objectives

After reading this chapter, you should understand the following:

1. How products-liability law allocates the costs of a consumer society.
2. How warranty theory works in products liability, and what its limitations are.
3. How negligence theory works, and what its problems are.
4. How strict liability theory works, and what its limitations are.
5. What efforts are made to reform products-liability law, and why.

10.1 Introduction: Why Products-Liability Law Is Important

Learning Objectives

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

1. Understand why products-liability law underwent a revolution in the twentieth century.
2. Recognize that courts play a vital role in policing the free enterprise system by adjudicating how the true costs of modern consumer culture are allocated.
3. Know the names of the modern causes of action for products-liability cases.

In previous chapters, we discussed contract and tort remedies for various types of injury. In this chapter, we focus specifically on remedies available when a defective product causes personal

injury or other damages. Products liability describes a type of claim, not a separate theory of liability. Products liability has strong emotional overtones—ranging from the prolitigation position of consumer advocates to the conservative perspective of the manufacturers.

10.1.1 History of Products-Liability Law

The theory of caveat emptor—let the buyer beware—that pretty much governed consumer law from the early eighteenth century until the early twentieth century made some sense. A horse-drawn buggy is a fairly simple device: its workings are apparent; a person of average experience in the 1870s would know whether it was constructed well and made of the proper woods. Most foodstuffs 150 years ago were grown at home and "put up" in the home kitchen or bought in bulk from a local grocer, subject to inspection and sampling; people made home remedies for coughs and colds and made many of their own clothes. Houses and furnishings were built of wood, stone, glass, and plaster—familiar substances. Entertainment was a book or a piano. The state of technology was such that the things consumed were, for the most part, comprehensible and—very important—mostly locally made, which meant that the consumer who suffered damages from a defective product could confront the product's maker directly. Local reputation is a powerful influence on behavior.

The free enterprise system confers great benefits, and no one can deny that: materialistically, compare the image sketched in the previous paragraph with circumstances today. But those benefits come with a cost, and the fundamental political issue always is who has to pay. Consider the following famous passage from Upton Sinclair's novel *The Jungle*. It appeared in 1906. He wrote it to inspire labor reform; to his dismay, the public outrage focused instead on consumer protection reform. Here is his description of the sausage-making process in a big Chicago meatpacking plant:

> There was never the least attention paid to what was cut up for sausage; there would come all the way back from Europe old sausage that had been rejected, and that was moldy and white—it would be dosed with borax and glycerin, and dumped into the hoppers, and made over again for home consumption. There would be meat that had tumbled out on the floor, in the dirt and sawdust, where the workers had tramped and spit uncounted billions of consumption germs. There would be meat stored in great piles in rooms; and the water from leaky roofs would drip over it, and thousands of rats would race about on it. It was too dark in these storage

places to see well, but a man could run his hand over these piles of meat and sweep off handfuls of the dried dung of rats. These rats were nuisances, and the packers would put poisoned bread out for them; they would die, and then rats, bread, and meat would go into the hoppers together. This is no fairy story and no joke; the meat would be shoveled into carts, and the man who did the shoveling would not trouble to lift out a rat even when he saw one—there were things that went into the sausage in comparison with which a poisoned rat was a tidbit. There was no place for the men to wash their hands before they ate their dinner, and so they made a practice of washing them in the water that was to be ladled into the sausage.[1]

1. Upton Sinclair, The Jungle (New York: Signet Classic, 1963), 136.

It became clear from Sinclair's exposé that associated with the marvels of then-modern meatpacking and distribution methods was food poisoning: a true cost became apparent. When the true cost of some money-making enterprise (e.g., cigarettes) becomes inescapably apparent, there are two possibilities. First, the legislature can in some way mandate that the manufacturer itself pay the cost; with the meatpacking plants, that would be the imposition of sanitary food-processing standards.

Typically, Congress creates an administrative agency and gives the agency some marching orders, and then the agency crafts regulations dictating as many industry-wide reform measures as are politically possible. Second, the people who incur damages from the product (1) suffer and die or (2) access the machinery of the legal system and sue the manufacturer. If plaintiffs win enough lawsuits, the manufacturer's insurance company raises rates, forcing reform (as with high-powered muscle cars in the 1970s); the business goes bankrupt; or the legislature is pressured to act, either for the consumer or for the manufacturer.

If the industry has enough clout to blunt—by various means—a robust proconsumer legislative response so that government regulation is too lax to prevent harm, recourse is had through the legal system. Thus for all the talk about

the need for tort reform (discussed later in this chapter), the courts play a vital role in policing the free enterprise system by adjudicating how the true costs of modern consumer culture are allocated.

Obviously the situation has improved enormously in a century, but one does not have to look very far to find terrible problems today.[2]

Products liability can also be a life-or-death matter from the manufacturer's perspective. In 2009, Bloomberg BusinessWeek reported that the costs of product safety for manufacturing firms can be enormous: "Peanut Corp., based in Lynchberg, Va., has been driven into bankruptcy since health officials linked tainted peanuts to more than 600 illnesses and nine deaths. Mattel said the first of several toy recalls it announced in 2007 cut its quarterly operating income by $30 million. Earlier this decade, Ford Motor spent roughly $3 billion replacing 10.6 million potentially defective Firestone tires."[3]

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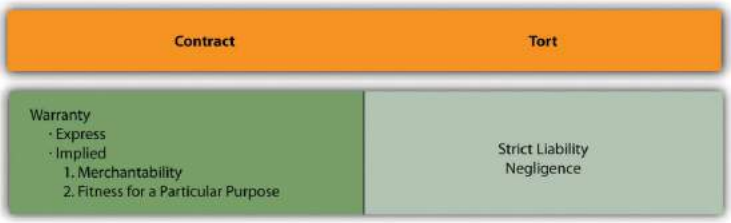
2. For example, google "open class action lawsuit settlements" to see what's currently being litigated.
3. Michael Orey, "Taking on Toy Safety," BusinessWeek, March 6, 2009.

10.1.2 Current State of the Law

Although the debate has been heated and at times simplistic, the problem of products liability is complex and most of us regard it with a high degree of ambivalence. We are all consumers, after all, who profit greatly from living in an industrial society. In this chapter, we examine the legal theories that underlie products-liability cases that developed rapidly in the twentieth century to address the problems of product-caused damages and injuries in an industrial society.

In the typical products-liability case, three legal theories are asserted—a contract theory and two tort theories. The contract theory is warranty[4], governed by the UCC, and the two tort theories are negligence[5] and strict products liability[6], governed by the common law.

4. A guarantee.
5. The legal theory imposing liability on a person for the proximate consequences of her carelessness.
6. Liability imposed on a merchant-seller of defective goods without fault.



Major products liability theories

Key Takeaway

As products became increasingly sophisticated and potentially dangerous in the twentieth century, and as the separation between production and consumption widened, products liability became a very important issue for both consumers and manufacturers. Millions of people every year are adversely affected by defective products, and manufacturers and sellers pay huge amounts for products-liability insurance and damages. The law has responded with causes of action that provide a means for recovery for products-liability damages.

10.2 Warranties

Learning Objectives

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

1. Recognize a UCC express warranty and how it is created.
2. Understand what is meant under the UCC by implied warranties, and know the main types of implied warranties: merchantability, fitness for a particular purpose, and title.
3. Know that there are other warranties: against infringement and as may arise from usage of the trade.
4. See that there are difficulties with warranty theory as a cause of action for products liability; a federal law has addressed some of these.

The UCC governs express warranties and various implied warranties, and for many years it was the only statutory control

on the use and meanings of warranties. In 1975, after years of debate, Congress passed and President Gerald Ford signed into law the Magnuson-Moss Act, which imposes certain requirements on manufacturers and others who warrant their goods. We will examine both the UCC and the Magnuson-Moss Act.

10.2.1 Types of Warranties

10.2.1.1 Express Warranties An express warranty[7] is created whenever the seller affirms that the product will perform in a certain manner. Formal words such as "warrant" or "guarantee" are not necessary. A seller may create an express warranty as part of the basis for the bargain of sale by means of (1) an affirmation of a fact or promise relating to the goods, (2) a description of the goods, or (3) a sample or model. Any of these will create an express warranty that the goods will conform to the fact, promise, description, sample, or model. Thus a seller who states that "the use of rustproof linings in the cans would prevent discoloration and adulteration of the Perform solution" has given an express warranty, whether he

7. Any manifestation of the nature or quality of goods that becomes a basis of the bargain.

realized it or not.[8] Claims of breach of express warranty are, at base, claims of misrepresentation.

But the courts will not hold a manufacturer to every statement that could conceivably be interpreted to be an express warranty. Manufacturers and sellers constantly "puff" their products, and the law is content to let them inhabit that gray area without having to make good on every claim. UCC 2-313(2) says that "an affirmation merely of the value of the goods or a statement purporting to be merely the seller's opinion or commendation of the goods does not create a warranty." Facts do.

8. *Rhodes Pharmacal Co. v. Continental Can Co.*, 219 N.E.2d 726 (Ill. 1976).

It is not always easy, however, to determine the line between an express warranty and a piece of puffery. A salesperson who says that a strawberry huller is "great" has probably puffed, not warranted, when it turns out that strawberries run through the huller look like victims of a massacre. But consider the classic cases of the defective used car and the faulty bull. In the former, the salesperson said the car was in "A-1 shape" and "mechanically perfect."

In the latter, the seller said not only that the bull calf would "put the buyer on the map" but that "his father was the greatest living dairy bull." The car, carrying the buyer's seven-month-old child, broke down while the buyer was en route to visit her husband in the army during World War II. The court said that the salesperson had made an express warranty.[9] The bull calf turned out to be sterile, putting the farmer on the judicial rather than the dairy map. The court said the seller's

9. *Wat Henry Pontiac Co. v. Bradley*, 210 P.2d 348 (Okla. 1949).

spiel was trade talk, not a warranty that the bull would impregnate cows.[10]

Is there any qualitative difference between these decisions, other than the quarter century that separates them and the different courts that rendered them? Perhaps the most that can be said is that the more specific and measurable the statement's standards, the more likely it is that a court will hold the seller to a warranty, and that a written statement is easier to construe as a warranty than an oral one. It is also possible that courts look, if only subliminally, at how reasonable the buyer was in relying on the statement, although this ought not to be a strict test. A buyer may be unreasonable in expecting a car to get 100 miles to the gallon, but if that is what the seller promised, that ought to be an enforceable warranty.

10.2.1.2 Implied Warranties Express warranties are those over which the parties dickered— or could have. Express warranties go to the essence of the bargain. An implied warranty[11], by contrast, is one that circumstances alone, not specific language, compel reading into the sale. In short, an implied warranty is one created by law, acting from an impulse of common sense.

10.2.1.2.1 Implied Warranty of Merchantability

10. *Frederickson v. Hackney*, 198 N.W. 806 (Minn. 1924).
11. A warranty imposed by law that comes along with a product automatically.

Section 2-314 of the UCC lays down the fundamental rule that goods carry an implied warranty of merchantability. What is merchantability? Section 2-314(2) of the UCC says that merchantable goods are those that conform at least to the following six characteristics:

1. Pass without objection in the trade under the contract description
2. In the case of fungible goods, are of fair average quality within the description
3. Are fit for the ordinary purposes for which such goods are used
4. Run, within the variations permitted by the agreement, of even kind, quality, and quantity within each unit and among all units involved
5. Are adequately contained, packaged, and labeled as the agreement may require
6. Conform to the promise or affirmations of fact made on the container or label if any

For the purposes of Section 2-314(2)(c) of the UCC, selling and serving food or drink for consumption on or off the premises is a sale subject to the implied warranty of merchantability—the food must be "fit for the ordinary purposes" to which it is put. The problem is common: you bite into a cherry pit in the cherry-vanilla ice cream, or you choke on the clam shells in the chowder. Is such food fit for the ordinary purposes to which it is put? There are two schools of thought. One asks whether the food was natural as prepared. This view adopts the seller's perspective. The other asks what the consumer's reasonable expectation was.

The first test is sometimes said to be the "natural-foreign" test. If the substance in the soup is natural to the substance—as bones are to fish—then the food is fit for consumption. The second test, relying on reasonable expectations, tends to be the more commonly used test.

10.2.1.3 Fitness for a Particular Purpose Section 2-315 of the UCC creates another implied warranty. Whenever a seller, at the time she contracts to make a sale, knows or has reason to know that the buyer is relying on the

seller's skill or judgment to select a product that is suitable for the particular purpose the buyer has in mind for the goods to be sold, there is an implied warranty that the goods are fit for that purpose. For example, you go to a hardware store and tell the salesclerk that you need a paint that will dry overnight because you are painting your front door and a rainstorm is predicted for the next day. The clerk gives you a slow-drying oil-based paint that takes two days to dry. The store has breached an implied warranty of fitness for particular purpose.[12]

Note the distinction between "particular" and "ordinary" purposes. Paint is made to color and when dry to protect a surface. That is its ordinary purpose, and had you said only that you wished to buy paint, no implied warranty of fitness would have been breached. It is only because you had a particular purpose in mind that the implied warranty arose. Suppose you had found a can of paint in a general store and told the same tale, but the proprietor had said, "I don't know enough about that paint to tell you anything beyond what's on

12. A seller's implied warranty that the goods will be suitable for the buyer's expressed need.

the label; help yourself." Not every seller has the requisite degree of skill and knowledge about every product he sells to give rise to an implied warranty. Ultimately, each case turns on its particular circumstances.

10.2.1.4 Other Warranties Article 2 contains other warranty provisions, though these are not related specifically to products liability. Thus, under UCC, Section 2-312, unless explicitly excluded, the seller warrants he is conveying *good title* that is rightfully his and that the goods are transferred free of any security interest or other lien or encumbrance. In some cases (e.g., a police auction of bicycles picked up around campus and never claimed), the buyer should know that the seller does not claim title in himself, nor that title will necessarily be good against a third party, and so subsection (2) excludes warranties in these circumstances. But the circumstances must be so obvious that no reasonable person would suppose otherwise.

In *Menzel v. List*, an art gallery sold a painting by Marc Chagall that it purchased in Paris.[13] The painting had been stolen by the Germans when the original owner was forced to flee Belgium in the 1930s. Now in the United States, the original owner discovered that a new owner had the painting and successfully sued for its return. The customer then sued the gallery, claiming that it had breached the implied warranty

13. Menzel v. List, 246 N.E.2d 742 (N.Y. 1969).

of title when it sold the painting. The court agreed and awarded damages equal to the appreciated value of the painting. A good-faith purchaser who must surrender stolen goods to their true owner has a claim for breach of the implied warranty of title against the person from whom he bought the goods.

A second implied warranty, related to title, is that the merchant-seller warrants the goods are *free of any rightful claim by a third person that the seller has infringed his rights* (e.g., that a gallery has not infringed a copyright by selling a reproduction). This provision only applies to a seller who regularly deals in goods of the kind in question. If you find an old print in your grandmother's attic, you do not warrant when you sell it to a neighbor that it is free of any valid infringement claims.

A third implied warranty in this context involves the course of dealing or usage of trade. Section 2-314(3) of the UCC says that unless modified or excluded implied warranties may arise from a course of dealing or usage of trade. If a certain way of doing business is understood, it is not necessary for the seller to state explicitly that he will abide by the custom; it will be implied. A typical example is the obligation of a dog dealer to provide pedigree papers to prove the dog's lineage conforms to the contract.

10.2.2 Problems with Warranty Theory

10.2.2.1 In General It may seem that a person asserting a claim for breach of warranty will have a good chance of success under an express warranty or implied warranty theory of merchantability or fitness for a particular purpose. In practice, though, claimants are in many cases denied recovery. Here are four general problems:

- The claimant must prove that there was a sale.
- The sale was of goods rather than real estate or services.
- The action must be brought within the four-year statute of limitations under Article 2-725, when the tender of delivery is made, not when the plaintiff discovers the defect.
- Under UCC, Section 2-607(3)(a) and Section 2A-516(3)(a), which covers leases, the claimant who fails to give notice of breach within a reasonable time of having accepted the goods will see the suit dismissed, and

> few consumers know enough to do so, except when making a complaint about a purchase of spoiled milk or about paint that wouldn't dry.

In addition to these general problems, the claimant faces additional difficulties stemming directly from warranty theory, which we take up later in this chapter.

10.2.2.2 Exclusion or Modification of Warranties The UCC permits sellers to exclude or disclaim warranties in whole or in part. That's reasonable, given that the discussion here is about contract, and parties are free to make such contracts as they see fit. But a number of difficulties can arise.

10.2.2.3 Exclusion of Express Warranties The simplest way for the seller to exclude express warranties is not to give them. To be sure, Section 2-316(1) of the UCC forbids courts from giving operation to words in fine print that negate or limit express warranties if doing so would unreasonably conflict with express warranties stated in the main body of the contract—as, for example, would a blanket statement that "this contract excludes all warranties express or implied." The purpose of the UCC provision is to prevent customers from being surprised by unbargained-for language.

10.2.2.4 Exclusion of Implied Warranties in General Implied warranties can be excluded easily enough also, by describing the product with language such as "as is" or "with all faults." Nor is exclusion simply a function of what the seller says. The buyer who has either examined or refused to exam-

ine the goods before entering into the contract may not assert an implied warranty concerning defects an inspection would have revealed.

10.2.2.5 Implied Warranty of Merchantability Section 2-316(2) of the UCC permits the seller to disclaim or modify the implied warranty of merchantability, as long as the statement actually mentions "merchantability" and, if it is written, is "conspicuous." Note that the disclaimer need not be in writing, and—again—all implied warranties can be excluded as noted.

10.2.2.6 Implied Warranty of Fitness Section 2-316(2) of the UCC permits the seller also to disclaim or modify an implied warranty of fitness. This disclaimer or modification must be in writing, however, and must be conspicuous. It need not mention fitness explicitly; general language will do. The following sentence, for example, is sufficient to exclude all implied warranties of fitness: "There

are no warranties that extend beyond the description on the face of this contract."

Here is a standard disclaimer clause found in a Dow Chemical Company agreement: "Seller warrants that the goods supplied here shall conform to the description stated on the front side hereof, that it will convey good title, and that such goods shall be delivered free from any lawful security interest, lien, or encumbrance. SELLER MAKES NO WARRANTY OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR USE. NOR IS THERE ANY OTHER EXPRESS OR IMPLIED WARRANTY."

10.2.2.7 Conflict between Express and Implied Warranties Express and implied warranties and their exclusion or limitation can often conflict. Section 2-317 of the UCC provides certain rules for deciding which should prevail. In general, all warranties are to be construed as consistent with each other and as cumulative. When that assumption is unreasonable, the parties' intention governs the interpretation, according to the following rules: (a) exact or technical specifications displace an inconsistent sample or model or general language of description; (b) a sample from an existing bulk displaces inconsistent general language of description; (c) express warranties displace inconsistent implied warranties other than an implied warranty of fitness for a particular purpose. Any inconsistency among warranties must always be resolved in favor of the implied warranty of fitness for a particular purpose. This doesn't mean that warranty cannot be

limited or excluded altogether. The parties may do so. But in cases of doubt whether it or some other language applies, the implied warranty of fitness will have a superior claim.

10.2.2.8 The Magnuson-Moss Act and Phantom Warranties After years of debate over extending federal law to regulate warranties, Congress enacted the Magnuson-Moss Federal Trade Commission Warranty Improvement Act (more commonly referred to as the Magnuson- Moss Act) and President Ford signed it in 1975. The act was designed to clear up confusing and misleading warranties, where—as Senator Magnuson put it in introducing the bill—"purchasers of consumer products discover that their warranty may cover a 25-cent part but not the $100 labor charge or that there is full coverage on a piano so long as it is shipped at the purchaser's expense to the factory. There is a growing need to generate consumer understanding by clearly and conspicuously disclosing the terms and conditions of the warranty and by telling the consumer what to do if his guaranteed product becomes defective or malfunctions." The Magnuson-Moss Act only applies to consumer products (for household and domestic uses); commercial purchasers are presumed to be knowledgeable enough not to need these protections, to be able to hire lawyers, and to be able to include the cost of product failures into the prices they charge.

The act has several provisions to meet these consumer concerns; it regulates the content of warranties and the means of disclosing those contents. The act gives the Federal Trade

Commission (FTC) the authority to promulgate detailed regulations to interpret and enforce it. Under FTC regulations, any written warranty for a product costing a consumer more than ten dollars must disclose in a single document and in readily understandable language a variety of information items, such as a statement of when the warranty period starts and expires, how the consumer can utilize informal dispute mechanisms, etc.

In addition to these requirements, the act requires that the warranty be labeled either a full or limited warranty. A full warranty[14] means (1) the defective product or part will be fixed or replaced for free, including removal and reinstallation; (2) it will be fixed within a reasonable time; (3) the consumer need not do anything unreasonable (like shipping the piano to the factory) to get warranty service; (4) the warranty is good for anyone who owns the product during the period of the warranty; (5) the consumer gets money back or a new product if the item cannot be fixed within a reasonable number of attempts. But the full warranty may not cover the whole product: it may cover only the hard drive in the computer, for example; it must state what parts are included and excluded. A limited warranty[15] is less inclusive. It may cover only parts, not

14. Under the Magnuson-Moss Act, a complete promise of satisfaction limited only in duration.
15. Under the Magnuson-Moss Act, a less-than-full warranty.

labor; it may require the consumer to bring the product to the store for service; it may impose a handling charge; it may cover only the first purchaser. Both full and limited warranties may exclude consequential damages.

Disclosure of the warranty provisions prior to sale is required by FTC regulations; this can be done in a number of ways. The text of the warranty can be attached to the product or placed in close conjunction to it. It can be maintained in a binder kept in each department or otherwise easily accessible to the consumer. Either the binders must be in plain sight or signs must be posted to call the prospective buyer's attention to them. A notice containing the text of the warranty can be posted, or the warranty itself can be printed on the product's package or container.

Phantom warranties are addressed by the Magnuson-Moss Act. As we have seen, the UCC permits the seller to disclaim implied warranties. This authority often led sellers to give what were called phantom warranties—that is, the express warranty contained disclaimers of implied warranties, thus leaving the consumer with fewer rights than if no express warranty had been given at all. In the words of the legislative report of the act, "The bold print giveth, and the fine print taketh away." The act abolished these phantom warranties by providing that if the seller gives a written warranty, whether express or implied, he cannot disclaim or modify implied warranties. However, a seller who gives a limited warranty can limit

implied warranties to the duration of the limited warranty, if the duration is reasonable.

A seller's ability to disclaim implied warranties is also limited by state law in two ways. First, by amendment to the UCC or by separate legislation, some states prohibit disclaimers whenever consumer products are sold. A number of states have special laws that limit the use of the UCC implied warranty disclaimer rules in consumer sales. Some of these appear in amendments to the UCC and others are in separate statutes. The broadest approach is that of the nine states that prohibit the disclaimer of implied warranties in consumer sales (Massachusetts, Connecticut, Maine, Vermont, Maryland, the District of Columbia, West Virginia, Kansas, Mississippi, and, with respect to personal injuries only, Alabama). There is a difference in these states whether the rules apply to manufacturers as well as retailers. Second, the UCC at 2-302 provides that unconscionable contracts or clauses will not be enforced. UCC 2-719(3) provides that limitation of damages for personal injury in the sale of "consumer goods is prima facie unconscionable, but limitation of damages where the loss is commercial is not."

A first problem with warranty theory, then, is that it's possible to disclaim or limit the warranty. The worst abuses of manipulative and tricky warranties are eliminated by the Magnuson-Moss Act, but there are several other reasons that

warranty theory is not the panacea for claimants who have suffered damages or injuries as a result of defective products.[16]

Key Takeaway

A first basis of recovery in products-liability theory is breach of warranty. There are two types of warranties: express and implied. Under the implied category are three major subtypes: the implied warranty of merchantability (only given by merchants), the implied warranty of fitness for a particular purpose, and the implied warranty of title. There are a number of problems with the use of warranty theory: there must have been a sale of the goods; the plaintiff must bring the action within the statute of limitations; and the plaintiff must notify the seller within a reasonable time. The seller may—within the constraints of the Magnuson-Moss

16. Other issues with warranty law that may limit the plaintiff's recovery are lack of "privity" (a contractual relationship with the seller), along with tort-theories like assumption of the risk.

Act—limit or exclude express warranties or limit or exclude implied warranties.

10.3 Strict Liability in Tort

Learning Objectives

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

1. Recognize how the tort theory of negligence may be of use in products-liability suits.
2. Understand why negligence is often not a satisfactory cause of action in such suits: proof of it may be difficult, and there are powerful defenses to claims of negligence.
3. Know what "strict products liability" means and how it differs from the other two products-liability theories.

4. Understand the basic requirements to prove strict products liability.
5. See what obstacles to recovery remain with this doctrine.

In addition to contract-law based theories for product liability, tort theories offer powerful remedies for product liability. Consumers may allege negligence, or proceed on a strict products liability theory.

10.3.1 Negligence Claims for Products Liability

Negligence is the second theory raised in the typical products-liability case. It is a tort theory (as compared to breach of warranty, which is of course a contract theory), and it does have this advantage over warranty theory: privity (a contractual relationship) is never relevant. A pedestrian is struck in an intersection by a car whose brakes were defectively manufactured. Under no circumstances would breach of warranty be a useful cause of action for the pedestrian—there is no privity at all.

There are substantial difficulties in using negligence as a cause of action in products liability cases. These include:

- Proving negligence at all: just because a product is defective does not necessarily prove the manufacturer breached a duty of care.
- Proximate cause: even if there was some negligence, the plaintiff must prove her damages flowed proximately from that negligence.
- Contributory and comparative negligence: the plaintiff's own actions contributed to the damages.
- Subsequent alteration of the product: generally the manufacturer will not be liable if the product has been changed.
- Misuse or abuse of the product: using a lawn mower to trim a hedge or taking too much of a drug are examples.
- Assumption of the risk: knowingly using the product in a risky way.

Preemption[17] (or "pre-emption") is another possible defense: suppose there is a federal standard concerning the product, and the defendant manufacturer meets it, but the standard is not really very protective. (It is not

17. The theory that a federal law supersedes any inconsistent state law or regulation.

uncommon, of course, for federal standard makers of all types to be significantly influenced by lobbyists for the industries being regulated by the standards.) Is it enough for the manufacturer to point to its satisfaction of the standard so that such satisfaction preempts (takes over) any common-law negligence claim? "We built the machine to federal standards: we can't be liable. Our compliance with the federal safety standard is an affirmative defense."

Preemption is typically raised as a defense in suits about (1) cigarettes, (2) FDA-approved medical devices, (3) motorboat propellers, (4) pesticides, and (5) motor vehicles. This is a complex area of law. Questions inevitably arise as to whether there was federal preemption, express or implied. Sometimes courts find preemption and the consumer loses; sometimes the courts don't find preemption and the case goes forward. According to one lawyer who works in this field, there has been "increasing pressure on both the regulatory and congressional fronts to preempt state laws." That is, the usual defendants (manufacturers) push Congress and the regulatory agencies to state explicitly in the law that the federal standards preempt and defeat state law.[18]

18. C. Richard Newsome and Andrew F. Knopf, "Federal Preemption: Products Lawyers Beware," Florida Justice Association Journal, July 27, 2007.

10.3.2 Strict Liability

The warranties grounded in the Uniform Commercial Code (UCC) are often ineffective in assuring recovery for a plaintiff's injuries. The notice requirements and the ability of a seller to disclaim the warranties remain bothersome problems, as does the privity requirement in those states that continue to adhere to it.

Negligence as a products-liability theory obviates any privity problems, but negligence comes with a number of familiar defenses and with the problems of preemption.

To overcome the obstacles, judges have gone beyond the commercial statutes and the ancient concepts of negligence. They have fashioned a tort theory of products liability based on the principle of strict products liability. One court expressed the rationale for the development of the concept as follows: "The rule of strict liability for defective products is an example of necessary paternalism judicially shifting risk of loss by application of tort doctrine because [the UCC] scheme fails to adequately cover the situation. Judicial paternalism is to loss shifting what garlic is to a stew—sometimes necessary to give full flavor to statutory law, always distinctly noticeable in its result, overwhelmingly counterproductive if excessive,

and never an end in itself.[19] Paternalism or not, strict liability has become a very important legal theory in products-liability cases.

10.3.2.1 Strict Liability Defined The formulation of strict liability that most courts use is Section 402A of the Restatement of Torts (Second), set out here in full:

1. One who sells any product in a defective condition unreasonably dangerous to the user or consumer or to his property is subject to liability for physical harm thereby caused to the ultimate user or consumer, or to his property, if
2. (a) the seller is engaged in the business of selling such a product, and
3. (b) it is expected to and does reach the user or consumer without substantial change in the condition in which it is sold.
4. This rule applies even though
5. (a) the seller has exercised all possible care in the preparation and sale of his product, and
6. (b) the user or consumer has not bought the product from or entered into any contractual relation with the seller.

19. *Kaiser Steel Corp. v. Westinghouse Electric Corp.*, 127 Cal. Rptr. 838 (Cal. 1976).

Section 402A of the Restatement avoids the warranty booby traps. It states a rule of law not governed by the UCC, so limitations and exclusions in warranties will not apply to a suit based on the Restatement theory. And the consumer is under no obligation to give notice to the seller within a reasonable time of any injuries. Privity is not a requirement; the language of the Restatement says it applies to "the user or consumer," but courts have readily found that bystanders in various situations are entitled to bring actions under Restatement, Section 402A. The formulation of strict liability, though, is limited to physical harm. Many courts have held that a person who suffers economic loss must resort to warranty law.

Strict liability avoids some negligence traps, too. *No proof of negligence is required.*

10.3.2.2 Section 402A Elements

10.3.2.2.1 Product in a Defective Condition Sales of goods but not sales of services are covered under the Restatement, Section 402A. Furthermore, the plaintiff will not prevail if the product was safe for normal handling and consumption when sold. A glass soda bottle that is properly capped is not in a defective condition merely because it can be broken if the consumer should happen to drop it, making the jagged glass dangerous. Chocolate candy bars are not defective merely because you can become ill by eating too many of them at once. On the other hand, a seller would be liable for a product defectively packaged, so that it could explode or deteriorate and change its chemical composition. A product

can also be in a defective condition if there is danger that could come from an anticipated wrongful use, such as a drug that is safe only when taken in limited doses. Under those circumstances, failure to place an adequate dosage warning on the container makes the product defective.

Chocolate bars are not defective because one becomes ill by eating too many!

The plaintiff bears the burden of proving that the product is in a defective condition, and this burden can be difficult to meet. Many products are the result of complex feats of engineering. Expert witnesses are necessary to prove that the products were defectively manufactured, and these are not always easy to come by. This difficulty of proof is one reason why many cases raise the failure to warn as the dispositive issue, since in the right case that issue is far easier to prove. The Anderson case

(detailed in the exercises at the end of this chapter) demonstrates that the plaintiff cannot prevail under strict liability merely because he was injured. It is not the fact of injury that is dispositive but the defective condition of the product.

10.3.2.2.2 Unreasonably Dangerous The product must be not merely dangerous but unreasonably dangerous. Most products have characteristics that make them dangerous in certain circumstances. As the Restatement commentators note, "Good whiskey is not unreasonably dangerous merely because it will make some people drunk, and is especially dangerous to alcoholics; but bad whiskey, containing a dangerous amount of fuel oil, is unreasonably dangerous. Good butter is not unreasonably dangerous merely because, if such be the case, it deposits cholesterol in the arteries and leads to heart attacks; but bad butter, contaminated with poisonous fish oil, is unreasonably dangerous."[20] Under Section 402A, "the article sold must be dangerous to an extent beyond that which would be contemplated by the ordinary consumer who purchases it, with the ordinary knowledge common to the community as to its characteristics."

Even high risks of danger are not necessarily unreasonable. Some products are unavoidably unsafe; rabies vaccines, for example, can cause dreadful side effects. But the disease itself,

20. Restatement (Second) of Contracts, Section 402A(i).

almost always fatal, is worse. A product is unavoidably unsafe when it cannot be made safe for its intended purpose given the present state of human knowledge. Because important benefits may flow from the product's use, its producer or seller ought not to be held liable for its danger.

However, the failure to warn a potential user of possible hazards can make a product defective under Restatement, Section 402A, whether unreasonably dangerous or even unavoidably unsafe. The dairy farmer need not warn those with common allergies to eggs, because it will be presumed that the person with an allergic reaction to common foodstuffs will be aware of them. But when the product contains an ingredient that could cause toxic effects in a substantial number of people and its danger is not widely known (or if known, is not an ingredient that would commonly be supposed to be in the product), the lack of a warning could make the product unreasonably dangerous within the meaning of Restatement, Section 402A. Many of the suits brought by asbestos workers charged exactly this point; "The utility of an insulation product containing asbestos may outweigh the known or foreseeable risk to the insulation workers and thus justify its marketing. The product could still be unreasonably dangerous, however, if unaccompanied by adequate warnings. An insulation worker, no less than any other product user, has a right to decide whether to expose

himself to the risk."[21] This rule of law came to haunt the Manville Corporation: it was so burdened with lawsuits, brought and likely to be brought for its sale of asbestos—a known carcinogen—that it declared Chapter 11 bankruptcy in 1982 and shucked its liability.[22]

10.3.2.2.3 Engaged in the Business of Selling Restatement, Section 402A(1)(a), limits liability to sellers "engaged in the business of selling such a product." The rule is intended to apply to people and entities engaged in business, not to casual one-time sellers. The business need not be solely in the defective product; a movie theater that sells popcorn with a razor blade inside is no less liable than a grocery store that does so. But strict liability under this rule does not attach to a private individual who sells his own automobile. In this sense, Restatement, Section 402A, is analogous to the UCC's limitation of the warranty of merchantability to the merchant.

The requirement that the defendant be in the business of selling gets to the rationale for the whole

21. *Borel v. Fibreboard Paper Products Corp.*, 493 F.Zd 1076 (5th Cir. 1973).
22. *In re Johns-Manville Corp.*, 36 R.R. 727 (So. Dist. N.Y. 1984).

concept of strict products liability: businesses should shoulder the cost of injuries because they are in the best position to spread the risk and distribute the expense among the public. This same policy has been the rationale for holding bailors and lessors liable for defective equipment just as if they had been sellers.[23]

10.3.2.2.4 Reaches the User without Change in Condition Restatement, Section 402A(1)(b), limits strict liability to those defective products that are expected to and do reach the user or consumer without substantial change in the condition in which the products are sold. A product that is safe when delivered cannot subject the seller to liability if it is subsequently mishandled or changed. The seller, however, must anticipate in appropriate cases that the product will be stored; faulty packaging or sterilization may be the grounds for liability if the product deteriorates before being used.

10.3.2.2.5 Liability Despite Exercise of All Due Care Strict liability applies under the Restatement rule even though "the seller has exercised all possible care in the preparation and sale of his product." This is the crux of "strict liability" and distinguishes it from the conventional theory of negligence. It does not matter how reasonably the seller acted or how exemplary is a manufacturer's quality control system—what matters is whether the product was defective and the user

23. *Martin v. Ryder Rental, Inc.*, 353 A.2d 581 (Del. 1976).

injured as a result. Suppose an automated bottle factory manufactures 1,000 bottles per hour under exacting standards, with a rigorous and costly quality-control program designed to weed out any bottles showing even an infinitesimal amount of stress. The plant is "state of the art," and its computerized quality-control operation is the best in the world. It regularly detects the one out of every 10,000 bottles that analysis has shown will be defective. Despite this intense effort, it proves impossible to weed out every defective bottle; one out of one million, say, will still escape detection. Assume that a bottle, filled with soda, finds its way into a consumer's home, explodes when handled, sends glass shards into his eye, and blinds him. Under negligence, the bottler has no liability; under strict liability, the bottler will be liable to the consumer.

10.3.2.2.6 Liability without Contractual Relation Under Restatement, Section 402A(2)(b), strict liability applies even though the user has not purchased the product from the seller nor has the user entered into any contractual relation with the seller. In short, privity is abolished and the injured user may use the theory of strict liability against manufacturers and wholesalers as well as retailers. Here, however, the courts have varied in their approaches; the trend has been to allow bystanders recovery. The Restatement explicitly leaves open the question of the bystander's right to recover under strict liability.

10.3.2.3 Specific Strict Liability Theories Plaintiffs in strict products liability actions apply these standards through

three theories: manufacturing defect, design defect, and failure to warn (which is really just a special case of design defect, with the defect being the failure to warn).

10.3.2.3.1 Manufacturing Defect A manufacturing defect claim centers on the production process. The plaintiff alleges the product, although potentially designed correctly, was produced in a faulty manner. This error in the production process resulted in the plaintiff's injury.

10.3.2.3.2 Design Defect Manufacturers can be, and often are, held liable for injuries caused by products that were defectively designed. The question is whether the designer used reasonable care in designing a product reasonably safe for its foreseeable use. The concern over reasonableness and standards of care are elements of negligence theory.

Defective-design cases can pose severe problems for manufacturing and safety engineers. More safety means more cost. Designs altered to improve safety may impair functionality and make the product less desirable to consumers. At what point safety comes into reasonable balance with performance, cost, and desirability is impossible to forecast accurately, though some factors can be taken into account. For example, if other manufacturers are marketing comparable products whose design are intrinsically safer, the less-safe products are likely to lose a test of reasonableness in court.

The Reasonable Design Balance

10.3.2.3.3 Failure to Warn We noted that a product may be defective if the manufacturer failed to warn the user of potential dangers. Whether a warning should have been affixed is often a question of what is reasonably foreseeable, and the failure to affix a warning will be treated as negligence. The manufacturer of a weed killer with poisonous ingredients is certainly acting negligently when it fails to warn the consumer that the contents are potentially lethal.

The law governing the necessity to warn and the adequacy of warnings is complex. What is reasonable turns on the degree to which a product is likely to be misused and, as the disturbing *Laaperi* case (below) illustrates, whether the hazard is obvious.

Failure to warn is a common strict liability theory.

10.3.3 Problems with Strict Liability

Strict liability is liability without proof of negligence and without privity. It would seem that strict liability is the "holy grail" of products-liability lawyers: the complete answer. Well, no, it's not the holy grail. It is certainly true that 402A abolishes the contractual problems of warranty. Restatement, Section 402A, Comment m, says,

The rule stated in this Section is not governed by the provisions of the Uniform Commercial Code, as to warranties; and it is not affected by limitations on the scope and content of warranties, or by limitation to "buyer" and "seller" in those statutes. Nor is the consumer required to give notice to the seller of his injury within a reasonable time after it occurs,

as provided by the Uniform Act. The consumer's cause of action does not depend upon the validity of his contract with the person from whom he acquires the product, and it is not affected by any disclaimer or other agreement, whether it be between the seller and his immediate buyer, or attached to and accompanying the product into the consumer's hands. In short, "warranty" must be given a new and different meaning if it is used in connection with this Section. It is much simpler to regard the liability here stated as merely one of strict liability in tort.

Inherent in the Restatement's language is the obvious point that if the product has been altered, losses caused by injury are not the manufacturer's liability. Beyond that there are still some limitations to strict liability.

10.3.3.1 Disclaimers Comment m specifically says the cause of action under Restatement, Section 402A, is not affected by disclaimer. But in nonconsumer cases, courts have allowed clear and specific disclaimers. In 1969, the Ninth Circuit observed: "In Kaiser Steel Corp. the [California Supreme Court] court upheld the dismissal of a strict liability action when the parties, dealing from positions of relatively equal economic strength, contracted in a commercial setting to limit the defendant's liability. The court went on to hold that in this situation the strict liability cause of action does not apply at all. In reaching this conclusion, the court in Kaiser reasoned that strict liability 'is designed to encompass situations in which the principles of sales warranties serve their

purpose "fitfully at best." ' " It concluded that in such commercial settings the UCC principles work well and "to apply the tort doctrines of products liability will displace the statutory law rather than bring out its full flavor."[24]

10.3.3.2 Plaintiff's Conduct Conduct by the plaintiff herself may defeat recovery in two circumstances.

10.3.3.2.1 Assumption of Risk Courts have allowed the defense of assumption of the risk in strict products-liability cases. A plaintiff assumes the risk of injury, thus establishing defense to claim of strict products liability, when he is aware the product is defective, knows the defect makes the product unreasonably dangerous, has reasonable opportunity to elect whether to expose himself to the danger, and nevertheless proceeds to make use of the product. The rule makes sense.

10.3.3.2.2 Misuse or Abuse of the Product Where the plaintiff does not know a use of the product is dangerous but nevertheless uses for an incorrect purpose, a defense arises, but only if such misuse was not foreseeable. If it was, the manufacturer should warn against that misuse. In *Eastman v. Stanley Works*, a carpenter used a framing hammer to drive masonry nails; the claw of the hammer broke off, striking him in the eye.[25] He sued. The court held that while a defense

24. *Idaho Power Co. v. Westinghouse Electric Corp.*, 596 F.2d 924, 9CA (1979).

25. *Eastman v. Stanley Works*, 907 N.E.2d 768 (Ohio App. 2009).

does exist "where the product is used in a capacity which is unforeseeable by the manufacturer and completely incompatible with the product's design. . . misuse of a product suggests a use which was unanticipated or unexpected by the product manufacturer, or unforeseeable and unanticipated [but] it was not the case that reasonable minds could only conclude that appellee misused the [hammer]. Though the plaintiff's use of the hammer might have been unreasonable, unreasonable use is not a defense to a strict product-liability action or to a negligence action."

10.3.3.3 Limited Remedy The Restatement says recovery under strict liability is limited to "physical harm thereby caused to the ultimate user or consumer, or to his property," but not other losses and not economic losses. In *Atlas Air v. General Electric*, a New York court held that the "economic loss rule" (no recovery for economic losses) barred strict products-liability and negligence claims by the purchaser of a used airplane against the airplane engine manufacturer for damage to the plane caused by an emergency landing necessitated by engine failure, where the purchaser merely alleged economic losses with respect to the plane itself, and not damages for personal injury (recovery for damage to the engine was allowed).[26]

But there are exceptions. In *Duffin v. Idaho Crop Imp. Ass'n*,

26. *Atlas Air v. General Electric*, 16 A.D.3d 444 (N.Y.A.D. 2005).

the court recognized that a party generally owes no duty to exercise due care to avoid purely economic loss, but if there is a "special relationship" between the parties such that it would be equitable to impose such a duty, the duty will be imposed.[27] "In other words, there is an extremely limited group of cases where the law of negligence extends its protections to a party's economic interest."

Key Takeaway

Negligence is a second possible cause of action for products-liability claimants. A main advantage is that no issues of privity are relevant, but there are often problems of proof; there are a number of robust common-law defenses, and federal preemption is a recurring concern for plaintiffs' lawyers.

Because the doctrines of breach of warranty and negligence did not provide adequate relief to those

27. *Duffin v. Idaho Crop Imp. Ass'n*, 895 P.2d 1195 (Idaho 1995).

suffering damages or injuries in products-liability cases, beginning in the 1960s courts developed a new tort theory: strict products liability, restated in the Second Restatement, section 402A. Basically the doctrine says that if goods sold are unreasonably dangerous or defective, the merchant-seller will be liable for the immediate property loss and personal injuries caused thereby. But there remain obstacles to recovery even under this expanded concept of liability: disclaimers of liability have not completely been dismissed, the plaintiff's conduct or changes to the goods may limit recovery, and—with some exceptions—the remedies available are limited to personal injury (and damage to the goods themselves); economic loss is not recoverable.

10.4 Tort Reform

Learning Objectives

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

1. See why tort reform is advocated, why it is opposed, and what interests take each side.
2. Understand some of the significant state reforms in the last two decades.
3. Know what federal reforms have been instituted.

10.4.1 The Cry for Reform

In 1988, The Conference Board published a study that resulted from a survey of more than 500 chief executive officers from large and small companies regarding the effects of products liability on their firms. The study concluded that US companies are less competitive in international business because of these effects and that products-liability laws must be reformed. The reform effort has been under way ever since, with varying degrees of alarms and finger-pointing as to who is to blame for the "tort crisis," if there even is one. Business and professional groups beat the drums for tort reform as a means to guarantee "fairness" in the courts as well as spur US economic competitiveness in a global marketplace, while plaintiffs' attorneys and consumer advocates claim that

businesses simply want to externalize costs by denying recovery to victims of greed and carelessness.

Each side vilifies the other in very unseemly language: probusiness advocates call consumer- oriented states "judicial h***-holes" and complain of "well-orchestrated campaign[s] by tort lawyer lobbyists and allies to undo years of tort reform at the state level,"[28] while pro-plaintiff interests claim that there is "scant evidence" of any tort abuse.[29] It would be more amusing if it were not so shrill and partisan. Perhaps the most one can say with any certainty is that peoples' perception of reality is highly colored by their self-interest. In any event, there have been reforms (or, as the detractors say, "deforms").

Prodded by astute lobbying by manufacturing and other business trade associations, state legislatures responded to the cries of manufacturers about the hardships that the judicial transformation of the products-liability lawsuit ostensibly worked on them. Most state legislatures have enacted at least one of some three dozen "reform" proposal pressed on them over the last two decades. Some of these measures do little more than affirm and clarify case law. Among the most that have passed in several states are outlined in the next sections.

10.4.1.1 Statutes of Repose Perhaps nothing so

28. American Tort Reform Association website, accessed March 1, 2011, http://www.atra.org.
29. http://www.shragerlaw.com/html/legal_rights.html.

frightens the manufacturer as the occa- sional reports of cases involving products that were fifty or sixty years old or more at the time they injured the plaintiff. Many states have addressed this problem by enacting the so-called statute of repose.[30] This statute establishes a time period, generally ranging from six to twelve years; the manufacturer is not liable for injuries caused by the product after this time has passed.

10.4.1.2 State-of-the-Art Defense Several states have enacted laws that prevent advances in technology from being held against the manufacturer. The fear is that a plaintiff will convince a jury a product was defective because it did not use technology that was later available. Manufacturers have often failed to adopt new advances in technology for fear that the change will be held against them in a products-liability suit. These new statutes declare that a manufacturer has a valid defense if it would have been technologically impossible to have used the new and safer technology at the time the product was manufactured.

Key Takeaway

30. A statute limiting the time that a product manufacturer can be liable for its defects.

Business advocates claim the American tort system—products-liability law included—is broken and corrupted by grasping plaintiffs' lawyers; plaintiffs' lawyers say businesses are greedy and careless and need to be smacked into recognition of its responsibilities to be more careful. The debate rages on, decade after decade, but there have been some reforms at the state level.

11.

INTRODUCTION TO CONTRACT LAW

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. Common problems with contracts, such as undue influence and fraud.
7. The circumstances when a contract needs to

be in writing to be enforceable.
8. The remedies for breach of contract.

The two legal 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 voluntary consent; 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, whether or not the parties desire. Together, voluntary obligations in contract and involuntary obligations in tort are the foundational aspects of the common law of business.

11.1 General Perspectives on Contracts

Learning Objectives

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

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.

11.1.1 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 historical 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.[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

1. Sir Henry Maine, Ancient Law (1869), 180–82.

United States and England, did a full-fledged law of contracts arise together with modern capitalism.

11.1.2 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."[2]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."[3] A short-hand definition is: "A contract is a legally enforceable promise."

11.1.3 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

2. Restatement (Second) of Contracts, Section 1.
3. Section 1-201(11).

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.

11.1.4 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[4] and statutes.

11.1.4.1 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

4. Law decided by judges as recorded and published in cases.

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[5], completed in 1932. A revision—the Restatement (Second) of Contracts—was undertaken in 1946 and finally completed in 1979.

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.

5. An organized codification of the common law of contracts.

11.1.4.2 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), the modern American state statutory law governing commercial transactions, especially Article 2[6], which deals with the sale of goods (movable, tangible items). Briefly put, 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. 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.

The UCC provides a flexible and yet highly technical framework for sale of goods that will, for large part, be beyond the scope of this chapter. The text will note some cases when substantial and important differences exist between the common law (services and real estate) and the UCC (sale of goods). For example, under the common law offer must meet

6. That part of the Uniform Commercial Code dealing with the sale of goods.

acceptance exactly for a contract to be formed, while the UCC is much more flexible, which reflects commercial practice in which offered terms and conditions often don't match terms and conditions in acceptances.

11.1.5 The Convention on Contracts for the International Sale of Goods

A Convention on Contracts for the International Sale of Goods (CISG)An international body of contract law. 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.[7]

11.1.6 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.

11.1.6.1 Explicitness

11.1.6.1.1 Express Contract An express contract[8] is

7. So yes, the parties may contract for which form of contract law applies to their agreement!
8. A contract in words, orally or in writing.

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.

11.1.6.1.2 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.

11.1.6.1.3 Contract Implied in Law: *Quasi*-contract Both express and implied contracts embody an actual agreement of the parties. A quasi-contract[9], 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

9. A contract imposed on a party when there was none, to avoid unjust enrichment.

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.

11.1.6.2 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.[10] But mutual promises are not necessary to constitute a contract. Unilateral contracts[11], 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.

11.1.6.3 Enforceability Not every agreement between

10. A contract where each party makes a promise to the other.
11. A contract that is accepted by the performance of the requested action, not by a promise.

two people is a binding contract. An agreement that is lacking one of the legal elements of a contract is said to be **void**[12]—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[13] 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.

12. An agreement that never was a contract.
13. A contract that can be annulled.

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[14] 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.)

14. A contract for which the non-breaching party has not remedy for its breach.

11.1.7 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 modern 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[15] 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

15. A contract that has yet to be completed.

the wheat to Humphrey—the contract is called partially executed.[16] A contract that has been carried out fully by both parties is called an executed contract.[17]

Finally, the common law recognizes contracts that are "substantially" performed. If one party to a contract performs in a way that doesn't precisely fulfill the contract, but fulfills its essential terms, the common law would require the other party perform. For example, if someone building a house for another installed the cabinets incorrectly, the buyer would still need to pay for the house. The buyer could then claim damages or require the builder to fix the cabinets. The UCC has a different rule for buying goods: sellers are bound by the "perfect tender" rule, which requires that buyers receive exactly what they ordered or they may reject the good.

Key Takeaway

Contract is the mechanism by which people in

16. A contract in which one party has performed, or partly performed, and the other has not.
17. A contract that has been completed.

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.

11.2 Contract Formation

Learning Objectives

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

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).

11.2.1 The Agreement: Offer and Acceptance

The core of a legal contract is the agreement between the parties. Although agreements may take any form, including unspoken conduct between the parties, 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.

The *Restatement (Second) of Contracts* defines agreement as a "manifestation of mutual assent by two or more persons to one another."[18] The UCC defines agreement as "the bargain of

18. (Section 3)

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."[19] The critical question is what the parties objectively said or did, not what they subjectively 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

19. (Section 1-201(3))

> 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.[20]

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. If the offer says "accept in skywriting at noon", then the only way to accept the offer is to hire an airplane. If the offeror specifies no particular mode, then acceptance is effective when transmitted

20. Barnes v. Treece, 549 P.2d 1152 (Wash. App. 1976).

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.[21]

11.2.2 Consideration

Not every agreement forms a contract. One way in which agreements fail to become contracts is because they lack **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

21. Adams v. Lindsell, 1 Bamewall & Alderson 681 (K.B. 1818).

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.[22]

The existence of consideration is determined by examining whether the person against whom a promise is to be enforced (the promisor[23]) received something in return from the person to whom he made the promise (the promisee[24]). That may seem a simple enough question. But as with much in the law,

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22. 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.
23. The one who makes a promise.
24. The one to whom a promise is made.

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[25]—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.

25. The giving up by a person of that which she had a right to retain.

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[26] 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

26. To be prohibited from denying a promise when another has subsequently relied upon it.

that under the three-pronged promissory estoppel test, Timko's estate was liable.[27]

11.2.3 Illegality

In general, illegal contracts are unenforceable. Thus, one can think of "legality" as being a required element of a contract, along with agreement, consideration, and capacity. As illegality is also a defense to a contract, we cover it later in the chapter.

11.2.4 Capacity

A contract is a meeting of minds. If someone lacks mental capacity[28] 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.

Capacity issues often arise when contracting with minors. The general rule is that persons younger than eighteen can avoid their contracts.

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27. Estate of Timko v. Oral Roberts Evangelistic Assn., 215 N.W.2d 750 (Mich. App. 1974).
28. The mental state of mind sufficient to understand that a contract is made and its consequences.

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, she has two choices:

she may ratify the contract or disaffirm[29] 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.

11.2.4.1 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

29. To legally disavow or avoid a contract.

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.

11.2.4.2 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 *highly 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).

11.2.5 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[30], first enacted in England in 1677 under the formal name "An Act for the Prevention of Frauds and Perjuries." The purpose of the Statute of Frauds is to prevent the fraud that occurs when one party attempts to impose upon another a contract that did not in fact exist.

The Statute of Frauds requires that certain kinds of contracts be in writing to be enforceable. These include:

1. Contracts to convey an interest in land (such as sale of a home);
2. Contracts that are impossible to fulfill within one year (such as a contract entered July 1, for employment beginning August 1 and lasting a year);
3. Contracts in which the consideration is marriage;
4. Contracts to pay another's debt; and

30. A rule requiring that certain contracts be evidenced by some writing, signed by the person to be bound, to be enforceable.

5. Under the UCC, contracts for sale of goods for at least $500 (and lease of goods of at least $1,000).

The Statute of Frauds requires certain kinds of contracts to be in writing.

Again, as may be evident from the title of the act and its requirements, 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."[31]

There are many exceptions to the Statute of Frauds. For example, under the UCC, custom goods manufactured, such

31. Restatement (Second) of Contracts Chapter 5, statutory note.

as with the logo of another company, would be evidence of the agreement, as it is unlikely someone would produce custom goods without an agreement. If the parties have began to perform according to the oral agreement, it would also be hard to deny the contract exists, at least as to what has been performed. For contracts to pay another's debt, if the primary purpose for which the agreement was made was to benefit the guarantor, then again an exception applies. These are just several examples, and so one should research the law carefully before trying to back out of a contract for Statute of Frauds concerns. Of course, it would be prudent to render the agreement in writing to begin with!

11.2.5.1 Parol Evidence

11.2.5.1.1 The Rule Unlike Minerva sprung forth whole from the brow of Zeus in Greek mythology, contracts do not appear at a stroke memorialized on paper. Almost invariably, negotiations of some sort precede the concluding of a deal. People write letters, talk by telephone, meet face-to-face, send e-mails, and exchange thoughts and views about what they want and how they will reciprocate. They may even lie and cajole in duplicitous ways, making promises they know they cannot or will not keep in order not to kill the contract talks. In the course of these discussions, they may reach tentative agreements, some of which will ultimately be reflected in the final contract, some of which will be discarded along the way, and some of which perhaps will not be included in the final agreement but will nevertheless not be contradicted

by it. Whether any weight should be given to these prior agreements is a problem that frequently arises.

The rule at common law is this: a written contract intended to be the parties' complete understanding discharges all prior or contemporaneous promises, statements, or agreements that add to, vary, or conflict with it.

The rule applies to all written contracts, whether or not the Statute of Frauds requires them to be in writing. The Statute of Frauds gets to whether there was a contract at all; the parol evidence rule says, granted there was a written contract, does it express the parties' understanding? But the rule is concerned only with events that transpired before the contract in dispute was signed. It has no bearing on agreements reached subsequently that may alter the terms of an existing contract.

11.2.5.1.2 Exceptions to the Parol Evidence Rule

Despite its apparent stringency, the parol evidence rule does not negate all prior agreements or statements, nor preclude their use as evidence. A number of situations fall outside the scope of the rule and hence are not technically exceptions to it, so they are better phrased as exemptions (something not within the scope of a rule).

If the parties never intended the written contract to be their full understanding—if they intended it to be partly oral—then the rule does not apply. If the document is fully integrated, no extrinsic evidence will be permitted to modify the terms of the agreement, even if the modification is in addition to

the existing terms, rather than a contradiction of them. If the contract is partially integrated, prior consistent additional terms may be shown. It is the duty of the party who wants to exclude the parol evidence to show the contract was intended to be integrated. That is not always an easy task. To prevent a party later from introducing extrinsic evidence to show that there were prior agreements, the contract itself can recite that there were none. Here, for example, is the final clause in the National Basketball Association Uniform Player Contract: "This agreement contains the entire agreement between the parties and there are no oral or written inducements, promises or agreements except as contained herein." Such a clause is known as a merger or integration clause

When the parties orally agree that a written contract is contingent on the occurrence of an event or some other condition (a condition precedent[32]), the contract is not integrated and the oral agreement may be introduced. The classic case is that of an inventor who sells in a written contract an interest in his invention. Orally, the inventor and the buyer agree that the contract is to take effect only if the buyer's engineer approves the invention. (The contract was signed in advance of approval so that the parties would not need to meet again.) The engineer did not approve it, and in a suit

32. A term in a contract that something has to happen before the obligation to perform the contract ripens.

for performance, the court permitted the evidence of the oral agreement because it showed "that in fact there never was any agreement at all."[33] Note that the oral condition does not contradict a term of the written contract; it negates it. The parol evidence rule will not permit evidence of an oral agreement that is inconsistent with a written term, for as to that term the contract is integrated.

11.2.6 Third-Party Rights

11.2.6.1 Assigning Rights Contracts create rights and duties. By an assignment[34], an obligee (one who has the right to receive a contract benefit) transfers a right to receive a contract benefit owed by the obligor (the one who has a duty to perform) to a third person (assignee); the obligee then becomes an assignor (one who makes an assignment). The assignor may assign any right unless (1) doing so would materially change the obligation of the obligor, materially burden her, increase her risk, or otherwise diminish the value to her of the original contract; (2) statute or public policy forbids the assignment; or (3) the contract itself precludes assignment. A common example of this last point are prohibitions against subletting

33. Pym v. Campbell, 119 Eng. Rep. 903 (Q.B. 1856).
34. The passing or delivering by one person to another of the right to a contract benefit.

commonly found in leases–subletting is assigning the contractual right of occupancy.

An assignment of rights effectively makes the assignee stand in the shoes of the assignor.[35] She gains all the rights against the obligor that the assignor had, but no more. An obligor who could avoid the assignor's attempt to enforce the rights could avoid a similar attempt by the assignee.

11.2.6.2 Delegating Duties To this point, we have been considering the assignment of the assignor's rights (usually, though not solely, to money payments). But in every contract, a right connotes a corresponding duty, and these may be delegated. A delegation is the transfer to a third party of the duty to perform under a contract. The one who delegates is the delegator. Because most obligees are also obligors, most assignments of rights will simultaneously carry with them the delegation of duties. Unless public policy or the contract itself bars the delegation, it is legally enforceable.

An obligor who delegates a duty (and becomes a delegator) does not thereby escape liability for performing the duty himself. The obligee of the duty may continue to look to the obligor for performance unless the original contract specifically provides for substitution by delegation. This is a big difference between assignment of contract rights and delegation of contract duties: in the former, the assignor is

35. An assignee takes no greater rights than his assignor had.

discharged (absent breach of assignor's warranties); in the latter, the delegator remains liable. The obligee (again, the one to whom the duty to perform flows) may also, in many cases, look to the delegatee, because the obligee becomes an intended beneficiary of the contract between the obligor and the delegatee.

11.2.6.3 Third-Party Beneficiaries The general rule is this: persons not a party to a con- tract cannot enforce its terms; they are said to lack privity[36], a private, face-to-face relationship with the contracting parties. But if the persons are intended to benefit from the performance of a contract between others, then they can enforce it: they are *intended* beneficiaries.

For example, a contract to paint one's house cannot be enforced by a neighbor–the neighbor might benefit from an increased home value due to your house looking maintained, but this benefit is only *incidental*. In contrast, a contract between A and B to deliver insurance proceeds to C would be enforcable by C. C is an intended, rather than merely incidental, beneficiary of the contract.

36. The relationship of the immediate parties to a contract, a "private" relationship, as between retailer and customer.

Key Takeaway

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. The parol evidence rule states that if a written contract is integrated, evidence of prior oral agreements cannot be used in court. Third parties may have stakes in contracts: contractual rights can be assigned in most cases, and contractual duties may be delegated. Intended third party beneficiaries may be able to enforce contracts to which they are not a party.

11.3 Defenses and

Interpretations

Learning Objectives

Type your learning objectives here.

1. Understand problems with voluntary consent, such as fraud, mistake, duress, and undue influence
2. Understand when courts will choose not to enforce contracts for public policy reasons, such as unconscionability.
3. Understand implications of illegal contracts.
4. Understand rules for resolving ambiguity in contracts

Because contracts are voluntary agreements the law will enforce, the common law developed a variety of doctrines that responded to situations in which someone was not truly free to enter into the contract, or to situations in which courts felt it unfair to enforce the agreement. In this section we will study these doctrines.

11.3.1 Fraud

Misrepresentation is a statement of fact that is not consistent with the truth. If misrepresentation is intentional, it is fraudulent misrepresentation; if it is not intentional, it is nonfraudulent misrepresentation, which can be either negligent or innocent.

In further taxonomy, courts distinguish between fraud in the execution and fraud in the induce- ment. Fraud in the execution occurs when the nature of the document itself is misrepresented. For example, Alphonse and Gaston decide to sign a written contract incorporating terms to which they have agreed. It is properly drawn up, and Gaston reads it and approves it. Before he can sign it, however, Alphonse shrewdly substitutes a different version to which Gaston has not agreed. Gaston signs the substitute version. There is no contract. There has been fraud in the execution.

Fraud in the inducement is more common. It involves some misrepresentation about the subject of the contract that induces assent. Alphonse tells Gaston that the car Gaston is buying from Alphonse has just been overhauled—which pleases Gaston—but it has not been. This renders the contract voidable.

11.3.1.1 Nondisclosure A passive type of concealment is nondisclosure. Although generally the law imposes no obligation on anyone to speak out, nondisclosure of a fact can operate as a misrepresentation under certain circumstances.

This occurs, for example, whenever the other party has erroneous information where the nondisclosure amounts to a failure to act in good faith, or where the party who conceals knows or should know that the other side cannot, with reasonable diligence, discover the truth.

In a remarkable 1991 case out of New York, a New York City stockbroker bought an old house upstate (basically anyplace north of New York City) in the village of Nyack, north of New York City, and then wanted out of the deal when he discovered—the defendant seller had not told him—that it was "haunted." The court summarized the facts: "Plaintiff, to his horror, discovered that the house he had recently contracted to purchase was widely reputed to be possessed by poltergeists [ghosts], reportedly seen by defendant seller and members of her family on numerous occasions over the last nine years. Plaintiff promptly commenced this action seeking rescission of the contract of sale. Supreme Court reluctantly dismissed the complaint, holding that plaintiff has no remedy at law in this jurisdiction."

The high court of New York ruled he could rescind the contract because the house was "haunted as a matter of law": the defendant had promoted it as such on village tours and in *Reader's Digest*. She had concealed it, and no reasonable buyer's inspection would have revealed the "fact." The dissent basically hooted, saying, "The existence of a poltergeist is no

more binding upon the defendants than it is upon this court."[37]

Can failing to disclose haunting void a real estate contract?

11.3.1.2 Statement Made False by Subsequent Events

If a statement of fact is made false by later events, it must be disclosed as false. For example, in idle chatter one day, Alphonse tells Gaston that he owns thirty acres of land. In fact, Alphonse owns only twenty-seven, but he decided to exaggerate a little. He meant no harm by it, since the conversation had no import. A year later, Gaston offers to buy the "thirty acres" from Alphonse, who does not correct

37. *Stambovsky v. Ackley*, 169 A.D.2d 254 (N.Y. 1991).

the impression that Gaston has. The failure to speak is a nondisclosure—presumably intentional, in this situation—that would allow Gaston to rescind a contract induced by his belief that he was purchasing thirty acres.

11.3.1.3 Statements of Opinion An opinion, of course, is not a fact; neither is sales puffery. For example, the statements "In my opinion this apple is very tasty" and "These apples are the best in the county" are not facts; they are not expected to be taken as true. Reliance on opinion is hazardous and generally not considered justifiable.

If Jack asks what condition the car is in that he wishes to buy, Mr. Olson's response of "Great!" is not ordinarily a misrepresentation. As the Restatement puts it: "The propensity of sellers and buyers to exaggerate the advantages to the other party of the bargains they promise is well recognized, and to some extent their assertions must be discounted."[38] Vague statements of quality, such as that a product is "good," ought to suggest nothing other than that such is the personal judgment of the opinion holder.

Despite this general rule, there are certain exceptions that justify reliance on opinions and effectively make them into facts. Merely because someone is less astute than the one with whom she is bargaining does not give rise to a claim of justifiable reliance on an unwarranted opinion.

38. Restatement (Second) of Contracts, Section 168(d).

11.3.2 Mistake

In discussing fraud, we have considered the ways in which trickery by the other party makes a contract void or voidable. We now examine the ways in which the parties might "trick" themselves by making assumptions that lead them mistakenly to believe that they have agreed to something they have not. A mistake is "a belief about a fact that is not in accord with the truth."[39]

11.3.2.1 Mistake by One Party

11.3.2.1.1 Unilateral Mistake Where one party makes a mistake, it is a unilateral mis- take.[40] The rule: ordinarily, a contract is not voidable because one party has made a mistake about the subject matter (e.g., the truck is not powerful enough to haul the trailer; the dress doesn't fit).

11.3.2.1.2 Exceptions If one side *knows* or *should know* that the other has made a mistake, he or she may not take advantage of it. A person who makes the mistake of not reading a written document will usually get no relief, nor will relief be afforded to one whose mistake is caused by negligence (a contractor forgets to add in the cost of insulation) unless the negligent party would suffer unconscionable hardship if the

39. Restatement (Second) of Contracts, Section 151.
40. A mistake made by one party to a contract; relief is not usually granted.

mistake were not corrected. Courts will allow the correction of drafting errors in a contract ("reformation") in order to make the contract reflect the parties' intention.[41]

11.3.2.2 Mutual Mistake In the case of mutual mistake[42]—both parties are wrong about the subject of the contract—relief may be granted.

The Restatement sets out three requirements for successfully arguing mutual mistake.[43] The party seeking to avoid the contract must prove that:

1. The mistake relates to a "basic assumption on which the contract was made,"
2. The mistake has a material effect on the agreed exchange of performances, and
3. The party seeking relief does not bear the risk of the mistake.

Basic *assumption* is probably clear enough. In the famous "cow case," the defendant sold the plaintiff a cow—Rose of Abalone—believed by both to be barren and thus of less value than a fertile cow (a promising young dairy cow in 2010 might

41. *Sikora v. Vanderploeg*, 212 S.W.3d 277 (Tenn. Ct. App. 2006).
42. Erroneous belief shared and relied on by both parties to a contract for which a court often grants relief.
43. Restatement (Second) of Contracts, Section 152.

sell for $1,800).[44] Just before the plaintiff was to take Rose from the defendant's barn, the defendant discovered she was "large with calf"; he refused to go on with the contract. The court held this was a mutual mistake of fact—"a barren cow is substantially a different creature than a breeding one"—and ruled for the defendant. That she was infertile was "a basic assumption," but—for example—that hay would be readily available to feed her inexpensively was not, and had hay been expensive, that would not have vitiated the contract.

11.3.2.2.1 Material Effect on the Agreed-to Exchange of Performance "Material effect on the agreed-to exchange of performance" means that because of the mutual mistake, there is a significant difference between the value the parties thought they were exchanging compared with what they would exchange if the contract were performed, given the standing facts. Again, in the cow case, had the seller been required to go through with the deal, he would have given up a great deal

44. *Sherwood v. Walker*, 33 N.W. 919 (1887).

more than he anticipated, and the buyer would have received an unagreed-to windfall.

11.3.2.2.2 Party Seeking Relief Does Not Bear the Risk of the Mistake Assume a weekend browser sees a painting sitting on the floor of an antique shop. The owner says, "That old thing? You can have it for $100." The browser takes it home, dusts it off, and hangs it on the wall. A year later a visitor, an expert in art history, recognizes the hanging as a famous lost El Greco worth $1 million. The story is headlined; the antique dealer is chagrined and claims the contract for sale should be voided because both parties mistakenly thought they were dickering over an "old, worthless" painting. The contract is valid. The owner is said to bear the risk of mistake because he contracted with conscious awareness of his ignorance: he knew he didn't know what the painting's possible value might be, but he didn't feel it worthwhile to have it appraised. He gambled it wasn't worth much, and lost.

11.3.3 Duress and Undue Influence

11.3.3.1 Duress When a person is forced to do something

against his or her will, that person is said to have been the victim of duress There are two types of duress: physical duress and duress by improper threat.

11.3.3.1.1 Physical Duress If a person is forced into entering a contract on threat of physical bodily harm, he or she is the victim of physical duress. It is defined by the Restatement (Second) of Contracts in Section 174: "If conduct that appears to be a manifestation of assent by a party who does not intend to engage in that conduct is physically compelled by duress, the conduct is not effective as a manifestation of assent." A contract induced by physical violence is void.[45]

11.3.3.1.2 Duress by Economic Threat The second kind of duress is *duress by economic threat*; it is more common than physical duress. Here the perpetrator threatens the victim economically, who feels there is no reasonable alternative but to assent to the contract. It renders the contract voidable. This rule contains a number of elements.

First, the threat must be improper. Second, there must be no reasonable alternative. If, for example, a supplier threatens to hold up shipment of necessary goods unless the buyer agrees to pay more than the contract price, this would not be duress

45. There is different authority on physical violence as a threat or a physical action that actually forces a contractual action. For our purposes, all forms of physical threat make a contract void.

if the buyer could purchase identical supplies from someone else. Third, the test for inducement is subjective. It does not matter that the person threatened is unusually timid or that a reasonable person would not have felt threatened. The question is whether the threat in fact induced assent by the victim. Such facts as the victim's belief that the threatener had the ability to carry out the threat and the length of time between the threat and assent are relevant in determining whether the threat did prompt the assent.

There are many types of improper threats that might induce a party to enter into a contract: threats to commit a crime or a tort (e.g., bodily harm or taking of property), to instigate criminal prosecution, to instigate civil proceedings when a threat is made in bad faith, to breach a "duty of good faith and fair dealing under a contract with the recipient," or to disclose embarrassing details about a person's private life.

Jack buys a car from a local used-car salesman, Mr. Olson, and the next day realizes he bought a lemon. He threatens to break windows in Olson's showroom if Olson does not buy the car back for $2,150, the purchase price. Mr. Olson agrees. The agreement is voidable, even though the underlying deal is fair, if Olson feels he has no reasonable alternative and is frightened into agreeing. Suppose Jack knows that Olson has been tampering with his cars'

odometers, a federal offense, and threatens to have Olson prosecuted if he will not repurchase the car. Even though Olson may be guilty, this threat makes the repurchase contract voidable, because it is a misuse for personal ends of a power (to go to the police) given each of us for other purposes. If these threats failed, suppose Jack then tells Olson, "I'm going to haul you into court and sue your pants off." If Jack means he will sue for his purchase price, this is not an improper threat, because everyone has the right to use the courts to gain what they think is rightfully theirs. But if Jack meant that he would fabricate damages done him by a (falsely) claimed odometer manipulation, that would be an improper threat. Although Olson could defend against the suit, his reputation would suffer in the meantime from his being accused of odometer tampering.

11.3.3.2 Undue Influence The Restatement of Contracts (Second) characterizes undue influence as "unfair persuasion."[46] It is a milder form of duress than physical harm or threats. The unfairness does not lie in any misrepresentation; rather, it occurs when the victim is under the domination of the persuader or is one who, in view of the relationship between them, is warranted in believing that the persuader will act in a manner detrimental to the victim's

46. Restatement (Second) of Contracts, Section 177.

welfare if the victim fails to assent. It is the improper use of trust or power to deprive a person of free will and substitute instead another's objective. Usually the fact pattern involves the victim being isolated from receiving advice except from the persuader. Falling within this rule are situations where, for example, a child takes advantage of an infirm parent, a doctor takes advantage of an ill patient, or a lawyer takes advantage of an unknowledgeable client. If there has been undue influence, the contract is voidable by the party who has been unfairly persuaded. Whether the relationship is one of domination and the persuasion is unfair is a factual question. The answer hinges on a host of variables, including "the unfairness of the resulting bargain, the unavailability of independent advice, and the susceptibility of the person persuaded."[47]

11.3.4 Illegal Contracts

11.3.4.1 Contracts that violate a statute Any bargain that violates the criminal law— including statutes that govern extortion, robbery, embezzlement, forgery, some gambling, licensing, and consumer credit transactions—is illegal. Thus determining whether contracts are lawful may seem to be an easy enough task. Clearly, whenever the statute itself explicitly forbids the making of the contract or the performance agreed

47. Restatement (Second) of Contracts, Section 177(b).

upon, the bargain (such as a contract to sell drugs) is unlawful. But when the statute does not expressly prohibit the making of sthe contract, courts examine a number of factors.

11.3.4.2 Unconscionable contracts Courts may refuse to enforce unconscionable contracts, those that are shockingly one-sided, unfair, the product of unequal bargaining power, or oppressive; a court may find the contract divisible and enforce only the parts that are not unconscionable.

The common-law rule is reflected in Section 208 of the Restatement: "If a contract or term thereof is unconscionable at the time the contract is made a court may refuse to enforce the contract, or may enforce the remainder of the contract without the unconscionable term, or may so limit the application of any unconscionable term as to avoid any unconscionable result."

Unconscionability may arise procedurally or substantively. A term is procedurally unconscionable if it is imposed upon the "weaker" party because of fine or inconspicuous print, unexpected place- ment in the contract, lack of opportunity to read the term, lack of education or sophistication that precludes understanding, or lack of equality of bargaining power. Substantive unconscionability arises where the affected terms are oppressive and harsh, where the term deprives a party of any real remedy for breach. Most often—but not always—courts find unconscionable contracts in the context of consumer transactions rather than commercial transactions. In the latter case, the assumption is that the parties tend to

be sophisticated businesspeople able to look out for their own contract interests.

11.3.5 Specific Contractual Pitfalls

Courts have long held that public policy disfavors attempts to contract out of tort liability. Exculpatory clauses that exempt one party from tort liability to the other for harm caused intentionally or recklessly are unenforceable without exception. A contract provision that exempts a party from tort liability for negligence is unenforceable under two general circumstances: (1) when it "exempts an employer from liability to an employee for injury in the course of his employment" or (2) when it exempts one charged with a duty of public service and who is receiving compensation from liability to one to whom the duty is owed.[48] Contract terms with offensive exculpatory clauses may be considered somewhat akin to unconscionability.

Put shortly, exculpatory clauses are okay if they are reasonable. Put not so shortly, exculpatory clauses will generally be held valid if (1) the agreement does not involve a business generally thought suitable for public regulation (a twenty-kilometer bicycle race, for example, is probably not one thought generally suitable for public regulation, whereas a bus

48. Restatement (Second) of Contracts, Section 195.

line is); (2) the party seeking exculpation is not performing a business of great importance to the public or of practical necessity for some members of the public; (3) the party does not purport to be performing the service to just anybody who comes along (unlike the bus line); (4) the parties are dealing at arms' length, able to bargain about the contract; (5) the person or property of the purchaser is not placed under control of the seller, subject to his or his agent's carelessness; or (6) the clause is conspicuous and clear.[49]

Another broad area in which public policy intrudes on private contractual arrangements is that of undertakings between couples, either prior to or during marriage. Marriage is quintessentially a relation- ship defined by law, and individuals have limited ability to change its scope through legally enforceable contracts. Moreover, marriage is an institution that public policy favors, and agreements that unreasonably restrain marriage are void. Thus a father's promise to pay his twenty-one-year-old daughter $100,000 if she refrains from marrying for ten years would be unenforceable. However, a promise in a postnuptial (after marriage) agreement that if the husband

49. *Henrioulle v. Marin Ventures, Inc.*, 573 P.2d 465 (Calif. 1978).

predeceases the wife, he will provide his wife with a fixed income for as long as she remains unmarried is valid because the offer of support is related to the need.

Finally, a promise by an employee not to compete with his or her former employer is scrutinized carefully by the courts, and an injunction[50] will be issued cautiously, partly because the prospective employee is usually confronted with a contract of adhesion[51] and is in a weak bargaining position compared to the employer, and partly because an injunction might cause the employee's unemployment. Many courts are not enthusiastic about employment noncompete agreements. The California Business and Professions Code provides that "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void."[52] As a result of the statute, and to promote entrepreneurial robustness, California courts typically interpret the statute broadly and refuse to enforce noncompete agreements. Other states are less stingy, and employers have attempted to avoid the strictures of no-enforcement state rulings by providing that their employment

50. A judicial order directing a person to stop doing that which he or she should not do.
51. A contract presented to the offeree to take or leave without bargaining.
52. California Business and Professions Code, Section 16600.

contracts will be interpreted according to the law of a state where noncompetes are favorably viewed.

11.3.6 Ways to Resolve Ambiguity

As any reader knows, the meaning of words depends in part on context and in part on the skill and care of the writer. As Justice Oliver Wendell Holmes Jr. once succinctly noted, "A word is not a crystal, transparent and unchanged; it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used."[53] Words and phrases can be ambiguous, either when they stand alone or when they take on a different coloration from words and phrases near them. A writer can be careless and contradict himself without intending to; people often read hurriedly and easily miss errors that a more deliberate perusal might catch. Interpretation difficulties can arise for any of a number of reasons: a form contract might contain language that is inconsistent with provisions specifically annexed; the parties might use jargon that is unclear; they might forget to incorporate a necessary term; assumptions about prior usage or performance, unknown to outsiders like judges, might color their understanding of the words they do

53. *Towne v. Eisner*, 245 US 418, 425 (1917).

use. Because ambiguities do arise, courts are frequently called on to give content to the words on paper.

Courts attempt to give meaning to the parties' understanding when they wrote the contract. The intention of the parties governs, and if their purpose in making the contract is known or can be ascertained from all the circumstances, it will be given great weight in determining the meaning of an obscure, murky, or ambiguous provision or a pattern of conduct. A father tells the college bookstore that in consideration of its supplying his daughter, a freshman, with books for the coming year, he will guarantee payment of up to $350. His daughter purchases books totaling $400 the first semester, and he pays the bill. Midway through the second semester, the bookstore presents him with a bill for an additional $100, and he pays that. At the end of the year, he refuses to pay a third bill for $150. A court could construe his conduct as indicating a purpose to ensure that his daughter had whatever books she needed, regardless of cost, and interpret the contract to hold him liable for the final bill.

The policy of uncovering purpose has led to a number of tools of judicial interpretation:

- More specific terms or conduct are given more weight than general terms or unremarkable conduct. Thus a clause that is separately negotiated and added to a contract will be counted as more significant than a standard term in a form contract.

- A writing is interpreted as a whole, without undue attention to one clause.
- Common words and terms are given common meaning; technical terms are given their technical meaning.
- In the range of language and conduct that helps in interpretation, the courts prefer the following items in the order listed: express terms, course of performance, course of dealing, and usage of trade.
- If an amount is given in words and figures that differ, the words control.
- Writing controls over typing; typing controls over printed forms.
- Ambiguities are construed against the party that wrote the contract.

For an example of resolving ambiguity by construing against, the drafter, see *Grove v. Charbonneau Buick-Pontiac, Inc.* in the Cases section.

Key Takeaway

The common law protects the voluntary aspect of contract law by policing various ways in which free

will may not be manifest in an agreement. These are doctrines such as mistake, duress, and undue influence. It also provides methods to avoid unconscionable exchanges, methods to stop illegal contracts from being enforced, and ways to interpret situations in which the parties' intent is unclear.

11.4 Remedies for Breach of Contract

Learning Objectives

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

- Know the types of damages: compensatory and punitive.
- Understand specific performance as a remedy.
- Understand restitution as a remedy.

- Recognize the interplay between contract and tort as a cause of action.

Monetary awards (called "damages"), specific performance, and restitution are the three principle remedies when a contract is broken or "breached".

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.

This is very different than tort law! Tort law looks *backward*, to put the injured party in the same position as if the tort had not occurred. Contract law looks *forward* to put the injured party in the same position as if the contract had been fulfilled. These are called "expectation damages." If giving expectation damages is impossible, such as if they cannot be calculated,[54] the law might then look backward and put the parties in the same position as if the contract had not been entered.

11.4.1 Damages

11.4.1.1 Compensatory Damages One party has the right to damages[55] (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.

54. Such as a contract to start a new business, in which nobody knows how well the new business would have performed.
55. Money paid by one party to another to discharge a liability.

11.4.1.2 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.[56]

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.[57]

This subset of compensatory damages is called consequential damages[58]—damages that flow as a foreseeable consequence of the breach. For example, if you hire a roofer to

56. *Hadley v. Baxendale* (1854), 9 Ex. 341, 354, 156 Eng.Rep. 145, 151.
57. R. J. Danzig, "Hadley v. Baxendale: A Study in the Industrialization of the Law," Journal of Legal Studies 4, no. 249 (1975): 249.
58. Damages that flow as a foreseeable but indirect result of the breach of contract.

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.

Whether consequential damages are allowed under the contract is the source of much litigation. The UCC provides an extensive set of rules for sale of goods to determine whether sellers' disclaimers or buyers' inclusion of these terms in contracts are binding. This kind of dispute is called a "battle of the forms."

11.4.1.3 Nominal Damages If the breach caused no loss, the plaintiff is nevertheless entitled to a minor sum, perhaps one dollar, called nominal damages. When, for example, a buyer could purchase the same commodity at the same price as that contracted for, without spending any extra time or money, there can be no real damages in the event of breach.

11.4.1.4 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[59] 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.

11.4.1.5 Punitive Damages Punitive damages[60] 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

59. Money paid to the non-breaching party in an attempt to avoid further loss on account of the breach.
60. Money awarded to the non-breaching party in excess of any loss suffered to punish the breaching party.

good-faith purchaser for value even though the debtor was not in default, he has breached the contract and committed the tort of conversion.[61] 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 remitA judicial reduction in the amount of a damage award (the noun is remission). (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

61. The wrongful taking of someone's property by another; the civil equivalent of theft.

awarded punitive damages against other types of companies for breach of contract.

11.4.2 Specific Performance

Specific performance[62] 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).

62. An order directing a person to deliver the exact property (real or personal) that she contracted to sell to the buyer.

11.4.3 Liquidated Damages

In order to limit risk in contracts, many contractual drafters choose to include "liquidated damages" clauses. These are statements in the contract that spell out what damages will be if the contract is broken. This makes the damages certain, which lowers risk for the contracting parties. For example, in a contract for sale of a home, a party might lose their "ready money" if they back out of the agreement without cause.

Courts will uphold these clauses so long as they are reasonable, e.g., in the range of what actual damages might be. If the liquidated damages clause is unreasonably large, courts will not enforce it as a penalty. After all, if a liquidated damages clause was large enough, and courts chose to enforce it, the law would be favoring a regime of specific performance (as parties would always find it worthwhile to fulfill contracts rather than efficiently breach). For example, a liquidated damages clause of $10,000,000 on the sale of a $100,000 home would is excessive. If a court chose to enforce a clause like that, the parties would essentially be forced to perform.

11.4.4 Restitution

As the word implies, restitution is a restoring to one party of what he gave to the other. Therefore, only to the extent that the injured party conferred a benefit on the other party may the injured party be awarded restitution.

If the claimant has given the other party a sum of money, there can be no dispute over the amount of the restitution interest. Tom gives Tim $100 to chop his tree into firewood. Tim repudiates. Tom's restitution interest is $100. But serious difficulties can arise when the benefit conferred was performance. The courts have considerable discretion to award either the cost of hiring someone else to do the work that the injured party performed (generally, the market price of the service) or the value that was added to the property of the party in breach by virtue of the claimant's performance. Mellors, a gardener, agrees to construct ten fences around Lady Chatterley's flower gardens at the market price of $2,500. After erecting three, Mellors has performed services that would cost $750, market value. Assume that he has increased the value of the Lady's grounds by $800. If the contract is

repudiated, there are two measures of Mellors's restitution interest: $800, the value by which the property was enhanced; or $750, the amount it would have cost Lady Chatterley to hire someone else to do the work. Which measure to use depends on who repudiated the contract and for what reason.

11.4.5 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 Takeaway

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.

12.

SMALL BUSINESS ORGANIZATIONS

Learning Objectives

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

- Identify the costs and benefits of operating as a sole proprietorship.
- Identify the liability and default management rules for general partnerships.
- Distinguish between LPs, LLPs, and LLCs.
- Understand the steps needed to form an LLC and begin a small business in practice.

One of the major decisions involved in starting, or growing, a

business is how to legally structure the business entity. If one does nothing, then a sole proprietorship is created. This has great flexibility but unlimited personal liability. If one starts a business with another, but takes no legal steps, a general partnership has been created. Again, this offers unlimited personal liability. In contrast, creating a business entity like an LLC takes little effort and offers the owner protection against lawsuits.

12.1 Sole Proprietorships

Learning Objectives

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

- Understand the costs and benefits of operating as a sole proprietorship.
- Understand the concept of unlimited personal liability.

If an individual starts a business by themselves without taking

any legal precautions, they have created a "sole proprietorship". This is a business in which the owner is the business. This offers great flexibility: if the owner wishes to work, they may do so. If they wish not to work, nobody will compel them. The owner can come and go as they please, set prices as they desire, hire the employees they want, and fire employees they don't like, all without consulting other owners.

These are definitely advantages! It lets businesses be nimble, and one can start such a business without legal formalities. In fact, many small businesses in the United States begin as sole proprietorships. If you've began a solo business enterprise without taking other legal steps, then you created a sole proprietorship without realizing it.

At the same time, operating as a sole proprietor has major disadvantages. First, it can be hard to raise capital for the business, because you cannot offer ownership rights in the form of stock or partnership interests. Second, this type of business form has unlimited personal liability. Because the owner is the business, the owner faces unlimited personal liability for the business. If someone slips and falls on the premises because the owner was negligent in cleaning up a spill, and then sues and wins, the owner may lose their home or retirement account, or be forced into bankruptcy.

For these reasons, particularly the second, careful entrepreneurs give thought to liability as they begin a business. Some feel comfortable by purchasing liability insurance, while

many others take the steps to create a business entity that offers a liability shield, such as a Limited Liability Company or LLC. Forming an LLC is relatively painless and can protect the personal assets of the owner.

Key Takeaway

A sole proprietorship is a very common way to start a new business. No legal formalities need to be followed, making this a very easy way to begin an enterprise. At the same time, the absence of a liability shield means that the proprietor will be personally responsible for the liability of the business.

12.2 Partnerships

Learning Objectives

Type your learning objectives here.

- The importance of partnership and the present status of partnership law.
- The tests that determine whether a partnership exists.
- Partnership formation.
- The operation of a partnership, including the relations among partners and relations between partners and third parties.

It would be difficult to conceive of a complex society that did not operate its businesses through organizations. In this section we study partnerships, limited partnerships, and limited liability companies, and we touch on joint ventures and business trusts.[1]

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

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."

or more persons to carry on as co-owners a business for profit. . . whether or not the persons intend to form a partnership."[2] When we use the word partnership, we are referring to the *general* business partnership. There are also *limited* partnerships and *limited liability* partnerships, which are discussed later.

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.

12.2.1 Entity Characteristics of a Partnership

Partnership law is in a state of flux: some states base their partnership law on a law called the Uniform Partnership Act (UPA) while others use the Revised Uniform Partnership Act (RUPA). These laws differ in significant ways, such as whether

2. Revised Uniform Partnership Act, Section 202(a).

they treat the partnership as generally a separate legal entity (RUPA) or as merely the aggregation of the partners (UPA). In this chapter, for simplicity we will study principles from RUPA.

Partnership law (under RUPA) treats a partnership as a separate legal entity for most purposes. This means the partnership may keep business records as if it were a separate entity, it owns property as a distinct entity, it can be sued as a distinct legal entity, and its accountants may treat it as such for purposes of preparing income statements and balance sheets.[3] However, for tax purposes and liability purposes, the partnership remains treated as an aggregation. As such, partnerships 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

3. When this is not the case, for example, to sue a partnership you must sue each partner.

or not the share is actually distributed. Similarly for liability purposes, 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 later.

12.2.2 Partnership Formation

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.

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 of contract law. 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.

If the parties do not provide for these in their agreement, RUPA will do it for them as the default. 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.

12.2.2.1 Implied Partnerships 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.

12.2.2.2 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.

The crucial test for a partnership is: 1) the association of persons, (2) as co-owners, (3) for profit. Under (1) "persons" can include an individual, LLC, other partnership, corporation, and so on. For (2), 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. To establish a partnership, the ownership must be of a business, not merely of property. (So owning land with someone does not necessarily mean there is a partnership.)

For (3), 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.

12.2.3 Partnership Operation

Most of the rules discussed in this section apply unless otherwise agreed, and they are really intended for the small firm."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."[4]

12.2.3.1 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

4. Donald J. Weidner, "RUPA and Fiduciary Duty: The Texture of Relationship," Law and Contemporary Problems 58, no. 2 (1995): 81, 83.

very similar to the duty owed by an agent to the principal, as partnership law is based on agency concepts.

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[5] 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."[6] Breach of the fiduciary duty gives rise to a claim for compensatory, consequential, and incidental damages; recoupment of compensation; and—rarely—punitive damages.

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, and
- must maintain the confidentiality of partnership information.

5. The highest duty of good faith and trust, imposed on partners as to each other and the firm.
6. *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928).

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. 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.

12.2.3.2 Partnership Rights 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." 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.

All partners are entitled to share equally in the management and conduct of the business, unless the partnership agreement provides otherwise. 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.

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." 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.[7]

Key Takeaway

Partnership law defines a partnership as "an association of two or more persons to carry on as co-owners a business for profit." The Revised Uniform Partnership Act (RUPA) assumes a

7. *Hishon v. King & Spalding*, 467 U.S. 69 (1984).

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.

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.

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.

12.3 Special Forms of Partnerships

Learning Objectives

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

- Understand the basics of limited partnerships.
- Understand the basics of limited liability partnerships.
- Explain how these differ from general partnerships.

This and the following section provide 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.

12.3.1 Limited Partnerships

The limited partnership is attractive because of its treatment of taxation and its imposition of limited liability on its limited partners.

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."[8] 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.

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.

The act requires that the firm's promoters file a certificate of limited partnership[9] 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

8. ULPA, Section 102(11).
9. The document filed with the appropriate state authority that, when approved, marks the legal existence of the limited partnership.

somewhat of a "clunky" arrangement. That problem is obviated in the limited liability company, discussed below.

Any natural person, partnership, limited partnership (domestic or foreign), trust, estate, association, or corporation may become a partner of a limited partnership.

The control of the limited partnership is in the hands of the general partners, which may—as noted—be partnerships or corporations. A limited partner who exercises any significant control can 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; and
- 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.

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.

The Limited Partnership

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.

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. 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 their 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

12.3.2 Limited Liability Partnerships

A limited liability partnership (LLP) is a partnership in which some or all partners have limited liability, such as from the partnership obligations or the actions of the members of the partnership. 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.[10] (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 discussed below attracted the attention of professionals like accountants, lawyers, and doctors who sought insulation from personal liability for the mistakes or

10. 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.

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.

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. States may limit these to professionals such as lawyers, doctors, or accountants.

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."[11]

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

11. Revised Code of Washington (RCW), Section 25.05.130.

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.

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.

A limited liability partnership limits personal liability for the actions of other partners or the partnership itself. In a limited liability partnership, the partner may retain liability for their own actions or those they supervise. For this reason, for example, attorneys or doctors in an LLP will still retain malpractice insurance.

12.4 LLCs and S-Corps

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.

12.4.0.1 Creating an 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 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.

12.4.0.2 Controlling an LLC 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.

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.

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.

12.4.0.3 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.

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.

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.

12.4.0.4 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.

12.4.1 S-Corporations

The sub-S corporation or the S corporation[12] 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

12. A corporation whose owners elect to have it treated as a partnership for tax purposes.

few, but increasingly powerful, huge multinational corporations.

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.

The owners of the S corporation have limited liability. For taxation, 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.

13.

AGENCY AND EMPLOYMENT LAW

Learning Objectives

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

1. Explain why agency is important, what an agent is, and the types of agents.
2. Understand what an independent contractor is.
3. Summarize the duties owed by principals and agents.
4. Explain the liability of principals and agents.
5. Understand how common-law employment at will is modified by common-law doctrine,

federal statutes, and state statutes.
6. Explain various kinds of prohibited discrimination under Title VII and examples of each kind.

Employment law is made up of a broad body of law that governs employment relationships between a business and its employees. It consists of numerous federal and state statutes, administrative regulations, and judicial decisions. Additionally, employment law draws from other areas of law such as contracting, agency, and torts. This chapter provides an overview of some of the key concepts in this area of law.

13.1 Types of Employment Relationships

Employment law governs the relationship between an employer and its employee. There are three key types of employment relationships covered in this chapter: employment for a contracted period of time, employment at will, and independent contractors. In the United States, the majority of employment relationships are at will or through independent contractors. As you will learn, the type of

employment relationship impacts the responsibilities and liabilities of both the employer and employee.

13.1.1 Employment for a Contracted Period of Time

Historically, employment by contract was the most common form of employment relationship. Under this model, employees entered into a contract to work for a company for a fixed period of time. Employees could not be fired during that time frame unless the company had a good reason for doing so. For example, a Starbucks barista could sign a contract to work for the company for a two year term. Starbucks would then be obligated to employ that barista for the full two years unless it had some "just cause" for firing him.

One benefit of the employment by contract model is that employees could not be fired without just cause. Although there is no universal meaning of the term, it generally protects individuals from being fired unless they engage in some misconduct or negligent job performance. However, individuals employed by contract cannot be fired for things like a change in market conditions, employer profitability, or reduced staffing needs. This provides more stability and predictability to employees.

Carroll Daugherty, a well-known arbitrator, created the

following seven-factor test for determining whether a firm had just cause to fire an employee:

1. Did the Company give to the employee forewarning or foreknowledge of the possible or probable disciplinary consequences of the employee's conduct?
2. Was the company's rule or managerial order reasonably related to the orderly, efficient, and safe operation of the Company's business?
3. Did the company, before administering discipline to an employee make an effort to discover whether the employee did in fact violate or disobey a rule or order of management?
4. Was the Company's investigation conducted fairly and objectively?
5. At the investigation did the "judge" obtain substantial evidence or proof that the employee was guilty as charged?
6. Has the company applied its rules, orders, and penalties evenhandedly and without discrimination to all employees?
7. Was the degree of discipline administered by the company in a particular case reasonably related to (a) the seriousness of the employee's proven offense and (b) the record of the employee in his service with the company?[1]

While this test is less applicable in the modern era where contract employment relationships are rare, it sheds light on the underlying considerations and rights created by employment contracts.

Contract-based employment has some benefits but it also has several major drawbacks. First, contracted employees may face more restrictions in changing their jobs. They often must provide some notice if they want to quit before their term ends and may face other penalties for doing so. Additionally, these contracts reduce the leverage employees have if they want to negotiate a higher salary or better benefits in the middle of their contract term. Finally, firms have significantly less flexibility to reduce their staffing levels based on their own needs and changes in the market.

Although employment by contract is rare in the modern United States economy, it still exists in some industries. Tenured professors, for example, have strong protections against being fired without just cause. Unionized employees may also receive some just cause protections if they have negotiated for them in a contract. In a recent decision, the 7th Circuit considered a situation where a union agreement provided its members with for cause protections, but the

1. In re Enterprise Wire Company and Enterprise Independent Union, Decision of Arbitrator, March 28, 1966.

employer's handbook did not.[2] Joshua Cheli was a computer systems administrative assistant at a local school district. He was also a member of a union that had an agreement with the district. The relevant language in the agreement read:

"An employee may be disciplined, suspended, and/or discharged for reasonable cause. Grounds for discharge and/or suspension shall include, but not be limited to, drunkenness or drinking or carrying intoxicating beverages on the job, possession or use of any controlled and/or illegal drug, dishonesty, insubordination, incompetency, or negligence in the performance of duties."

In addition to this agreement with the union, the district also had an employee handbook outlining its employment policies. The handbook stated: "Unless otherwise specifically provided, District employment is at-will, meaning that employment may be terminated by the District or employee at any time for any reason, other than a reason prohibited by law, or no reason at all."

The court considered whether this language in the union agreement provided Cheli with for-cause protections, or whether the at-will language in the handbook instead applied. The district argued that the union agreement said an employee *may* be fired for reasonable cause but did not state that they

2. *Cheli v. Taylorville Community School District,* 7th Cir., No. 20-2033 (Feb. 3, 2021).

could *only* be fired for cause. The court rejected this interpretation based on the detailed language in the union agreement explaining the protections afforded to its members. Thus, Cheli was a contract-based employee and could only be fired for reasonable cause, regardless of the language in the handbook. Cases like this show the importance of carefully considering the content of agreements with unions and employees, and how these agreements may modify other documents like an employment policy manual.

In addition to these modern examples of contract-based employment, benefits like severance packages and "golden parachutes" provide some of the same benefits as contractual employment relationships by discouraging firms from firing employees and by protecting those employees if they are fired. For example, as of March 2022, the CEO of Moderna stands to receive a package worth $922.5 million if he loses his job as a result of the company being sold. Benefits like this have a similar effect to employment contracts because they strongly discourage employers from discharging their employees.

13.1.2 Employment at Will

Employment at will is the most common form of employment relationship in the United States. Unlike a contracted employee, the two parties in an at-will relationship – the employer and employee – owe no duty to one another to continue the employment. A supervisor can fire an employee

for nearly any reason, so long as it does not violate state or federal law. Similarly, an employee can quit at any time and for any reason.

There is a presumption of at-will employment in most states in the United States. For example, California Labor Code Section 2922 reads: "An employment, having no specified term, may be terminated at the will of either party on notice to the other." Under this regime, the default state of employment contracts is at-will. Employers and employees are free to modify this presumption by including for-cause language in an agreement. Absent this language, however, courts will presume that an at-will relationship exists.

Remember that both at-will and contract-based employees generally work under the terms of an employment contract. In other words, simply signing a contract with an employee does not make someone a contract-based employee with for cause protections. The presence of either a fixed length of employment or for cause protections make someone into a contract-based employee, not the mere existence of a contract. Without this language, an employee – regardless of whether or not they have a contract with their employer – is presumed to be at-will.

Even at-will employees receive some protections when they are fired for wrongful or illegal reasons. These protections include:

Discharging an Employee for Refusing to Violate a Law.

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

Discharging an Employee for Exercising a Legal Right. Most state courts recognize a second, similar public policy exception preventing employers from firing an employee for exercising some legal right. Courts most commonly apply this exception to situations where an employee was fired for seeking workers' compensation after being injured on the job. Suppose Bob Berkowitz files a claim for workers' compensation for an accident at Pacific Gas & Electric, where he works and where the accident that injured him took place. He is fired for doing so, because the employer does not want to have its workers'

comp premiums increased. In this case, the right exercised by Berkowitz is supported by public policy: he has a legal right to file the claim, and if he can establish that their discharge was caused by their filing the claim, he will prove the tort of wrongful discharge.

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

Discharging an Employee in a Way That Violates Public Policy. In addition to the specific public policy protections listed here, some states recognize a broader protection against being fired in a way that violates public policy. This is the most controversial basis for a tort of wrongful discharge. A state's public policy encapsulates the "basic social rights, duties, or responsibilities" of its citizens. However, there is an inherent vagueness to these terms that make them difficult to apply in practice. Like in contract law, courts most often look to statutes and case law for guidelines on public policy.

In *Wagenseller v. Scottsdale Memorial Hospital*, for example, a nurse who refused to "play along" with her

coworkers on a rafting trip was discharged.[3] The group of coworkers had socialized at night and had been drinking alcohol. When the partying was near its peak, the plaintiff refused to be part of a group that performed nude actions to the tune of "Moon River" (a composition by Henry Mancini that was popular in the 1970s). The court, at great length, considered that "mooning" was a misdemeanor under Arizona law and that therefore her employer could not discharge her for refusing to violate a state law. Many courts that recognize the general public policy exception follow this practice of looking to state laws and regulations as a basis for finding a public policy.

Good Faith and Fair Dealing Standard. A few states, among them Massachusetts and California, have modified the at-will doctrine in a far-reaching way by holding that every employer has entered into an implied covenant of good faith and fair dealing with its employees. That means, the courts in these states say, that it is "bad faith" and therefore unlawful to discharge employees to avoid paying commissions or pensions due them. Under this implied covenant of fair dealing, any discharge without good cause—such as incompetence,

3. *Wagenseller v. Scottsdale Memorial Hospital*, 147 Ariz. 370; 710 P.2d 1025 (1085).

corruption, or habitual tardiness—is actionable. This is not the majority view.

13.1.3 Independent Contractors

In addition to hiring employees on an at-will and contract basis, businesses frequently rely on the services of independent contractors. 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."

Individuals participating in the "gig economy" are a commonly encountered example of independent contractors. People driving cars for Uber and delivering food for Door Dash retain high levels of independence and control. An Uber driver can begin and end work when she wants, accept or reject ride requests, and pick up customers in whatever area of the city she would like. Although Uber provides the means for a driver to connect with her customers, it leaves drivers with substantial amounts of autonomy that an employee would not have.

This distinction between employee 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 a Grub Hub delivery driver, 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 Corporation*, an injured salesman sought workers' compensation benefits, claiming to be an employee of the New York Commodities Corporation.[4] The state workmen's compensation board concluded that he was an independent contractor, not an employee, and so he did not qualify for workers' compensation. It took a holistic approach that can shed some light onto factors that distinguish an employee from an independent contractor. 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 facts specific to each case determines whether a worker

4. *Robinson v. New York Commodities Corp.*, 396 N.Y.S.2d 725, App. Div. (1977).

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 explained 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."[5]

Although distinguishing between an employee and independent contractor is often fact-specific, the **right of control** test is one helpful way to identify an independent contractor. Under this approach, a court will consider the extent of a business's **behavioral and financial control** over an individual.

5. *Vizcaino v. Microsoft Corp*, 120 F.3d 1006 (9th Cir. 1997).

	Behavioral Control	Financial Control
Independent Contractor	– Ability to decide when to work and how often to work – Control or ownership over the equipment used to work – Minimal training provided by the business	– Ability to set rates on a per-project or task basis – No benefits like paid time off – Freedom to perform tasks for as many clients/ businesses as they want
Employee	– The business controls when and how often to come to work – Little to no control or ownership over equipment – Training may be provided by the business	– Paid hourly or on a salary basis – Benefits such as sick leave, paid time off, or retirement plan – Limited ability to decide who to work for and what projects to accept

13.2 Agency Relationships and Employment

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. The person or corporation the agent acts on behalf of is called the "principal." Most organized human activity—and virtually all commercial activity—is carried on through agency. An agency relationship can be created by

something as simple as a father giving his child money to go buy some milk from the store. In this scenario, the father is the principal and the child is ahis gent for the purposes of that trip. Another common example of agency is in professional sports. In this relationship, the athlete is the principal and her agent is responsible for helping her choose a team and negotiate favorable contracts with that team. Agents have a duty to work in the athlete's best interest when performing this job.

No corporation would be possible, even in theory, without the concept of agency. We might say "General Motors is building cars in China," for example, but General Motors itself cannot build cars or do business. "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.

Employees are usually agents of their employers. In contrast, determining whether an independent contractor is an agent of a firm depends on the specific facts, situation, and actions being performed. As you read about the responsibilities associated with agency relationships, consider how these responsibilities would differ for an employee and an independent contractor.

13.2.1 Creating Agency Relationships

There are three basic ways in which agency power is granted: express authorization, implied authorization, and apparent authorization. Because employees and managers of a corporation serve as its agents, they act with one or more of these three types of authority on behalf of the business.

Express Authority (Agency Created by Agreement) 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 authority340

is the standard signature card on file with banks allowing corporate agents to write checks on the company's credit.

This express grant of authority is often part of a contract. In those cases the general rules of contract law covered in Chapter 8 apply. But agencies can also be created without contract, by agreement (for instance, without consideration, which not make the relationship contractual).

Implied Authority Implied authority exists to reasonably carry out the express authority granted to the agent. 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

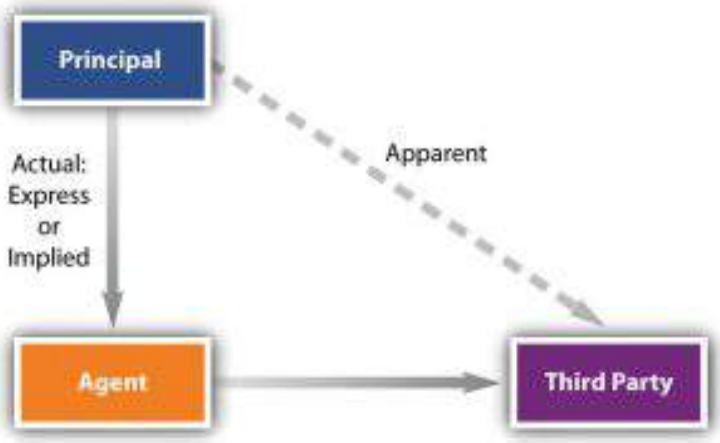
drive to the bank unless the principal specifically prohibits the agent from doing so.

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 they suppose 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 their conduct that they have 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.

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.



13.2.2 Fiduciary Duties in an Agency Relationship

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. Their responsibility is to subordinate their self-interest to that of their 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: the agent or employee must avoid self-dealing, be loyal, be lawfully obedient, perform their tasks with reasonable skill and care, preserve confidential information, and so on.

The fiduciary duty does not run in reverse: the principal owes the agent general contractual duties but not fiduciary duties. Thus, the principal should, e.g., reimburse the agent for expenses but does not owe them a duty of loyalty. One particular duty of the employer is to provide workers' compensation.

13.2.2.1 Worker's Compensation. Alan, who works in a dynamite factory, negligently stores dynamite in the wrong shed. Alan 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 Alan'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.

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 they can avoid the time-consuming and uncertain judicial process and assure himself that their medical

costs and a portion of their salary will be paid—and paid promptly. The employer must pay for all injuries, even those for which they are blameless, but in return they avoid the risk of losing a big lawsuit, can calculate their 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.

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. In addition, independent contractors are not eligible for workers' compensation because they are not employees of the firm.

Recurring legal issues in workers' compensation include whether the injury was work related, whether the injured person was actually an employee, and whether psychological injury counts.

13.2.3 Agent and Principal Liability in Tort

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 their 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 their 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 they had no intention to commit nor involvement in, and that they may in fact have expressly prohibited the agent from engaging in. This is the principle of respondeat superior or the master-servant doctrine, which imposes on the principal vicarious liability347 (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.

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.

In general, the broadest liability is imposed on the master in the case of tortious physical conduct by a servant or employee. If the servant or employee acted within the scope of their

employment—that is, if the servant's wrongful conduct occurred while performing their 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 inde- pendent contractors. The plumber who rushes to a client's house to repair a leak and causes a traffic accident does not subject the home- owner 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.

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.

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 their instructions, it will be easy to determine liability. But suppose an agent deviates in some way from their job. The classic test of liability was set forth in an 1833 English case, *Joel v. Morrison*.[6] 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 they and their 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

6. *Joel v. Morrison*, 6 Carrington & Payne 501.

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 their 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 their master's purposes during their departure from the letter of their assignment, or if they committed the wrong while returning to their master's task after the completion of their frolic, then the tort was held to be within the scope of employment.

This test is not always easy to apply. If a hungry delivery driver stops at a restaurant outside the normal lunch hour, intending to continue to their next delivery after eating, they are within the scope of employment. But suppose they decide to take the truck home that evening, in violation of rules, in order to get an early start the next morning. Suppose they decide to stop by the beach, which is far away from the route. Does it make a difference if the employer knows that the driver do this?

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 their 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.

13.2.4 Agent and Principal Liability in Contract

The key to determining whether a principal is liable for contracts made by their 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 their behalf, and that authorization must be communicated to the third party by the principal.

The agent will be liable in some cases as well. If the agent acted without authority, then they weren't really acting as an agent and so will be personally liable for their contractual actions. If the third-party does not know the agent is acting for a principal (that is, if the principal is undisclosed), the third party will naturally sue the agent.349 For these reasons, agents who wish to avoid liability should always make it clear they are acting as agent for someone else. For example, an agent acting for a corporation in signing documents might wish their signature block to read "Jane Doe, Agent for BigCorp" or something similar. Finally, an agent acting in their personal capacity remains liable for their personal contracts.

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 they **ratify** or adopt 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 their behalf but without authorization and through no fault of their own, they may affirm or disavow them as they choose. To ratify, the principal may tell the parties concerned or by their conduct manifest that they are willing to accept the results as

though the act were authorized. Or by their silence they may find under certain circumstances that they have ratified. Note that ratification does not require the usual consideration of contract law. The principal need be promised nothing extra for their decision to affirm to be binding. Nor does ratification depend on the position of the third party; for example, a loss stemming from their 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

14.

EMPLOYMENT DISCRIMINATION LAW

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

14.1 Equal Pay Act

The Equal Pay Act of 1963 protects both men and women from pay discrimination based on sex. The act covers all levels of private sector employees and state and local government employees but not federal workers. The act prohibits disparity in pay for jobs that require equal skill and equal effort. Equal skill means equal experience, and equal effort means comparable mental and/or physical exertion. The act prohibits disparity in pay for jobs that require equal responsibility, such as equal supervision and accountability, or similar working conditions.

In making their determinations, courts will look at the stated requirements of a job as well as the actual requirements of the job. If two jobs are judged to be equal and similar, the employer cannot pay disparate wages to members of different sexes. Along with the EEOC enforcement, employees can also bring private causes of action against an employer for violating this act. There are four criteria that can be used as defenses in justifying differentials in wages: seniority, merit, quantity or quality of product, and any factor other than sex. The employer will bear the burden of proving any of these defenses.

14.2 Title VII of the Civil Rights Act of 1964

The most basic anti-discrimination law in employment is in Title VII of the federal Civil Rights Act of 1964. In Title VII, Congress for the first time outlawed discrimination in employment based on race, religion, sex, or national origin. Title VII declares: "It shall be an unlawful employment practice for an employer to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin." Title VII applies to (1) employers with fifteen or more employees whose business affects interstate commerce, (2) all employment agencies, (3) labor unions with fifteen or more members, (4) state and local governments and their agencies, and (5) most federal government employment.[1]

Title VII established the Equal Employment Opportunity

1. In 1984, the Supreme Court said that Title VII applies to partnerships as well as corporations when ruling that it is illegal to discriminatorily refuse to promote a female lawyer to partnership status in a law firm. This applies, by implication, to other fields, such as accounting.

Commission (EEOC) to investigate violations of the act. A victim of discrimination who wishes to file suit must first file a complaint with the EEOC to permit that agency to attempt conciliation of the dispute. The EEOC has filed a number of lawsuits to prove statistically that a company has systematically discriminated on one of the forbidden bases. The EEOC has received perennial criticism for its extreme slowness in filing suits and for failure to handle the huge backlog of complaints with which it has had to wrestle.

The courts have come to recognize two major types of Title VII cases:

14.2.1 Disparate Treatment

In this type of lawsuit, the plaintiff asserts that because of race, sex, religion, or national origin, they have been treated less favorably than others within the organization. To prevail in a disparate treatment suit, the plaintiff must show that the company intended to discriminate because of one of the factors the law forbids to be considered. Thus in *McDonnell Douglas Corp. v. Green*, the Supreme Court held that the plaintiff had shown that the company intended to discriminate by refusing to rehire him because of his race.[2] Based on that

2. *McDonnell Douglas Corp. v. Green*, 411 U.S. 792 (1973).

case, courts use a burden-shifting framework to evaluate Title VII cases.

- First, the plaintiff needs to allege membership in a protected class and that they suffered an adverse action. An adverse action could include not being hired, being fired, being passed over for a promotion or a raise, or so on.
- If the plaintiff can make this showing, the burden shifts to the defendant to show a legitimate, non-discriminatory reason for the action. These will be discussed later under "Defenses to Employment Discrimination".
- Finally, if the defendant can show a legitimate reason for the action, the burden shifts back to the plaintiff to show "pretext", that is, to show that the *real* reason for the action was discriminatory.

14.2.2 Disparate Impact

In this second type of Title VII case, the employee need not show that the employer intended to discriminate but only that the effect, or impact, of the employer's action was discriminatory. Usually, this impact will be upon an entire class of employees. The plaintiff must demonstrate that the reason for the employer's conduct (such as refusal to promote) was not job related. Disparate impact cases often arise out

of practices that appear to be neutral or nondiscriminatory on the surface, such as educational requirements and tests administered to help the employer choose the most qualified candidate. In the seminal case of *Griggs v. Duke Power Co.*, the Supreme Court held that under Title VII, an employer is not free to use any test it pleases; the test must bear a genuine relationship to job performance.[3] *Griggs* stands for the proposition that Title VII "prohibits employment practices that have discriminatory effects as well as those that are intended to discriminate."

The same burden shifting framework applies, with some difference. For example, if an employer is using a neutral test to screen applicants, the plaintiff's prima facie case can be built on statistical evidence showing that, e.g., all women passed the test but half of men did not, or vice versa. The employer would then show a legitimate business reason for the test, after which the burden would shift to the plaintiff to show that a less discriminatory test that accomplished that interest exists.

We now cover several specific areas of discrimination.

3. *Griggs v. Duke Power Co.*, 401 U.S. 424 (1971).

14.2.3 Discrimination Based on Religion

An employer who systematically refuses to hire Catholics, Jews, Buddhists, or members of any other religious group engages in unlawful disparate treatment under Title VII. But refusal to deal with someone because of their religion is not the only type of violation under the law. Title VII defines religion as including religious observances and practices as well as belief and requires the employer to "reasonably accommodate to an employee's or prospective employee's religious observance or practice" unless the employer can demonstrate that a reasonable accommodation would work an "undue hardship on the conduct of the employer's business." Thus a company that refused even to consider permitting a devout Sikh to wear his religiously prescribed turban on the job would violate Title VII.

But the company need not make an accommodation that would impose more than a minimal cost. For example, an employee in an airline maintenance department, open twenty four hours a day, wished to avoid working on his Sabbath. The employee belonged to a union, and under the collective bargaining agreement, a rotation system determined by seniority would have put the worker into a work shift that fell on his Sabbath. The Supreme Court held that the employer was not required to pay premium wages to someone whom the

seniority system would not require to work on that day and could discharge the employee if they refused the assignment.

14.2.4 Sex Discrimination

A refusal to hire or promote a woman simply because she is female is a clear violation of Title VII. Under the Pregnancy Act of 1978, Congress declared that discrimination because of pregnancy is a form of sex discrimination. Equal pay for equal or comparable work has also been an issue in sex (or gender) discrimination.

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

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

14.2.4.1 Quid pro quo harassment *Quid pro quo* comes from the Latin phrase "one thing in return for another." If

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

14.2.4.2 Hostile work environment Hostile work environment claims are more frequent than quid pro quo claims and so are more worrisome to management. An employee has a valid claim of sexual harassment if sexual talk, imagery, or behavior becomes so pervasive that it interferes with the employee's ability to work to her best capacity. On occasion, courts have found that offensive jokes, if sufficiently frequent and pervasive in the workplace, can create a hostile work environment. Likewise, comments about body parts or public displays of pornographic pictures can also create a hostile work environment. In short, the plaintiff can be detrimentally offended and hindered in the workplace even if there are no measurable psychological injuries.

14.2.5 Discrimination Based on Race, Color, and National Origin

Title VII was primarily enacted to prohibit employment discrimination based on race, color, and national origin. Race refers to broad categories such as Black, Caucasian, Asian, and Native American. Color simply refers to the color of a person's skin, and national origin refers to the country of the person's ancestry.

14.2.6 Discrimination based on sexual orientation

In 2020, the Supreme Court decided *Bostock v. Clayton County*. In that case, the Court found that discrimination based on sexual orientation was discrimination based on sex, and thus actionable under Title VII. The Court's reasoning is worth noting, as it focuses on the text of the law over the "anticipation" of the drafters:

> Sometimes small gestures can have unexpected consequences. Major initiatives practically guarantee them. In our time, few pieces of federal legislation rank in significance with the

Civil Rights Act of 1964. There, in Title VII, Congress outlawed discrimination in the workplace on the basis of race, color, religion, sex, or national origin. Today, we must decide whether an employer can fire someone simply for being homosexual or transgender. The answer is clear. An employer who fires an individual for being homosexual or transgender fires that person for traits or actions it would not have questioned in members of a different sex. Sex plays a necessary and undisguisable role in the decision, exactly what Title VII forbids.

Those who adopted the Civil Rights Act might not have anticipated their work would lead to this particular result. Likely, they weren't thinking about many of the Act's consequences that have become apparent over the years, including its prohibition against discrimination on the basis of motherhood or its ban on the sexual harassment of male employees. But the limits of the drafters' imagination supply no reason to ignore the law's demands. When the express terms of a statute give us one answer and extratextual considerations suggest another, it's

> no contest. Only the written word is the law, and all persons are entitled to its benefit.

14.3 Defenses to Employment Discrimination

14.3.1 Merit

Employers are allowed to select on merit and promote on merit without offending title VII's requirements. Merit decisions are usually based on work, educational experience, and ability tests. All requirements, however, must be job related. For example, the ability to lift heavy cartons of sixty pounds or more is appropriate for certain warehouse jobs but is not appropriate for all office workers. The ability to do routine maintenance (electrical, plumbing, construction) is an appropriate requirement for maintenance work but not for a teaching position.

14.3.2 Seniority

Employers may also maintain seniority systems that reward workers who have been with the company for a long time.

Higher wages, benefits, and choice of working hours or vacation schedules are examples of rewards that provide employees with an incentive to stay with the company. If they are not the result of intentional discrimination, they are lawful. Where an employer is dealing with a union, it is typical to see seniority systems in place.

14.3.3 Bona Fide Occupational Qualification (BFOQ)

For certain kinds of jobs, employers may impose bona fide occupational qualifications (BFOQs). Under the express terms of Title VII, however, a bona fide (good faith) occupational qualification of race or color is never allowed. In the area of religion, as noted earlier, a group of a certain religious faith that is searching for a new spiritual leader can certainly limit its search to those of the same religion. With regard to sex (gender), allowing women to be locker-room attendants only in a women's gym is a valid BFOQ. One important test that the courts employ in evaluating an employer's BFOQ claims is the "essence of the business" test.

14.3.4 Defenses in Sexual Harassment Cases

The Supreme Court has rejected the notion of strict or automatic liability for employers when agents (employees)

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

14.4 The Age Discrimination in Employment Act

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

14.5 Disabilities: Discrimination against the Handicapped

The 1990 Americans with Disabilities Act (ADA) prohibits employers from discriminating on the basis of disability. A disabled person is someone with a physical or mental impairment that substantially limits a major life activity or someone who is regarded as having such an impairment. This definition includes people with mental illness, epilepsy, visual impairment, dyslexia, and AIDS. It also covers anyone who has recovered from alcoholism or drug addiction. It specifically does not cover people with sexual disorders, pyromania, kleptomania, exhibitionism, or compulsive gambling.

Employers cannot disqualify an employee or job applicant because of disability as long as they can perform the essential functions of the job, with reasonable accommodation. Reasonable accommodation might include installing ramps for a wheelchair, establishing more flexible working hours, creating or modifying job assignments, and the like.

Reasonable accommodation means that there is no undue hardship for the employer. The law does not offer uniform standards for identifying what may be an undue hardship other than the imposition on the employer of a "significant difficulty or expense." Cases will differ: the resources and situation of each particular employer relative to the cost or difficulty of providing the accommodation will be considered;

relative cost, rather than some definite dollar amount, will be the issue.

14.6 Occupational Safety and Health Act

In a heavily industrialized society, workplace safety is a major concern. Hundreds of studies for more than a century have documented the gruesome toll taken by hazardous working conditions in mines, on railroads, and in factories from tools, machines, treacherous surroundings, and toxic chemicals and other substances. Studies in the late 1960s showed that more than 14,000 workers were killed and 2.2 million were disabled annually—at a cost of more than $8 billion and a loss of more than 250 million worker days. Congress responded in 1970 with the Occupational Safety and Health Act, the primary aim of which is "to assure so far as possible every working man and woman in the Nation safe and healthful working conditions."

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

from employees or reports about fatal or multiple injuries. The agency may assess penalties and proceed administratively to enforce its standards. Criminal provisions of the act are enforced by the Justice Department.

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

14.7 Employee Retirement Income Security Act

More than half the US workforce is covered by private pension plans for retirement. One 1988 estimate put the total held in pension funds at more than $1 trillion, costing the federal Treasury nearly $60 billion annually in tax write-offs. As the size of the private pension funds increased dramatically in the 1960s, Congress began to hear shocking stories of employees defrauded out of pension benefits, deprived of a lifetime's savings through various ruses (e.g., by long vesting provisions and by discharges just before retirement). To put an end to

such abuses, Congress, in 1974, enacted the Employee Retirement Income Security Act (ERISA).

In general, ERISA governs the vesting of employees' pension rights and the funding of pension plans. Within five years of beginning employment, employees are entitled to vested interests in retirement benefits contributed on their behalf by individual employers. Multiemployer pension plans must vest their employees' interests within ten years. A variety of pension plans must be insured through a federal agency, the Pension Benefit Guaranty Corporation, to which employers must pay annual premiums. The corporation may assume financial control of underfunded plans and may sue to require employers to make up deficiencies. The act also requires pension funds to disclose financial information to beneficiaries, permits employees to sue for benefits, governs the standards of conduct of fund administrators, and forbids employers from denying employees their rights to pensions. The act largely preempts state law governing employee benefits.

14.8 Fair Labor Standards Act

In the midst of the Depression, Congress enacted at President Roosevelt's urging a national minimum wage law, the Fair Labor Standards Act of 1938 (FLSA). The act prohibits most forms of child labor and established a scale of minimum wages for the regular workweek and a higher scale for overtime. (The

original hourly minimum was twenty-five cents, although the administrator of the Wage and Hour Division of the US Department of Labor, a position created by the act, could raise the minimum rate industry by industry.) The act originally was limited to certain types of work: that which was performed in transporting goods in interstate commerce or in producing goods for shipment in interstate commerce.

Employers quickly learned that they could limit the minimum wage by, for example, separating the interstate and intrastate components of their production. Within the next quarter century, the scope of the FLSA was considerably broadened, so that it now covers all workers in businesses that do a particular dollar-volume of goods that move in interstate commerce, regardless of whether a particular employee actually works in the interstate component of the business. It now covers between 80 and 90 percent of all persons privately employed outside of agriculture, and a lesser but substantial percentage of agricultural workers and state and local government employees. Violations of the act are investigated by the administrator of the Wage and Hour Division, who has authority to negotiate back pay on the employee's behalf. If no settlement is reached, the Labor Department may sue on the employee's behalf, or the employee, armed with a notice of the administrator's calculations of back wages due, may sue in federal or state court for back pay. Under the FLSA, a successful employee will receive double the amount of back wages due.

14.9 Public Accommodation Law

It is worth closing this chapter with brief mention of related law: that prohibiting discrimination in "public accommodation", or who businesses serve. Law governing who businesses must serve is broadly similar to Title VII but with important differences. As with employment-based discrimination, both federal and state laws have relevant provisions for public accommodations.

At the federal level, Title II of the Civil Rights Act of 1964 prohibits discrimination in "public accommodations" on the basis of "race, color, religion, or national origin." Note that unlike Title VII in the workplace, sex is not a protected category here. Also, "public accommodations" are a specific list of establishments–basically places where people eat, sleep, buy gas, or are entertained. Private clubs are specifically excluded and retain the ability to discriminate under Title II, unless the private club hosts a public gathering, in which case it becomes a place of public accommodation.

States and territories may have laws that go further and protect broader categories of people in more expansive ways. For instance, many states protect against discrimination based on sexual orientation, marital status, and age. Washington DC makes discriminating based on political affiliation illegal! See here for more details across the states.

In general, dress code measures such as "no shirt no shoes

no service" don't discriminate on the basis of these categories and are permissible. Of course, if the policy were only enforced against a protected class, then that would become discrimination based on the protected class and would be illegal.

Finally, note that federal protection against discrimination for *disabilities* in public accommodations is broader than Title II. For purposes of disabilities, the definition of public accommodation includes those above and places like stores and schools.

This is where you can add appendices or other back matter.