



Business and the Legal and Ethical Environment

v. 1.0

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Preface

Welcome to *The Legal and Ethical Environment of Business*! We are excited that you have selected this textbook to serve as your guide to learning about how our legal system shapes and informs the myriad of decisions that business professionals make daily. Collectively, we have taught this course for fourteen years to over sixteen hundred students. Our experience informs us that our students view current text offerings in this area as largely dry and irrelevant. We realize that you, the student, demand an engaging and lively delivery of educational materials. You believe that interaction, multimedia, multitasking, bite-size content, and twenty-four-hour cycles are the norm for processing and learning. The challenge for legal environment textbooks, as we see it, is to meet the needs of your generation while maintaining the academic integrity and rigor that this core course demands.

The sheer volume of information to be covered makes the legal environment of business one of the denser courses for the business undergraduate. Review the table of contents of most legal environment textbooks, and they read like the first-year curriculum at a major law school (typically, Contracts, Torts, Criminal Law, Constitutional Law, Civil Procedure, and Property). It's also one of the few business courses grounded in the humanities, which can make the subject even more alienating if you are taking the course at the same time you are taking statistics, macro- or microeconomics, and accounting. This textbook, therefore, begins by removing some of the topical areas typically found in a legal environment textbook, such as antitrust, agency, and labor relations. Of the topical areas we retain, we have condensed and streamlined the presentation of material to ensure that every page is relevant, engaging, and interesting to you. Our textbook is intentionally shorter in length compared to other texts, with much greater emphasis on application of the concepts presented to real-life experiences and examples.

We believe that the concepts of business law must be illustrated with real-life examples in order to be meaningful to you. The textbook contains dozens of these examples to help you understand the material. In addition, since the world of business moves at light-speed, we've created a blog just for you. Our blog, located at <http://legalenvironment.gone.2012books.lardbucket.org>, is continually updated with our discussion of news headlines that contain an application of business law. Your professor may assign you to read the blog on a regular basis. Even if it's not assigned, we encourage you to check in regularly so that you can see how relevant and high-impact the legal environment is when it comes to the operation of businesses everywhere.

You can't avoid having to learn the rules of law. We strongly believe, however, that merely memorizing the law won't serve you, your future employers, or society. Faith in our capitalist corporate structure has been shaken by waves of scandal, from the greed exhibited by Enron to the arrogance demonstrated by Lehman Brothers to the incompetence displayed by General Motors and Chrysler. We assume that the business professionals in charge of those failed institutions all knew the law. In order to achieve profitable success that also delivers long-term value to all stakeholders, we believe you have to understand the *reason* for the law. More than anything else, it is this practical wisdom that we hope to impart to you. Our textbook is therefore designed to help you first understand the materials through the use of key learning objectives, then assimilate the material through the use of lively and interesting examples, and finally reinforce the material through key terms, key takeaways, and exercises.

We are passionate about teaching, and we hope that passion shines through in our textbook. If we can ignite that same passion in you for the legal environment, then we consider our task complete. We hope you enjoy this textbook, and we encourage you to contact us directly if you have any feedback for future editions.

Chapter 1

Introduction to Law

LEARNING OBJECTIVES

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

1. What is the law?
2. Where does our law come from?
3. What is a rule of law?
4. How is the law relevant to business?
5. How does the study of the legal environment of business create a foundation for future business courses?

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

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

Consider the credit crisis that came to the world's attention in October 2008 and nearly toppled the U.S. economy into depression. Hundreds of thousands of homes were foreclosed by banks ([Figure 1.1 "The Credit Crisis"](#)), leading to a vicious cycle of depressed housing prices, shattered consumer confidence, and business

retrenchment. You may be thinking that this has little to do with you or with the study of the legal environment of business. Think again. The credit crisis affected everyone. And the nature of the crisis implicated several legal environment issues.

In a nutshell, the U.S. financial system nearly collapsed under the weight of high default rates among mortgagees, the issuance of excessive subprime mortgages to unqualified debtors, collateralized debt obligations (CDOs) that were not being serviced and could not be sold, and a mortgage banking system with flawed incentive structures from the bottom to the top. The mortgage industry created incentives for those who worked in that industry to act in their own self-interest to make a profit, even at the expense of the long-term health of the institutions for which they were working.

Figure 1.1 *The Credit Crisis*



Source: Photo courtesy of Brendel, <http://en.wikipedia.org/wiki/File:Foreclosedhome.JPG>.

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

Hyperlink: Credit Crisis

<http://vimeo.com/3261363>

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

After watching the video in [Note 1.2 "Hyperlink: Credit Crisis"](#), consider the intersection between law and economics. Former Federal Reserve Chairman Alan Greenspan had consistently maintained that private regulation (that is, self-regulation by private industry) was better at containing risk than government regulation. But when the 2008 credit crisis manifested, Greenspan retracted this belief, at least in part. He expressed that he was in “a state of shocked disbelief” concerning the financial institutions’ inability to self-regulate. Brian Knowlton and Michael M. Grynbaum, “Greenspan ‘Shocked’ That Free Markets Are Flawed,” *New York Times*, October 23, 2008, <http://www.nytimes.com/2008/10/23/business/worldbusiness/23iht-gspan.4.17206624.html> (accessed August 18, 2010). He always believed that the incentive of survival of the institution itself would force banks to self-regulate. However, this “shocked disbelief” underscored a fissure within the discipline of economics—namely, whether the same economic principles that apply to individuals also apply to organizations. While we know from our study of economics that individuals act in their own self-interest, the 2008 credit crisis perhaps illustrated that people continue to act in their own self-interest, even when working within a firm. The firm itself is only a collection of individual people, and so the firm itself does not act in any type of organizational self-interest.

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

the chances of getting caught to determine how they should behave. In both instances, the law is a restraint on behavior.

Reflect on the credit crisis and how our laws could have entirely averted or seriously mitigated the fallout that resulted from it. For example, if the laws regulated the incentive structures that exist within private industry, the individual incentive to make a profit would not have been allowed to overtake the financial institutions' need to self-preserve by limiting risk. Likewise, if our banking regulations limited the types of services that banks could offer, perhaps the exotic financial instruments that were created as a precursor to the credit crisis would not have been permitted in the first place. If the size of our financial institutions had been limited by law, the dangerous fallacy that the financial institutions were too large to fail could not have been perpetuated. If compensation packages were legally restricted by limitations on size or severed from linkages to performance, then individual incentives to maximize profit could have been restrained. Additionally, this situation raises several ethics questions. For example, was it ethical to loan money to people who were not able to service those debts?

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

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

aggrieved parties need a method to press their claims to be compensated for their damages.

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

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

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

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

Key Takeaways

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

1.1 What Is Law?

LEARNING OBJECTIVES

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

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

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

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

Jurisprudence¹ is the philosophy of law. The nature of law has been debated for centuries, giving rise to a general coalescence of ideas to create particular schools of thought. Several different theories of jurisprudence are explored in the paragraphs that follow.

1. The philosophy of law.

At a most basic interpretation, some believe that law is simply power. That is, the law is followed because the sovereign issues orders that are backed by threats. Consider tyrannical rulers who create arbitrary laws or bad laws. If the sovereign has the power to enforce those “laws,” then regardless of the “badness” of the law, it is still law. The Nazis executed six million Jews pursuant to German law during World War II. Saddam Hussein routinely tortured and executed political opponents and minority Sunni Muslims in Iraq under Iraqi law. The military in Myanmar (known euphemistically as the State Peace and Development Council) imprisoned the democratically elected and Nobel Peace Prize–winning prime minister of the country, Aung San Suu Kyi (Figure 1.2 "Aung San Suu Kyi"), under **color of authority**². (Actions taken under the law are said to be under the color of authority.) Those who ascribe to the idea that law is power often argue that coercion is an essential and necessary feature of law.

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

Figure 1.2 Aung San Suu Kyi



Source: Photo courtesy of the U.S. Department of State, http://en.wikipedia.org/wiki/File:Burma_3_150.jpg.

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

2. Refers to actions taken under the law.

A competing view is that of **legal positivism**³, whose proponents disagree that law is simply power. Legal positivists believe that the law is what the law says. The laws are written, human-made rules. The law is not drawn from any source higher than man. Legal positivists do not try to read between the lines. They may disagree with the law as it is written, but they will acquiesce to the sovereign power and follow the law as it is written. They reject any belief that they have an individual right to disobey a law that they happen to oppose, providing that the law is from a legitimate source. Positivists believe that law is wholly separate from any consideration of ethics. Moreover, they do not believe that people have intrinsic human rights other than those created by the law. This is very different from a natural rights perspective, which is discussed in the following paragraphs.

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

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

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

Some critics point out that legal positivism is too limited in its conception of law. For instance, at least some laws seem to reflect a moral stance. The prohibition against **insider trading**⁴ (using nonpublic information to buy or sell a stock to make money) might be said to encompass the idea of fairness, which is a moral consideration. Likewise, **due process**⁵ (fundamental fairness and decency in government actions) might be said to encompass the ideas of both fairness and a moral position against cruelty. Moreover, not all law is the result of a sovereign-issued, written rule. For example, **international customary law**⁶ has developed through customary practices. It is valid law, but it is not a set of rules handed down from a sovereign ruler.

3. A belief that the law is whatever the sovereign says it is. The law is written, human-made rules.
4. The use of nonpublic information to buy or sell a stock to make money.
5. Ensures fundamental fairness and decency in government actions; levels of due process vary according to the property or liberty interest at stake.
6. Law composed of long-standing international customs or practices that have the force of law.

A different viewpoint is **legal realism**⁷, which is the belief that the law itself is far less important than the consideration of who is in the position to enforce the law. Like positivists, legal realists believe that law is the product of human making. However, unlike positivists, they believe that the outcome of any issue that arises under law is dependent on the person, such as a judge, who is in the position to exercise power under the mantle of the law. Additionally, realists believe that social and economic considerations should be brought to bear in legal disputes, which may very well be “extra” considerations that are not captured by the written law itself.

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

Critics of legal realism point out that those who are in the position to exercise the power of the law over others should not circumscribe the checks and balances of our system of government by considering factors outside of legitimate sources of law when making decisions. For instance, they argue that judges should not use any factors other than the written law when rendering decisions. Legal realists, however, point out that judicial interpretation not only is necessary but also was contemplated by our Founding Fathers as a built-in check and balance to our other branches of government.

Natural law⁸ is the idea that humans possess certain inalienable rights that are not the products of human-made law. Therefore, we can say that natural law differs from both positivism and realism in this important respect. Humans are able to reason, and therefore they are able to discover moral truths on their own. They are not automatons who require a sovereign power to tell them right from wrong. Natural law adherents do not reject human-made law. However, they recognize that human-made law is subordinate to natural law if the two types of law conflict.

Civil rights activists often rely on natural law arguments to advance their platforms. This is true today as well as historically. For example, a civil rights

7. A belief that the law itself is less important than who is in the position to enforce it.

8. A belief that humans possess certain inalienable rights that are not the products of human-made law.

advocate might point out that regardless of what the law “says,” discrimination based on race is simply wrong. If the written law allowed racial discrimination, natural law adherents would not recognize the law as valid.

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

KEY TAKEAWAYS

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

EXERCISES

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

1.2 Sources of Law

LEARNING OBJECTIVES

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

Hyperlink: Supreme Court Friezes

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

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

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

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

employer to refuse to hire you based on your lack of social skills. However, it would be illegal for the employer not to hire you based solely on your race.

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

A Question of Ethics

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

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

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

Check out a video of Royal Caribbean’s CEO discussing his company’s involvement in bringing emergency supplies to Haiti, as well as the potential for using ships as hotels or hospitals in the interim.

<http://cnn.com/video/?/video/world/2010/01/18/ct.anderson.haiti.cruise.cnn>

Social customs may be violated on pain of embarrassment or ostracism. Someone may choose to ignore social customs, but there are usually negative social or professional consequences to doing so. A person who violates social customs may be said to be a boor, or people may try to avoid that person because his or her actions and comments make others uncomfortable. However, no legal repercussions follow violating social customs.

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

Law can generally be classified as public law or private law. **Public law**⁹ applies to everyone. It is law that has been created by some legitimate authority with the power to create law, and it has been “handed down” to the people within its jurisdiction. In the United States, the lawmaking authority itself is also subject to those laws, because no one is “above” the law. If the law is violated, penalties can be levied against the violator. These penalties are also “handed down” from some recognized source of authority, like the judiciary. Of course, people in the United States may participate in many law-creating activities. For instance, they may vote in elections for legislators, who, in turn, create legislation. Likewise, if people have a legal claim, their case may be heard by the judiciary.

It’s important to note, however, that not all law is public law. **Private law**¹⁰ is typically understood to be law that is binding on specific parties. For instance, parties to a contract are involved in a private law agreement. The terms of the contract apply to the parties of the contract but not to anyone else. If the parties have a contract dispute, they will be able to use dispute-resolution methods to resolve it. This is because both parties of the contract recognize the judiciary as a legitimate authority that can resolve the contract dispute. However, regardless of the resolution, the terms of the contract and the remedy for breach will apply only to the parties of the contract and not to everyone else.

9. Law that applies to everyone.

10. Law that is legally binding on parties who agree to it, such as a contract.

11. The legal rules that must be followed by government officials in the execution of law.

12. The actual substance of the law or the merits of the claim, case, or action.

Additionally, some law is procedural and some law is substantive. **Procedural law**¹¹ describes the legal rules that must be followed. In other words, it details the process or rules that are legally required. For instance, the U.S. government must generally obtain a warrant before searching someone’s private home. If the process of obtaining the warrant is ignored or performed illegally, then procedural law has been violated. **Substantive law**¹² refers to the actual substance of the law or the merits of the claim, case, or action. Substantive law embodies the ideas of legal rights and duties and is captured by our different sources of law, like statutes, the Constitution, or common law.

Sources of Law

In the United States, our laws come primarily from the U.S. Constitution and the state constitutions; from statutory law from Congress, the state legislatures, and local legislative bodies; from common law; and from administrative rules and regulations. Executive orders and treaties are also important sources of law. These are all **primary sources of law**¹³. As is true in any democracy, U.S. law reflects the will of the people who vote for representatives to make the law. In this way, U.S. law is also a reflection of public policy.

Secondary sources of law¹⁴ include restatements of the law, law review and journal articles, uniform codes, and **treatises**¹⁵. These sources are created by legal scholars rather than by a recognized, legitimate law-creating authority. However, these sources are read by and often influence those who are in the position to create law. Members of the judiciary, for example, may consult a restatement of law or law-review articles when making decisions. Likewise, state legislatures often adopt whole or parts of uniform acts, such as the **Uniform Commercial Code (UCC)**¹⁶. When a body of secondary law is formally adopted by a legitimate lawmaking authority, then it becomes primary law. In this example, adoption of the UCC by a state legislature transforms the UCC from a secondary source of law (a model code) to a primary source of law in that state—namely, a statute.

Hyperlink: The U.S. Constitution

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

Read the U.S. Constitution at this link.

13. Actual laws; these include constitutions, statutes, and judicial opinions.
14. Interpretations of law. These include restatements of law, journal articles, and treatises.
15. An exposition or summary of an area or body of law.
16. A model statute that seeks to provide uniformity to contracts law among the different states. It is not a law until state legislatures adopt it as law.
17. The supreme law of the land. It created the structure of the U.S. federal government.

The **U.S. Constitution**¹⁷ created the structure of our federal government. Among other things, it sets forth the three branches—the legislative, executive, and judicial branches.

It provides organizational and procedural requirements, defines the boundaries of each branch's jurisdiction, and creates “checks” on each branch by the other branches. For example, look at **Note 1.26 "Hyperlink: The U.S. Constitution"**. As you can see, in Article II, Section 2 the president is the commander in chief of the several armed forces, but he does not have the power to declare war. That duty falls to Congress.

The first ten amendments to the U.S. Constitution are known as the Bill of Rights. Some of the Founding Fathers did not believe that a **Bill of Rights**¹⁸ was necessary because the power granted to the federal government created by the U.S. Constitution was expressly limited. Any powers not expressly granted to the federal government by the U.S. Constitution are reserved to the states. This means that if the U.S. Constitution does not state that one of the federal branches of government has jurisdiction over a particular area, then that area falls to the states to regulate.

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

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

This dual system of government present in the United States is called **federalism**¹⁹, which is a governance structure whereby the federal government and the state governments coexist through a shared power scheme. State laws may not conflict with federal laws, including the U.S. Constitution. This is because the U.S. Constitution is the supreme law of the land.

Statutory law²⁰ is law created by a legislative body. Congress is the legislative body at the federal level. The states also have legislative bodies, most of which are **bicameral**²¹, like our federal system. The state legislatures' names vary by state. For instance, in Indiana, the legislature is known as the General Assembly. In North Dakota, it is the Legislative Assembly. In New York, it is called the Legislature. Nevertheless, their purposes are the same. They are the legislative branches of their respective state governments.

Congress is composed of a Senate, with 100 members, and a House of Representatives, with 435 members. The forefathers who wrote the Constitution deliberated and argued over how to compose the legislature, and the result is a deliberative body that doesn't always respond quickly to the will of the majority. Since population numbers from the census taken every ten years determine how many House seats a state receives, smaller states are sometimes disproportionately represented in the Senate. Alaska and Delaware, for example, have only one representative in the House, but each has two senators. Senators serve six-year

18. The first ten amendments to the U.S. Constitution.

19. A system in which power is divided between two or more forms of government.

20. Law created by legislative bodies.

21. A term used to describe a legislature in which two bodies exist, such as the U.S. Congress, which is composed of the Senate and the House of Representatives.

terms, and members of the House of Representatives serve two-year terms. There are no term limits for either senators or members of the House. One benefit of having no term limits is that institutional knowledge and wisdom can be carried forward in perpetuity. One drawback is that elected officials may hedge their votes on important issues in a calculated way, to ensure reelection. If term limits were imposed, then vote pandering would not be a problem, but the Congress would be forever laboring with many inexperienced lawmakers.

As you can see from [Note 1.32 "Hyperlink: How a Bill Becomes a Law"](#), a bill may be introduced in Congress through the Senate or through the House of Representatives. Both the House of Representatives and the Senate have many committees, and these are related to all areas under the purview of Congress to legislate. After a bill is introduced, it is sent to an appropriate committee in the chamber of the Congress where the bill originated. If the committee moves forward with the bill, it modifies the bill as it sees fit to do, and then it sends the bill to the house of origination (either the Senate or the House of Representatives) for a vote. If the bill passes, then it is sent to the other house (again, either the Senate or the House of Representatives), where it undergoes the same process. If the other house votes to approve the bill, then the bill goes to the joint committee, which is composed of members of both the House of Representatives and the Senate, where final work is completed. After that, the bill is sent to Congress for a full vote. If the bill passes, it is sent to the president. If the president signs the bill, then it becomes a statute.

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

Hyperlink: How a Bill Becomes a Law

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

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

Importantly, Congress may not act outside of its enumerated powers. Many people wrongfully believe that Congress can do anything. That is simply not true. Look at Article I, Section 8, accessible through [Note 1.26 "Hyperlink: The U.S. Constitution"](#), for the enumerated powers of Congress. Remember that any power not granted to the federal government by the U.S. Constitution is reserved to the states. This means that if Congress passed a law in an area that was actually reserved to the states to regulate, Congress would have acted outside the scope of its powers. If challenged, the law would be struck down as unconstitutional.

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

Common law²² is judge-made law. Common law is a feature of most countries previously colonized by Great Britain, where it originated. In continental Europe, an alternative system called **civil law**²³ developed, where judges do not have the power to create law through interpretation. In civil-law jurisdictions, only the legislature may create law. A **jurisdiction**²⁴ is an area where power may be exercised.

In a common-law system, when an appellate court hears cases and writes opinions, rules of law are created, formed, and shaped. After a particular legal issue has been decided in a jurisdiction, there is a high probability that subsequent cases that present the same legal issue will use the same rule of law generated from already-decided cases regarding the same legal issue. This policy is known as **stare decisis**²⁵, or "let the decision stand." This is how a **precedent**²⁶ is formed, though precedents may shift or change over time. Precedents also may be entirely overturned, though that is rare. Precedents and stare decisis allow us to anticipate the behavior of others and to gauge the legality of our own actions.

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

Common law is an important source of law in those many areas that are reserved to the states to regulate. A state may exercise its **police powers**²⁷ to regulate the safety, health, and welfare of its citizens, for example. The laws implemented in these areas may give rise to laws in divergent areas, such as property law (e.g.,

22. Judge-made law.

23. A system of law in which only the legislature creates law.

24. An area where power may be exercised.

25. "Let what has already been decided stand." It is the principle that courts should follow precedents.

26. Existing interpretation of law, based on prior decisions.

27. The general power of states to regulate for the health, safety, and general welfare of the public.

zoning regulations), so-called **vice laws**²⁸ (e.g., restrictions on vice business activities in certain areas or during certain days), and domestic relations (e.g., laws relating to marriage and adoption). It's also important to note that precedents vary among different jurisdictions because precedents created by one jurisdiction are not binding in other jurisdictions.

Most administrative agencies are created by the legislature. At the federal level they are created by Congress, and at the state level they are created through the state legislative bodies. Administrative agencies may be thought of as a delegation of congressional authority to area experts in particular fields, so that those experts can engage in limited lawmaking, adjudicative procedures, and investigations within their particular purviews. Laws made by administrative agencies are called **rules or regulations**²⁹. Administrative agencies are created by **enabling legislation**³⁰, which sets forth the agencies' jurisdictional boundaries, rule-making procedures, and other information relating to agencies' scopes of power.

KEY TAKEAWAYS

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

EXERCISES

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

28. Laws targeted at regulating or prohibiting vice activities or businesses engaged in vice activities, such as gambling, prostitution, the consumption of alcohol, and pornography.

29. Created by administrative agencies and have the force of law.

30. Statutes created by Congress to create individual administrative agencies.

1.3 The Rule of Law

LEARNING OBJECTIVES

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

When you hear the term “rule of law,” what comes to mind? It may seem like an ambiguous term, but it is used frequently in legal and governance circles. **Rule of law**³¹ is a system of laws under which the people and the government are bound, which allows predictability and restraint of government action.

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

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

Can you imagine if we had no way to determine these things? Imagine that we did not know who had the legitimate right to govern or that we did not know which sources of law were legitimate. If we did not have a rule of law system that specified and legitimized these and other foundational issues, chaos would rule. There would likely be competing claims of authority between different factions of power if our U.S. Constitution and our state constitutions did not create our systems of government. Likewise, there would be competing sources of law—such as those based on religious texts, or others created by modern human beings—if our

31. A system of laws under which the people and the government are bound.

constitutions did not legitimize the manner in which laws were to be created. Also, there would be different methods of dispute resolution. Perhaps some people would favor a vigilante system, while others would prefer a procedural system. This type of unpredictability would result in a very unstable society. We should not take the American rule of law system for granted. It provides predictability and stability to our lives.

Rule of law systems establish authority, create expectations for behavior, and establish redress for grievances and penalties for deviance. Governance of conflict and the attainment of peace among the governed are primary goals of rule of law systems. For example, securing peace is a goal within the U.S. rule of law system. The U.S. Constitution's preamble states, "We the People...in Order to...insure domestic Tranquility." We see this same notion in the **English Bill of Rights of 1689**³², though the words used are somewhat different.

According to many rule of law systems, the attainment of peace relies on the establishment of a hierarchical authority structure. This recognition of the right to govern provides legitimacy. For instance, in the **Code of Hammurabi**³³ and the **Magna Carta**³⁴, these rights are derived from religious authority. In the U.S. Constitution and the English Bill of Rights of 1689, the power is derived from the people.

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

32. Contains the basis for many concepts contained in the U.S. Constitution, including the rights of the people to limit the sovereign.

33. The oldest record that we have of a seemingly complete rule of law system.

34. Contains the basis for many legal principles recognized in the U.S. Constitution, including due process and habeas corpus.

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

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

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

The **U.S. Constitution**³⁵ is the foundation on which the U.S. federal rule of law system rests. It asserts the supremacy of law. “We the people” is a very important part of the preamble, because it confers power on the people as well as on the states. Notably, unlike the Magna Carta and the English Bill of Rights of 1689, it does not focus on individual rights. Of course, the Bill of Rights does focus on individual rights, but those amendments were passed after the Constitution was written. (That is why they are called *amendments* to the constitution.) The U.S. Constitution implemented the supremacy of law using structure and processes. The Founding Fathers were particularly concerned about giving the government the power to do its job without encouraging tyranny. They built in processes to ensure the supremacy of law. Indeed, ours is “a government of laws and not of men,” John Adams wrote in the Massachusetts Constitution. Thomas Paine noted the same sentiment in *Common Sense*, when he wrote, “the law is king.”

35. The supreme law of the land. It created the structure of the U.S. federal government.

KEY TAKEAWAYS

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

EXERCISES

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

1.4 Importance of Rule of Law to Business

LEARNING OBJECTIVES

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

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

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

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

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

Additionally, in the United States, the rule of law provides a sophisticated system of federalism, where state and federal laws coexist. This allows people and businesses to determine which system of government pertains to them and which jurisdiction they belong to. Imagine that you sell firearms in a retail capacity. You would be subject to both state and federal laws. You would be required to carry a federal permit from the federal administrative agency known as the Bureau of Alcohol, Tobacco, Firearms, and Explosives. You would be forbidden from engaging in illegal arms trading. According to state laws, you would likely have to ensure that each purchaser of a firearm held a valid permit for a firearm. You would be required to check identification, enforce waiting periods, and refuse to sell guns to people who were not permitted to carry them according to your state's laws. If we did not have a rule of law system, you might be uncertain how to conduct your business, and you would be subject to arbitrary enforcement of unstated or **ex post facto**³⁶ (retroactive) laws that affected your business.

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

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

36. A type of law that is applied retroactively to its passage.

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

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

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

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

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

KEY TAKEAWAYS

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

EXERCISES

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

1.5 How Law Affects Business Disciplines

LEARNING OBJECTIVES

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

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

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

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

The law also affects finance. Like accounting professionals, many who work in finance are also regulated by the SEC. The SEC is concerned that investors receive accurate information to make investment decisions. Moreover, the SEC enforces prohibitions against insider trading and pursues claims of other types of securities fraud, such as **Ponzi schemes**³⁷.

Similarly, several statutes protect consumers in financial transactions. For example, the **Truth in Lending Act (TILA)**³⁸ requires lenders to accurately provide information concerning the costs involved in offers of credit. TILA and its corresponding **Regulation Z**³⁹ are administered by federal banking agencies.

Law also affects those in management. For instance, knowledge of employment law is essential to those in human resources. **Title VII of the Civil Rights Act**⁴⁰ prohibits discrimination related to protected characteristics in hiring and employment practices. Those in management also must be aware of the potential liability that demands on employees might create. For example, in Oregon, McDonald's was found to be liable for injuries resulting when an off-duty, off-premises worker fell asleep while driving. *Faverty v. McDonald's*, 892 P.2d 703 (Or. Ct. App. 1995). The employee had worked three shifts during a twenty-four-hour period. The court held that employers have a duty to avoid conduct that creates a foreseeable risk of harm to others.

If your field is marketing, the law also relates to your work. Marketers must be particularly attuned to tort law, consumer protection law, and intellectual property law. For example, to avoid charges of libel, those in advertising need to take care not to defame another person, business, or product. It might be tempting to do so, especially if you were engaged in serious competition with another company that sold a similar product. Likewise, marketers must take great care not to engage in deceptive advertising practices, lest their employer run afoul of the **Federal Trade Commission's (FTC)**⁴¹ policies or the FTC Act. Additionally, marketers must be aware of other people's intellectual property to avoid copyright or trademark infringement in their own work product.

These are a few examples of how the law relates to specific business disciplines. Of course, this is just an overview. It is incumbent on each business professional to become familiar with the legal environment in his or her profession. Employers may provide training regarding legal environment issues, such as anti-sexual harassment training or anti-insider trading training, but ultimately, becoming familiar with the legal environment is each person's individual responsibility. Remember that a defense of "I didn't know the law!" is no defense at all.

37. A type of investment fraud similar to a pyramid scheme.

38. A federal statute that requires lenders to provide accurate information concerning costs involved in offers of credit.

39. The regulation that implements the Truth in Lending Act.

40. The act that prohibits discrimination related to protected characteristics in hiring and employment practices.

41. A federal agency that protects consumers.

KEY TAKEAWAYS

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

EXERCISES

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

1.6 Concluding Thoughts

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

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

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

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

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

Chapter 2

The Court System

LEARNING OBJECTIVES

After reading this chapter, you should have a thorough understanding of the U.S. court system and how it affects the conduct of businesses and individuals. Specifically, you should be able to answer the following questions:

1. What role does each of the three branches of government play?
2. How do the other two branches of government balance the judiciary?
3. How are the state and federal courts structured?
4. What are the primary differences between trial and appellate courts?
5. How does the Supreme Court do its work?

As you now know, laws are meaningless if they are not enforced. Companies have to make a barrage of decisions daily, from product development to marketing to strategies to maintain growth, but most of these are based on sound business acumen rather than legal requirements. If a company does violate a law, however, it must be held accountable. Typically, that accountability comes in the form of a lawsuit heard in court. Whether a suit is brought by a supplier, customer, employee, shareholder, or other stakeholder, litigation is a fact of life for companies. As future business professionals, being familiar with our court system will lay the foundation for your understanding of the litigation process.

2.1 The Third Branch

LEARNING OBJECTIVES

1. Understand the constitutional basis for the judicial branch.
2. Explore the differences among the three branches of government.
3. Learn about the chief justice's role in judicial administration.
4. Explore the concept of judicial review.
5. Become familiar with how the other two branches check and control the judiciary.

Under the federal Constitution, power is separated among three branches of government. Article I of the Constitution allocates the **legislative**¹ power to Congress, which is composed of the House of Representatives and the Senate. Congress makes laws and represents the will of the people in doing so. Article II of the Constitution creates the **executive**² power in the president and makes the president responsible for enforcing the laws passed by Congress. Article III of the Constitution establishes a separate and independent **judiciary**³, which is in charge of applying and interpreting the meaning of the law. The U.S. Supreme Court sits at the top of the federal judiciary as the supreme court of the land. There are nine judges on the Supreme Court. (See [Figure 2.1 "The U.S. Supreme Court in 2009"](#).)

1. Created by Article I of the Constitution at the federal level, this branch is responsible for drafting laws.
2. Created under Article II of the Constitution, this is another name for the office of the president and its related agencies.
3. Created by Article III of the Constitution and by various state constitutions and laws, this is the branch of government dedicated to the administration of justice.

Figure 2.1 *The U.S. Supreme Court in 2009*



Justice Stevens has since retired and was replaced by Justice Kagan in 2010.

Source: Photo courtesy of Steve Petteway, Collection of the Supreme Court of the United States, http://en.wikipedia.org/wiki/File:Supreme_Court_US_2009.jpg.

The Constitution is remarkably short in describing the judicial branch. The president, under Article II, has the power to nominate judges with the advice and consent of the Senate. Article III also provides the following: “The judicial power of the United States, shall be vested in one Supreme Court, and in such inferior courts as the Congress may from time to time ordain and establish. The judges, both of the supreme and inferior courts, shall hold their offices during good behaviour, and shall, at stated times, receive for their services, a compensation, which shall not be diminished during their continuance in office.” Under the Constitution, therefore, there are only two requirements to becoming a federal judge: nomination by the president and confirmation by the Senate. There are no age, citizenship, or qualification requirements. If the president wanted to, he could nominate any reader of this book as a federal judge. Additionally, the Constitution guarantees that judges are relatively free from political interference by providing them with lifetime tenure and a salary that cannot be reduced.

It is commonly accepted that the three branches of government are coequal, but in reality they are very different. The judiciary is the only unelected branch of government and is therefore the most mysterious. Although many Americans know who the president is, and many are familiar with their representatives in Congress, very few know the names of the judges who sit on the Supreme Court or any lower court. When politicians run for Congress or president, they spend months campaigning, begging voters to look into their eyes and trust them enough to cast their votes. Since judges are not elected, the vast majority of Americans cannot associate them with a face. Indeed, many visitors to the Supreme Court building in Washington, DC, routinely come face-to-face with a justice and don't realize it.

The three branches also consume vastly different resources in serving the public, with the entire federal court system consuming less than two-tenths of 1 percent of the federal budget. The political branches capture the public imagination with monuments and landmarks (Air Force One, the White House, the Capitol), while the federal judiciary works in relative anonymity. (All federal judges, for example, travel commercially and do not have access to government-owned planes.) Finally, the judiciary is designed to be the most remote branch from the people. In addition to being unelected, federal judges have life tenure and can be removed from office only through impeachment. They also tend to be in public office far longer than politicians. While the United States has had forty-four presidents and more than two thousand members of Congress, Chief Justice John Roberts is only the seventeenth chief justice. Roberts was only fifty years old when he became chief justice and will likely be chief justice for many decades to come, certainly long after his nominating president, George W. Bush, has faded from public life.

4. The agency responsible for rent, payroll, budget, and other administrative matters relating to the functioning of the federal judiciary.
5. A federal agency dedicated to conducting research on judicial administration and providing judicial education.
6. The commission created by Congress to explore ways to establish uniformity in federal criminal sentencing.
7. In the U.S. Supreme Court, the representative of the judicial branch to other branches and the administrative head of the judiciary.
8. In the U.S. Supreme Court, one of the eight regular members of the Court.

When we speak of the “federal judiciary,” we are referring to a very small entity compared to other federal bureaucracies. The Supreme Court (the building, justices, and staff) is one part of the federal judiciary. The district and appellate courts (described later in this chapter) are another part, and they also comprise judges and staff (although these courts do not own their own buildings; rather, all courts other than the Supreme Court are rented from other branches of the government). The **Administrative Office**⁴ of the United States Courts runs the day-to-day issues for all the courts, such as payroll and rent. A second component of the judiciary is the **Federal Judicial Center**⁵, an agency dedicated to conducting research on judicial administration and providing judicial education. A third component is the **United States Sentencing Commission (USSC)**⁶, established by Congress to make recommendations on how to establish uniformity in federal criminal sentencing. In addition to his responsibilities in hearing cases and writing opinions, the **chief justice**⁷ oversees the overall operation of the federal courts and represents the courts to the other branches of government. When it comes to hearing and deciding cases, however, the chief justice is “first among equals”: he has no more power than any of the other justices, known as **associate justices**⁸.

In that capacity, the chief justice traditionally releases an annual report on the judiciary. Since becoming chief justice in 2005, Chief Justice Roberts ([Figure 2.2 "Chief Justice John G. Roberts"](#)) has focused his annual reports on judicial pay. Although judicial salaries cannot be reduced, years have passed since Congress approved a cost-of-living increase for judges. District court judges are currently paid \$169,300 (the same salary as members of Congress), while circuit court judges are paid \$179,500. Supreme Court justices earn \$208,100, and the chief justice earns \$217,400. While this may seem like a lot of money, it's important to keep in mind that the integrity of the judicial system depends on attracting the very best lawyers to join the bench. Lawyers of that caliber are also in high demand in private law firms, where they can earn many times more than what judges earn. As a result, high-quality lawyers who otherwise may serve the country by becoming judges never even consider joining the bench. As you can see from [Note 2.11 "Hyperlink: Excerpt from 2008 Year-End Report to Congress"](#), there is a risk, the chief justice believes, that the pool of judicial talent may be limited to less-than-the-best lawyers or those who are independently wealthy.

Figure 2.2 Chief Justice John G. Roberts



Source: Photo courtesy of the Supreme Court of the United States, http://en.wikipedia.org/wiki/File:File:Official_roberts_CJ_cropped.jpg.

Hyperlink: Excerpt from 2008 Year-End Report to Congress

<http://www.supremecourt.gov/publicinfo/year-end/2008year-endreport.pdf>

I suspect many are tired of hearing it, and I know I am tired of saying it, but I must make this plea again—Congress must provide judicial compensation that keeps pace with inflation. Judges knew what the pay was when they answered the call of public service. But they did not know that Congress would steadily erode that pay in real terms by repeatedly failing over the years to provide even cost-of-living increases.

Last year, Congress fell just short of enacting legislation, reported out of both House and Senate Committees on the Judiciary, that would have restored cost-of-living salary adjustments that judges have been denied in past years. One year later, Congress has still failed to complete action on that crucial remedial legislation, despite strong bipartisan support and an aggregate cost that is miniscule in relation to the national budget and the importance of the Judiciary's role. To make a bad situation worse, Congress failed, once again, to provide federal judges an annual cost-of-living increase this year, even though it provided one to every other federal employee, including every Member of Congress. Congress's inaction this year vividly illustrates why judges' salaries have declined in real terms over the past twenty years.

Our Judiciary remains strong, even in the face of Congress's inaction, because of the willingness of those in public service to make sacrifices for the greater good. The Judiciary is resilient and can weather the occasional neglect that is often the fate of those who quietly do their work. But the Judiciary's needs cannot be postponed indefinitely without damaging its fabric. Given the Judiciary's small cost, and its absolutely critical role in protecting the Constitution and rights we enjoy, I must renew the Judiciary's modest petition: Simply provide cost-of-living increases that have been unfairly denied! We have done our part—it is long past time for Congress to do its.

The Supreme Court is a well-known institution today, but it wasn't always that way. When the Court first met, many of the justices (then appointed by George Washington) couldn't travel in time for the Court's opening day, so the session was dismissed. For the first three years of its existence, the Court heard no cases of any importance. John Jay, the first chief justice, traveled to Europe while he was chief justice to negotiate the Jay Treaty with Great Britain. While there, he won election as governor of New York. He was reappointed as chief justice by President Washington and confirmed by the Senate but declined to return to the Court, citing the Court's lack of energy, weight, and dignity as part of his reasoning. It wasn't until John Marshall became the fourth chief justice (a position he held for a record thirty-four years) that the Supreme Court firmly established itself as a separate and coequal branch of government. The Supreme Court did not even get its own building until 1932, years after the nation's capital was established in Washington, DC. Before then, it met in the basement of the old Senate building to hear cases. When William Taft (the only president who also served as a Supreme Court justice) became chief justice, he persuaded Congress to appropriate funds, and the Court finally got its own building in Washington, DC (see [Figure 2.3 "U.S. Supreme Court"](#)).

Figure 2.3 U.S. Supreme Court



© Thinkstock

Hyperlink: Supreme Court Virtual Tour

<http://supremecourt.c-span.org/VirtualTour.aspx>

The Supreme Court building, located at 1 First Street, is an impressive marble building that sits at the northern border of Washington, DC's, famous plaza. It is open year-round and is free to visit. If you have not been there, you can use the link to take a virtual tour of the entire building, inside and out, courtesy of C-Span.

The Supreme Court's early malaise can partially be attributed to the problem that no one really had a good idea of what the Supreme Court was supposed to do. There were few cases of tremendous national importance in the new republic, and a quirky tradition known as "riding circuit" meant that the Supreme Court justices also acted as lower appellate court judges, thus making their work at the Supreme

Court somewhat duplicitous. The Constitution simply states that the judicial power of the United States is vested in the Supreme Court, without expounding what that means. It wasn't until 1803 that the modern role of the Supreme Court began to emerge.

In 1800, the presidential election between John Adams and Thomas Jefferson nearly tore the country apart. The election was bitter, partisan, and divisive. Jefferson won but wasn't declared the winner until early in 1801. In the meantime, Adams and other Federalists in Congress attempted to leave their mark on government by creating a slate of new life-tenured judgeships and appointing Federalists to those positions. For the judgeships to become effective, certain paperwork (known as commissions) had to be delivered in person to the new judges. At the time power transitioned from Adams to Jefferson, several commissions had not been delivered, and Jefferson ordered his acting secretary of state to stop delivering them. When Jefferson came to power, there was not a single judge from his Democratic-Republican Party sitting on the bench, and he wasn't keen on expanding the Federalist influence on the bench any further. One Federalist judge, William Marbury, sued the secretary of state, James Madison, to deliver his commission. The case was filed in the Supreme Court, led by Chief Justice John Marshall ([Figure 2.4 "Chief Justice John Marshall"](#)). Marshall himself was a Federalist and had served as Adams's secretary of state, so he understood how political the case was and how he stood to be accused of bias if he ruled the wrong way. In a shrewd and calculated move, he ultimately ruled against Marbury but at the same time declared that it was the Supreme Court's role to decide the meaning of the Constitution. This is called **judicial review**⁹, and it makes the U.S. Supreme Court the most powerful judicial body in the world. The following is from *Marbury v. Madison*: "It is emphatically the province and duty of the Judicial Department to say what the law is. Those who apply the rule to particular cases must, of necessity, expound and interpret that rule. If two laws conflict with each other, the Courts must decide on the operation of each." *Marbury v. Madison*, 5 U.S. 137 (1803).

9. The power of courts to declare legislative or executive acts unlawful.

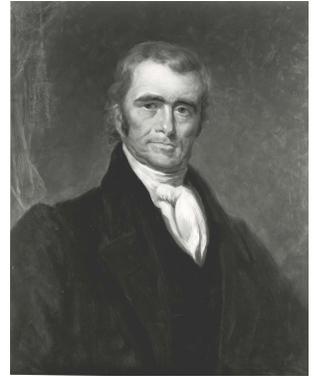
Chief Justice Marshall did not invent judicial review; it is a feature of most common-law countries and as a concept goes back centuries. He did, however, institutionalize judicial review at the U.S. Supreme Court at a time when there was great uncertainty about the Court's future role in government. While all three branches are bound to uphold the Constitution, on all matters relating to the meaning of the Constitution, the Supreme Court has the final say.

After *Marbury v. Madison*, it took the Supreme Court nearly sixty years to again use the power of judicial review to strike down legislation. The case was *Dred Scott v. Sanford*, *Dred Scott v. Sanford*, 60 U.S. 393 (1857), and it involved a slave who traveled with his owner, a doctor in the army, to many states including free states (**Figure 2.5 "Dred Scott"**). Dred Scott filed suit for his freedom, and the case ended up before the Supreme Court. In what many commentators call the Supreme Court's "self-inflicted injury," the Court, in an opinion written by Chief Justice Roger Taney, used judicial review to overturn the Missouri Compromise and held that Dred Scott was not a person under the Constitution and therefore could not file suit. The decision hastened the country into Civil War, and it took years for the Supreme Court to recover its standing with the public.

Judicial review means that any federal court can hold any act of the president or the Congress to be unconstitutional. It is a power that rests with each of the more than eight hundred federal judges, from the trial courts through the appellate courts. It is an extraordinary power in a democracy, as an unelected life-tenured person or group of persons overturns the acts of a popularly elected branch of government. Rather than give rise to judicial tyranny, however, our system of checks and balances ensures that the other two branches also play a critical role in "checking" the judiciary.

Take, for example, the executive branch. The president can control the judiciary by making careful judicial selections. The power of the president to name federal judges is absolute—he is not required to consult with

Figure 2.4 Chief Justice John Marshall



Source: Photo courtesy of the U.S. Department of State, <http://www.flickr.com/photos/statephotos/2267272626>.

Figure 2.5 Dred Scott



Source: Photo courtesy of the Missouri Historical Society,

any other individual in making his choice. As a matter of custom, presidents have traditionally looked to senators to provide names of judicial candidates for consideration, and some presidents are more willing than others to defer to the advice of aides and advisors.

<http://en.wikipedia.org/wiki/File:DredScott.jpg>.

For much of the nation's history, the Senate routinely confirmed the president's choices. President Reagan's nomination of Robert Bork in 1987 changed that tradition forever. Alarmed Democrats grilled Bork in confirmation hearings and ultimately declined to confirm him, setting the stage for a new breed of confirmation hearings where senators try to ascertain not just the nominee's character but also how he or she will judge certain issues. Judicial nominees, especially to the Supreme Court, are under so much scrutiny now that sometimes even the president's own party will turn against a nominee. This happened to President George W. Bush when he named his close friend Harriet Miers to fill a vacancy left by Justice Sandra Day O'Connor's retirement. Alarmed at her lack of judicial experience and record on conservative judicial issues, Republicans urged the president to reconsider his choice, and Ms. Miers eventually withdrew as a nominee.

Presidents hope, and believe, that their selections reflect their own ideologies and beliefs. Federal judges are notoriously independent, however, and many demonstrate little hesitance to overrule their nominating president if they believe it necessary to do so. Several presidents have been disappointed in their nominee as they watched the judge move away from his or her earlier political roots. For example, President Eisenhower, a Republican, nominated Earl Warren as chief justice. Warren would later transform the civil rights landscape with a series of decisions, leading Eisenhower to describe nominating Warren as "the biggest damned fool mistake I ever made." John Fox, "Biographies of the Robes: Earl Warren," PBS, December 2006, http://www.pbs.org/wnet/supremecourt/democracy/robes_warren.html (accessed August 22, 2010). President Nixon, a Republican, placed Harry Blackmun on the Supreme Court, only to see Blackmun later move to the left and author *Roe v. Wade*, *Roe v. Wade*, 410 U.S. 113 (1973), the principal decision legalizing access to abortion services. More recently, President George H. W. Bush nominated David Souter to the Court on the belief that Souter would be a reliable conservative. Souter quickly aligned himself with the liberal wing of the Court.

In addition to nominating judges, the president serves as a check on the judiciary by being the primary means of enforcing judicial decisions. Federal judges do not control any police force and as such are unable to ensure their decisions are carried out. That responsibility falls on the executive branch. No matter how much a president may disagree with a judicial decision, it is a testament to our republican

form of government, and the rule of law, that the president nonetheless faithfully executes a federal court's decision.

Hyperlink: The Little Rock Nine

<http://www.npr.org/templates/story/story.php?storyId=14091050>

Figure 2.6
Elizabeth Eckford



Source: Photo courtesy of Will Counts, http://en.wikipedia.org/wiki/File:Little_Rock_Desegregation_1957.jpg.

After the Supreme Court handed down its seminal decision in *Brown v. Board of Education*, *Brown v. Board of Education*, 347 U.S. 483 (1954), many Southern states continued to resist desegregation. In Little Rock, Arkansas, the local NAACP chapter enrolled nine students in Little Rock High School to begin with the fall term in September 1957. Several segregationist groups protested, and Arkansas governor Orval Faubus deployed Arkansas National Guard troops to stop the students from entering the school. President Eisenhower reluctantly ordered the 101st Airborne Division of the U.S. Army to Little Rock to ensure the students could enroll and attend class. Click the link to listen to a story about one of the students, Elizabeth Eckford (Figure 2.6 "Elizabeth Eckford"), who tried to enroll in Little Rock High School that day.

The Congress can also play an important role in “checking” the judiciary. The most obvious role is in confirming judicial selections. In the last few years, judicial confirmations have become a political battlefield, as activists on both the left and right seek to block judicial nominees they view as being too radical. It’s not unusual for some judicial candidates to wait years for their confirmation hearings. President George W. Bush, for example, initially appointed Chief Justice Roberts to a court of appeals judgeship in 2001, but he wasn’t confirmed until 2003, after Republicans regained control of Congress in midterm elections. Similarly, the newest member of the Supreme Court, Elena Kagan, was nominated for a federal appellate judgeship in 1999 by President Bill Clinton but was never confirmed due to Republican objections to her nomination.

In addition to confirmation, Congress also controls the judiciary through its annual budgetary process. Although the Constitution protects judicial salaries from any reductions, Congress is not obligated to grant any raises. For several years, judges have worked without cost-of-living raises. Although no one has seriously suggested that Congress is withholding money from the courts in retaliation for judicial decisions, some have observed that Congress would like to see the judicial branch yield on some high-profile issues such as televising Supreme Court proceedings in turn for pay raise consideration.

Finally, Congress can control the judiciary by determining how the courts are organized and what kind of cases the courts can hear. After the 1800 presidential election, for example, the newly elected Congress canceled the Supreme Court’s term for the entire year while they reorganized the judiciary. More recently, several conservative members of Congress have suggested splitting up the liberal-leaning Ninth Circuit Court of Appeals on the West Coast, to reduce its influence. The Constitution also gives Congress the authority to determine the courts’ jurisdiction. Congress has used this authority in the past to take away controversial cases from judicial consideration. During Civil War Reconstruction, for example, Congress passed a law taking away the Supreme Court’s jurisdiction to hear an appeal from a newspaper publisher jailed for publishing articles opposing Reconstruction. *Ex parte McCordle*, 74 U.S. 506 (1869). Recently, Congress did the same thing, removing federal court jurisdiction from hearing appeals involving detainees held at the military prison in Guantanamo Bay. In the recent past, members of Congress have also introduced legislation prohibiting federal courts from hearing cases about the public display of religion and flag burning or from using any foreign law as support for their decisions.

KEY TAKEAWAYS

The third branch (judicial branch) is the only unelected branch of government. As such, it can sometimes appear remote or detached from the American public. The judiciary is composed of federal courts, the Administrative Office, the Federal Judicial Center, and the U.S. Sentencing Commission. The chief justice has administrative responsibilities over these agencies in addition to his adjudicatory duties. The judiciary comprises less than two-tenths of 1 percent of the federal budget. In spite of this, judicial pay is very low compared to pay in the private sector and is a source of tension between the judiciary and the other branches of government. *Marbury v. Madison* established the doctrine of judicial review, which allows courts to determine the final validity of laws as well as the meaning of the Constitution. Judicial review is an awesome power, and it is used sparingly. The president can check the judiciary through appointments and the enforcement of judicial decisions. The Congress can check the judiciary through funding, administrative control of court calendars and funds, and jurisdiction-stripping legislation.

EXERCISES

1. Do you believe that judicial review is a good thing for American democracy? Why or why not?
2. How does the Constitution guarantee judicial independence? Do you think judges have enough independence? Too much?
3. How much money do you think federal judges should be paid?
4. Do you believe that Congress should have the ability to remove cases from federal courts? If so, what types of cases are appropriate for removal?
5. What options does a president have if he disagrees with a federal court's opinion?
6. Should a federal court force desegregation on a community that is overwhelmingly against it?

2.2 Activists and Strict Constructionists

LEARNING OBJECTIVES

1. Explore the strict constructionist, or originalist, judicial philosophy.
2. Explore the judicial activist philosophy.
3. Learn about the modern origin of the divide between these two philosophies.
4. Examine the evolution of the right to privacy and how it affects judicial philosophy.
5. Explore the biographies of the current Supreme Court justices.

In the early years of the republic, judges tended to be much more political than they are today. Many were former statesmen or diplomats and considered being a judge to be a mere extension of their political activities. Consider, for example, the presidential election of 1800 between John Adams and Thomas Jefferson. Even by today's heated standards of presidential politics, the 1800 election was bitter and partisan. When Jefferson won, he was in a position of being president at a time when not a single federal judge in the country came from his political party. Jefferson was extremely wary of judges, and when the Supreme Court handed down the *Marbury v. Madison* decision in 1803 declaring the Supreme Court the ultimate interpreter of the Constitution's meaning, Jefferson wrote that "to consider the judges as the ultimate arbiters of all constitutional questions is a very dangerous doctrine indeed, and one which would place us under the despotism of an oligarchy." Thomas Jefferson to William C. Jarvis, 1820, in *The Writings of Thomas Jefferson*, ed. Andrew A. Lipscomb and Albert Ellery Bergh, Memorial Edition (Washington, DC: Thomas Jefferson Memorial Association of the United States, 1903–4), 15:277, quoted in Eyler Robert Coates Sr., "18. Judicial Review," *Thomas Jefferson on Politics & Government: Quotations from the Writings of Thomas Jefferson*, 1999, <http://etext.virginia.edu/jefferson/quotations/jeff1030.htm> (accessed September 24, 2010). A few years later, the first justice to be impeached, Samuel Chase, was accused of being overly political. His impeachment (and subsequent acquittal) started a trend toward nonpartisanship and political impartiality among judges. Today, judges continue this tradition by exercising impartiality in cases before them. Nonetheless, charges of political bias continue to be levied against judges at all levels.

In truth, the majority of a judge's work has nothing to do with politics. Even at the Supreme Court level, most of the cases heard involve conflicts among circuit courts of appeals or statutory interpretation. In a small minority of cases, however, federal

judges are called on to interpret a case involving religion, race, or civil rights. In these cases, judges are guided sometimes by nothing more than their own interpretation of case law and their own conscience. This has led some activists to claim that judges are using their positions to advance their own political agendas.

In general terms, judges are thought to fall into one of two ideological camps. On the politically conservative right, judges are described as either **strict constructionists**¹⁰ or **originalists**¹¹. Judges who adhere to this philosophy believe that social change is best left to the politically elected branches of government. The role of judges is therefore to strictly interpret the Constitution, and nothing more. Strict constructionists also believe that the Constitution contains the complete list of rights that Americans enjoy and that any right not listed in the Constitution does not exist and must be earned legislatively or through constitutional amendment. Judges do not have the power to “invent” a new right that does not exist in the Constitution. These judges believe in **original meaning**¹², which means interpreting the Constitution as it was meant when it was written, as opposed to how society would interpret the Constitution today. Strict constructionists believe that interpreting new rights into the Constitution is a dangerous exercise because there is nothing to guide the development of new rights other than a judge’s individual conscience. Justice Antonin Scalia, appointed by Ronald Reagan to the Supreme Court in 1984, embodies the modern strict constructionist.

10. Also known as originalists. Politically conservative judges who adhere to the view that the Constitution should be interpreted in light of its original meaning when it was adopted and that new rights should be granted by the legislative process rather than through judicial review.

11. Jurists who subscribe to original meaning.

12. The view that the Constitution should be interpreted in light of what the Founding Fathers meant when they wrote the document.

Hyperlink: Justice Antonin Scalia

Figure 2.7
Justice Antonin Scalia



Source: Photo courtesy of Steve Petteway, Collection of the Supreme Court of the United States, http://en.wikipedia.org/wiki/File:Antonin_Scalia,_SCOTUS_photo_portrait.jpg.

<http://www.cbsnews.com/stories/2008/04/24/60minutes/main4040290.shtml>

In 2008, Justice Antonin Scalia (Figure 2.7 "Justice Antonin Scalia") sat down with *60 Minutes* to discuss a new book he wrote and his originalist judicial philosophy. Click the link to watch a portion of this fascinating interview with one of the most powerful judges in the country.

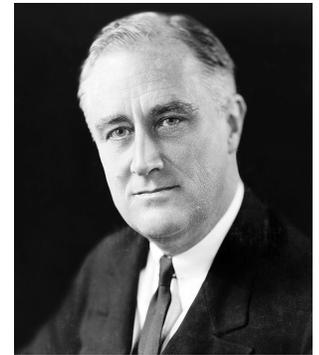
13. Judges who adhere to the view that the Constitution is a living document that should adapt and change with the times.

On the politically liberal left are judges who are described as activist. **Judicial activists**¹³ believe that judges have a role in shaping a “more perfect union” as described in the Constitution and that therefore judges have the obligation to seek justice whenever possible. They believe that the Constitution is a “living document” and should be interpreted in light of society’s needs, rather than its historical meaning. Judicial activists believe that sometimes the political process is flawed and that majority rule can lead to the baser instincts of humanity becoming the rule of law. They believe their role is to safeguard the voice of the minority and the

oppressed and to deliver the promise of liberty in the Constitution to all Americans. Judicial activists believe in a broad reading of the Constitution, preferring to look at the motivation, intent, and implications of the Constitution's safeguards rather than merely its words. Judicial activism at the Supreme Court was at its peak in the 1960s, when Chief Justice Earl Warren led the Court in breaking new ground on civil rights protections. Although a Republican, and nominated by Republican President Eisenhower, Earl Warren became a far more activist judge than anyone anticipated once on the Supreme Court. Chief Justice Warren led the Court in the desegregation cases in the 1950s, including the one affecting the Little Rock Nine. The "Miranda" *Miranda v. Arizona*, 384 U.S. 436 (1969). warnings—familiar to nearly every American who has ever seen a police show or movie—come from Chief Justice Warren, as does the fact that anyone who cannot afford an attorney has the right to publicly funded counsel in most criminal cases.

The modern characterization of judges as politically motivated can be traced to the Great Depression. Against cataclysmic economic upheaval, Americans voted for Franklin D. Roosevelt (Figure 2.8 "President Franklin Roosevelt") in record numbers, and they delivered commanding majorities in both the Senate and House of Representatives to his Democratic Party. President Roosevelt vowed to alter the relationship between the people and their government to prevent the sort of destruction and despair wreaked by the Depression. The centerpiece of his action plan was the New Deal, a legislative package that rewrote the role of government, vastly increasing its size and its role in private commercial activity. The New Deal brought maximum working hours, the minimum wage, mortgage assistance, economic stimulus, and social safety nets such as Social Security and insured bank deposits. Although the White House and the Congress were in near-complete agreement on the New Deal, the Supreme Court was controlled by a slim majority known as the "Four Horsemen of the Apocalypse" because of their dire warnings of the consequences of economic regulation. Three justices known as the "Three Musketeers"—Justice Brandeis, Justice Cardozo, and Justice Stone—opposed the Four Horsemen. In the middle sat two swing votes. The Four Horsemen initially prevailed, and one by one, pieces of President Roosevelt's New Deal were struck down as unconstitutional reaches of power by the federal government. Frustrated, President Roosevelt devised a plan to alter the makeup of the Supreme Court by increasing the number of judges and appointing new justices. The "court-packing plan" was never implemented due to the public's reaction, but nonetheless, the swing votes on the Supreme Court switched their votes and began

Figure 2.8 President Franklin Roosevelt



Source: Photo courtesy of the U.S. Library of Congress, <http://loc.gov/pictures/resource/cph.3c17121>.

upholding New Deal legislation, leading some historians to label their move the “switch in time that saved Nine.” During the public debate over the Supreme Court’s decisions on the New Deal, the justices came under constant attack for being politically motivated. The loudest criticism came from the White House.

Hyperlink: Fireside Chats

<http://millercenter.org/scripps/archive/speeches/detail/3309>

One of the hallmarks of FDR’s presidency was his use of the radio to reach millions of Americans across the country. He regularly broadcast his “fireside chats” to inform and lobby the public. In this link, President Roosevelt complains bitterly about the Supreme Court, claiming that “the Court has been acting not as a judicial body, but as a policy-making body.” Do modern politicians make the same accusation?

The abortion debate is a good example of the politically charged atmosphere surrounding modern judicial politics. Strict constructionists decry *Roe v. Wade* as an extremely activist decision and bemoan the fact that in a democracy, no one has ever had the chance to vote on one of the most socially controversial and divisive issues of our time. *Roe* held that a woman has a right to privacy and that her right to privacy must be balanced against the government’s interest in preserving human life. Within the first trimester of her pregnancy, her right to privacy outweighs governmental intrusion. Since there is no right to privacy mentioned in the Constitution, strict constructionists believe that *Roe* has no constitutional foundations to stand on.

Roe did not, however, declare that a right to privacy exists in the Constitution. A string of cases before *Roe* established that right. In 1965 the Supreme Court overturned a Connecticut law prohibiting unmarried couples from purchasing any form of birth control or contraceptive. *Griswold v. Connecticut*, 381 U.S. 479 (1965). The Court reasoned that the First Amendment has a “penumbra of privacy” that must include the right for couples to choose if and when they want to have children. Two years later, the Supreme Court found a right to privacy in the due process clause when it declared laws prohibiting mixed-race marriages to be unconstitutional. *Loving v. Virginia*, 388 U.S. 1 (1967). As a result of these decisions and others like them, the phrase “right to privacy” today is widely accepted as a form of litmus test for whether a judge (or judicial candidate) is a strict constructionist or activist.

Video Clip: A Question of Ethics: The Right to Privacy and Confirmation Hearings

[\(click to see video\)](#)

Since federal judges are appointed for lifetime, the turnover rate for federal judgeships is low. Recently, the Supreme Court went through an eleven-year period without any changes in membership. In the last five years, however, four new justices have joined the Court. First, John Roberts was nominated by George W. Bush in 2005 to replace retiring Justice Sandra Day O'Connor. President Bush did not have the opportunity to nominate anyone to the Supreme Court during his first term as president, and John Roberts's nomination was viewed widely as a smart move to place on the Court a young, smart, and popular judge with solid Republican credentials. (Roberts began his legal career as an attorney with the Reagan administration.) Before the Senate could confirm Roberts, however, Chief Justice Rehnquist died of thyroid cancer while still in office. President Bush withdrew his nomination and renominated John Roberts as chief justice, which the Senate confirmed. President Bush then began looking for a nominee to replace Justice O'Connor. His first nominee was a close personal friend, Harriet Miers. Selecting Miers allowed him to replace a woman with a woman, something important to First Lady Laura Bush. More importantly, the president felt that Miers, a born-again Christian, would comfortably establish herself as a solid judicial conservative. Others in the Republican Party, however, were nervous about her nomination given her lack of judicial experience. (Miers had never been a judge.) Keen to avoid another situation in which a conservative president nominated a judge who turned out liberal, as was the case with President George H. W. Bush's nomination of David Souter, key lawmakers put enough pressure on Miers that she withdrew her nomination. For his second nominee, President George W. Bush selected Samuel Alito, a safe decision given Alito's prior judicial record. Although he has been on the Court for only a few years, most legal observers believe Alito's nomination is critical in moving the Court to the political right, as Alito has demonstrated himself to be more ideological in his opinions than the pragmatic O'Connor. In his first term as president, President Barack Obama has had the opportunity to name two justices to the Supreme Court: Sonia Sotomayor in 2009 to replace David Souter and Elena Kagan in 2010 to replace John Stevens. Both nominations are widely regarded as not moving the Court too much in either direction in terms of activism or originalism. There are now three women on the Supreme Court, a historical record.

Hyperlink: Biographies of the Current Supreme Court Justices

<http://www.supremecourt.gov/about/biographiescurrent.pdf>

The Supreme Court today is more diverse than it ever has been throughout its history. The hardworking men and women of the Court command respect from the legal community both in the United States and abroad. Click the link to explore their biographies.

KEY TAKEAWAYS

Judicial conservatives, also known as originalists or strict constructionists, believe that the Constitution should be interpreted strictly, in light of its original meaning when it was written. They believe that societal change, especially the creation of new civil rights, should come from the political process rather than the judicial process. Judicial liberals, also known as judicial activists, believe that judges have a role to play in shaping a more perfect union. They believe that the outcome of a case is paramount over other considerations, including past precedent. Judicial activists are more likely to find new civil rights in the Constitution, which they believe should be broadly interpreted in light of modern society's needs. The modern fight over judicial conservatives and judicial liberals began with FDR's New Deal and his court-packing plan and continues to this day. The right to privacy is a good example of the difference between judicial conservatives and judicial liberals, and it is seen as a test to determine what philosophy a judge subscribes to. After a long period of stability, membership in the Supreme Court has changed substantially in the last three years with three new members. The Court remains closely divided between judicial conservatives and judicial liberals, with conservatives poised to control the Court's direction. Justice Anthony Kennedy, a moderate conservative, remains the key swing vote on the Supreme Court.

EXERCISES

1. Read Justice Stewart's dissent in the *Griswold* case here: http://www4.law.cornell.edu/supct/html/historics/USSC_CR_0381_0479_ZD1.html. Although he believes Connecticut's law is "uncommonly silly," he nonetheless believes that it's not unconstitutional. Do you think that judges have an obligation to overturn "uncommonly silly" laws?
2. Modern judicial confirmation hearings have been described as an intricate dance between nominees and Senators, with the nominees giving broad scripted answers that reveal little about their actual judicial philosophy. Do you agree with this characterization? Do you think any changes should be made to the confirmation process?
3. If you were president, what characteristics would you look for in nominating federal judges?
4. If an elected legislature refuses to grant citizens a right to privacy, do you believe it is appropriate for the courts to do so? Why or why not?
5. If a president believes that the Court has reached the wrong result, should the president be able to change the Court by increasing its numbers or forcing early retirement?

2.3 Trial and Appellate Courts

LEARNING OBJECTIVES

1. Learn the differences between the state and federal constitutions.
2. Understand subject matter jurisdiction.
3. Explore the state and federal court systems.
4. Distinguish the work of trial and appellate courts.

In many American cities, you can find both a state and a federal courthouse. These courts hear different types of cases, involving different laws, different law enforcement agencies, and different judicial systems. The rules governing the procedures used in these courts are known as **civil procedure**¹⁴ or **criminal procedure**¹⁵ and are sometimes so hard to understand they confound experienced attorneys and judges. Nonetheless, as future business professionals, it's important for you to understand the general boundaries between state and federal courts.

Most people forget that there are actually fifty-one separate legal systems in the United States: one federal and fifty in the states. Within each legal system is a complex interplay among executive, legislative, and judicial branches of government. The foundation of each of these systems of government is a constitution. Some state constitutions are actually older than the federal Constitution, while others are relatively new. The Massachusetts Constitution, for example, was ratified in 1780, seven years before the federal Constitution. The Montana Constitution, on the other hand, was adopted in 1972. In some states, state constitutions remain vibrant and provide civil protections beyond the federal Constitution. Several state Supreme Courts, for example, have interpreted their various state constitutions as prohibiting treating gays and lesbians differently when it comes to marriage under their "equal protection" provisions. Other state supreme courts have interpreted their state constitutions to grant citizens the right to choose the time and manner of their own death. Since these decisions are by state supreme courts interpreting their own state constitutions, they are beyond the reach or review of the federal Congress or federal courts. This dynamic power sharing between state and federal governments is known as federalism and is a key feature of our republican form of government.

To determine which court a case belongs in, lawyers look first to what the case is about. The rules of **subject matter jurisdiction**¹⁶ dictate whether a case is heard in federal or state court. Lawsuits involving state laws are generally heard in state

14. The rules governing litigation in civil cases.
15. The rules governing litigation in criminal cases.
16. The authority of a court to hear cases in a specific subject area or matter.

17. The legal process of administering a deceased person's property.
18. A model statute that seeks to provide uniformity to contracts law among the different states. It is not a law until state legislatures adopt it as law.
19. Any civil wrong, other than a breach of contract.
20. Any case involving a federal law or the federal Constitution gives rise to subject matter jurisdiction in federal courts.
21. A small category of cases, such as lawsuits between states, that allows the U.S. Supreme Court to hear a case for a first time rather than on appeal.
22. The power of federal courts to hear a case based on state law if all plaintiffs are from different states than all defendants and damages claimed exceed seventy-five thousand dollars.
23. The process of moving a case from state court to federal court under diversity jurisdiction.

courts. Most criminal laws, for example, are state laws. There may be wide differences among the states about what behavior constitutes criminal behavior. Speed limits, for example, are different from state to state. Even serious crimes such as murder or manslaughter, and possible defenses to those crimes, are defined differently by the states. Domestic issues such as divorce and family law are also handled at the state level. Some states make it very easy to marry (Nevada provides an obvious example), while others define marriage differently. Some states permit same-sex marriage, but most do not. Child custody and adoption laws are state based. Property and **probate**¹⁷ laws are also based on state law. Laws related to the transfer of property (including real estate), vehicle or watercraft ownership registration, and the disposition of property after death are different depending on what state you live in. The laws surrounding contracts are also passed at the state level (although most are based on a common law called the **Uniform Commercial Code [UCC]**¹⁸). Finally, the law of **torts**¹⁹ is state based. Torts are any civil wrong other than a breach of contract and can cover a vast array of situations in which people and businesses suffer legal injury. Some states are far friendlier toward torts than others, and the resulting patchwork of tort laws means that companies that do business across the country need to bear in mind the different standards they are held to, based on what state their customers live in.

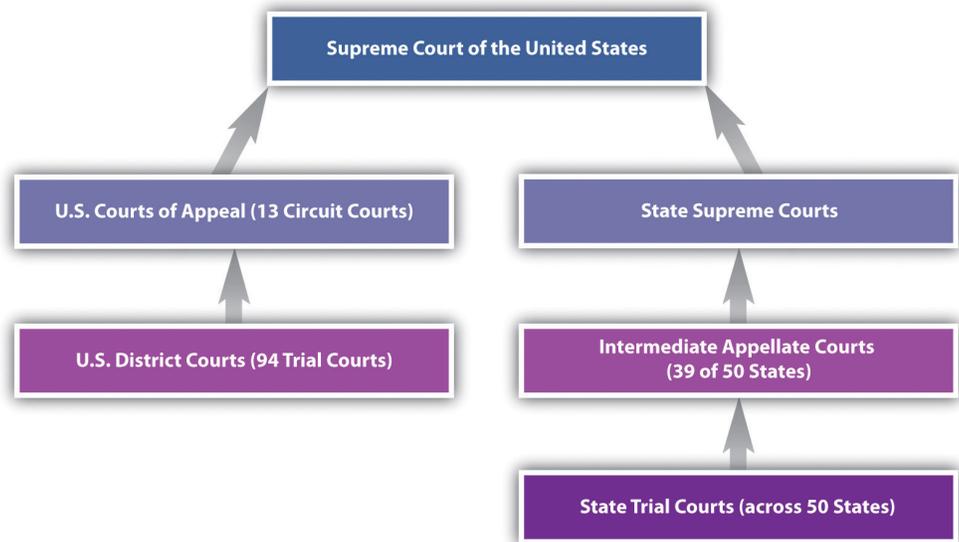
Given the wide array of subject areas regulated by state law, it's not surprising that for most individuals and businesses, their experience with courts is with state courts. Nonetheless, cases do sometimes end up in federal court as well. Federal court subject matter jurisdiction is generally limited to cases involving a **federal question**²⁰—either the federal Constitution or a federal law. Cases involving the interpretation of treaties to which the United States is a party are also subject to federal court jurisdiction. In fact, any case involving the United States as a party is properly litigated in federal court. Finally, in **original jurisdiction**²¹ cases (so called because the Constitution specifically grants this jurisdiction), lawsuits between states can be filed directly with the U.S. Supreme Court. Ongoing disputes between Wyoming and Montana over the use of the Tongue and Powder rivers, for example, were litigated in the Supreme Court in 2005.

Sometimes it's possible for a federal court to hear a case involving a state law. These cases are called **diversity jurisdiction**²² cases, and they arise when all plaintiffs in a civil case are from different states than all defendants and the amount claimed by the plaintiffs exceeds seventy-five thousand dollars. Diversity jurisdiction cases allow one party who feels it may not receive a fair trial where its opponent has a "home court" advantage to seek a more neutral forum to hear its case, a process called **removal**²³.

Within both the federal court and the state court system, there is a hierarchy of higher and lower courts. The diagram in [Figure 2.9 "State and Federal Court](#)

Systems" demonstrates this hierarchy. The U.S. Supreme Court is the highest court in the country, and all courts are bound to follow precedent established by the U.S. Supreme Court through the doctrine of **stare decisis**²⁴. Keep in mind, though, that if an issue is exclusively a state matter (such as a state court interpreting its own state's Constitution), then the U.S. Supreme Court has no jurisdiction on that matter, leaving the state supreme court as the highest court on that particular issue.

Figure 2.9 State and Federal Court Systems



On the left-hand side of the diagram is the federal court system. Cases are filed in a U.S. District Court, the trial court in the federal system. Under the court administration system, there are ninety-four judicial districts in the country. Some states with low population have only one judicial district, while more populous states have multiple judicial districts. The districts are named for their geographical location—the federal court in Manhattan, for example, is the U.S. District Court for the Southern District of New York. The U.S. Department of Justice, which acts as the prosecutor representing the federal government in both civil and criminal cases, divides its attorneys among the ninety-four judicial districts, with each district led by a U.S. attorney appointed by the president without any Senate confirmation.

As a trial court, the U.S. district courts hear civil and criminal trials. The trials may be **bench trials**²⁵ (heard only by the judge), or they may be jury trials. At the trial, witnesses are called and their testimonies are recorded, word for word, into a **trial record**²⁶ (transcript of what was said in the courtroom along with supporting documentation). At the conclusion of the trial, if the losing side is unhappy with the

24. Literally, “let the decision stand.” A doctrine that requires lower courts to follow prior precedents in similar cases by higher courts whenever possible.

25. A case heard only by a judge, wherein the judge acts as both trier of law and trier of fact.

26. The transcript of all proceedings related to litigation at a trial court, along with accompanying paperwork such as memoranda and briefs.

outcome, it is entitled as a matter of right to appeal its case to the U.S. Circuit Court of Appeals. There are thirteen circuit courts of appeals in the United States, also spread geographically through the states. A party losing an appeal at the circuit court level can appeal one more time to the U.S. Supreme Court for review, but given the extremely small odds of that appeal being granted, most federal litigation ends at the U.S. circuit court level.

On the right side of the diagram is the state court system. In all fifty states, a trial court of **general jurisdiction**²⁷ accepts most types of civil and criminal cases. These courts are called various names such as superior court, circuit court, or district court. Confusingly, trial courts in New York State are called supreme courts. There may be other courts of **limited jurisdiction**²⁸ at the state level, such as traffic court, juvenile court, family court, or small claims court. Increasingly, states are also experimenting with specialized drug courts to treat drug abuse (not distribution or trafficking) as a health problem rather than a criminal problem. State judges may be either appointed by the governor or elected by the public. Like their federal counterparts, state trial courts hold trials, and most preserve a trial record for review by an appellate court. In thirty-nine states, a party that loses at trial can file an appeal with an intermediate court of appeals. The remaining states are smaller and therefore don't maintain this level of appeal, in which case appeals are filed directly with the state supreme court. In states with an intermediate court of appeals, the party losing the appeal can typically file one more time with the state supreme court, although state supreme court rules vary on whether appeals are a matter of right or discretion. Finally, in certain cases that involve a federal constitutional right, a party that loses at the state supreme court level can appeal to the U.S. Supreme Court for review. These cases are typically criminal and involve the application of the Constitution to criminal procedure, evidence collection, or punishment.

27. The power of a court to hear a broad array of civil and criminal matters without limitation.

28. The type of jurisdiction in which a court is restricted to hearing cases in a specific subject matter or threshold damages amount.

29. A fact-finding entity, such as a jury (or judge in a bench trial).

30. Strictly legal issues, such as which evidence to admit, that are resolved by the judge during a trial.

Whenever an appeal is filed, the trial record is forwarded to the appellate court for review. Appellate courts do not conduct new trials and are unable to recall witnesses or call new witnesses. The trial court's duty is to figure out the facts of the case—who did what, when, why, or how. This process of fact-finding is an important part of the judicial process, and a great deal of deference is placed on the judgment of the fact finder (**trier of fact**²⁹). The trier of fact is typically the jury, or the judge in the case of a bench trial. On appeal, the appellate judge cannot substitute his or her interpretation of the facts for that of the trier of fact, even if the appellate judge believes the trier of fact was wrong. The issues on appeal are therefore limited to **questions of law**³⁰ or legal errors. For example, the appellate court may disagree with the trial judge's interpretation of the meaning of a law, or it may disagree with a ruling the trial judge made about what evidence should be admitted or excluded to the trier of fact.

The deference to the trier of fact (trial court) means that, as a practical matter, appeals are rarely won. Even if a litigant is successful in persuading a court of appeals that legal error has taken place, it doesn't automatically win the case. In most cases, the best remedy a litigant can hope for is for the court of appeals to send the case back to a trial court (a process called **remand**³¹) for reconsideration or perhaps a new trial.

KEY TAKEAWAYS

There are fifty-one separate legal systems in the United States, each with its own executive, legislative, and judicial functions. State constitutions remain a vibrant source of civil rights protections for many citizens because state constitutions are permitted to grant more civil rights (but not less) than the federal Constitution. Subject matter jurisdiction is the authority of a court to hear a case based on its subject matter. State law claims are generally heard in state courts, while federal question cases are generally heard in federal court. Federal courts sometimes hear state law claims under diversity jurisdiction. Federal cases are filed in a U.S. district court and appealed to a U.S. circuit court of appeals. State cases are typically filed in a trial court and appealed to an intermediate court of appeals. The U.S. Supreme Court is the highest court in the country, and all other courts must follow the precedent in Supreme Court opinions. Trial courts are the triers of fact, and their judgment is not questioned by appellate courts. Appellate court review is limited to legal errors.

EXERCISES

1. Do you think that the “home court advantage” that justifies diversity jurisdiction still exists? Why or why not?
2. Should states retain the ability to grant more civil rights than the federal Constitution? Can you think of historical examples of this happening? What implications does this have for the future?
3. Stare decisis requires courts to respect and follow established precedent. Why do you think stare decisis is important in our common-law system? What do you think would happen if courts were not bound to stare decisis?
4. Under what circumstances do you think the Supreme Court should feel comfortable abandoning a prior precedent? Do you think the answer differs depending on whether you believe in judicial originalism or activism?

31. The process of sending a case from an appellate court back to the trial court for further action in accordance with the appellate court's instructions.

2.4 The Certiorari Process

LEARNING OBJECTIVES

1. Understand the Supreme Court's jurisdiction, including what kinds of cases are selected for review.
2. Explore what happens when lower courts of appeal disagree with each other.
3. Learn about the Supreme Court's process in hearing and deciding a case.

Video Clip: The U.S. Supreme Court

[\(click to see video\)](#)

The Supreme Court's jurisdiction is discretionary, not mandatory. This means the justices themselves decide which cases they want to hear. For the justices to hear a case, the losing party from the appeal below must file a petition for a **writ of certiorari**³². During the 2008 term (a **term**³³ begins in October and ends the following June), the Supreme Court received approximately 7,700 petitions. Of these, about 6,100 were **in forma pauperis**³⁴, leaving only approximately 1,600 paid petitions. In forma pauperis petitions are filed by indigent litigants who cannot afford to hire a lawyer to write and file a petition for them. Supreme Court rules permit these petitions to be filed, sometimes handwritten, without any filing fees. These petitions are typically filed by prisoners protesting a condition of their detention or a defect in their conviction and are quickly dismissed by the Supreme Court. Not all in forma pauperis petitions are meritless, however. In the case of *Gideon v. Wainwright*, *Gideon v. Wainwright*, 372 U.S. 335 (1963), a poor defendant convicted of burglary without being represented by a lawyer filed a handwritten in forma pauperis writ of certiorari with the Supreme Court. The Court granted the writ, heard the case, and ruled that Gideon was entitled to have a lawyer represent him and that if he could not afford one, then the government had to pay for one. Gideon was retried with a lawyer's assistance, and he was acquitted and released.

32. A petition filed with a supreme court arguing why the case should be heard.

33. When used by the Supreme Court, a period of time when the Court is in session, from October until June.

34. Leave by a court to indigent litigants to proceed without paying any fees.

Of the 7,700 petitions filed in the 2008 term, 87 cases were eventually argued. With such a large number of petitions filed, and a less than 1 percent acceptance rate, what kind of cases do the justices typically grant? Remember, the Supreme Court is a court of discretionary jurisdiction. It does not exist as a court to right every legal wrong, or to correct every social injustice. Typically, the cases fall into one of three categories. The first category is a case of tremendous national importance, such as the *Bush v. Gore* *Bush v. Gore*, 531 U.S. 98 (2000), case to decide the outcome of the

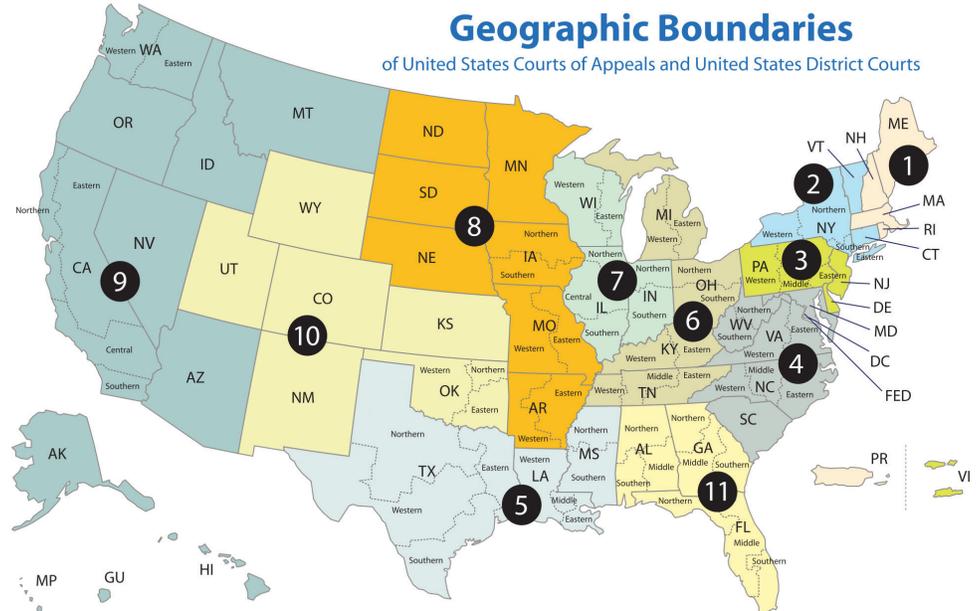
2000 presidential election. These cases are rare, but they dominate headlines on the Supreme Court. Second, the justices typically take on a case when they believe that a lower court has misapplied or misinterpreted a prior Supreme Court precedent. This category is also fairly infrequent. By far, the majority of cases granted by the Supreme Court fall into the third category, the **circuit split**³⁵.

Recall that there are thirteen circuit courts of appeals in the United States (see [Figure 2.10 "Geography of U.S. Federal Courts"](#)). Eleven are divided geographically among the several states and hear cases coming from district courts within their jurisdiction. Thus, for example, someone who loses a case in federal district court in Pennsylvania will appeal his or her case to the Third Circuit Court of Appeals, while a litigant who loses in Florida will appeal his or her case to the Eleventh Circuit Court of Appeals. In addition to the eleven numbered circuit courts, there are two additional specialized courts of appeals. They are both seated in the District of Columbia. The U.S. Court of Appeals for the Federal Circuit is a specialized court that mainly hears appeals involving intellectual property cases, such as those involving patent law. Decisions by this court on patent law are binding on all district courts throughout the country, unless overruled by the Supreme Court. The second specialized court is the U.S. Court of Appeals for the District of Columbia Circuit. Although this appellate court has the smallest geographical area of any court of appeal, it is a very important court as it hears cases against the federal government and the myriad federal agencies in Washington, DC. Chief Justice Roberts, as well as Justices Scalia, Ginsburg, and Thomas, served on this important court before being appointed to the Supreme Court.

A circuit split arises when the circuit courts of appeals disagree with each other on the meaning of federal law. Let's assume that two similar cases are being decided in federal district court at the same time, one in California and the other in South Carolina. The cases present similar facts and involve the same federal law passed by Congress. Both cases are appealed—the California case to the Ninth Circuit and the South Carolina case to the Fourth Circuit. On appeal, it's possible that the two appellate courts may come to opposite conclusions on what the law means, especially if Congress has recently passed the law. Since the circuit court of appeal decision is binding for that circuit, the state and meaning of federal law is different based on where a citizen lives. The Supreme Court is therefore very likely to grant certiorari in this case to resolve the split and decide the meaning of the law for the entire country.

35. A split among the federal circuit courts of appeals on the meaning of a federal law.

Figure 2.10 Geography of U.S. Federal Courts



Source: Photo courtesy of the U.S. Department of Justice, http://en.wikipedia.org/wiki/File:US_Court_of_Appeals_and_District_Court_map.svg.

When a petition for writ of certiorari is filed with the Supreme Court, the party that won the case in the appeal below (called the respondent) files an opposition. Together, these two documents are considered by the justices during one of their weekly conferences to decide whether or not the case should be granted. As previously discussed, cases that fall into one of three categories are generally granted, while others are dismissed. The conference works on the **rule of four**³⁶—only four justices (a minority) need to agree to hear a case for the petition to be granted. The vast majority of cases are dismissed, which means the decision of the lower court stands.

Each Supreme Court justice is permitted to hire up to four law clerks every term to assist with his or her work. These law clerks are typically new attorneys from the nation’s best law schools. Being selected as a clerk is obviously very prestigious, and the job is reserved for the brightest young legal minds. Many justices rely on their clerks to read the thousands of filed petitions and to make recommendations on whether or not to grant the case. This arrangement, called a cert pool (the clerk assigned to the case writes a memo that is circulated to all the justices), has been criticized as giving too much power to inexperienced lawyers. Participation in the cert pool is voluntary and not all the justices participate. Justice Alito, for example, does not participate, and his clerks read all the incoming petitions independently.

36. A Supreme Court rule that only four justices need to agree for a case to be heard.

Until his retirement, Justice Stevens also did not participate in the cert pool process.

If a petition is granted, the parties are then instructed to file written briefs with the Court, laying out arguments of why their side should win. At this point, the Court also allows nonparties to file briefs to inform and persuade the justices. This type of brief, known as an **amicus brief**³⁷, is an important tool for the justices. Many cases before the Supreme Court are of tremendous importance to a broad array of citizens and organizations beyond the petitioner and respondent, and the amicus brief procedure allows all who are interested to have their voice heard. For example, in the 2003 affirmative action cases from the University of Michigan, more than sixty-five amicus briefs were filed in support of the university's policies, from diverse parties such as MTV, General Motors, and retired military leaders.

Hyperlink: Amicus Briefs

http://www.vpcomm.umich.edu/admissions/legal/gru_amicus-ussc/um.html

The University of Michigan affirmative action cases drew national attention to the practice of colleges and universities using race as a factor in deciding whether or not to admit a college applicant. The Supreme Court ultimately held that race may be used as a factor but not as a strict numerical quota. The Court was aided in its decision by numerous amicus briefs urging it to find in favor of the university, including briefs filed by many corporations. Click the link to read some of these briefs and to understand why these companies are strong supporters of affirmative action.

After the justices have read the briefs in the case, they hear oral arguments from both sides. Oral arguments are scheduled for one hour, in the main courtroom of the Supreme Court building. They are open to the public but not televised. Members of the press are given special access on one side of the courtroom, where they are permitted to take handwritten notes; no other electronic aids are permitted. During the oral arguments, the justices are interested not in the attorneys repeating the facts in the briefs but rather in probing the weaknesses of their arguments and the implications should their side win. The justices typically hear two or three cases a day while the Court is in session. Before each day's session, the marshal of the court begins with the invocation in Note 2.58 "Hyperlink: Oyez.org".

37. Also known as friend-of-the-court brief, it is filed by nonlitigants, with permission of the court, to inform and persuade a court.

Hyperlink: Oyez.org

<http://www.oyez.org/media/oyezoyezoyez>

After the oral arguments, the justices once again meet in conference to decide the outcome of the case. Unlike the other branches of government, the justices work alone. No aides or clerks are permitted into their conferences. Once they decide which side should win, they begin the task of drafting their legal opinions. The opinions are the only way that justices communicate with the public and the legal community, so a great deal of thought and care is given to opinion drafting. If the chief justice is with the winning side, he or she decides which justice writes the **majority opinion**³⁸, which becomes the opinion of the Court. The chief justice can use this assignment power wisely by assigning the opinion to a swing or wavering member of the Court to ensure that justice's vote doesn't change. If the chief justice is in the minority, then the most senior of the justices in the majority decides who writes the majority opinion. Dissenting justices are entitled to write their own **dissenting opinions**³⁹, which they do in hopes that one day their view will become the law. Occasionally, a justice may agree with the outcome of the case but disagree with the majority's reasoning, in which case he or she may write a **concurring opinion**⁴⁰. After all the opinions are drafted, the Court hands down the decision to the public. Except in very rare instances, all cases heard in a term are decided in the same term, as the Court maintains no backlog.

KEY TAKEAWAYS

The Supreme Court has discretionary jurisdiction to hear any case it wishes to hear. Every year, the chance of having the Supreme Court hear a particular case is less than 1 percent. The Supreme Court is more likely to hear a case if it involves an issue of national importance, if the Court believes a lower court has misinterpreted precedent, or if the case involves a split in the appellate circuits. A circuit split occurs when two or more federal circuit courts of appeals disagree on the meaning of a federal law, resulting in the law being different depending on where citizens live. Although it takes a majority of justices to vote together to win a case, only a minority decides the Court's docket under the rule of four. The Supreme Court decides cases every term by reading briefs and amicus briefs and by hearing oral arguments. In any case, the Court may issue a majority opinion, dissenting opinions, and concurring opinions.

38. An opinion of the court, usually written by a single judge and joined by other judges who voted the same way.

39. An opinion of a judge who disagrees with the outcome and reasoning employed by the court majority.

40. An opinion written by a judge who agrees with the majority's outcome but disagrees with their reasoning.

EXERCISES

1. Do you believe that Supreme Court oral arguments should be televised, as government proceedings are on C-Span? Why or why not?
2. Do you think the Supreme Court should act more as a court of last resort, especially in serious cases such as capital crimes, or should the Supreme Court continue to accept only a very small number of cases?

2.5 Concluding Thoughts

As the smallest branch of government, and with the shortest founding text in the Constitution among the three branches, the U.S. judiciary faced uncertainty and political interference in its early days. In recent decades, however, the judiciary has matured into an independent and transparent institution, remarkably resilient to political turbulence and attack. It's also a relative bargain for taxpayers, considering its role as the primary interpreter and defender of the Constitution.

None of this has prevented political attacks on the judiciary, which continue to this day. You may recall the Florida case involving Terri Schiavo, a patient in a permanent vegetative state, and what happened when her husband won judicial relief to stop medical measures to keep her alive. Prominent pro-life politicians launched vitriolic attacks on the judges involved. Attacks on the judiciary for politically unpopular decisions have become so toxic that former Supreme Court Justice Sandra Day O'Connor has made it part of her post-Court retirement to stop these attacks and inject more civility into political treatment of judges. While citizen frustration with government is not new, dangerous threats against the judiciary are on the rise and represent a worrying trend.

You may spend your entire life without ever meeting a single judge. If you do have experiences with a judge, you will likely find him or her to be surprisingly human, honest, and above all, fair. The judiciary lacks a natural constituency, so the burden of ensuring the continued success of this American institution falls on all of us, citizens and corporations alike.

Chapter 3

Litigation

LEARNING OBJECTIVES

In this chapter, you will explore our litigation system in detail. Litigation provides an opportunity for each side in a dispute, whether criminal or civil, to lay their side of the story to an impartial jury or judge and ask that jury or judge to decide who wins and loses, and how much the loser should pay or how much time the defendant should spend in jail. After reading this chapter, you should have a deeper understanding of how litigation is conducted in the United States. Specifically, you should be able to answer the following questions:

1. Who are the parties involved in litigation?
2. What is standing and how does it impact litigation?
3. How does a court obtain personal jurisdiction over a defendant?
4. How does a trial progress from beginning to end?
5. How does a losing side appeal a case?

Even if you've never stepped foot in a courtroom before, you can probably describe what a courtroom looks like. It's a large, imposing room with tall ceilings, flags on stands, and wood paneling on the walls. The majority of the floor space is taken up with seating for the public. The front of the courtroom is dominated by the bench, behind which the judge sits, above everyone else in the room. Next to the bench is a solitary chair with a microphone in front of it, where a witness sits. Along one side of the wall is a separated area with two rows of seats, where the jury sits. Facing the bench, and always closest to the jury, is one table for the party that is carrying the burden of proof in the case: the **prosecution**¹ in a criminal trial and the **plaintiff**² in a civil trial. Across the aisle, there is another impressive table for the opposite side, the **defense**³. When court is in session, a hush settles into the room so that everyone can hear the judge, commanding in presence, or the witness, captivating in detail.

Figure 3.1 A Typical Courtroom



© Thinkstock

1. The government's side in a criminal case.
2. The party that starts a lawsuit.
3. The party that responds to a civil or criminal complaint.

Many of us have such clear imagery of a courtroom because our experiences are drawn from popular culture. Whether in movies (*A Civil Action*, *To Kill a Mockingbird*, *Erin Brockovich*), on television shows (*Law & Order*, *L.A. Law*, *Boston Legal*), or in fictional books (*The Firm*, *Twelve Angry Men*), courtroom scenes capture our imagination and fire our sense of righteousness and justice as good always prevails over evil. In our collective courtrooms the truth always comes out, our ideals are always upheld, and the bad guys always lose. Who could forget, for example, the psychological breakdown on the witness stand in the movie *A Few Good Men*, as Jack Nicholson plays it out?

Video Clip: You Can't Handle the Truth

[\(click to see video\)](#)

Scenes like these, while providing wonderful imagery, are pure fiction. In a real courtroom, there is no back-and-forth argument between counsel and witness as examinations proceed through questioning alone. In a real courtroom, the truth doesn't always emerge. In a real courtroom, there are many shades of gray between good and evil. And finally, in a real courtroom, the bad guys don't always lose, and the good guys don't always win.

As future business professionals, your responsibility to your company, to your company's stakeholders, and to yourself is to avoid ever seeing the inside of a courtroom. Acting ethically and legally, and identifying the legal pitfalls that you may encounter by mastering the elements of this course, will help you achieve this goal. Agreeing to arbitration for parties that you have a preexisting relationship with, such as your customers, suppliers, or employees, will also help you stay away from a courtroom. In spite of this planning, however, many companies still find that **litigation**⁴ is sometimes unavoidable. Whether litigation is initiated against parties you don't have a contract with (such as another company that steals your intellectual property rights) or by parties you don't have a contract with (such as a customer who is injured by your product or an employee harassed by another employee), litigation may be the only dispute-resolution mechanism available.

In this chapter we'll explore the process of litigation from the beginning to the end. You'll learn about the parties involved and about preliminary matters such as standing and personal jurisdiction and then explore the trial and appeal. We'll also discuss the role of lawyers and juries in our litigation system. By the end of the chapter, you'll have an appreciation that while our litigation system is cherished for its ability to resolve disputes peacefully and establishes a hallmark for public accessibility, for businesses it is often a far from satisfactory forum for dispute resolution.

4. A lawsuit filed in court to determine liability and remedies.

Key Takeaways

Litigation is an inevitable part of a business's activities. Lawsuits, trials, and appeals can be ruinously expensive for some companies, especially small- and medium-sized enterprises. Learning about our litigation system will give you the skills and comfort you need should your company find itself in litigation.

3.1 The Parties Involved

LEARNING OBJECTIVES

1. Identify the parties involved in litigation.
2. Explore the role of lawyers in our adversarial system.
3. Understand the roles and obligations of jurors.

The litigation system relies on parties bringing forth and defending their respective claims. As in the game of chess, each move can take place only if a player makes a decision to move in a particular direction; the game does not play itself. Courts, jurors, and witnesses are similarly moribund: it is up to the players, in this case called **litigants**⁵, to act decisively. Occasionally, a court may act **sua sponte**⁶, without a direct request from a party. A judge may decide, for example, to fine a party for bad or unethical behavior. These actions are fairly rare. More commonly, judges act on a **motion**⁷ filed by either party asking the judge to make a particular decision.

The party that begins the lawsuit is called the plaintiff in a civil case. The plaintiff is a victim that has presumably suffered some sort of legal wrong that the law recognizes. The plaintiff brings suit against the defendant—the alleged wrongdoer or perpetrator. Note that in a criminal trial, the party that initiates litigation is the prosecution, representing the people of a state or, in federal cases, representing the people of the United States. In a criminal trial the alleged wrongdoer is also called the defendant.

Many cases involve multiple plaintiffs and multiple defendants. Civil procedure encourages, and makes it easy for, parties to air all their grievances against each other at once. All parties, and every possible **claim**⁸ (each claim is a separate violation of law) arising out of a single incident or series of related incidents, should be identified and named in a lawsuit. For example, if you go to an off-campus party one night and witness a friend being harassed, you might feel the need to step in to defend your friend. The harasser may then turn his attention toward you, perhaps taking a swing at you. Let's assume that the harasser is drunk and misses, but in return you take a swing and hit him, knocking him to the ground. The harasser may file a lawsuit against you, alleging assault and battery. The harasser is the plaintiff, and you are the defendant. The lawsuit filed in court would be captioned *Harasser v. You*. You might decide in return to file a claim against the harasser, alleging that the harasser started the fight and that you acted in self-defense. This is called a

5. Parties in litigation.

6. Latin for “of its own accord,” an action by a court without motion by the parties.

7. Any request to a court for the court to take a specific action.

8. Any legal right to seek a remedy for a wrong.

counterclaim⁹, and you are now the **counterplaintiff**¹⁰, making the harasser the **counterdefendant**¹¹. In return, the harasser may allege that he wasn't really harassing your friend but trying to defend himself from your friend's unwanted advances. The harasser may sue your friend as a third-party defendant through a process called **joinder**¹².

Except in some small-claims courts, parties hire attorneys to litigate most cases. Sometimes individuals feel like they have a sufficient grasp on the law to proceed in litigation without a lawyer or that they have sufficient legal training (or even a law degree) that hiring a lawyer would be a waste of money. Individuals who represent themselves are called **pro se**¹³ litigants and can only proceed pro se if the judge overseeing the case allows it. Abraham Lincoln once famously said, "He who represents himself has a fool for a client." The complexities of litigation require a cool and detached mind to thread a route to success, and if you are representing yourself it is all too easy to allow passion to cloud your judgment.

Attorneys are sometimes called members of the **bar**¹⁴. The U.S. legal profession is unique in several respects. In most countries, legal education is an undergraduate program followed by a period of apprenticeship before an individual is allowed to practice law. Many countries also make a distinction between attorneys who litigate in court and those who do not. In the United Kingdom, for example, solicitors are lawyers who deal with ordinary legal matters outside of court, while Queen's Counsel (QC) are specially trained lawyers who are permitted to argue in court. In the United States, lawyers undertake three years of graduate study resulting in the award of the **Juris Doctorate**¹⁵ degree, or JD. Every year, more than thirty thousand students graduate from U.S. law schools with their JD. They then sit for the bar exam in the state where they wish to practice. Since the practice of law in the United States varies widely by different jurisdictions, lawyers are only permitted to practice in jurisdictions where they are licensed. Some states permit lawyers from out of state, after a few years of being in practice, to apply for bar admission without taking the exam through a process called reciprocity. Other states, notably California and Florida, require attorneys to take the bar exam no matter how long they have been in practice. If a lawyer is dealing with an issue or matter that takes him or her out of state to litigate a case, he or she can ask to be admitted temporarily by a court in that foreign state through a motion called **pro hac vice**¹⁶. Once the lawyer passes the state's bar exam or is otherwise admitted, he or she is permitted to practice all aspects of law in that state, from drafting wills and contracts to arguing a case before the U.S. Supreme Court.

Attorneys in the United States are broadly divided into civil and criminal attorneys; few lawyers excel in both areas. Civil attorneys generally work in two different categories: in law firms, where they may represent multiple clients, and as **in-house counsel**¹⁷, where they represent only one client, their employer. Most large

9. A claim by a defendant against the plaintiff.
10. The original defendant in a lawsuit, when asserting a claim against the plaintiff.
11. The original plaintiff in a lawsuit, when sued in return by the defendant.
12. Joining of parties or claims in litigation.
13. Latin for "on one's own behalf," a litigant representing herself without an attorney.
14. A body of attorneys and judges.
15. A professional degree and doctorate in law, required for practicing law in the United States.
16. Latin for "for this occasion," a motion allowing out-of-state attorneys to practice in-state for a specific case or matter.
17. The attorney employed by and representing only one enterprise.

corporations have an in-house legal department to control legal costs but may still hire **outside counsel**¹⁸ for representation and advice in complex matters.

With the possible exception of politicians, no other profession is subject to more morbid jokes than lawyering. William Shakespeare famously wrote in *Henry VI*, through a character speaking of a utopian world, “The first thing we do, let’s kill all the lawyers.” In spite of this public animosity toward lawyers, however, if there comes a time when someone needs a lawyer, it’s not uncommon to hear them wish they had the most aggressive lawyer money can buy.

Perhaps part of the reason the public has a low opinion of lawyers can be traced to the ethical and legal obligations of attorneys. Lawyers may be the most regulated of all the professional industries, and they are required to comply with complex and sometimes rigid **rules of professional conduct**¹⁹. Unlike rules for other professions, the rules of professional conduct for lawyers are largely drafted and enforced by the bar itself (other lawyers and judges) and almost never involve external enforcement mechanisms. These rules govern virtually every aspect of the practice of law, and a violation of these rules can result in disciplinary action from the state bar or supreme court of the state in which the lawyer practices, up to lifetime disbarment. When President Bill Clinton, for example, lied under oath about certain aspects of his extramarital affairs, he was suspended from practicing law for five years in Arkansas and ordered to pay a \$25,000 fine. These rules of professional responsibility require attorneys to represent their clients with zealous advocacy. Ordinarily, we associate the word “zealot” with extremists, but that is the standard by which lawyers must represent their clients. This might clarify why some lawyers act the way they do.

18. Law firm attorneys representing a company or other enterprise.
19. Rules for attorney conduct issued by a licensing entity such as a state bar or supreme court. The American Bar Association issues a set of Model Rules of Professional Conduct for attorneys nationwide, which can be found at <http://www.abanet.org/cpr/mrpc/mrpc.toc.html>.
20. A doctrine that requires all communications between client and attorney be kept secret by the attorney from any disclosure to any person.
21. A doctrine protecting communications between spouses from disclosure in court.
22. A doctrine that prevents medical personnel from testifying in court about their patients’ communications with them.
23. A doctrine protecting communications between clergy and penitent from disclosure.

One of the most sacrosanct rules of professional responsibility is the obligation to keep a client’s secrets. The communications between a client and his or her attorney are absolutely confidential under the **attorney-client privilege**²⁰ doctrine. There are many privileges under the law, such as the **spousal privilege**²¹, **doctor-patient privilege**²², and **priest-penitent privilege**²³. The attorney-client privilege, however, is arguably the strongest of these privileges. The privilege belongs to the client, and the attorney is not permitted to reveal any of these communications without the client’s consent. A narrow exception exists for clients who tell their lawyers they intend to harm others or themselves, but attorneys must tread very carefully to avoid violating the privilege. Many members of the public feel that the privilege may be open to abuse and can’t understand, for example, why an attorney can’t reveal a client’s confession to a heinous crime. Ultimately, the privilege exists for the client’s benefit. Someone who cannot communicate with his or her attorney freely is unable to help the attorney prepare the best possible case for litigation. You should note that in-house attorneys represent the corporations they work for and not individual employees. If you

communicate with an in-house attorney for the company where you work, for example, that communication may not be automatically protected by the attorney-client privilege.

Hyperlink: The Lynne Stewart Case

<http://www.lynnestewart.org>

Lynne Stewart, a human rights attorney, was assigned to represent Sheik Omar Abdel-Rahman, the blind Egyptian cleric convicted of conspiracy in the 1993 World Trade Center bombing in New York City. As part of her representation, she agreed to abide by certain conditions when communicating with her client, including not speaking to the media. Ms. Stewart broke those promises and inadvertently passed on a communication from her client to his followers around the world. She was indicted and convicted of conspiracy and providing material support to terrorists. She was sentenced to a twenty-eight-month prison term. Click the link to read more about her case, including the legal documents involved. A very controversial aspect of the case involved the use of secret cameras and recorders to listen in on her conversations with her client while he was in prison.

Figure 3.2
Lynne Stewart



Source: Photo courtesy of Robert B. Livingston,
[http://en.wikipedia.org/wiki/
File:Lynne_Stewart.JPG](http://en.wikipedia.org/wiki/File:Lynne_Stewart.JPG).

24. The highest duty of any attorney.

In spite of an attorney's professional obligations to his or her client, it's important to remember that ultimately a lawyer's first duty is to the **administration of justice**²⁴. The rules of professional conduct are written with this goal in mind. The

requirements for lawyers on civility, honesty, and fairness are all written to ensure that lawyers represent the very best aspects of our judicial system. Let's say, for example, a client admits to his lawyer that he is guilty or liable in a case. The client then wants to testify under oath that he is innocent. Although a lawyer cannot tell anyone what her client has told her, the lawyer is also prohibited from knowingly suborning **perjury**²⁵. The attorney must either convince the client to not testify, or withdraw from the case.

In the case in [Note 3.31 "Hyperlink: A Question of Ethics"](#), an attorney goes a little too far in her representation and draws a heavy fine from a judge as a result.

25. Lying under oath.

Hyperlink: A Question of Ethics

The Case of the Birther Attorney

Order Hon. Clay D. Land, U.S. District Judge, District Court for the Middle District of Georgia, Case No. 4:09-CV-106, *Rhodes v. MacDonald*, at <http://www.scribd.com/doc/20996403/Gov-uscourts-gamd-77605-28-0>.

Throughout the presidential election campaign in 2008, persistent rumors swirled around whether Barack Obama was born in the United States, a requirement under the Constitution to serve as president. After the election, California attorney Orly Taitz launched a campaign to prove that the president was not, in fact, born in Hawaii. Her bizarre tirades against the media and the courts earned her this unusual reprimand from a federal judge. Click the link to read the entire order. Do you believe that in their “zealous” representation of their clients, attorneys have the ethical duty to pursue claims such as these?

Order

Introduction

Commenting on the special privilege granted to lawyers and the corresponding duty imposed on them, Justice Cardozo once observed, “Membership in the bar is a privilege burdened with conditions. [A lawyer is] received into that ancient fellowship for something more than private gain. He [becomes] an officer of the court, and, like the court itself, an instrument or agency to advance the ends of justice.” Competent and ethical lawyers “are essential to the primary governmental function of administering justice.” For justice to be administered efficiently and justly, lawyers must understand the conditions that govern their privilege to practice law. Lawyers who do not understand those conditions are at best woefully unprepared to practice the profession and at worst a menace to it.

When a lawyer files complaints and motions without a reasonable basis for believing that they are supported by existing law or a modification or extension of existing law, that lawyer abuses her privilege to practice law. When a lawyer uses the courts as a platform for a political agenda disconnected from any legitimate legal cause of action, that lawyer abuses her privilege to practice

law. When a lawyer personally attacks opposing parties and disrespects the integrity of the judiciary, that lawyer abuses her privilege to practice law. When a lawyer recklessly accuses a judge of violating the Judicial Code of Conduct with no supporting evidence beyond her dissatisfaction with the judge's rulings, that lawyer abuses her privilege to practice law. When a lawyer abuses her privilege to practice law, that lawyer ceases to advance her cause or the ends of justice.

It is irrefutable that a lawyer owes her client zealous advocacy, but her zeal must be constrained within the bounds placed on her as an officer of the Court and under the Court's rules. Specifically, Rule 11 of the Federal Rules of Civil Procedure expressly sets forth the outer boundaries of acceptable attorney conduct. That rule prohibits a lawyer from asserting claims or legal positions that are not well-founded under existing law or through the modification, extension, or expansion of existing law. Rule 11 also prohibits an attorney from using the courts for a purpose unrelated to the resolution of a legitimate legal cause of action.

Regrettably, the conduct of counsel Orly Taitz has crossed these lines, and Ms. Taitz must be sanctioned for her misconduct. After a full review of the sanctionable conduct, counsel's conduct leading up to that conduct, and counsel's response to the Court's show cause order, the Court finds that a monetary penalty of \$20,000.00 shall be imposed upon counsel Orly Taitz as punishment for her misconduct, as a deterrent to prevent future misconduct, and to protect the integrity of the Court. Payment shall be made to the United States, through the Middle District of Georgia Clerk's Office, within thirty days of today's Order. If counsel fails to pay the sanction due, the U.S. Attorney will be authorized to commence collection proceedings. The Court does not take this action lightly, and in fact, cannot recall having previously imposed monetary sanctions upon an attorney sua sponte.

As the Orly Taitz case demonstrates, attorneys must take care to respect a court's authority at all times and conduct themselves in a civil manner. Most attorneys have no problem discharging this obligation to the judge, but it is to the jury that they focus their attention the most. In our legal system, the jury has a very special role to play in ensuring citizen participation in the administration of justice. As the trier of fact, the jury has the duty of determining the truth in any given situation: who said and did what, why, and when?

Do you know when someone is lying to you? Have you ever been lied to so well that you didn't find out about the lie until much later? Have your roommates or friends who were involved in a dispute ever asked you to decide who should win? In essence, being a juror relies on those same human skills. In every legal proceeding, each of two adversarial sides, absolutely opposed to each other, claims that it is right and the other side is wrong. Our litigation system is a process by which each side gets to present its case to a group of stranger citizens, and then ask them to decide who is lying and who is telling the truth.

There are two types of juries. A **grand jury**²⁶ is a group of citizens convened by the prosecution in serious criminal cases to simply determine whether there is probable cause to believe that a crime has occurred and whether it's more likely than not that the defendant in question committed the crime. The grand jury serves as a procedural step to prevent prosecutors from abusing their powers of arrest and indictment, a sort of "sanity check" on the awesome power of government to accuse citizens of crime. The grand jury requirement exists at the federal level and in some, but not all, states. A grand jury typically meets for an extended period of time and can hear several different cases in one day.

The grand jury does not determine guilt or innocence. A **petit jury**²⁷ does that. This jury is impaneled for a specific trial. During the trial, members of the jury listen to the evidence presented and then deliberate as a group on what they believe the facts of the case are. They then apply the law, as instructed by the judge, to the facts. There are typically twelve members in a petit jury in criminal trials and from six to twelve members in civil trials, and generally speaking they must arrive at a unanimous verdict.

The jury system is a jewel in our litigation system for it involves ordinary citizens in adjudicating all sorts of disputes, from domestic family issues to complex business and insurance litigation to heart-wrenching criminal cases. There are problems with administering this system, however.

Both grand and petit juries are drawn from citizen voter and driver license rolls. In high-profile cases, it may be difficult to find citizens who have not heard about the case or who can be impartial about the case, in spite of their promises to be open minded. When Enron collapsed in 2001, for example, defense attorneys for former CEO Jeff Skilling argued strenuously that the trial should not be held in Houston, where almost every citizen was affected in some way by the energy giant's collapse or knew someone affected. The question of juror bias was so serious that the U.S. Supreme Court agreed to hear Skilling's appeal based partially on this argument. Although the Court eventually found that Skilling's jury was adequately impartial, Justice Sotomayor noted in a dissenting opinion that the "deep seated animosity

26. A body of citizens examining whether someone accused of a crime should be formally charged.

27. A body of citizens determining guilt or innocence in a criminal trial or liability in a civil trial.

that pervaded the community at large” caused her great concern. *Skilling v. United States*, 561 U.S. ___ (2010), <http://www.supremecourt.gov/opinions/09pdf/08-1394.pdf> (accessed October 2, 2010).

Another problem arises from the burdens placed on jurors’ personal lives through their service. While most states have laws that prevent an employer from firing a worker or taking any negative work action, such as demotion, against the worker for being on jury duty, there is no legal requirement that an employer continue to pay a worker on jury duty. The court system does not pay juries for their services either (although some court systems pay a small amount, typically less than twenty dollars per day, to cover food and transportation costs). Some citizens, such as those who are self-employed, are therefore at great risk for losing personal income by serving on juries. Imagine being on the O. J. Simpson criminal trial jury, for example—that trial lasted ten months. The effects of jury service on a juror’s personal life can be staggering.

Another potential problem arises in the makeup of the jury itself. To provide a fair jury, courts attempt to draw from a cross-section of society to reflect the diversity of the surrounding community. Local court rules typically allow judges to excuse potential jurors for hardship or extreme inconvenience. If these rules are too generous, then the only citizens left may be those without full-time employment, such as students or retirees. Such a narrow cross-section of society would tend to skew the reliability and trust of the jury system, and judges across the country are becoming increasingly intolerant of attempts to evade jury service. The only professions that automatically exempt citizens from jury duty are active-duty soldiers, police officers and firefighters, and public officers.

In spite of these administrative problems, our jury system remains a cornerstone of litigation and is often openly admired. In South Korea, for example, attempts to create a more open and responsive democracy resulted in a novel and wholesale revision to the country’s court system: the adoption of citizen juries.

Hyperlink: Korea Adopts Jury System

<http://www.nytimes.com/2008/07/07/world/asia/07iht-jury.2.14299454.html>

In 2007, with little public debate or preparation, South Korea adopted a jury system in certain criminal and civil trials. For now, the jury's decision is only advisory, and the court is free to reject it. The result has been some confusion about the role of citizens in the legal system, some concern about the methodology employed to implement the jury system, and an increase in transparency and greater citizen participation in government affairs.

KEY TAKEAWAYS

The federal rules of civil procedure make it easy for parties in a lawsuit to identify and join other relevant parties and to make legal claims against each other. The goal of civil litigation is to find the truth. Litigants typically rely on lawyers to assist them in litigation. An attorney's highest duty is to the administration of justice. Lawyers are ethically bound to represent their clients with zealous advocacy. A grand jury acts as a body of citizens to prevent abuse of discretion by prosecutors. A petit jury sits in trials as the trier of fact to ascertain the truth through their observations of the presented evidence.

EXERCISES

1. Can you think of a situation where an in-house attorney may advise you to retain your own counsel?
2. Most rules of legal professional conduct are drafted and enforced by the bar itself, but the Sarbanes-Oxley Act (passed in reaction to the Enron accounting scandal) imposed a legal duty on lawyers to report acts of misconduct in publicly traded corporations. Do you believe that the bar does an effective job of policing itself, or do you think external government agencies should be more involved?
3. Read the legal documents available for the Lynne Stewart case at [Note 3.28 "Hyperlink: The Lynne Stewart Case"](#). Do you think that the U.S. government should be able to curb the attorney-client privilege when the client is a convicted terrorist? Or a suspected terrorist?
4. How aggressive should a lawyer be in representing his or her client "zealously"? Read the rest of Judge Land's order in [Note 3.31 "Hyperlink: A Question of Ethics"](#). Do you think Orly Taitz's conduct warranted a twenty-thousand-dollar fine?
5. Do you think that juries can be trusted to always arrive at the truth? Why or why not?
6. Do you think the U.S. jury system should be adopted by other countries? What factors do you think should affect a country's decision to adopt a jury system?

3.2 Standing and Personal Jurisdiction

LEARNING OBJECTIVES

1. Explore the standing requirement.
2. Understand how a court obtains personal jurisdiction over the parties.

Before a case can be litigated, parties have to demonstrate that they meet two pretrial requirements: standing and personal jurisdiction.

Standing²⁸ is a constitutional requirement. Article III of the Constitution grants the judiciary the power to hear “cases” and “controversies.” This means actual cases and controversies, not merely hypothetical ones. Unlike some other jurisdictions, the standing requirement means that courts are unable to give advisory opinions. Let’s say, for example, Congress is considering whether or not to pass a law and would like to know whether the law is constitutional. Standing prevents this question from being litigated, because it’s not yet an actual case or controversy. Standing, therefore, is a doctrine that limits judicial overreach by circumscribing the types of cases that are litigated in our courts.

To demonstrate standing, a party has to prove first that it has an actual case to proceed. This is a procedural matter, and it requires the case to be brought at the right time. If a case is brought too early, it’s not yet **ripe**²⁹. If it’s brought too late, then the case is **moot**³⁰. For example, assume that a state is debating whether or not to pass a law that would require thirty hours of financial management classes before anyone is allowed to form his or her own company. If an entrepreneur who wishes to form her own company but doesn’t want to take the thirty hours of classes sues the state for an unconstitutional law, that lawsuit would be dismissed for being brought too early—it is not ripe since the law hasn’t been passed yet. Now let’s assume that the law has been passed, and the entrepreneur, who has abandoned her plans and is now working for someone else, sues the state anyway. That lawsuit would also be dismissed since it is now moot. Even if the entrepreneur won the case and the law was overturned, the remedy would be meaningless to her since she does not plan to take the class anyway.

In addition to being brought at the right time, the case has to be brought by the right person. To show standing, a plaintiff has to demonstrate that he has an actual stake in the litigation, or something of value that would be lost if he loses the case. Of course, if a plaintiff has lost money in a contract dispute or has been injured in a

28. The Constitutional requirement for the right plaintiff to bring a claim at the right time in litigation.

29. A claim ready for litigation.

30. Abstract and theoretical. In standing cases, a case is moot if granting the remedy asked would not help the plaintiff.

tort case, that is sufficient legal injury. Let's say, for example, that your roommate is the victim of Internet fraud when she does not receive the goods that she paid for online. She would rather move on and forget the whole episode, but you are outraged and decide to sue the perpetrator in court. Even if the perpetrator admitted that it committed fraud, you would still lose the case because you're not the right plaintiff here; your roommate is.

Cases that don't involve monetary damages are sometimes more difficult to call. For example, what if a constitutional right is at stake? What standing does a citizen have to prove to file a lawsuit? Courts have generally held that merely being a taxpayer does not give standing to challenge government expenditures. So, for example, a citizen cannot sue the government to stop the war in Afghanistan just because he pays his taxes. If taxpayers don't have standing to challenge government action, then who does?

In 2007 Massachusetts, along with eleven other states, sued the Environmental Protection Agency (EPA) to force the agency to regulate carbon dioxide as a pollutant. For years, the EPA had argued that carbon dioxide is not a pollutant and therefore could not be regulated. In response to the suit, the EPA argued that the states lacked standing since they couldn't prove they had been harmed by excess carbon dioxide in the air. In a major decision, *Massachusetts v. EPA*, 549 U.S. 497 (2007), the Supreme Court ruled that the states had standing because they had suffered environmental degradation as a result of global warming brought about by excess carbon dioxide and that therefore the EPA has jurisdiction over carbon dioxide as a pollutant. This decision, along with the election of President Obama, led to a major policy reversal at the EPA, which is now aggressively pursuing the regulation of carbon pollution to combat global warming.

Another high-profile case on standing involves the Pledge of Allegiance. In 2000 a California attorney and physician sued the government because his daughter attended a school where the Pledge of Allegiance was recited every morning. The plaintiff, Michael Newdow, claimed that the pledge is unconstitutional under the First Amendment because it contains the words "under God." In 2002 the Ninth Circuit Court of Appeals agreed with Newdow, ruling that the pledge is indeed unconstitutional. On appeal to the Supreme Court, the Court ducked the question of whether the pledge is unconstitutional. *Elk Grove Unified School District v. Newdow*, 542 U.S. 1 (2004). Instead, the Court held that Newdow lacked standing to bring the lawsuit in the first place since he is a noncustodial parent. Only his wife, who had custody of the daughter, could bring the lawsuit.

It's important to note that standing doesn't have anything to do with the merits of the case. Being able to prove standing doesn't mean that you can win the case at

hand. It only means that you've been able to clear a procedural bar toward proceeding with litigation.

Another procedural bar before a plaintiff can proceed is **personal jurisdiction**³¹. Personal jurisdiction is different from subject matter jurisdiction, which is the power of a court to hear a case. Personal jurisdiction is the power of a court over specific litigants, and it requires litigants to have some form of **minimum contacts**³² with the state where the case is filed. Personal jurisdiction seeks to avoid inconvenient litigation, even if the case has actual merit. If you've never been to Nebraska, for example, and don't have any connections to Nebraska, then you might be very surprised to find that you're being sued in a Nebraska state court. In addition to that, you'd have to go to Nebraska to answer the lawsuit, hire local lawyers to assist you, and spend a lot of time and money in a state you have nothing to do with.

A court obtains personal jurisdiction over the plaintiff when the plaintiff files its lawsuit. Obtaining personal jurisdiction over the defendant can be a little trickier. Typically, there has to be some sort of connection between the defendant and the state where the court is located. For example, living in the state would create personal jurisdiction. Residency for purposes of personal jurisdiction is different from residency for other legal requirements such as voting and driving. Even temporary residency, such as a college student studying out of state, creates residency for personal jurisdiction purposes. Moreover, merely being in the state temporarily creates personal jurisdiction. If you're driving through Nebraska, for example, and you're speeding on a local highway, Nebraska courts have jurisdiction to hear a speeding ticket issued against you. Owning property in a state also creates jurisdiction. For corporations, courts generally hold that personal jurisdiction is proper in the state of incorporation as well as in any state the corporation does business.

Personal jurisdiction, like standing, is a constitutional requirement. The due process clause of the Fourteenth Amendment requires government processes to be carried out fairly. In 1980, the Supreme Court heard an important case on personal jurisdiction involving a car crash in Oklahoma. *World-Wide Volkswagen v. Woodson*, 444 U.S. 286 (1980). The plaintiff purchased the car in New York and filed a lawsuit against the manufacturer (Volkswagen) and the distributor and retailer (car dealer). The distributor and the retailer moved to dismiss the case for lack of personal jurisdiction, arguing that they had no business in Oklahoma, had no employees or property there, and did not target citizens of Oklahoma to purchase vehicles from them in New York. The Supreme Court held in favor of the distributor and car dealer, finding that neither had "purposefully availed" themselves of the privileges that come from doing business in Oklahoma. The Court noted that for

31. A court's jurisdiction over parties in litigation.

32. The Constitutional requirement for some form of contact with a forum state before the proper exercise of personal jurisdiction.

personal jurisdiction to attach, “substantial notions of fair play and justice” cannot be offended.

Today, most states have written these concepts into laws known as **long-arm statutes**³³. These statutes set forth the procedure by which out-of-state defendants can be required to appear before a local court. The statutes provide for how service of process can occur. **Service of process**³⁴ is the process by which any defendant (both local and out-of-state) is notified that it is being sued. Service of process typically requires a copy of the **summons**³⁵ (notice to appear before a court) to be personally delivered to the defendant or the defendant’s agent. In the case of companies and other nonhuman entities, service of process is usually easy since they are required to have a registered agent as part of the process of forming an organization. Service can be more challenging with an individual, since some defendants know that litigation can be held up while service is attempted and therefore choose to avoid being served at all costs. While the best service is personal delivery of the summons, some states prescribe alternative methods such as leaving a copy with a family member while also mailing a copy.

The Internet era has raised some interesting personal jurisdiction issues. Does creating a Web site, for example, subject you to personal jurisdiction in all states where the Web site is accessible? Courts have ruled that the answer depends on what kind of Web site you have created. If it is a general informational Web site that describes a product, then there are insufficient minimum contacts to create personal jurisdiction. If, on the other hand, the Web site reaches out to specific customers and urges them to make a purchase, either through a shopping cart function or by calling the seller, then there are minimum contacts to justify jurisdiction.

33. State laws allowing service of process on an out-of-state defendant with some form of minimum contact with the state.

34. The procedure to give legal notice to a litigant that a court is exercising personal jurisdiction over that person.

35. A judicial order to appear before a court.

KEY TAKEAWAYS

Standing is a constitutional requirement that requires a plaintiff prove that he or she is the right person to bring a lawsuit and that he or she is bringing the lawsuit at the right time. Taxpayers lack standing to sue the government just by being taxpayers. Legal injury does not have to be monetary based; environmental harm, for example, may be sufficient to demonstrate standing. Standing has nothing to do with the merits of the underlying case. Courts must have personal jurisdiction over a defendant before litigation can proceed. Personal jurisdiction, a constitutional requirement, requires minimum contacts with the state such that substantial notions of fair play and justice are not offended. Once personal jurisdiction is established, service of process can occur, where a copy of the summons is delivered to the defendant. If the defendant lives out of state, a long-arm statute prescribes the method for service to occur. A Web site creates personal jurisdiction in any state where it reaches out for customers through a shopping cart function.

EXERCISES

1. When President Obama nominated Hillary Clinton as secretary of state in 2008, several constitutional scholars observed that it may be unconstitutional for her to assume the post due to an often-ignored section of the Constitution. What procedural bar stopped citizens from challenging the nomination?
2. Do you believe the Supreme Court acted properly by finding that states with environmental damage from global warming had standing to challenge the federal government?
3. In the Volkswagen car crash case, the manufacturer (Volkswagen, a German company) and the importer did not contest personal jurisdiction of Oklahoma state courts. Why do you think they submitted to jurisdiction so readily?
4. If a car dealer in a neighboring state runs advertisements in your state claiming that its deals are better than those of in-state dealers, does that out-of-state car dealer create personal jurisdiction in your state?
5. If you sell something on eBay, do you create personal jurisdiction in the buyer's state? Why or why not?
6. If you commit a tort on the Internet, do you create personal jurisdiction in the victim's state? For example, if you defamed someone who lives out of state on Facebook, have you created jurisdiction in that foreign state?

3.3 Pretrial Procedures

LEARNING OBJECTIVES

1. Explore pretrial procedures such as pleadings, discovery, and motions.
2. Find out how class-action lawsuits are organized and prosecuted.
3. Learn about issues and challenges facing parties during discovery.

After issues related to subject matter jurisdiction, standing, and personal jurisdiction are sorted out and parties have hired counsel to represent them, then a dispute can proceed to the pretrial stage. In civil cases, litigation begins with the filing of a **complaint**³⁶ by the plaintiff. The complaint is a simple document setting forth who the parties are, the facts of the case, and what specific laws the defendant has violated. (Each of these is a claim.) The complaint ends with a **prayer for relief**³⁷. The plaintiff may be seeking **damages**³⁸ (money), **specific performance**³⁹ in certain kinds of contract cases, or a temporary or permanent **injunction**⁴⁰. It is much easier to get a temporary injunction in the early stages of litigation, because courts don't want to see the defendant take some action that may result in **irreparable harm**⁴¹. For example, if a real estate development company wants to tear down an old shopping mall to build a new skyscraper, and one of the tenants in the old mall claims it still has a right to be there, the tenant may be able to obtain a temporary injunction stopping the demolition until the lease issues are sorted out. If the demolition is allowed to continue and the tenant later turns out to be the winner, it will be too late to grant the tenant any meaningful remedy.

36. The initial document that starts the lawsuit by setting forth the plaintiff's claims.
37. A claim by the plaintiff for damages sought from the defendant.
38. Loss suffered by plaintiff, typically expressed in terms of money.
39. A nonmonetary remedy available in certain cases whereby the defendant is ordered to perform the specific act agreed to in a contract.
40. An order by a court to a party to do something or to stop doing something.
41. A type of injury that cannot be corrected by money or by putting things back to where they were.
42. Lacking in legal merit.

Citizen advocacy groups with an antilitigation public policy agenda often complain about **frivolous**⁴² lawsuits being filed in court. Most court systems have rules to prevent the filing of frivolous suits. In the federal system, the rules state that all claims must be signed by a lawyer certifying that to the "best of the person's knowledge," formed after "an inquiry reasonable under the circumstances," the claim is not being presented for an unlawful purpose such as harassment and that the claims are either "warranted by existing law" or a nonfrivolous argument for modifying existing law. In practice, this standard is quite easy to meet, and it's hard to think of a factual scenario—other than the most absurd—that would rise to the level of being legally frivolous.

The complaint is filed with the clerk of the court where the suit is to be heard. Every court has a clerk's office to handle administrative matters relating to

litigation. Even though the court system is a public service, there is usually a fee associated with filing a complaint to cover some of the court's costs.

The clerk will next issue a summons to the defendant, along with a copy of the complaint. The summons is sent to a process server to effect service on the defendant. When the defendant is served, it is very important for the defendant to respond to the complaint in a timely manner. Ignoring the complaint, even if the defendant believes the complaint is devoid of any merit, is a fatal error. If the defendant does not reply to the complaint, the plaintiff can ask the court to issue a **default judgment**⁴³ against the defendant, including granting all the relief the plaintiff is asking for.

In certain types of cases, there may be a large number of plaintiffs injured by a defendant's actions. This may happen in a product liability lawsuit where a product is purchased by many thousands of consumers, all of whom experience the same product failure. The batteries for Apple's popular iPod, for example, had a high failure rate, leading to a large number of consumer claims. There also may be a large number of plaintiffs in financial services cases, where a financial institution or investment firm defrauds a large number of investors. In these cases, several **lead plaintiffs**⁴⁴ may attempt to form a class in a **class-action**⁴⁵ lawsuit against the defendants. Under federal civil procedure rules, class actions may be granted when there are so many plaintiffs that it is impractical for them to file separate lawsuits, there are questions of law or fact that are common to members of the class, and the lead plaintiffs will fairly and adequately protect the interests of the class.

43. A judgment entered against a party for misconduct or failure to answer.

44. In a class-action suit, the representative plaintiffs of the class.

45. Describes a lawsuit in which a representative plaintiff represents an entire class of similarly situated plaintiffs against the defendant.

46. The defendant's written response in civil suit to the plaintiff's complaint.

47. A defense that does not deny the defendant's actions but provides a reason or justification, such as self-defense.

48. The complaint, answer, and any supporting documentation.

The defendant must file an **answer**⁴⁶ to the complaint within a specified period of time, typically thirty days. The answer is a paragraph-by-paragraph response to the complaint, admitting certain paragraphs and denying others. The answer may also contain an **affirmative defense**⁴⁷ (self-defense in an assault charge, for example) the defendant wishes to pursue. Taken together, the complaint and answer are known as the **pleadings**⁴⁸. The answer may admit, for example, noncontroversial claims by the plaintiff such as the defendant's name, address, and the nature of the defendant's relationship with the plaintiff. Each time the defendant denies a plaintiff's claim in the complaint, that sets up a controversy or argument that must be litigated. Reducing the number of claims to be resolved before an actual trial begins makes the trial shorter. For example, in many civil cases, the plaintiff will make claims about liability and damages. A defendant may be willing to admit that it is liable but may argue about the plaintiff's claims for damages. This can sometimes lead to bifurcated trials, where the issues of liability and damages are litigated separately.

At any point in litigation, either party may file motions with the court. The motions are designed to short-circuit the litigation and lead to an early end to the lawsuit. Litigation is so time consuming and expensive that either party would be gratified if the judge would simply cut the lawsuit short and declare a winner. One such motion is the motion to dismiss for failure to state a cause of action. In this motion, the defendant argues that even if it admits everything in the complaint is factually true, that doesn't lead to any legal liability. In other words, the defendant's conduct has not broken any laws. A similar motion is the motion for judgment on the pleadings. In this motion, one party asks the judge to decide the case based simply on the answer and complaint.

If a long period of time has passed since the incident in question and the filing of the lawsuit, a defendant may file a motion to dismiss based on the statute of limitations. Every civil and criminal action has a **statute of limitations**⁴⁹, which states that any claim or prosecution under the statute must be brought within a specified period of time or it will be dismissed. Only a few crimes are exempt from the statute of limitations and can be prosecuted at any time: murder (in most states) and rape (in many states). The statute of limitations exists to encourage aggrieved parties to file their lawsuits quickly, while evidence is still fresh and relevant people have memories of what occurred. As time passes, evidence may become stale, witnesses may die or move away, and those that can be located can't remember what they saw or heard. In other words, the quicker a suit is filed, the more likely that the real truth will be discovered by litigation. For businesses, a statute of limitations also allows it to "close the books" on past liabilities, such as accounts payable or tax payments, knowing that too much time has passed for anyone to come collecting on those monies. It is possible, though, in many cases to **toll**⁵⁰ the statute of limitations. If an accountant commits fraud, for example, and a criminal complaint is filed but the accountant flees overseas for many years, the statute of limitations does not run while the suspect is hiding.

49. A defined time limit under which a legal action must commence or be forever barred.

50. A temporary halting of the clock in calculating whether the statute of limitations has run out.

51. A sworn statement in writing made under oath.

52. The method used in civil and criminal cases to obtain information about each party's case.

In support of any motion, a party may submit an **affidavit**⁵¹. Affidavits play an important role in pretrial procedure because they are an effective way for parties to tell their side of the story to the judge. They are limited, however, because even though they are given under oath, they may raise more questions and are not subject to examination by the other side.

After pleadings are filed, the litigation moves into the **discovery**⁵² phase. Discovery is a process in which each side finds out information about the other's case. Let's assume, for example, that you buy a new car and within a few weeks, a tire falls off suddenly while you're driving. You would rightly conclude that there's something wrong with the car, so you sue the manufacturer. At this point, you have no idea what's wrong with the vehicle. Was the design flawed? Was there something wrong with the manufacturing of your specific vehicle? All you know is that new cars

should not experience this sort of failure. After you file a lawsuit against the manufacturer, discovery allows you to find out more information about the vehicle so that you can effectively proceed with the lawsuit. You could find out what engineers did when they designed the vehicle and review records of similar accidents or factory records from the day your vehicle was produced.

Discovery is designed to prevent trial by surprise, where either side may suddenly produce a damning piece of evidence that allows it to win the trial. Since trials are based on the discovery of truth, they should be tried on the merits of the case rather than a party's deceit. In that spirit, the rules of discovery are written broadly to cover scope and obligation. In scope, any piece of evidence that may be relevant to the trial is discoverable. Even if evidence may be ruled later to be inadmissible for a legal reason, it is discoverable during discovery. In obligation, both parties are obligated to turn over material that supports their own case, without demand from the other side. If the material harms their own case, they have to turn it over if the other side asks for it.

There are four types of discovery. The simplest (and least expensive) is an **interrogatory**⁵³. These are written questions addressed to the other party. The questions tend to be simple and straightforward, dealing with uncontroversial matters such as a company's structure or the names and addresses of relevant witnesses.

A second type is a request for production. Using this form of deposition, a party can request the other party to produce written communications such as internal company reports, e-mails, product manuals, and engineering specifications. In some cases physical evidence may also be produced. If you sued a vehicle manufacturer because your tire fell off while driving, for example, the manufacturer may ask you to produce your vehicle so that its engineers can inspect it. Failure to preserve and produce key evidence in litigation can lead to charges of **spoliation**⁵⁴, which may result in severe sanctions against the offending party.

A third form of discovery is a **request for admission**⁵⁵. Remember that a complaint contains a series of claims the plaintiff is making against the defendant, and the answer is mainly a series of denials of those claims. As each party finds more information about the other's case in discovery, one party may ask the other to admit that one of the contested claims is true. Doing so narrows the issues for trial because it is one less thing that the jury has to decide. Asking a party to give up a contested claim can be done at any time during litigation. If not done as a formal method of discovery, it may be done as a **stipulation**⁵⁶ instead. For example, in your trial against the vehicle manufacturer, you may ask the manufacturer to admit that your specific vehicle was manufactured on a specific date at a specific factory.

53. Written questions posed by a party to another party during discovery.

54. Destruction of key evidence in a trial.

55. A set of statements posed by one party to another for purposes of having the other party admit or deny the statements, to narrow the scope of facts to be tried.

56. An agreement made between opposing parties in litigation.

Finally, discovery can take the form of a **deposition**⁵⁷. A deposition is a sworn oral statement, in response to questions, given by a potential witness in a trial to the attorneys in the case. A deposition hearing is attended by the witness being deposed and lawyers from both side, as well as a court reporter who keeps a written transcript of the entire deposition. In your product liability suit against your vehicle's manufacturer, for example, you might want to depose the safety engineer who designed the car's tire and braking systems. There is no judge present, so there is great latitude for parties to ask questions, even if those questions may result in testimony that is later inadmissible in court. Depositions serve to allow attorneys to prepare for trial by knowing everything a witness may say in court. They also serve to pin down a witness's testimony, since a witness who changes testimony between a deposition and trial can be easily **impeached**⁵⁸. Depositions are easily the most expensive form of discovery, sometimes requiring weeks or months of advance planning, travel, extra costs, and lost work time from witnesses being deposed. In some cases they can degenerate without the presence of a judge, as [Note 3.72 "Video Clip: A Deposition Goes Awry"](#) shows.

Video Clip: A Deposition Goes Awry

[\(click to see video\)](#)

Although the policy behind liberal rules of discovery is to permit both sides to prepare adequately for trial, in effect discovery is an expensive phase of litigation. With most lawyers charging by the hour, responding to discovery requests can quickly rack up daunting legal bills. Discovery can also drag out litigation to many months or years. Most large corporations find they must dedicate entire in-house staffs of attorneys, paralegals, and support staff to respond exclusively to discovery requests. The judge assigned to the case is supposed to supervise discovery and ensure that the parties respond in a timely manner, as well as make rulings on specific discovery requests and objections. Theoretically, a judge has the power to sanction parties for abusive discovery, up to and including ordering a default judgment against the offending party. There are, however, few meaningful sanctions that can be levied against parties that abuse discovery, and plaintiffs in particular have a vested interest in making discovery last longer than the price of a sought-after settlement. These issues are magnified in **e-discovery**⁵⁹, when mountains of electronic data have to be sifted through to find relevant discoverable material. Objections to turning over material that may be proprietary, privileged, or the result of the **work product doctrine**⁶⁰ also become more time consuming when parties are engaged in e-discovery.

During or after discovery, parties typically make a motion for **summary judgment**⁶¹. This motion is designed to cut the trial short by asking the judge to decide based on the information discovered so far in the case. In essence, the party

57. A statement by a party or witness made under oath.

58. To challenge the credibility of a witness to tell the truth.

59. Discovery involving electronically stored information.

60. Materials prepared in anticipation of litigation protected from disclosure during discovery.

61. A judicial order declaring a winner on the merits of a case.

making the motion is saying, “Why have a trial?” since the evidence would lead any reasonable jury to the same and inevitable conclusion.

KEY TAKEAWAYS

Litigation commences with the filing of a complaint by the plaintiff. If the plaintiff wishes to represent many others with the same claim against the same defendants, the plaintiff may try to certify the lawsuit as a class-action suit. Frivolous cases are prohibited in litigation, but it is relatively easy to argue that a case is not frivolous. The defendant files an answer to the complaint or risks a default judgment. Most civil and criminal cases must be brought within the prescribed statute of limitations. During the discovery phase of litigation, parties share and exchange information about each other’s cases so that neither side is surprised during the trial. There are four methods for conducting discovery: interrogatories, requests for production, requests for admissions, and depositions.

EXERCISES

1. During the Catholic priest sex scandal, many potential plaintiffs who were abused as children found that their lawsuits against the church and individual priests were barred by the statute of limitations because the abuse happened so many years ago. Do you believe that these lawsuits were rightfully barred? Why or why not? Should the statute be changed in sexual misconduct cases?
2. Do you think there are too many frivolous cases filed? If you answered yes, how would you revise the federal rules of civil procedure to raise the standard on what constitutes a frivolous case?
3. Look at a sample interrogatory at <http://www.justice.gov/atr/foia/frito-lay/8-16-96.htm>. This interrogatory was issued by the U.S. Department of Justice in an antitrust investigation against Frito-Lay for possible violations of the Sherman Antitrust Act. What do you notice about the questions? How long do you think it would take to compile a response to these questions? If you were the defendant, would you object to any of them? If so, on what grounds?

3.4 The Trial and Appeal

LEARNING OBJECTIVES

1. Learn about jury selection.
2. Follow a trial from opening statement to closing arguments.
3. Explore the public policy rationale for the trial system.

After discovery is finally completed, and assuming that neither side has been successful in short-circuiting litigation through motions, the case is finally scheduled for a trial. In civil litigation, this is a most unusual development, for well over 90 percent of cases filed are resolved or settled before a trial. If a case actually goes to trial, it means there are genuine issues of fact that the parties cannot resolve, and both sides are determined to see their side win. Remember that a trial is a fact-finding process, through which the trier of fact (the jury in most cases or the judge in a bench trial) attempts to determine what happened. The trier of fact applies the facts to applicable law as instructed by the judge and determines guilt or innocence in a criminal case, or liability or no liability in a civil case. The first step in this process is to seat a jury.

At any given day in a courthouse, several citizens may be called by a judge as potential jurors in a case. If a jury needs twelve members, it's not unusual for a judge to begin with a pool of more than fifty or sixty potential jurors to narrow down to a dozen. The process of selecting a petit jury is called **voir dire**⁶².

Voir dire typically begins with the jurors filling out a written questionnaire. The questionnaire asks the jurors to identify their occupation, any work or occupational conflicts, and any potential conflicts of interest with the case. The process then continues with attorneys quizzing each potential juror in turn. During this questioning, attorneys ask each juror if he or she has any biases against upholding the law and whether he or she can keep an open mind during the trial.

62. The questioning of prospective jurors.

63. A challenge to a prospective juror for a good reason such as bias.

64. A challenge to a juror without giving a reason.

If an attorney does not like a juror's response, that juror may be excused. There are two types of challenges to a potential juror: peremptory or for cause. A party can make a **for cause**⁶³ challenge if it can demonstrate to the judge that there is a good reason to excuse the juror, such as the juror's personal relationship with one of the parties, or the juror's stated unwillingness to be unbiased. Since these excuses are for a good reason, each side is allowed an unlimited number of for cause challenges. A party can also make a **peremptory**⁶⁴ challenge against a juror, without giving any

reason for the challenge. Since these challenges are unsupported by rationale or reason, each side is given a limited number of peremptory challenges. A party may make a peremptory challenge based on a juror's perceived bias because of that juror's occupation or life background but may not make a peremptory challenge because of the juror's race *Batson v. Kentucky*, 476 U.S. 79 (1986). or gender.

After a jury has been selected and sworn in, the trial begins. The plaintiff or prosecution begins by delivering an **opening statement**⁶⁵. The opening statement is a preview of the trial. In it, the attorneys explain the facts of the case to the jury and indicate what witnesses they will be calling and what the witnesses will say. Attorneys do not make any arguments during the opening statement; they simply lay out what jurors can expect from the trial ahead. In a trial against your vehicle's manufacturer, your attorney may begin by telling the jury to expect testimony from you about your car accident, from your doctor about the injuries you suffered, and perhaps from an expert witness who has examined your vehicle and believes it was manufactured defectively. Once the plaintiff has delivered an opening statement, the defendant will deliver the defense opening statement. In a criminal case, the defense has the right to reserve delivering the opening statement until after the prosecution has rested its case (concluded presenting all the witnesses).

After opening statements, the trial moves into the examination phase. Jurors are presented with witnesses, called by each side, to give evidence. The plaintiff begins by calling its witnesses. The attorney will guide the witness in delivering testimony by a series of short open-ended questions during the **direct examination**⁶⁶. Leading questions (questions that call for a yes or no answer) are not permitted during direct examination. As the questioning proceeds, a court reporter maintains a record of all the words spoken in case there is an appeal. The opposing side may raise objections during the examination, which the judge will rule on. These rulings can also form the basis for a later appeal.

All the evidence in a trial must be introduced in this manner (questioning a live witness). If one side wants to introduce videotape into evidence, for example, it has to call the person who took the footage or was in charge of running the camera to testify about his or her personal knowledge of where the camera footage came from before the jury can watch the video. In a criminal case, if the prosecution wants to introduce the murder weapon into evidence, it must first call the detective or police officer who found the weapon to testify about where he or she found it and where it has been since then.

65. The statement by attorneys to the jury at the beginning of the trial, laying out the essential facts of the case.

66. Examination through questioning of a witness by the side that called the witness.

Hyperlink: O. J. Simpson Tries on Gloves

<http://video.google.com/videoplay?docid=-7472594685651342793#>

O. J. Simpson's criminal murder trial was probably the most-watched courtroom proceeding in history. During the trial, the prosecution sought to introduce a pair of gloves into evidence. The prosecution claimed the gloves contained blood from the victims. In this scene, the defendant, O. J. Simpson, is asked to try on the gloves so that the jury can see for themselves whether or not the gloves might belong to him. The fact that the gloves appear too small for his hands later becomes fertile ground for the defense attorneys to argue that reasonable doubt exists as to his guilt.

After direct examination, the other side has the right to conduct a **cross-examination**⁶⁷. During the cross-examination, the attorney will try to discredit the witness to convince the jury that the witness is not credible. The attorney may probe into any potential biases the witness may have or try to prove that the witness's recollection of events may not be as clear or certain as the witness believes. During cross-examination, attorneys frequently engage in asking leading questions, which is permitted.

Once the prosecution or plaintiff has called all its witnesses, and the witnesses have undergone direct and cross-examination, then the prosecution or plaintiff will rest its case. The defendant may make a motion for a **directed verdict**⁶⁸, arguing that no reasonable juror could possibly find in favor of the prosecution or plaintiff after hearing the evidence presented so far. This motion can be made anytime during the trial before the jury returns a verdict. The motion is typically denied, and the trial moves on to the defense phase. The defense will then present its witnesses, who are led through direct and cross-examination.

After the defense has rested its case, the attorneys once again address the jury in **closing arguments**⁶⁹. Here, the attorneys summarize the case for the jury. They address what witnesses were called and what the witnesses said. During closing arguments, the attorneys are permitted to be much more persuasive and argumentative than during the opening statement. They appeal to the jury's emotions and argue how the jury should interpret the evidence before them.

67. Examination through questioning of a witness called by the opposing side.

68. An action by the court to direct a verdict when a party has failed to meet its burden of proof.

69. Summation of the case presented by attorneys at the conclusion of presentation of evidence.

Video Clip: Johnnie Cochran Delivers Closing Arguments

[\(click to see video\)](#)

After closing arguments are made, the judge in the case charges the jury by giving the jury its instructions. The instructions acquaint the jury with the relevant law. The jury then retires to deliberate. During deliberations, the jury will decide first what facts it believes to be true. Then it will apply those facts to the law as outlined in the jury instructions. In a trial against your vehicle's manufacturer, for example, the judge may explain to the jury what is legally required for a product to be considered defective so that the jury can make a determination, based on the evidence presented, whether or not there is any liability.

Central to the jury's deliberations is the **burden of proof**⁷⁰ applicable to the case. In criminal trials, the prosecution always carries the burden of proof. That burden is to prove the defendant committed all the elements required in the crime **beyond a reasonable doubt**⁷¹. If any member of the jury has any reasonable doubts about the defendant's guilt or innocence, then the only appropriate verdict is not guilty. Many people confuse the burden with "without a doubt." Jurors may have doubts, but the only question for the jurors is whether they have any reasonable doubts. This standard is deliberately set high because of the severe sanctions and penalties that follow a criminal conviction. In a criminal trial, the defense only has to prove reasonable doubt exists and has no burden of proof at all. That is why in criminal trials, the defense may strategically decide to not call any witnesses and to rest its case strictly on creating doubt by cross-examining the prosecution's witnesses.

In civil cases the burden of proof is **preponderance of the evidence**⁷². This standard requires the scales of justice to tilt ever so slightly toward one party to declare that party the winner. If the jury believes one side is 51 percent correct and the other is 49 percent correct, that is enough to declare a winner. It is a much easier standard to win, because it only requires a party to prove that its side is more likely than not telling the truth. In a civil liability suit against your vehicle's manufacturer, your burden is to convince the jury that more likely than not, your vehicle was somehow defective. Sometimes it's possible for a jury in a criminal trial to find the defendant not guilty, while a separate jury in a civil case applying a lower burden of proof finds the defendant liable for the same act. This is what happened to O. J. Simpson when he was tried for the murder of his wife.

During jury deliberations, the jurors are permitted to ask the judge for clarification about the law and to request to see the evidence again. If the jury is unable to come to a verdict, the jury is said to be deadlocked, and a mistrial results. Since trials are expensive and time consuming, the judge will usually instruct the jury to try its best before giving up. If the jury does arrive at a decision, it is called a **verdict**⁷³.

70. The responsibility of a party to produce sufficient evidence to convince the trier of fact of a particular fact or issue.

71. The standard of proof in a criminal trial. It means that the evidence must be so compelling that there is no reasonable doubt as to the defendant's guilt.

72. The standard of proof in a civil trial. It means that the evidence that supports the claim is more likely than not.

73. A jury's decision.

Once the jury delivers its verdict, the losing side typically makes a motion for **judgment notwithstanding the verdict**⁷⁴. In this motion, the party is arguing that the jury arrived at the wrong verdict and that no reasonable jury could have arrived at that verdict. The judge typically will not grant this verdict. Even if the judge believes that the jury arrived at the wrong factual conclusion, the judge is not permitted to substitute his or her judgment for that of the jury. If, however, the jury clearly ignored the law in arriving at its verdict in a criminal case, the judge may overrule the jury. This phenomenon is known as **jury nullification**⁷⁵.

If the judge denies the motion for judgment notwithstanding the verdict, then the judge enters the jury's verdict as a **judgment**⁷⁶. After that, the losing party has the right to file an appeal. Remember that on appeal, the appellate court is only reviewing the record for legal error and cannot call new witnesses or substitute its judgment on the facts for the jury's. In the following excerpt, Supreme Court Justice Ruth Bader Ginsburg uses the trial record to make a point in her dissenting opinion in an important employment discrimination case involving gender discrimination. Although hers was a dissenting opinion and the plaintiff lost her case, Congress reacted to the decision by passing the Lily Ledbetter Fair Pay Act, the first law signed by President Obama after he assumed office.

74. A judgment setting aside the jury's verdict.

75. An act by a jury to willingly ignore the law to achieve an equitable result or outcome.

76. A formal determination of a matter by a court.

Hyperlink: Justice Ginsburg Reviews an Employment Discrimination Case

<http://www.law.cornell.edu/supct/html/05-1074.ZD.html>

From 1979 to 1998, Lilly Ledbetter worked as a supervisor at Goodyear's plant in Gadsden, Alabama. Over the course of her career, her pay slipped when compared to the pay of men of equal experience and seniority. She sued the company, alleging pay discrimination on the basis of her gender under Title VII of the 1964 Civil Rights Act. The law states that any lawsuit must be initiated within 180 days of the unlawful discriminatory act occurring. Ledbetter argued that each paycheck she received was an unlawful discriminatory act, so the fact that she filed her lawsuit within 180 days of her last paycheck means her lawsuit is within the time limit. Goodyear argued that the discriminatory act was the decision to pay her less, which took place many years ago and that therefore her lawsuit is too late. In a 5–4 decision, the Supreme Court ruled in Goodyear's favor. In her dissent, Justice Ginsburg returns to the trial record to make her point that Ledbetter is the victim of unlawful discrimination. The following is from the dissenting opinion:

Specifically, Ledbetter's evidence demonstrated that her current pay was discriminatorily low due to a long series of decisions reflecting Goodyear's pervasive discrimination against women managers in general and Ledbetter in particular. Ledbetter's former supervisor, for example, admitted to the jury that Ledbetter's pay, during a particular one-year period, fell below Goodyear's minimum threshold for her position. Although Goodyear claimed the pay disparity was due to poor performance, the supervisor acknowledged that Ledbetter received a "Top Performance Award" in 1996. The jury also heard testimony that another supervisor—who evaluated Ledbetter in 1997 and whose evaluation led to her most recent raise denial—was openly biased against women. And two women who had previously worked as managers at the plant told the jury they had been subject to pervasive discrimination and were paid less than their male counterparts. One was paid less than the men she supervised. Ledbetter herself testified about the discriminatory animus conveyed to her by plant officials. Toward the end of her career, for instance, the plant manager told Ledbetter that the "plant did not need women, that [women] didn't help it, [and] caused problems." After weighing all the evidence, the jury found for Ledbetter, concluding that the pay disparity was due to intentional discrimination.

Once all appeals are exhausted, the winner in litigation can finally collect whatever damages it is entitled to. This process is called **execution**⁷⁷. If the loser is unable or unwilling to pay the judgment, the winner can petition the court to use its full legal resources, including asking the sheriff to seize the loser's assets for sale, to satisfy the judgment. The winner can also ask that the loser's wages be **garnished**⁷⁸ until the judgment is satisfied. The loser in litigation cannot refile a civil lawsuit once it has been decided under the doctrine of **res judicata**⁷⁹. Just like criminal cases cannot be retried after acquittal under the double jeopardy clause of the Constitution, res judicata operates as a bar to relitigation.

KEY TAKEAWAYS

The process of selecting a jury is called voir dire. Each side is permitted to question a potential juror and excuse that juror for any reason through a peremptory challenge or for a good reason through a for cause challenge. A trial begins with opening statements where the parties lay out the essential facts of their case. Next, witnesses are called to provide testimonial evidence. The side calling the witness conducts a direct examination, while the opposing side conducts a cross-examination. After all witnesses are called, the parties make closing arguments to the jury, which then deliberates and applies the law as outlined in the jury instructions. The burden of proof in a criminal case is "beyond a reasonable doubt," while the burden of proof in a civil case is "preponderance of evidence." A jury's verdict must be converted into a legal judgment by the trial judge. Once all appeals are settled, res judicata prevents the case from being tried again.

EXERCISES

1. Why would a jury engage in jury nullification? If a jury cannot engage in nullification, what are its alternatives to express a similar view?
2. One of President Obama's first acts as president was to sign into law a statute aimed at overturning the Ledbetter decision. How can Congress overturn the Supreme Court in this instance?
3. Although litigation is rightfully criticized as slow and expensive, res judicata means the parties have only one chance to "get it right." Do you think relaxing the rules of res judicata would help with the expense and time involved in litigating cases?

77. The collection or enforcement of a judgment.

78. Attachment of a debtor's wages to pay a judgment.

79. The doctrine barring relitigation of issues and claims already finally determined.

3.5 Concluding Thoughts

The litigation system, publicly financed, is an important dispute-resolution mechanism that processes millions of cases in both state and federal courts every year. The system permits parties to air their grievances against each other in an open and transparent manner and is typically very effective at finding the truth. The jury system, in particular, is largely admired for its ability to involve ordinary citizens in an important form of civil service. For many businesses, however, litigation can be a vexing and distracting problem. The extraordinarily high costs associated with complex litigation, along with pressure from stakeholders to settle cases rather than litigate them fully, means that most businesses would prefer to avoid litigation whenever possible. These problems have led many courts to experiment with various levels of reform, from mandatory pretrial settlement attempts to mandatory mediation to jury selection and management reforms. These reforms are aimed at maintaining the vitality and usefulness of the litigation system, which can be a trusted and valuable resource for all citizens and corporations.

Chapter 4

Alternative Dispute Resolution

LEARNING OBJECTIVES

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

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

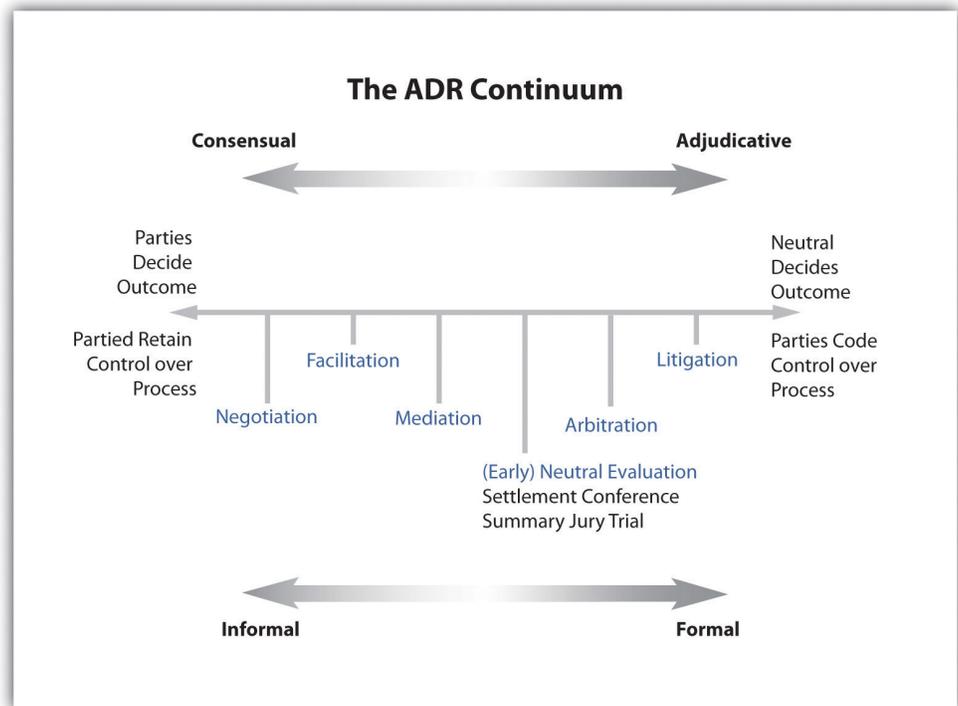
Imagine that you've been wronged by a supplier, by your employer, or by a business where you are a customer. You've correctly determined that you have an actionable legal claim. What are you going to do? You probably *won't* run to the courthouse to file a formal complaint to initiate litigation. This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

A common method of dispute resolution that avoids many of the challenges associated with litigation is alternative dispute resolution. **Alternative dispute resolution (ADR)**¹ is a term that encompasses many different methods of dispute resolution *other than* litigation. ADR involves resolving disputes outside of the judicial process, though the judiciary can require parties to participate in specific types of ADR, such as arbitration, for some types of conflicts. Moreover, some ADR methods vest power to resolve the dispute in a neutral party, while other strategies vest that power in the parties themselves. See [Figure 4.1 "A Continuum of Different](#)

1. Encompasses many different methods of dispute resolution *other than* litigation or trial.

ADR Methods" for a continuum of different ADR methods based on where power to solve the dispute is vested.

Figure 4.1 A Continuum of Different ADR Methods



Source: Adapted from New York State Unified Court System, <http://www.nycourts.gov/ip/adr/images/continuum2.jpg>.

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

ADR methods are used outside of the courtroom, but that does not mean that they are outside of the interests of our legal system. Participation in ADR has important legal consequences. For instance, parties that have agreed by contract to be subject to binding arbitration give up their constitutional right to bring their complaint to court. The **Federal Arbitration Act (FAA)**² is a federal statute under which parties are required to participate in arbitration when they have agreed by contract to do so, even in state court matters. Indeed, the FAA is a national policy favoring arbitration. *Southland Corp. v. Keating*, 465 U.S. 1 (1984). The *Southland Corp.* Court said that “in enacting...[the FAA], Congress declared a national policy favoring arbitration and withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration.” This is an example of **federal preemption**³ exercised through the **Supremacy Clause**⁴ in the U.S. Constitution.

There is a very good chance that you will—or already have—signed a contract that contains a mandatory arbitration clause. This means that if a dispute arises under that contract, then you will be required to arbitrate your claim rather than going straight to court. Under a binding arbitration clause, you will have waived your constitutional rights to go to court. Even if you have never signed such a contract and never will, there is still a good likelihood that you will be involved in a commercial dispute at some point in your life. Because of this, it’s important to understand the ADR process, situations in which litigation is a better choice than ADR, and special issues that arise when parties have unequal bargaining power.

2. A federal statute that requires parties that have entered into contracts with mandatory arbitration clauses to submit to arbitration to resolve disputes arising under such contracts if the contract involves commerce. The U.S. Supreme Court interpreted the Federal Arbitration Act as Congress’s declaration of a national policy in favor of arbitration.
3. A judicially developed doctrine that recognizes the federal government’s power, derived from the Supremacy Clause of the U.S. Constitution, to control a particular area of law, either expressly or impliedly, and to take priority over state law or state attempts to regulate in a particular area.
4. A clause in Article VI of the U.S. Constitution that declares federal law supreme, which means that in the event that federal and state law conflict, federal law trumps state law.

Key Takeaways

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

4.1 Negotiation

LEARNING OBJECTIVES

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

Imagine that you are a tent manufacturer. Your supplier of tent fabric routinely supplies you with appropriate water-resistant fabric to construct your tents, so that you can produce your products and bring them to market. After many years of a good working relationship, your fabric supplier delivered **nonconforming goods**⁵. Specifically, the fabric delivered was not water-resistant, despite your need for water-resistant fabric to produce your tents. However, on your notifying the supplier of the problem, the supplier denied that the fabric was nonconforming to your order. You refused to pay for the goods. The fabric supplier insisted on payment before future delivery of any additional fabric. Without water-resistant fabric, you cannot continue to produce your tents.

This is an example of a business to business (**B2B**⁶) dispute. Despite the problem, you will likely wish to continue working with this supplier, since you have a good, long-standing relationship with it. This problem seems to be a “hiccup” in your regular business relationship. Accordingly, you will probably want to resolve this dispute quickly and without hard feelings. It is very unlikely that you will immediately hire an attorney to file a formal complaint against your supplier. However, that does not change the fact that there is a dispute that needs to be resolved.

One of the first strategies that you and your supplier are likely to employ is negotiation. **Negotiation**⁷ is a method of alternative dispute resolution (ADR) that retains power to resolve the dispute to the parties involved. No outside party is vested with authoritative decision-making power concerning the resolution of the dispute. Negotiation requires the parties to define the conflicts and agree to an outcome to resolve those conflicts. Often, this can take the form of a compromise. Note that a compromise does not mean that anyone “loses.” Indeed, if both parties are satisfied with the result of the negotiation and the business relationship can

5. Goods that do not conform to the buyer’s order. Under the Uniform Commercial Code (UCC), nonconforming goods can be rejected by the buyer.

6. Business to business.

7. A method of ADR that retains power to the parties involved. It is often seen as a win-win ADR strategy, where both parties try to reach a mutually satisfactory outcome.

continue moving forward, then both parties will be very likely to consider this as a “winning” situation.

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

Though our example involves B2B, the parties may or may not have equal **bargaining power**⁸. If your business and your supplier are both dependent on each other for roughly equal portions of the respective businesses, then they are most likely relatively equal with respect to bargaining power. However, in our example, if your business is a very small business but your supplier is a very large business—perhaps with a patent protecting the rights to the specialty fabric that you need—then we might say that the B2B negotiation is potentially unbalanced, since one party has a much more powerful bargaining position than the other. Specifically, your business needs that particular type of fabric, which is only available from one supplier. But your supplier does not need your business because it has a legal monopoly in the form of a patent for its product, and it probably sells to many manufacturers. This would be an example of **unequal bargaining power**⁹.

When the negotiation occurs as a result of a dispute, but not a legal dispute per se, then the party with the weakest bargaining position may be in a very vulnerable spot. This is illustrated in [Note 4.13 "Hyperlink: Rubbermaid's Unequal Bargaining Power"](#). When Rubbermaid's raw materials price for resin increased, it needed to raise its prices. However, Wal-Mart refused to accept the necessary price increase for Rubbermaid products. This refusal had a substantial negative impact on Rubbermaid's business, since Wal-Mart was its main customer. In short, Rubbermaid needed Wal-Mart, but Wal-Mart did not need Rubbermaid.

8. The relative power of a party with respect to another party or parties that influences abilities to set agendas, influence outcomes, and negotiate terms during bargaining.

9. When parties possess different power relative to each other, and this difference creates opportunities or obstacles with respect to setting agendas, influencing outcomes, and negotiating terms during.

Hyperlink: Rubbermaid's Unequal Bargaining Power

A Question of Ethics

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

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

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

That doesn’t appear to be the case anymore.

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

In *Getting to Yes*, written by members of the Harvard Program on Negotiation, the goal of negotiation is viewed as “win-win.” Roger Fisher, William Ury, and Bruce Patton, *Getting to Yes* (New York: Penguin Books, 1991). Note that this is a substantially different goal from litigation. Our adversarial legal system requires one party to “win” and the other party to “lose.” *Getting to Yes* focuses on principled negotiation, and it sets forth specific steps and discusses strategies to allow participants to achieve the “win-win” goal. This book’s popularity perhaps suggests that people have a real interest in learning about ADR, avoiding litigation, and ensuring that all parties leave the resolution process as “winners.” Some concepts common in negotiation include the BATNA, WATNA, and the bargaining zone. For

example, the authors of *Getting to Yes* encourage negotiators to know their best alternative to a negotiated agreement (**BATNA**¹⁰). This ensures that unfavorable terms will not be accepted and terms consistent with a negotiator's interests won't be rejected. Roger Fisher, William Ury, and Bruce Patton, *Getting to Yes* (New York: Penguin Books, 1991), 100. Likewise, the worst alternative to a negotiated agreement (**WATNA**¹¹) is a concept used by some negotiators prior to entering negotiations. The **bargaining zone**¹² is the area in which parties to a negotiation are willing to trade, barter, or negotiate their positions, within which parties can find an acceptable agreement. If you think of a Venn diagram, the bargaining zone would be where the two ovals overlap. The **reservation point**¹³ is essentially a party's "bottom line," beyond which it will not agree to terms.

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

KEY TAKEAWAYS

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

10. Acronym for best alternative to a negotiated agreement. The concept is discussed in *Getting to Yes* and used by negotiators to ensure that favorable terms are not rejected and unfavorable terms are not accepted.
11. Acronym for worst alternative to a negotiated agreement, which is a concept used by some negotiators.
12. The area in which parties to a negotiation are willing to trade, barter, or negotiate their positions, within which parties can find an acceptable agreement.
13. A party's "bottom line" in negotiation.

EXERCISES

1. Visit <http://www.sfhgroup.com/ca/training/online-training/test-your-skills.php> and click “Negotiate with Bill” under “Online Negotiation Course.” This is a free interactive negotiation exercise. After completing the negotiation, answer the following questions: How far did you get? (If you did not get to level three, go back and try it again. See if you can get all the way through to level three.) What negotiation strategies did you learn? In other words, what works? What doesn’t work?
2. What are the benefits of negotiation as a dispute-resolution method? What are the drawbacks?
3. How can parties that have unequal bargaining power negotiate meaningfully, without one party taking advantage of the other? Have you ever negotiated with someone who had more bargaining power than you? What were your strategies during the negotiation? Did you obtain your goal by the conclusion of the negotiation?
4. Watch the video in [Note 4.13 "Hyperlink: Rubbermaid’s Unequal Bargaining Power"](#). If you were a manufacturer and you had to raise prices due to an increase in price for your raw materials, and if Wal-Mart was your most important customer, what strategies would you employ so that both parties would have a chance to have a “win-win” outcome?

4.2 Mediation

LEARNING OBJECTIVES

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

Mediation¹⁴ is a method of ADR in which parties work to form a mutually acceptable agreement. Like negotiation, parties in mediation do not vest authority to decide the dispute in a neutral third party. Instead, this authority remains with the parties themselves, who are free to terminate mediation if they believe it is not working. Often, when parties terminate mediation, they pursue another form of ADR, such as arbitration, or they choose to litigate their claims in court. Mediation is appropriate only for parties who are willing to participate in the process. Like negotiation, mediation seeks a “win-win” outcome for the parties involved. Additionally, mediation is confidential, which can be an attractive attribute for people who wish to avoid the public nature of litigation. The mediation process is usually much faster than litigation, and the associated costs can be substantially less expensive than litigation.

Unlike in many negotiations, a third party is involved in mediation. Indeed, a neutral **mediator**¹⁵ is crucial to the mediation process. Mediators act as a go-between for the parties, seeking to facilitate the agreement. Requirements to be a mediator vary by state. See [Note 4.23 "Hyperlink: Mediators"](#) to compare the requirements between states. There are no uniform licensing requirements, but some states require specific training or qualifications for a person to be certified as a mediator. Mediators do not provide advice on the subject matter of the dispute. In fact, the mediators may not possess any subject-matter expertise concerning the nature of the dispute. However, many mediators are trained in conflict resolution, and this allows them to employ methods to discover common goals or objectives, set aside issues that are not relevant, and facilitate an agreement into which the parties will voluntarily enter. Mediators try to find common ground by identifying common goals or objectives and by asking parties to set aside the sometimes emotionally laden obstacles that are not relevant to the sought-after agreement itself.

14. A method of alternative dispute resolution (ADR) in which parties work to form a mutually acceptable agreement.

15. A person who facilitates a mediation to achieve an acceptable, voluntary agreement between parties.

Hyperlink: Mediators

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

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

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

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

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

Like other forms of dispute resolution, mediation has benefits and drawbacks. Benefits are many. They include the relative expediency of reaching a resolution,

the reduced costs as compared to litigation, the ability for parties that are unable to communicate with each other to resolve their dispute using a nonadversarial process, the imposition of rules on the process by the mediator to keep parties “within bounds” of the process, confidentiality, and the voluntary nature of participation. Of course, the potential for a “win-win” outcome is a benefit. Attorneys may or may not be involved, and this can be viewed as either a benefit or a drawback, depending on the circumstances.

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

KEY TAKEAWAYS

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

EXERCISES

1. Visit the link in [Note 4.23 "Hyperlink: Mediators"](#) and find your state's requirements and qualifications for mediators. What would it take for you to become a mediator in your state? Do you think that your state requirements ensure that only qualified mediators practice? Why or why not?
2. Identify a situation in which you would choose mediation as your preferred method of dispute resolution. Why is mediation the best method in this situation? What are the potential benefits and drawbacks of mediation in this situation?
3. Should mediators be required to be licensed, like attorneys or physicians, before practicing? Why or why not?
4. Visit <http://www.sfhgroup.com/ca/training/online-training/test-your-skills.php> and scroll down to Mediation game. Click on "play game" under "The Angry Neighbours." This is a free interactive mediation exercise. After completing the mediation, answer the following questions: Were you able to successfully mediate this dispute? If you did not reach a successful resolution, go back and try it again. See if you can reach a successful resolution. What mediation strategies did you learn? What works? What doesn't work?

4.3 Arbitration

16. A method of alternative dispute resolution (ADR) in which parties vest authority in a third-party neutral decision maker who will hear their case and issue a decision.
17. An arbitrator's decision rendered after hearing the cases presented by the parties to an arbitration. The arbitration award can be confirmed and converted into a judgment by a court.
18. A federal statute that requires parties that have entered into contracts with mandatory arbitration clauses to submit to arbitration to resolve disputes arising under such contracts if the contract involves commerce. The U.S. Supreme Court interpreted the Federal Arbitration Act as Congress's declaration of a national policy in favor of arbitration.
19. A clause in Article I, Section 8 of the U.S. Constitution that gives Congress the power to regulate interstate commerce. This power is broadly construed.
20. A contractual clause that requires the parties to a contract that contains such a clause to submit to mandatory arbitration in the event of a dispute arising under the contract. Mandatory arbitration clauses frequently foreclose any possibility of appealing arbitration awards in court.

LEARNING OBJECTIVES

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

Arbitration¹⁶ is a method of ADR in which parties vest authority in a third-party neutral decision maker who will hear their case and issue a decision, which is called an **arbitration award**¹⁷.

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

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

Although perhaps not obvious, federal law lies at the heart of mandatory arbitration clauses in contracts. Specifically, Congress enacted the **Federal Arbitration Act (FAA)**¹⁸ 9 U.S.C. §1 et seq. through its **Commerce Clause**¹⁹ powers. This act requires parties to engage in arbitration when those parties have entered into legally binding contracts with a **mandatory arbitration clause**²⁰, providing the subject of those contracts involves commerce. 9 U.S.C. §2. In *Southland Park v. Keating*, the U.S. Supreme Court interpreted this federal statute to apply to matters of both federal and state court jurisdiction. Indeed, the Court held that the FAA created a national policy in favor of arbitration. It also held that the FAA preempts

state power to create a judicial forum for disputes arising under contracts with mandatory arbitration clauses. *Southland Corp. v. Keating*, 465 U.S. 1 (1984). In a later decision, the Court held that the FAA encompasses transactions within the broadest permissible exercise of congressional power under the Commerce Clause. *Citizens Bank v. Alafabco, Inc.*, 539 U.S. 52 (2003). This means that the FAA requires mandatory arbitration clauses to be enforceable for virtually any transaction involving interstate commerce, very broadly construed.

Some states require mandatory arbitration for certain types of disputes. For instance, in Oregon, the state courts require mandatory arbitration for civil suits where the **prayer for damages**²¹ is less than \$50,000, excluding attorney fees and costs. ORS 36.405. Many parties accept the arbitration award without appeal. However, when state law requires mandatory arbitration of certain types of disputes, parties are permitted to appeal because the arbitration is nonbinding. In nonbinding arbitration, the parties may choose to resolve their dispute through litigation if the arbitration award is rejected by a party. However, some states have statutory requirements that, in practice, create a chilling effect on appealing an arbitration award. For example, in the state of Washington, if the appealing party from a nonbinding mandatory arbitration does not do better at trial than the original award issued by the arbitrator, then that party will incur liability not only for its own expenses but also for those of the opposing side. Washington State Court Rules of Procedure, Superior Court Mandatory Arbitration Rules 7.3. In nonbinding arbitration, this is a powerful incentive for parties to accept the arbitration award without appealing to the judicial system.

21. A litigant's request for remedy or judgment,

22. An arbitration whose outcome is binding on the parties, without possibility of appeal to the courts.

23. An arbitration in which the arbitration award can be appealed to a court.

24. A court decision that sets forth the rights or duties of parties to a dispute.

25. In the context of arbitration, the process by which a court converts an arbitration award to a judgment.

26. A uniform statute adopted in whole or in part by some states, which seeks to create uniformity in arbitration proceedings between states.

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

Arbitration awards can be **binding**²² or **nonbinding**²³. Some states, like Washington State, have codified the rule that arbitration decisions are binding when parties voluntarily submit to the arbitration procedure. Uniform Arbitration Act, RCW 7.04.

In binding arbitration, the arbitration award is final; therefore, appealing an arbitration award to the judicial system is not available. In many states, an arbitration awards is converted to a **judgment**²⁴ by the court, thereby creating the legal mechanism through which the judgment holder can pursue collection activities. This process, called **confirmation**²⁵, is contemplated by the FAA and often included in arbitration agreements. But even if the FAA does not apply, most states have enacted versions of either the **Uniform Arbitration Act**²⁶ or the

Revised Uniform Arbitration Act²⁷. These state laws allow confirmation of arbitration awards into judgments as well.

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

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

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

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

27. A revised version of the Uniform Arbitration Act.

28. Business to business.

A common issue that arises is whether mandatory arbitration is fair in certain circumstances. It’s easy to imagine that arbitration is fair when both parties are equally situated. For example, business to business (**B2B**²⁸) arbitrations are often perceived as fair, especially if businesses are roughly the same size or have roughly

equal bargaining power. This is because they will be able to devote approximately the same amount of resources to a dispute resolution, and they both understand the subject under dispute, whatever the commercial issue may be. Moreover, in B2B disputes, the subjects of disputes are commercial issues, which may not implicate deeper social and ethical questions. For example, contract disputes between businesses might involve whether goods are **conforming goods**²⁹ or **nonconforming goods**³⁰ under the Uniform Commercial Code (UCC). No powerful social or ethical questions arise in such disputes. Indeed, resolving such disputes might be seen as “business as usual” to many commercial enterprises.

However, issues of fairness often arise in business to employee (**B2E**³¹) and business to consumer (**B2C**³²) situations, particularly where parties with unequal bargaining power have entered into a contract that contains a mandatory arbitration clause. In such cases, the weaker party has no real negotiating power to modify or to delete the mandatory arbitration clause, so that party is required to agree to such a clause if it wants to engage in certain types of transactions. For example, almost all credit card contracts contain mandatory arbitration clauses. This means that if a consumer wishes to have a credit card account, he will agree to waive his constitutional rights to a trial by signing the credit card contract. As we know, the FAA will require parties to adhere to the mandatory arbitration agreed to in such a contract, in the event that a dispute arises under that contract. In such cases, questions regarding whether consent was actually given may legitimately be raised. However, the U.S. Supreme Court has held that in B2E contexts, unequal bargaining power alone is not a sufficient reason to hold that arbitration agreements are unenforceable, *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20 (1991). and it is not sufficient to preclude arbitration. *Lozano v. AT & T Wireless*, 504 F.3d 718 (9th Cir. 2007).

Additionally, concerns about fairness do not end at contract formation. If a dispute arises and mandatory arbitration is commenced, the unequal power between parties will continue to be an important issue. In the case between a credit card company and an average consumer debtor, the credit card company would clearly be in a more powerful position vis-à-vis the debtor by virtue of the company’s financial strength and all that comes with it, such as experienced attorneys on staff, dispute-resolution experience, and contractual terms that favor it, rather than the consumer debtor. In such cases, if the consumer debtor is the aggrieved party, he may very well decide to drop the matter, especially if the arbitration clause requires arbitration proceedings to occur in a distant city. The credit card company will have vast financial resources as compared to the consumer debtor. Moreover, in this example the credit card company’s legal counsel will know how to navigate the arbitration process and will have experience in dispute resolution, processes that often confound people who are not trained in law. Additionally, the list of arbitrators may include people who are dependent on repeat business from the

29. Goods that conform to the buyer’s order.

30. Goods that do not conform to the buyer’s order. Under the Uniform Commercial Code (UCC), nonconforming goods can be rejected by the buyer.

31. Business to employee.

32. Business to consumer.

credit card company for their own livelihoods, thereby creating—or at least suggesting—an inherent conflict of interest. Many mandatory arbitration clauses create binding awards on one party while reserving the right to bring a claim in court to the other party. That is, a mandatory arbitration clause may allow the credit card company to appeal an arbitrator's award but to render an award binding on the consumer debtor. Obviously, this would allow the credit card company to appeal an unfavorable ruling, while requiring the consumer debtor to abide by an arbitrator's unfavorable ruling. To a consumer debtor, the arbitration experience can seem like a game played on the credit card company's home court—daunting, feckless, and intimidating.

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

In a similar case, employee Jamie Leigh Jones worked for KBR Inc. in Iraq when she was drugged and gang raped. She was initially prohibited from suing KBR Inc. in court because her employment contract contained a mandatory arbitration clause. However, when considering this case, the Fifth Circuit Court of Appeals ruled that sexual assault cases may, in fact, be brought in court rather than being subjected to mandatory arbitration, despite the contract language requiring mandatory arbitration. *Jones v. Halliburton Co.*, 583 F.3d 228 (5th Cir. 2009). Jones's claims were beyond the scope of the arbitration clause, because sexual assault is not within the scope of employment. Moreover, under Senator Al Franken's lead, the Senate took action to prohibit the Department of Defense from contracting with defense contractors that require mandatory arbitration for sexual assault claims. If such action is passed, it would essentially allow the Fifth Circuit's holding to apply in all federal jurisdictions rather than just in the Fifth Circuit. Check out [Note 4.44 "Video Clip: Al Franken"](#) to hear the details of Senator Franken's work on this matter. One

might think that passing such a law would be a “no brainer” to lawmakers. However, some Senators voted against the measure, arguing that the federal government should not insert itself into rewriting contracts. Instead, some argued that the use of arbitration and mediation should be expanded for such cases.

Video Clip: Al Franken

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

[\(click to see video\)](#)

In B2C cases, different issues of fairness exist. As noted previously, when the disputants possess unequal power, these issues can be magnified. Public Citizen, a nonprofit organization that represents consumer interests in Congress, released a report concerning arbitration in B2C disputes. Specifically, the report argued that arbitration is unfair to consumers in B2C disputes and that consumers fare better in litigation than in arbitration. According to the report, incentives exist to favor businesses over consumers in the arbitration process. It pointed to the lack of appeal rights, lack of requirement to follow precedents or established law, limits on consumers’ remedies, prohibitions against class-action suits, limitations on access to jury trials, limitations on abilities to collect evidence, and greater expense as additional factors speaking to the unfairness of arbitration over litigation in B2C disputes. Check out [Note 4.45 "Hyperlink: Arbitration"](#) for the full report.

Hyperlink: Arbitration

[http://www.citizen.org/documents/ArbitrationDebateTrap\(Final\).pdf](http://www.citizen.org/documents/ArbitrationDebateTrap(Final).pdf)

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

Importantly, and despite the FAA’s broad interpretation, not all binding arbitration clauses have been upheld by courts in B2C cases. In 2007, the Ninth Circuit Court of Appeals ruled that AT&T’s binding arbitration clause for wireless customers is unenforceable under California state law. *Lozano v. AT & T Wireless*, 504 F.3d 718 (9th Cir. 2007). The court further noted that the relevant state law is not preempted by the FAA, because the FAA does not prevent the courts from applying state law. In

this case, that law involved unconscionability of contract terms. As noted previously, the FAA requires parties to submit to mandatory arbitration when they agree to do so in a legally binding contract, and it preempts state powers to provide a judicial forum in those matters. However, the Ninth Circuit's holding in this case underscores the fact that state contract law is not circumvented by the federal statute.

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

KEY TAKEAWAYS

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

EXERCISES

1. Check out Jon Stewart's perspective on Senator Franken's proposed measure to prevent the Department of Defense from contracting with defense contractors that require mandatory arbitration for disputes arising from sexual assaults at <http://www.thedailyshow.com/watch/wed-october-14-2009/rape-nuts>. Does the comedian accurately portray this issue? What role does popular culture have in shaping our opinions and conceptions of our legal system?
2. In the *Barker v. Halliburton Inc.* case, does the three-million-dollar arbitration award in favor of the sexual assault victim prove that arbitration works, even in violations of civil rights disputes? Why or why not?
3. Choose one argument in *The Arbitration Debate Trap: How Opponents of Corporate Accountability Distort the Debate on Arbitration* in [Note 4.45 "Hyperlink: Arbitration"](#) and develop a counterargument to support the contention that arbitration *is* good in B2C disputes. Compare your argument with the argument in the report. Which side is the most persuasive? After completing this exercise, do you believe that arbitration is good or bad for consumers in B2C disputes? Why?
4. Bank of America announced that it would no longer require mandatory arbitration in disputes arising between it and consumer credit card account holders. Review the story here: <http://www.reuters.com/article/idUSTRE57D03E20090814>. What are the benefits and drawbacks to Bank of America's credit card account customers with respect to this change?
5. In what contexts have you entered into an arbitration agreement (e.g., home purchase, credit card agreement, cell phone agreement)? Write a short essay discussing the implications of entering into that agreement.

4.4 Other Methods of Alternative Dispute Resolution

LEARNING OBJECTIVES

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

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

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

Some ADR processes or programs are available only to certain groups of people, such as members of a particular organization. For instance, some organizations, like Boeing, have an internal **ethics hotline**³³. This hotline is available for employees to report perceived ethics violation that they have observed. Ethics advisors answer employees' questions and follow up on reports that need further investigation. One major benefit is that reporting parties generally (but not always) remain anonymous. Another benefit is that the company has time to redress problems that could give rise to disputes of much greater magnitude if left unaddressed.

An **open-door policy**³⁴ is an in-house program that allows company employees to go directly to any level of management to file a complaint or grievance, without threat of retaliation for their reporting. In theory, this policy creates an open atmosphere of trust, and it breaks down class barriers between groups of employees. However, many employees may not feel comfortable in making a complaint about a manager's decision. Moreover, supervisors may not be

33. An in-house program in some companies that seeks to redress disputes and observed ethics violations before they escalate to permeate the institutional culture, damage a company's reputation, or rise to criminal or civil offenses.

34. An in-house policy in which company managers allow employees to bring grievances directly to them to truncate any potential disputes and resolve them immediately.

comfortable with their employees bypassing them to file complaints. Open-door policies sound very good in theory, but they may not work as well in practice.

Another type of in-house program is an ombudsmen's office. These stations generally hear complaints from stakeholders, such as employees or customers. **Ombudsmen**³⁵ try to troubleshoot these complaints by investigating and attempting to resolve the issues before they escalate into more formal complaints.

More formal methods of ADR include **mediation-arbitration (med-arb)**³⁶, which is essentially a mediation followed by an arbitration. If the mediation does not produce a satisfactory outcome, then the parties submit to arbitration. The neutral party mediating the dispute also serves as the arbitrator if the dispute-resolution process goes that far. Med-arb has the same benefits and drawbacks as mediation and arbitration alone, with some important differences. For instance, parties in a med-arb know that their dispute will be resolved. This is unlike mediation alone, where parties may walk away if they do not think that the mediation is serving their interests. Moreover, the parties in med-arb have an opportunity to reach a win-win outcome as in mediation. However, if they do not reach a satisfactory outcome, then one party will "win" and one party will "lose" during the arbitration phase. The knowledge that an arbitration will definitely follow a failed mediation can be a strong incentive to ensure that the mediation phase of a med-arb works.

Private judging³⁷, contemplated by many state statutes, is a process in which active or retired judges may be hired for private trials. Private judging is essentially private litigation. The hired judge can preside over a private trial that is not truncated by limits on discovery or abbreviated rules of procedure, as would be the case in arbitration. Additionally, the judge who oversees the process is highly experienced in such matters as evidence and decision rendering. Moreover, the parties who can afford to pay for this service have a substantial benefit in not having to wait to have their cases heard in the public court. The private trial is also private rather than public, which may be important to parties who require confidentiality. In states where statutes permit hiring a judge for such matters, the parties' ability to appeal is often preserved. Drawbacks include the sometimes questionable nature of enforceability of judgments rendered, though some state statutes allow enforceability of those judgments as if they were issued in public court. Moreover, this system may benefit those who can afford to pay for this service, while others must wait for their case to appear on the docket in public court. This raises questions of fairness. See [Note 4.54 "Hyperlink: Private Judges"](#) for one state's frequently asked questions (FAQ) regarding private judges.

35. In-house intermediary or office in which disputes or grievances against a company can be brought. Ombudsmen investigate grievances and work with parties to resolve disputes.

36. A hybrid form of alternative dispute resolution (ADR) in which elements of mediation and negotiation are used in tandem.

37. This process allows judges to hire out privately, to conduct private trials, and to reach a rapid resolution overseen by an experienced judge.

Hyperlink: Private Judges

<http://www.in.gov/judiciary/admin/private-judges/faq.html>

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

Does your state permit private judging?

A **minitrial**³⁸ is a procedure that allows the parties to present their case to decision makers on both sides of the dispute, following discovery. This is a private affair. After the cases are presented, the parties enter into mediation or negotiation to resolve their dispute.

A **summary jury trial**³⁹ is a mock trial presented to a jury whose verdict is nonbinding. The presentation is brief and succinct, and it follows a discovery period. The jury does not know that its verdict will be advisory only. This process allows parties to measure the strengths and weaknesses of their cases prior to engaging in litigation, which presumably saves both time and money. After the minitrial, parties are in a better position to negotiate or mediate an outcome that fairly represents their positions.

KEY TAKEAWAYS

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

38. Similar to a mediation and arbitration, where parties present their case to a panel of decision makers who are involved in the dispute (like management), and then work with mediators or other neutral decision makers to reach an agreement.

39. A procedure similar to litigation, though the jury's verdict is nonbinding and advisory only. It is designed to present the merits and weaknesses of each case, after which the parties seek to reach an agreement through negotiation or mediation.

EXERCISES

1. Visit Boeing's Ethics Line Web page: <http://www.boeing.com/companyoffices/aboutus/ethics/hotline.html>. Do you think this program can address all disputes before they get out of hand? Why or why not? What type of dispute might not be appropriate to bring to an ethics hotline program?
2. Locate two "ethics hotline" programs from an online search. Compare these programs. What are the benefits and drawbacks to each?
3. Check out [Note 4.54 "Hyperlink: Private Judges"](#). Do you think that people should be permitted to hire judges to preside over private trials if they can afford to do so? What benefits to litigants in a private trial have over litigants in a public trial? What ethical issues exist with respect to private judges?
4. Why would a party choose med-arb over mediation or arbitration alone?

4.5 Public Policy, Legislation, and Alternative Dispute Resolution

LEARNING OBJECTIVES

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

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

The **Federal Arbitration Act (FAA)**⁴⁰ is a federal statute that the U.S. Supreme Court interpreted as a national policy favoring arbitration in *Southland Corp. v. Keating*, *Southland Corp. v. Keating*, 465 U.S. 1 (1984). According to the *Southland Corp* Court, state power to create judicial forums to resolve claims when contracting parties enter into a mandatory arbitration agreement has been preempted by the FAA. However, not all disputes are well suited for ADR. This is an area in which Congress could make substantial changes in public policy through the creation of new law, to ensure fairness between unequal parties and to ensure the protection of civil rights. Congress could do this by making ADR optional, rather than mandatory, for some types of disputes. It could exclude certain types of disputes from being bound to arbitration through mandatory arbitration clauses.

For example, the proposed **Arbitration Fairness Act of 2009 (AFA)**⁴¹ would invalidate mandatory arbitration clauses in employment and consumer disputes, as well as in disputes arising from civil rights violations. See [Note 4.63 "Hyperlink: Arbitration Fairness Act Bill"](#). The AFA is a proposed bill to amend the FAA. Under the Commerce Clause, Congress has the power to limit the use of mandatory arbitration, just as it has the power to enforce mandatory arbitration clauses under the Commerce Clause through the existing FAA. By passing a new law that excludes certain types of disputes from being subjected to mandatory arbitration, Congress could set new **policy**⁴² regarding fairness in dispute resolution. Likewise, if it fails to act, Congress is also acceding to the U.S. Supreme Court's broad interpretation of the FAA as a national policy favoring arbitration. Either way, policy regarding mandatory arbitration exists, and Congress has a central role in defining that policy.

40. A federal statute that requires parties that have entered into contracts with mandatory arbitration clauses to submit to arbitration to resolve disputes arising under such contracts if the contract involves commerce. The U.S. Supreme Court interpreted the Federal Arbitration Act as Congress's declaration of a national policy in favor of arbitration.
41. A bill that, if passed, would invalidate mandatory arbitration requirements for consumers in business to consumer (B2C) disputes and employees in business to employee (B2E) disputes, as well as in disputes involving violations of civil rights.
42. A plan or course of action that directs or influences decisions or processes to desired outcomes or objectives.

Hyperlink: Arbitration Fairness Act Bill

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

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

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

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

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

standing, they could ask the courts to interpret the statute narrowly, or they could ask the courts to strike down the statute altogether.

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

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

KEY TAKEAWAYS

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

EXERCISES

1. How many points of entry are there into lawmaking processes? Which point would be the easiest to access if you wanted to change the law? Why?
2. Check out [Note 4.63 "Hyperlink: Arbitration Fairness Act Bill"](#). Do you think that the AFA will solve the issue of perceived unfairness in dispute resolution? Why or why not? Are there any additions that you can make to this bill to make it more likely to achieve the goal of greater fairness in dispute resolution, if passed?

4.6 Concluding Thoughts

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

Chapter 5

The Constitution

LEARNING OBJECTIVES

In this chapter, we will discuss the federal U.S. Constitution and how it affects businesses. Specifically, you should be able to answer the following questions:

1. What are the main purposes of the U.S. Constitution?
2. How does the Constitution grant authority to the government to regulate business?
3. How does the Bill of Rights provide basic civil liberties to all persons in the United States?
4. How do due process and equal protection operate to constrain governments from acting unfairly?

Video Clip: Schoolhouse Rock, the Preamble

[\(click to see video\)](#)

The Constitution is not the first constitution adopted by the original thirteen colonies. During the time of the Revolutionary War against Great Britain, the states were governed by the **Articles of Confederation**¹. The articles granted limited authority to a federal government, including the power to wage wars, conduct foreign policy, and resolve issues regarding claims by the states on western lands. Many leading scholars and statesmen at the time, known as Federalists, thought that the articles created a federal government that was too weak to survive. The lack of power to tax, for example, meant that the federal government was frequently near bankruptcy in spite of its repeated requests to the states to put forth more money to the federal government. Larger states resented the structure under the articles, which gave small states an equal vote to larger states. Finally, the articles reserved the power to regulate commerce to the states, meaning each pursued its own trade and tariff policy with other states and with foreign nations. In 1786, work began in a series of conventions to rewrite the articles, resulting in the adoption of the U.S. Constitution in Philadelphia in 1787.

1. The first constitution of the United States of America; it established the union of states.

In this chapter we explore the Constitution in depth. We'll examine how the Constitution sought to rectify the weaknesses in the articles, especially in commerce. We go beyond the meaning of the words and explain how judicial interpretation of the Constitution, while still evolving, has forever changed its original place in U.S. political economy. We'll explore the first ten amendments to the Constitution, the **Bill of Rights**², and look at how many of the key civil liberties contained in the Bill of Rights also affect businesses. By the end of the chapter, you should have a solid grasp on why the Constitution remains an enduring document and why it's important for business professionals to be able to speak on it with authority.

Key Takeaways

The Articles of Confederation established the United States of America. It provided a central federal government with limited powers, including the power to wage war. The articles ultimately failed because the federal government lacked the power to raise its own taxes or to regulate commerce. In 1787, the Philadelphia Convention adopted a new Constitution to replace the articles.

2. The first ten amendments to the U.S. Constitution.

5.1 Federalism and Preemption

LEARNING OBJECTIVES

1. Explore how the Constitution creates a limited government through the separation of powers and through checks and balances among the three branches of government.
2. Learn how the Constitution resolves conflicts between state and federal laws.
3. Understand the rules surrounding preemption.

Have you ever read the Constitution from beginning to end? Look at the text of the Constitution. It's remarkably short—shorter than many people realize. Historically, it is the shortest and oldest written constitution still in force. Ironically, the Constitution's brevity may be one of the reasons that it endures to this day, as judicial interpretation has kept its meaning relevant for modern times.

Much of its content deals with the allocation of power among three separate and coequal branches of government. Substantively, much more attention is paid to the limitations on the power given to each of the three branches than to any positive grant of rights. Indeed, while many Americans believe that it is their “constitutional right” to be free, many of those freedoms are actually contained in the Bill of Rights, which are amendments to the Constitution. In contrast, the main body of the Constitution is concerned primarily with structure. In other words, the Constitution is a document of prohibition, outlining what government cannot do as opposed to what government must do.

As a result of this structure, the Constitution is rarely the right place to deal with contemporary political issues, no matter how important. At the state level, many states permit frequent amendments to their constitutions to reflect contemporary public policy, from school funding to gambling to gay marriage. There is often support among many people for constitutional amendments to ban flag burning,

Figure 5.1 Constitution of the United States of America



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permit prayer in school, ban gay marriage, or ban abortion. At the federal level, however, these issues are rarely resolved at the constitutional level. There is a practical bar, of course, given how difficult it is to amend the Constitution. Even if it were easier to amend, however, the Constitution remains very much a document of structure rather than substantive law.

During his confirmation hearings, Chief Justice John Roberts spoke of his role as an umpire calling the balls and strikes and not pitching or batting. If judges are umpires, then the Constitution sets forth the rules of the game. The biggest rule laid down in the Constitution is the **separation of powers**³.

Fundamentally, the separation of powers requires that each branch of government play its own role in governing the people. The judicial branch plays a critical role in interpreting the Constitution and outlining the powers of the legislature and executive branches. The interplay between Article I (legislative) and Article II (executive) is no less important. Although more than two centuries have passed since the first Congress and the first president served, the limits of power between these two branches continue to be redefined, especially in the wake of the September 11 terrorist attacks.

Article I of the Constitution establishes the legislative branch through a **bicameral legislature**⁴. The lower House of Representatives, with frequent elections (every even-numbered year), has 435 members, with representation spread proportionately to a state's population as determined by a census every decade. The most populous state, California, has fifty-three members, while several states are so small that they have only one representative (Alaska, Delaware, Montana, North Dakota, South Dakota, Vermont, and Wyoming). The House is led by the **Speaker of the House**⁵, typically from the party that holds the majority in the House. The House is generally thought to represent the most contemporary views of the American public, with its large body of members and frequent elections.

As a check on the majority will, and on the power of larger states, the Senate is a smaller body with one hundred members (two from each state) and with less frequent elections (every six years). The Senate is meant to be a more deliberative body and to ensure a wider level of debate before impassioned legislation is hastily rushed into law. The makeup of the Senate means that citizens from smaller states, representing much fewer people, can often frustrate the will of the majority of Americans. The Constitution places the power to legislate with both chambers, but the House retains the exclusive right to originate bills raising revenue (taxation), while the Senate maintains the exclusive right to provide advice and consent to the president, where advice and consent are required. Additionally, while the House

3. The division of enumerated powers of government among separate branches, typically the legislative, executive, and judicial.
4. A legislature with two chambers, or houses.
5. The presiding officer in the U.S. House of Representatives.

retains the right to **impeach**⁶ officials for “high crimes and misdemeanors,” the Senate tries such impeached officials.

Article II of the Constitution establishes the executive branch of government. While the Constitution was being drafted, the delegates knew that they wanted George Washington to be president. Washington was in retirement in Mount Vernon at the time, after successfully leading the colonies in the Revolutionary War. Since the delegates knew Washington would be president, they spent remarkably little time in writing Article II, which is very short. Washington was elected to both his first and second terms with 100 percent of the Electoral College vote, something no other president has since done. While Article II sets forth some of the mechanisms for becoming president—and is the only place in the Constitution that prescribes a specific oath of office—when the Constitution was drafted, little was known about what the president’s role would be.

Article II grants the president an almost total power over foreign affairs, including the power to make treaties and appoint ambassadors. He is commander-in-chief of the armed forces. The president is also responsible for executing, or enforcing, the laws of the country. While Congress can pass any legislation it wants to, ultimately legislation is meaningless unless there are sanctions for violating the law. Through the prosecutorial and police functions, the president ensures that the will of the people, as expressed through Congress, is carried out.

The Constitution’s deliberate ambiguity on the powers of the president left much room for debate on how strong the executive branch should be. After the September 11 attacks, many in the George W. Bush administration argued for a strong **unitary executive**⁷ theory. Bush administration lawyers reasoned that only a strong executive could effectively wage war with Al-Qaeda. Under a congressional authorization, the administration embarked on a program to capture and kill terrorists around the world and to gather as much information about terrorist activities as possible. Many in Congress believed, however, that the executive branch overstepped its authority in pursuing these goals, leaving Congress behind.

For example, to collect intelligence on suspected terrorists in the United States, Congress passed a law, the Foreign Intelligence Surveillance Act, in 1978. FISA, as the law is known, requires federal law enforcement officials to seek a search warrant from a secret court before carrying out surveillance or wiretapping. The Bush administration routinely carried out surveillance on persons in the United States without this judicial oversight, arguing that it was part of the unitary executive theory to do so. In another program, the Bush administration allegedly captured suspected terrorists abroad and moved them to secret prisons outside the jurisdiction of the United States for interrogation, a practice known as

6. To formally accuse an elected official of misconduct.

7. A theory in constitutional law that the president controls the entire executive branch, totally and completely.

extraordinary rendition⁸. In late 2009, an Italian court convicted twenty-three American officials, including members of the Central Intelligence Agency (CIA), of extraordinary rendition in the case of a Muslim cleric kidnapped from Milan. The officials were convicted in their absence and have not been extradited to Italy. Extraordinary rendition is likely illegal under U.S. and international law, but lawsuits attempting to find out more information about the program have been thwarted by the executive branch's claim of the **state secrets**⁹ doctrine.

Congress and the president have also clashed over the treatment of suspected terrorists. Article I, Section 9 of the Constitution states that "The Privilege of the Writ of **Habeas Corpus**¹⁰ shall not be suspended, unless when in Cases of Rebellion or Invasion the public Safety may require it." The right of habeas corpus is a fundamentally important right, appearing first in the Magna Carta and considered so important by Constitutional delegates that it was inserted into the text of the Constitution itself, not in the Bill of Rights. When the Bush administration began imprisoning suspected terrorists at the military base in Guantanamo Bay, Cuba, the administration took a series of unprecedented positions on the legal status of those detainees, including the position that the detainees did not have the right to seek habeas relief. Federal courts, including the Supreme Court, gradually overturned most of these positions, and the detainees are now being tried by either military tribunals or civilian courts.

Another controversial position adopted by the administration was on the use of enhanced, or aggressive, interrogation methods. Critics claimed these techniques amounted to torture (which is banned by U.S. law as passed by Congress) and may be unconstitutional under the Eighth Amendment, which prohibits cruel or unusual punishment.

Video Clip: "Mancow" Waterboarded

[\(click to see video\)](#)

Another aspect of the separation of powers that is less obvious is the separation of power between the federal and state governments, known as **federalism**¹¹. You already know that state and federal governments sometimes share power and that the rules of subject matter jurisdiction determine which legal system has jurisdiction over a particular matter or controversy. In some areas, such as family or property law, the states have near exclusive jurisdiction. In other areas, such as negotiating treaties with foreign countries or operating airports and licensing airlines, the federal government has near exclusive authority. In the middle, however, is a large area of subject matter where both state and federal governments may potentially have jurisdiction. What happens if state and federal

8. The capture and transfer of suspected criminals from one country to another for interrogation.
9. The doctrine that certain information on national security is so sensitive that it cannot be disclosed in court.
10. The right to seek release from unlawful detention by petitioning a neutral judge.
11. The division and sharing of power between state and federal governments.

laws exist on the same subject matter, or worse, what happens if they directly contradict each other?

Legal rules of **preemption**¹² seek to provide an answer to these questions. Under the Constitution’s Supremacy Clause (Article VI, Section 2), the Constitution and federal laws and treaties are the “supreme law of the land” and judges in every state “shall be bound” by those laws. Let’s say, for example, that Congress sets the minimum wage at \$7.25 an hour. A state that passes a law making the minimum wage lower than that would immediately see the law challenged in federal court as unconstitutional under preemption and Supremacy Clause principles, and the state law would be overturned.

Hyperlink: Medical Marijuana in the States

<http://www.npr.org/templates/story/story.php?storyId=113924395>

Under the federal Food and Drug Act, marijuana is classified as a Schedule I drug under the Controlled Substances Act, meaning it is restricted just like cocaine or heroin. Fourteen states have passed laws that permit marijuana to be grown, sold, and used for medicinal purposes, such as treating nausea and stimulating hunger in cancer patients. The federal government aggressively prosecuted medicinal use of marijuana, and in 2005 the Supreme Court ruled that the federal law trumps state laws, *Gonzalez v. Raich*, 545 U.S. 1 (2005), meaning that local growers could be arrested and prosecuted under federal law even if what they were doing was perfectly legal and authorized under state law. In 2009 the Obama administration announced a change in policy. Listen to this National Public Radio story about what this change means for the medicinal use of marijuana in the states.

When there is no direct conflict between state and federal law, then the rules of preemption state that courts must look to whether or not Congress intended to preempt the state law when it passed the federal statute. If there is no clear statement by Congress that it wishes to preempt state law, or if it is unclear what Congress meant to do, then the state law will survive if possible (i.e., there is a presumption against preemption). Even if there is no statement by Congress on preemption, however, if Congress so completely regulates a particular subject area that there is “no room” left for states to regulate, then preemption exists. For example, after September 11, Michigan passed a law requiring student pilots in Michigan to pass a Federal Bureau of Investigation (FBI) background check. The

12. The doctrine that permits federal law to trump, and render unenforceable, conflicting state laws.

Federal Aviation Administration, which sets forth pilot qualifications and licensing, has no such requirement, and since the federal government regulates the aviation industry completely (from airports to pilots to airlines to training standards), Michigan's law is preempted.

Hyperlink: Can States Regulate Car Safety Standards?

<http://www.nhtsa.dot.gov/cars/rules/import/fmvss/index.html>

Sometimes it's not clear whether or not a state law is preempted, and the courts must undertake a searching inquiry to determine congressional intent. In *Geier v. Honda*, *Geier v. American Honda Motor Company*, 529 U.S. 861 (2000). for example, a teenager filed a tort lawsuit against Honda for injuries she suffered during a car accident. Her lawsuit claimed that her 1987 Honda Accord was defective because it didn't have any airbags. Airbag technology, which existed at the time but was used primarily in expensive luxury cars, would have minimized her injuries. If she had won her state lawsuit in the District of Columbia, then in effect all 1987 Honda Accords sold in the District of Columbia would have to be equipped with airbags to avoid tort liability. Honda's defense was preemption. Under a federal regulatory scheme known as the Federal Motor Vehicle Safety Standards (FMVSS), the federal government sets forth safety standards that cars must meet to be sold in the United States. FMVSS 208 sets the standard for seat belts, and in 1987 manufacturers were required to install either airbags or passive (motorized) seat belts. A rule that required manufacturers to install airbags exclusively would directly contradict FMVSS 208, so the Supreme Court ruled that FMVSS preempted any state attempts to regulate motor vehicle safety standards.

When the Supreme Court found preemption in the Honda case, many in the business community wondered if a new era of preemption might have arrived. Federal regulation would in effect provide a shield against liability lawsuits. These hopes were short lived, as the Supreme Court continues to hold a presumption against preemption. The drug industry, in particular, would like preemption to end tort litigation.

Hyperlink: If the FDA Approves a Drug Label, Can Patients Still Sue Drug Manufacturers?

<http://www.npr.org/templates/story/story.php?storyId=101465350>

Wyeth Pharmaceuticals manufactures an anti-nausea drug called Phenergan, which was approved by the U.S. Food and Drug Administration (FDA) in 1955. Under federal law, the FDA must approve the wording on labels and documentation accompanying regulated drugs. The FDA-approved label contained warnings against “intra-arterial” injection, which carried the risk of irreversible gangrene. The plaintiff in the case, Vermont musician Diana Levine, went to a clinic for treatment and ended up losing her arm when Phenergan was incorrectly administered to her. She sued Wyeth, arguing that the warning label on the drug didn’t prohibit the type of injection that led to her injuries. A jury awarded her more than six million dollars in damages. On appeal to the Supreme Court, Wyeth argued that since the FDA approved the label, lawsuits arguing that the label was inadequate were preempted. The Supreme Court examined the history of the Food and Drug Act and ruled for Diana Levine, holding that when Congress wrote the law, it never meant to preempt state laws. In fact, the Supreme Court found that Congress meant for state lawsuits to work alongside the Food and Drug Act to ensure drug safety for consumers.

KEY TAKEAWAYS

The Constitution is mainly a structural document, setting forth the allocation of power among the three branches of government and the limitations on that power. It is concerned mainly with what the government cannot do, as opposed to what the government must do. At the federal level, constitutional amendments are rarely used to carry out social policy. Article I of the Constitution establishes a bicameral legislature, with a House of Representatives and a smaller, more deliberative Senate. Both chambers must agree before legislation can be passed. Article II of the Constitution establishes the executive power in the president, who must execute the laws passed by Congress. The balance of power between Congress and the president is subject to much interpretation and change throughout history, including the post-September 11 era. Power is also divided between state and federal governments under federalism. The Supremacy Clause states that when there is a conflict between state and federal law, federal law wins. If there is no direct conflict, the state law survives unless Congress expressly preempts state law.

EXERCISES

1. One of the attempts to use the Constitution to achieve a social policy was Prohibition. Review the twenty-seven amendments to the Constitution. Other than the Bill of Rights, can you identify other amendments used to achieve social policy?
2. Can you name your representatives in the House of Representatives and the Senate? Who is the current Speaker of the House and the Senate Majority Leader?
3. Can you think of current examples where legislation that is popular with the majority of Americans is held up in the Senate, especially by Senators from smaller states?
4. Do you believe that the United States is better served by a strong or weak unitary executive? Explain your answer.
5. Where should the balance of power lie between Congress and the president in prosecuting the war on terror? If the president believes enhanced interrogation such as waterboarding is necessary to obtain necessary intelligence, should Congress attempt to intervene?
6. In 2007 five victims of extraordinary rendition filed suit against Jeppesen Dataplan Inc. (a Boeing subsidiary), claiming that Jeppesen provided logistical support to the CIA's extraordinary rendition program. The government has so far successfully kept the case from going to trial, arguing that doing so would endanger government secrets. Do you believe that someone who has been subject to extraordinary rendition should be able to sue the government, or private companies, for what happened to them? Why or why not?
7. In the *Geier* case, the Supreme Court held that states may not regulate motor vehicle safety standards. How do you think states like California and Massachusetts can impose stricter emission controls on motor vehicles than the federal standard?

5.2 The Commerce, Taxing, and Spending Clauses

LEARNING OBJECTIVES

1. Explore how the Constitution grants the power to regulate commerce to the federal government.
2. Understand how the meaning of the Commerce Clause has expanded greatly.
3. Learn about state police powers and the limitations on those powers.
4. Learn about the power given to Congress to tax and spend money.

Figure 5.2



The Commerce Clause allows Congress to regulate all aspects of interstate commerce.

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Hyperlink: The Powers of Congress

<http://topics.law.cornell.edu/constitution/articlei#section8>

Members of the Constitutional Convention were divided about how powerful the new central government should be. To avoid the rise of tyrannical government, the Constitution carefully grants certain powers to Congress, reserving all other powers to the states. These powers are listed in Article I, Section 8. Look at this section in [Note 5.25 "Hyperlink: The Powers of Congress"](#) and notice how detailed these powers are.

The list begins with monetary matters, an issue of great concern at the time because the prior government was bankrupt and states regulated their own money supply. The Congress therefore has the power to borrow money, lay and collect taxes, regulate commerce (the **Commerce Clause**¹³), establish a uniform law on bankruptcy and **naturalization**¹⁴, make money (currency) and establish its value, punish the counterfeiting of U.S. money, and establish a uniform system of weights and measures. The list then moves on to aspirational ideals for the young new country to strive toward. Congress has the power to establish post offices and post roads and to protect intellectual property in copyrights and patents. Next, the list turns to Congress's adjudicative powers: to create lower courts under the Supreme Court created in Article III and to define crimes committed on the "high seas" and against the "law of nations." Congress is also given fiscal responsibility over the armed forces and navy (note there is, of course, no mention of an air force) and the power to provide oversight to the militia. Then, to help Congress with carrying out these powers, Article I, Section 8 provides that the states may cede to Congress a district, not to exceed ten square miles, that will become the seat of government, and to exercise exclusive legislative authority over this district.

The scope of power granted under Article I, Section 8 is the subject of much debate among legal scholars. The clause granting Congress the power to regulate commerce is particularly troublesome. There is very little debate about the power of Congress to regulate foreign trade. This power is explicit, total, and exclusive. If Congress wanted to ban all imports and exports into and out of the United States, for example, it could legitimately do so. Indeed, Congress routinely uses economic trade sanctions against "rogue" nations such as Cuba and North Korea as a means of economic warfare to try to bring about regime change. Even in the case of friendly allies such as Canada, Mexico, and the European Union, Congress routinely engages in trade regulations that restrict or distort foreign trade. Since this power is exclusive to Congress, state attempts to regulate foreign commerce are invalid. Oregon, for example, cannot ban Oregon companies from exporting to Mexico or establish a free trade zone with duty-free imports with China.

13. The power granted to Congress to regulate foreign and domestic commerce.

14. The process and procedure to become a citizen.

There is more disagreement about Congress's power to regulate domestic commerce. Notice how Article I, Section 8 is structured. Many scholars believe that this list is complete and exhaustive, since it lists all the powers the Founding Fathers wanted to give Congress at the time. The idea, they argue, was to create

powerful and limited government, leaving the states room to govern in all other areas. As evidence, these scholars point to the structure of the list and the high level of detail provided (such as specific crimes to be made punishable and the square mile limitation for the seat of government). Other scholars believe that the list should be interpreted more broadly and that the language granting Congress the power to “make all laws necessary and proper” to carry out the enumerated powers demonstrates the Founding Fathers’ desire for a more flexible interpretation, to allow Congress the power to react to needs and challenges not foreseeable at the time the clause was drafted.

In the early part of the country’s history, the first view held firm sway, and together courts and Congress carefully observed the constitutional limits to the growth of federal government power. If you consider our modern federal government, however, it’s obvious that the second view is now more prevalent. Today, the federal government does a lot more than what is enumerated on the list in Article I, Section 8. From regulating educational standards, to defining clean air and water, to outlawing workplace discrimination, to licensing portions of the electromagnetic spectrum for cell phone and digital television providers to use, it’s clear that if a member of the Constitutional Convention were to travel forward in time, he would be shocked at both the pace of progress and the size and power of the federal government. How did our country’s view of congressional power evolve over time?

The answer can be traced to the Great Depression. In response to unprecedented economic distress, President Roosevelt sought to redefine the very nature of the employer/employee relationship. He, along with Congress, enacted legislation that established a minimum hourly wage, set maximum weekly working hours, established workplace safety rules, outlawed child labor, and provided for a safety net to protect older and disabled workers. These laws initially ran into stiff opposition at the Supreme Court. The justices at the time clung to a more formalistic reading of Article I, Section 8 and saw the employer/employee relationship as one governed by freedom of contract. In this view, if a worker wanted to work and an employer was willing to provide that work, then the government should not interfere with that contract. Thus, early portions of the New Deal were struck down as unconstitutional under the Commerce Clause.

After President Roosevelt proposed his court-packing plan, leading one of the swing votes on the Supreme Court to change his vote to begin upholding the New Deal, the barriers surrounding the interpretation of the Commerce Clause came crashing down. Courts have now adopted a very flexible reading of the Commerce Clause. As long as Congress makes reasonable findings that a certain activity has some sort of effect on interstate commerce, Congress can regulate that activity.

This broad interpretation of the Commerce Clause has been challenged repeatedly. In 1964, for example, Congress passed a broad and sweeping Civil Rights Act, prohibiting discrimination against citizens on the basis of race, color, national origin, and sex. Congress relied on its power under the Commerce Clause to pass this legislation. That same year, the Heart of Atlanta Motel in Georgia ([Figure 5.3 "Heart of Atlanta Motel"](#)) filed a federal lawsuit seeking to overturn the Civil Rights Act as unconstitutional, arguing that Congress lacked the authority under the Commerce Clause to pass the law. The Supreme Court held the law to be constitutional, finding that since 75 percent of the motel's clients came from out of state and since the motel was located near Interstates 75 and 85, the business had an "effect" on interstate commerce. *Heart of Atlanta Motel v. United States*, 379 U.S. 241 (1964). Subsequent civil rights legislation, including the important Americans with Disabilities Act, is also grounded in congressional authority to regulate interstate commerce.

In the late 1990s, several curious decisions by the conservative wing of the Supreme Court led some observers to wonder if the days of virtually unfettered authority by Congress to regulate under the Commerce Clause were coming to an end. Judicial conservatives, especially the late Chief Justice Rehnquist, have always been somewhat uncomfortable with the broad reading of the Commerce Clause, worried that it has led to a runaway federal government many times bigger than what the Founding Fathers intended. In a 1995 case, the Supreme Court held that the 1990 Gun-Free School Zones Act was unconstitutional. The law prohibited the possession of weapons in schools and was based on a congressional finding that possession of firearms in educational settings would lead to violent crime, which in turn affects general economic conditions by causing damage and raising insurance costs and by limiting travel to and through unsafe areas. Students intimidated by a violent educational setting would also be affected, learning less and leading to a weaker educational system and economy. By a 5-4 margin, the Supreme Court found these arguments unpersuasive and overturned the law, holding that Congress lacked authority under the Commerce Clause to regulate the carrying of handguns into schools. *United States v. Lopez*, 514 U.S. 549 (1995). Then, five years later, the Supreme Court overturned a portion of the 1994 Violence Against Women Act, which gave a woman the right to sue her attacker in federal court for civil damages, holding that the effects of violence against women were too "attenuated" to be valid under the Commerce Clause. *United States v. Morris*, 529 U.S. 598 (2000). Any expected

Figure 5.3 *Heart of Atlanta Motel*



Source: Photo courtesy of Georgia State University, Special Collections of the University Library, http://tarlton.law.utexas.edu/clark/heart_long.html.

revolution in the scope of Congress’s authority failed to materialize, however, and these two cases are probably aberrations rather than predictors of where the Court is heading on this topic.

While the Constitution limits the federal government’s powers to those enumerated in Article I, Section 8, the states also have broad lawmaking authority. These powers stem from the states’ **police power**¹⁵, which permits states to regulate broadly to protect and promote the public order, health, safety, morals, and general welfare. You’ve probably experienced this yourself. Different states have different speed limits, for example. Some states permit the sale of alcohol on Sundays, while others prohibit it. Some states permit casino gambling, while others do not. A few states permit same-sex marriage, while many do not. Some states prohibit smoking in bars and restaurants, including North Carolina, home to the nation’s tobacco industry. In California, an attempt to rein in obesity resulted in a state law to require calorie counts on restaurant menus and a ban on the use of trans fats. In Texas, teenagers must have parental permission to use tanning beds at a salon. Massachusetts bans dog racing. Many states are implementing bans on texting while driving.

15. The general power of states to regulate for the health, safety, and general welfare of the public.

Hyperlink: How Assisted Suicide Ruling Affects Doctors' Work

<http://www.npr.org/templates/story/story.php?storyId=5160904>

In 1994 Oregon voters approved the country's first physician-assisted suicide law, the Oregon Death with Dignity Act. The law permits certain patients to voluntarily hasten death by taking a lethal dose of prescription medication. To meet the law's requirements, the patient must be terminally ill with less than six months to live, must be informed and voluntarily request the medication, must be able to consume the medication by himself or herself, must be referred to counseling, and must have the terminal diagnosis confirmed by a second doctor. Many patients, fearing a painful or torturous natural death, obtain the medication and never take it, but some do. In 2001 Attorney General John Ashcroft issued a rule interpreting the federal Controlled Substances Act as prohibiting any physician from prescribing medication under the Death with Dignity Act, subjecting any doctor who did so to federal prosecution. In a 6–3 decision, the Supreme Court decided that the Controlled Substances Act did not grant the attorney general the authority to override a state standard for regulating medicine. *Gonzalez v. Oregon*, 546 U.S. 243 (2006). In doing so, the Court held that the state police power is entitled to greater deference, in this case, than Congress's powers under the Commerce Clause. Listen to the National Public Radio story for one physician's account of how the Death with Dignity Act has affected his practice.

The Oregon Death with Dignity Act case illustrates how a state, in exercising its police power, can actually grant *more* civil rights to its citizens than the federal government does or wishes to. Similarly, states that have legalized same-sex marriage have done so under their police powers, which is permissible as long as the exercise of police power does not violate the federal Constitution. Generally, this means the state legislation must be reasonable and applied fairly rather than arbitrarily. Additionally, a critical limitation on the state police power is that it cannot interfere with Congress's power to regulate interstate commerce. This concept is known as the **dormant commerce clause**¹⁶ because it restricts the states' abilities to regulate commerce, rather than the federal government's.

A state law that discriminates against out-of-state commerce, or places an **undue burden**¹⁷ on interstate commerce, would violate the dormant commerce clause. For example, if a state required out-of-state corporations to pay a higher tax or fee than

16. The concept that restricts states from placing an undue burden on interstate commerce.

17. A constitutional test created by the Supreme Court to determine a law's validity.

an in-state corporation, that would be unconstitutional. A state that required health and safety inspections of out-of-state, but not in-state, produce or goods would be unconstitutional. In 2005 the Supreme Court held that state restrictions prohibiting out-of-state wineries from selling directly to consumers in-state was unconstitutional. *Granholm v. Heald*, 544 U.S. 460 (2005). Federal courts have repeatedly held that state attempts to regulate Internet content (typically to prevent pornography) are unduly burdensome on interstate commerce and therefore unconstitutional. Note, however, that this prohibition against out-of-state discrimination does not prevent a state from exercising its police power to protect state citizens, as long as the power is exercised evenly and equally. If a state wanted to weigh trucks on highways to ensure they did not exceed maximum weight rules, for example, that action would be permissible even if the trucks came from out of state, as long as the requirement applied equally to all trucks on that state's highways.

In addition to the power to regulate commerce, the Constitution places two critical powers with Congress: the **taxing power**¹⁸ and the power to spend the taxes it collects. The taxing power is a broad one, and the Supreme Court has not overturned a tax passed by Congress in nearly a century. As long as the tax bears some reasonable relationship to generating revenue, the tax is valid.

States are also permitted to tax, but only if the activity taxed has a **nexus**¹⁹ to the state. A transaction (such as a sale) that takes place inside the state would create a nexus for sales tax to attach. Working typically creates a nexus for state or local income tax to apply, and owning real property creates a nexus for real estate tax to apply. What happens, however, if a state's citizen purchases goods from a seller out of state? Traditionally, buyers do not pay sales tax to the government directly—rather, they pay the sales tax to the seller, who collects the tax on behalf of the government and turns it over to the government at regular intervals. In the past, mail-order catalog sellers from out of state would not collect sales tax in states where they don't have a physical presence. As the popularity of e-commerce has skyrocketed, more and more states are reexamining how to tax transactions from out-of-state sellers by compelling those sellers to collect the applicable sales tax. Some states are so desperate they are starting to look for a nexus anywhere they can. In New York, for example, the legislature passed a law requiring Amazon.com to collect sales tax from New York residents based on the presence of New York citizens who link to Amazon's Web site in turn for a commission generated by those links.

Congress also has the power to “pay the debts and provide for the common defense and general welfare.” This **spending power**²⁰ is considered very broad. Courts have interpreted this power to mean that Congress can spend money not only to carry out its powers under Article I, Section 8 but also to promote any other objective, as

18. The power granted to Congress to raise revenue through taxation.
19. A sufficient connection to justify state taxation.
20. Congress's power to spend public revenue to meet broad public objectives.

long as it does not violate the Constitution or Bill of Rights. For example, in 1984 Congress passed the National Minimum Drinking Age Act, which required states to adopt a minimum age of twenty-one for the purchase and possession of alcohol. If a state did not adopt the age-twenty-one requirement, Congress would withhold federal highway funds from that state to repair and build new roads. One by one, states began adopting age twenty-one as the minimum drinking age, even though the age requirement would typically be a matter of state police power. In a challenge by South Dakota, which wanted to keep nineteen as the minimum drinking age, the Supreme Court upheld Congress's use of withholding funds to force the states to raise the minimum drinking age. *South Dakota v. Dole*, 483 U.S. 203 (1987). Congress has used the spending power to coerce states to adopt a fifty-five-mile-per-hour speed limit (rescinded by the Clinton administration) and to lower the driving under the influence (DUI) blood alcohol level limit from 0.10 in most states to 0.08.

KEY TAKEAWAYS

Article I, Section 8 of the Constitution grants certain specific powers to Congress. The power to regulate commerce is one of these powers, and the power of foreign commerce is explicit, total, and exclusive. During the Great Depression, the Supreme Court greatly expanded the interpretation of Congress's ability to regulate domestic interstate commerce, and this expansion led to congressional authority to regulate virtually all human activity within the United States, with very few limited exceptions. This authority extends to civil rights, where Congress has passed several key pieces of legislation, including the Civil Rights Act of 1964 and the Americans with Disabilities Act, under the Commerce Clause. Attempts by judicial conservatives to circumscribe the power of the Commerce Clause appear to have failed for now. Unlike the federal government, states have broad police powers to regulate for the health, safety, and moral well-being of their citizens. The exercise of these police powers cannot violate the federal Constitution and, importantly, cannot violate the dormant commerce clause by discriminating against or placing an undue burden on interstate commerce. The power to tax is broad, and as long as a tax bears a reasonable relationship to raising revenue, the tax is upheld as constitutional. The power to spend is similarly broad, and Congress can spend funds to achieve broad objectives beyond its enumerated powers.

EXERCISES

1. Article I, Section 8 of the Constitution establishes the seat of government, which today is Washington, DC. Residents of Washington, DC, have no representation in Congress other than a nonvoting delegate. Should Washington, DC, residents be granted more representation? What are the legal impediments toward such a move? What would be the political repercussions?
2. Today the United States is one of the few remaining countries to refuse the adoption of the metric system for weights and measures. Would the decision to “go metric” be within the powers of Congress? For more information on this topic, explore the National Institute of Standards and Technology at <http://www.nist.gov>.
3. Congressional authority to regulate foreign trade extends to the use of economic sanctions against rogue foreign nations. How effective have these sanctions been in the past? Do you believe it is more effective for Congress to ban trade with a foreign nation to encourage its citizens to overthrow hostile governments or for Congress to encourage trade so that those citizens may prosper economically?
4. If states are prohibited by the dormant commerce clause from discriminating against out-of-state commerce, how can state universities charge a lower tuition rate to in-state residents? Can you distinguish the role the state is playing when it does so, between that of a spender and that of a collector of monies?
5. Read the *New York Times* article on Amazon.com and its efforts to avoid a nexus to collect sales tax, at <http://www.nytimes.com/2009/12/27/business/27digi.html>. Amazon.com generates more than twenty billion dollars in sales annually but only collects sales taxes in five states, where it is headquartered and where it has facilities. Through a process called “entity isolation,” the company has created methods that allow it to avoid creating a nexus even in states where it has employees and facilities. What are the implications of this behavior?
6. In 2005, in an effort to coerce states to tighten up standards for issuing identity cards and driver licenses in the fight against terrorism, Congress passed the REAL ID Act stipulating certain requirements for state-issued identification. States that failed to comply would be punished by its citizens being denied access to federally run facilities including airports. How is this an exercise of the spending power? Do you believe Congress should have the ability to stipulate who can use federally funded airports?

5.3 Business and the Bill of Rights

LEARNING OBJECTIVES

1. Learn how the Constitution protects the civil liberties of business entities.
2. Explore how the First Amendment protects a company's right to speak.
3. Discuss how the due process clause protects companies from arbitrary government action.
4. Learn how the equal protection clause protects companies from government discrimination.

The ink on the Constitution was barely dry when the first Congress began turning its attention to amending it. During the debate surrounding the Constitution, there was much discussion about whether or not an explicit protection of civil liberty was necessary. Some believed that the British common-law system implicitly protected civil liberties, so a written declaration of rights wasn't necessary. Others believed that the Constitution created a strong federal government and that a written declaration of rights was therefore critically necessary. In 1789, the same year the Constitution went into effect, Congress proposed ten amendments to the Constitution, a package that became known as the **Bill of Rights**²¹. Within two years, the Bill of Rights had garnered the necessary votes to become law.

When we speak of civil liberties protected in the Constitution, we often think of how these liberties apply to people. Although the Constitution does not contain the word "corporation," corporations have some characteristics of being a "person," so various courts have held that several of these civil rights also apply to business entities. In this section we'll take a closer look at how these rights apply to businesses. In particular, we'll examine the First, Fifth, and Fourteenth amendments.

Before we begin, it's worth making some observations about civil liberties generally. First, there are no absolute rights, in spite of the wording of any specific amendment. For example, the First Amendment states that "Congress shall make no law abridging the freedom of speech." In fact, there are many laws that limit the freedom of speech. You aren't allowed to libel or slander someone, for example, or incite a crowd into a riot. Instead of absolute rights, courts have to constantly balance competing interests in deciding where the limits of our rights lie. The right of the public to know information about the lives of politicians and other high-

21. The first ten amendments to the U.S. Constitution.

profile figures, for example, must often be balanced by the right those citizens have to their own privacy.

Second, it's fair to say that while the Constitution sets up a system of government based on principles of representative democracy, the Bill of Rights exists to protect the minority, not the majority. The vast majority of Americans will go through life without ever having their constitutional rights trampled on. It is for the very small minority of Americans that find themselves victims of constitutional violations that we find the greatest strength of the Bill of Rights. For this reason, many issues raised by civil liberties generally rise above the political process, where the majority generally prevails. For example, public opinion polls show that well over 95 percent of Americans feel that burning the American flag should be illegal. When such an overwhelming majority agrees on something, in a democracy the majority should prevail. In our democracy, however, the Supreme Court has stepped in and decided that the First Amendment will protect the very tiny percentage of the American population that wishes to burn the flag as a display of political opposition. Additionally, it's important to note that the only reason those of us in the majority know where the boundaries of our civil liberties lie is because of that tiny minority. If Americans weren't willing to test the boundaries by burning the flag or joining the Communist Party or refusing to take loyalty oaths or refusing to send their Amish children to public schools, then our civil liberties would remain theoretical ideals rather than concrete rights. Finally, note that other than the right to vote, the civil liberties protected by the Constitution extend to all persons physically on U.S. soil, not just citizens or legal immigrants. Persons visiting the United States temporarily, such as tourists and students, as well as undocumented aliens, are all entitled to the full protections of the U.S. Constitution while subject to U.S. law.

Third, the extent of our civil liberties protections vary from time to time. Society evolves with progress and challenges, and with that evolution, different needs arise in the realm of civil liberties. The Founding Fathers could not contemplate a digital world where an act of defamation on Facebook can spread to millions of people in a matter of hours, or imagine a society as pluralistic and diverse as ours has become. One constitutional amendment, the Eighth, illustrates how time shifts the meaning and application of civil liberty. The Eighth Amendment prohibits "cruel and unusual" punishment. The Supreme Court, in defining what "cruel and unusual" is, looks to "evolving standards of decency" in making the determination—in other words, what is cruel and unusual today may have been normal in years past.

Finally, major portions of the Bill of Rights apply equally to the states as they do the federal government. When adopted, the amendments were meant to restrict the federal government only (for example, "Congress shall make no law respecting an establishment of religion."). States were not similarly restricted, and many states

did in fact establish official state churches in the early days of the United States. After the Civil War, the Constitution was amended to include the Fourteenth Amendment, which prevents any state from depriving citizens of their rights without “due process of law.” Gradually, throughout the twentieth century, the Supreme Court developed a doctrine called **incorporation**²², by which the limitations on government behavior in the Bill of Rights were extended to apply to the states as well. While many portions of the Bill of Rights apply to the states, not all of it does. There is no requirement, for example, that states use a grand jury system to indict criminals. There is also no requirement that states provide juries in civil trials.

Hyperlink: Does the Second Amendment Apply to the States?

<http://www.npr.org/templates/story/story.php?storyId=128182208>

In 2008 the Supreme Court handed down a major victory for gun owners and gun rights advocates by declaring that a ban on handguns in the District of Columbia was unconstitutional under the Second Amendment, which the Court held protected an individual’s right to possess a firearm in private homes in Washington, DC, and other federal territories. *District of Columbia v. Heller*, 554 U.S. ___ (2008), <http://www.law.cornell.edu/supct/html/07-290.ZS.html> (accessed October 2, 2010). Soon after the case was decided, several lawsuits were filed across the nation, challenging similar bans on handguns in various states. In 2010 the Supreme Court decided that the Second Amendment is indeed incorporated against the states, meaning that state laws banning the possession of handguns in private homes are unconstitutional. *McDonald v. Chicago*, 561 U.S. ___ (2010), <http://www.supremecourt.gov/opinions/09pdf/08-1521.pdf> (accessed October 2, 2010).

22. The doctrine by which certain provisions of the Bill of Rights are applied against the states.

23. The section of the First Amendment prohibiting government from establishing a religion.

24. The section of the First Amendment prohibiting government from preventing the free exercise of religion.

We turn our attention first to the First Amendment. The First Amendment contains several important clauses pertaining to speech and religion. The two different clauses on religion are designed to be almost always in conflict with each other. On the one hand, the First Amendment prohibits the government from establishing any religion—this is called the **Establishment Clause**²³. On the other hand, the First Amendment prohibits the government from restricting the free exercise of religion—this is called the **Free Exercise Clause**²⁴. The conflict arises when some segments of society believe that the Free Exercise Clause means that they can practice their religion freely and openly, such as in a public school or city hall.

Those who believe in what Thomas Jefferson called a “**wall of separation**²⁵” between church and state, on the other hand, believe that the Free Exercise Clause must be subservient to the Establishment Clause, which would strictly prohibit such public displays of religious life.

As is often true in Bill of Rights cases, courts have had to fashion a test to draw the lines between these two competing visions of the Establishment and Free Exercise clauses. Generally speaking, the use of public funds for religious purposes and the public display of religious life are generally acceptable as long as the primary motivation is not to advance a specific religion. A city that wishes to display a Christmas tree or nativity scene, for example, would be permitted to do so as part of a general holiday-themed cultural display that also included a menorah and Rudolph, while a public high school that wished to have a public prayer before a football game would be prohibited. Several evangelical Christian groups have campaigned hard to de-emphasize teaching evolution in public high schools, replacing it with an alternative theory called **intelligent design**²⁶, which states that the universe is so complex that it is impossible to be explained by random nature and, therefore, an intelligent entity designed it. In one high-profile trial involving a lawsuit against a school board for adopting intelligent design, a Republican-appointed federal judge found intelligent design to be a thin disguise for the teaching of Bible-based creationism, a violation of the Establishment Clause. *Kitzmiller v. Dover Area School District*, 400 F. Supp. 2d 707 (M.D. Pa. 2005). On the other hand, the Supreme Court has found that the use of public funds to display the Ten Commandments on public lands such as parks is not automatically an Establishment Clause violation, depending on the context in which the monument or statue was erected. *Van Orden v. Perry*, 545 U.S. 677 (2005).

The First Amendment also protects the right to freedom of speech. While many nations believe in the right of citizens to think and speak freely, the United States is fairly unique in enshrining those principles into constitutional law. As is true in most Bill of Rights cases, the cases that test the limits of the First Amendment tend to be ones that involve the most unpopular, even heinous, speech. For example, after World War II many European nations outlawed the Nazi Party along with any Nazi propaganda material, as well as neofascist ideology. As a result, many pro-Nazi and white supremacist Web sites, books, catalogs, and music are hosted in the United States, where the First Amendment protects even hateful speech.

Not all speech is protected by the First Amendment; the type of speech very much drives the level of protection afforded it under the First Amendment. Courts generally recognize **political speech**²⁷ as speech most deserving of protection. Political dissent, displeasure with the government, forced loyalty oaths, restrictions on party membership, and even speech advocating the overthrow of government, all deserve extraordinary protection under the First Amendment. Political speech

25. The phrase coined by Thomas Jefferson (in a letter to the Danbury Baptist Association after it congratulated him on his election) to describe the Establishment Clause.

26. An alternative theory on the origin of life that states the universe is too complex to be explained by science alone.

27. Any speech dealing with politics or political figures.

isn't always written or uttered—it can sometimes take place through **symbolic speech**²⁸. The Supreme Court has held, for example, that burning the U.S. flag as a form of protest against U.S. government policy is symbolic speech, and therefore attempts to criminalize flag burning are unconstitutional restrictions on political speech. *Texas v. Johnson*, 491 U.S. 397 (1989).

On the other end of the spectrum is speech that deserves no protection under the First Amendment at all, such as speech that incites a panic (yelling “Fire” in a crowded theater when there is no fire, for example). **Defamation**²⁹ is another type of speech that falls into this category, and both **libel**³⁰ and **slander**³¹ are actionable torts. **Obscene**³² speech is also not subject to any protection under the First Amendment. Defining what is obscene has always vexed courts. The best test courts have developed is called the Miller test. *Miller v. California*, 413 U.S. 15 (1973). Under the Miller test, material is considered obscene if when applying contemporary community standards, the work, taken as a whole, appeals to a prurient interest in sex; portrays sexual conduct as specifically defined by applicable state law; and lacks serious literary, artistic, political, or scientific value. It's important to keep in mind, however, that even obscene and defamatory speech is subject to the doctrine of **prior restraint**³³. Attempts to shut down the speech before it is uttered are considered unconstitutional.

- 28. Speech that is not uttered or printed but displayed or performed instead.
- 29. False statements that impugn or damage someone's character or credibility.
- 30. Written forms of defamation.
- 31. Spoken forms of defamation.
- 32. A legal standard that, if met, means the work in question has no protection under the First Amendment.
- 33. A doctrine that prevents the government from restricting or punishing speech before it is uttered or published, in case the speaker changes his or her mind before proceeding.

Hyperlink: Fleeting Expletives

<http://www.npr.org/templates/story/story.php?storyId=10741235>

Although the First Amendment generally prevents the U.S. government from engaging in censorship, an exception exists for broadcast radio and television. Unlike cable and satellite programming, which requires viewers and listeners to “opt in” with a paid subscription to access content, broadcast radio and television use the public airwaves to carry transmissions that are readily accessible for free by anyone with a television or a radio. In 1973, in a case involving comedian George Carlin’s “Dirty Words” monologue, the Supreme Court held that although the monologue wasn’t obscene, the government (through the Federal Communications Commission, or FCC) could nonetheless regulate indecent material when vulnerable listeners, such as children, may be listening. *F.C.C. v. Pacifica*, 438 U.S. 726 (1978). Under this authority, the FCC enforces the “fleeting expletives” rule, which fines broadcasters for airing even momentary exclamations of profanity during live broadcasts. In 2010, after several rounds of litigation, the Second Circuit Court of Appeals held the FCC’s policy was unconstitutionally vague.

One area of First Amendment law that remains unsettled is what rights corporations have to speak, also known as **commercial speech**³⁴. In the early part of the twentieth century, the Supreme Court found that corporations had virtually no protection under the First Amendment. This view gradually evolved as the role and influence of companies grew. Today, corporations engage not just in purely commercial speech such as product advertising but also in matters of public policy, from globalization to human rights to environmental protection and global warming. In 2002 it looked like the Supreme Court would finally issue some guidance on this issue. *Nike v. Kasky*, 539 U.S. 654 (2003). In California, Nike Inc. was under fire from labor activists for allegedly engaging in sweatshop conditions in its foreign factories, including hiring child labor. In response to these allegations, Nike issued a series of press releases and denials, the “speech” in this case. Several activists filed lawsuits against Nike, claiming that these press releases and denials constituted false advertising by a company, which is against California law. Nike’s defense was that the press releases were more like political speech and were therefore protected by the First Amendment. Nike lost the argument in California state courts, and when the U.S. Supreme Court agreed to hear the case, the parties settled before the case could proceed any further.

34. Speech made by nonhuman entities.

In early 2010, however, the Supreme Court handed down another important decision on the rights of corporations to speak. *Citizens United v. Federal Election Commission*, 558 U.S. ___ (2010), http://www.fec.gov/law/litigation/cu_sc08_opinion.pdf (accessed October 2, 2010). In striking down federal and twenty-two state restrictions on corporate spending on political campaigns, the Supreme Court held that corporations are persons and therefore entitled to engage in political speech. Since corporations are unable to literally “speak,” they speak through spending money, and thus restrictions on how corporations may spend money during political campaigns are unconstitutional. The four dissenting justices worried about the implications of this ruling. If corporations aren’t allowed to vote, then why should corporations be allowed to spend freely to drown out the voices of real voters, who have no hopes of matching corporate spending on issue advertisements? Similarly, foreign persons have the same rights as U.S. citizens in making speeches on U.S. soil. If corporations are persons for purposes of speech, then it stands to reason that foreign corporations operating in the United States are entitled to the same protections and can also spend freely to influence U.S. elections. The implications of this ruling will likely be felt for many years to come.

Not all protected speech is protected all the time in all places. The government is permitted to place reasonable time, place, and manner restrictions on speech to maintain important governmental functions. These restrictions are generally upheld if they further an important or substantial governmental interest, they are unrelated to the suppression of free expression (in other words, are content neutral), and any restriction on First Amendment freedoms is no greater than that necessary to further governmental interests (the restriction is not **overbreadth**³⁵). Thus, for example, courts have upheld restrictions on posting signs on city-owned utility poles and picketing or protest permit requirements. On the other hand, when Congress tried to make it illegal for commercial Web sites to allow minors to access “harmful” content on the Internet in the Child Online Protection Act (COPA), the Supreme Court held the Act unconstitutional because of the overbreadth doctrine. *ACLU v. Ashcroft*, 535 U.S. 564 (2002). The Court found there were less restrictive alternatives than the Act, such as blocking and filtering software, and therefore the burdens placed by COPA on the First Amendment, by sweeping both legal as well as illegal behavior, were too heavy to be constitutional.

35. A law that covers legal conduct as well as illegal conduct.

Does this doctrine permit school officials to curb the free speech rights of high school students, who otherwise have rights outside of school hours? In 2002 an eighteen-year-old high school senior was suspended after he (with help from some friends) unfurled a banner during the Olympic torch relay through his town. The student, Joseph Frederick, was not in school that day and was standing across the street from the school when he unfurled the banner (Figure 5.4 "Joseph Frederick and Bong Hits 4 Jesus"). When asked later what the banner meant, Frederick replied that it was a nonsensical phrase he saw on a sticker while snowboarding. Frederick sued his high school principal for violating his First Amendment rights and won in the lower courts. On appeal, however, by a 5–4 decision the Supreme Court held that the school, which has a zero-tolerance policy on drug use, could restrict a student’s prodrug message even in these circumstances. *Morse v. Frederick*, 551 U.S. 393 (2007).

Figure 5.4 Joseph Frederick and Bong Hits 4 Jesus



Source: Photo courtesy of Clay Good / Zuma Press, <http://en.wikipedia.org/wiki/File:Bh4j.jpg>.

Another important restriction on governmental authority actually appears twice in the Constitution. The **due process**³⁶ clause appears in both the Fifth Amendment (“No person shall...be deprived of life, liberty or property without due process of law”) and the Fourteenth Amendment (“Nor shall any State deprive any person of life, liberty, or property, without due process of law”). The Fifth Amendment applies to the federal government, and after the Civil War, the Fourteenth Amendment made due process applicable to the states as well. At its core, due process means “fundamental fairness and decency.” The clause requires that all government action that involves the taking of life, liberty, or property be done fairly and for fair reasons. Notice that the due process clause applies only to government action—it does not apply to the actions of private citizens or entities such as corporations or, for that matter, to actions of private universities and colleges.

As interpreted by the courts, the due process clause contains two components. The first is called **procedural due process**³⁷. Procedural due process requires that any government action that takes away life, liberty, or property must be made fairly and using fair procedures. In criminal cases, this means that before a government can move to take away life, liberty, or property, the defendant is entitled to at least adequate notice, a hearing, and a neutral judge. For example, in 2009 the Supreme Court held that a state Supreme Court judge’s refusal to remove himself from a case involving a big campaign donor violated the procedural due process clause promise for a neutral judge.

36. Fundamental fairness and decency.

37. Government must use fair procedures.

Hyperlink: The Biased Judge

<http://www.npr.org/templates/story/story.php?storyId=105143851>

Hugh Caperton, a small coal mine operator in West Virginia, sued the giant Massey Coal Company, alleging that Massey used illegal tactics to force him out of business. A jury awarded Caperton more than fifty million dollars in damages. When Massey appealed the case to the West Virginia Supreme Court, he spent more than three million dollars on a campaign to defeat an incumbent judge and promote another judge, who then refused to excuse himself from the appeal and ended up casting the swing vote in a 3–2 decision to overturn the fifty-million-dollar award. On appeal to the Supreme Court, the Court held that the judge’s actions violated procedural due process.

The second component of the due process clause is **substantive due process**³⁸. Substantive due process focuses on the content of government legislation itself. Generally speaking, government regulation is justified whenever the government can articulate a rational reason for the regulation. In certain categories, however, the government must articulate a compelling reason for the regulation. This is the case when the regulation affects a fundamental right, which is a right deeply rooted in American history and implicit in the concept of ordered liberty. The government must also set forth compelling reasons for restricting the right to vote or the right to travel. Since substantive due process is a fairly amorphous concept, it is often used as a general basis for any lawsuit challenging government procedures or laws that affect an individual’s or company’s civil liberties.

38. Legislation must be fair.

Hyperlink: A Question of Ethics

When Can a State Force Sterilization?

http://www.usatoday.com/news/health/2009-06-23-eugenics-carrie-buck_N.htm

In the early 1920s, the state of Virginia experimented with a eugenics program in an attempt to improve the human race by eliminating “defects” from the human gene pool. As part of this program, Virginia approved a law that would allow the forced sterilization of inmates in state institutions. Eighteen-year-old Carrie Buck became the first woman sterilized under this program. Buck, who had been raped by a nephew, was committed to the Virginia State Colony for Epileptics and Feeble-minded in Lynchburg, Virginia. Her birth mother was also committed, as was her daughter. When Buck challenged Virginia’s law at the Supreme Court, Justice Oliver Wendell Holmes overruled her due process objections, holding that “it is better for all the world, if instead of waiting to execute degenerate offspring for crime, or to let them starve for their imbecility, society can prevent those who are manifestly unfit from continuing their kind...Three generations of imbeciles are enough.” *Buck v. Bell*, 274 U.S. 200 (1927). Buck became the first of tens of thousands of Americans forced to undergo sterilization as part of a general belief in eugenics, a belief apparently shared by members of the Supreme Court. Read the linked article to learn more about Carrie Buck, including the total lack of any evidence of mental defect when she was sterilized.

Businesses have used the substantive due process clause to limit the award of **punitive damages**³⁹ in tort cases. They argue that a startlingly high punitive damage award is a state-sanctioned deprivation of property, which means the due process clause is implicated. Furthermore, if the award is grossly excessive, then due process is violated. In 1996 the Supreme Court heard an appeal from German automobile manufacturer BMW arising from a case from Alabama. *BMW of North America Inc. v. Gore*, 517 U.S. 559 (1996). The plaintiff argued that although he bought his car new, it had in fact suffered some paint damage while in transit to the dealer, and the damage was not disclosed to him. When he found out about the prior damage, he sued BMW, arguing that BMW’s policy (which is that if damage to new cars can be repaired for 3 percent of the car’s value or less, then the car can be repaired and sold as new) damaged the resale value of his car. It cost six hundred dollars to fix the actual damage to his car, and the jury awarded him four thousand

39. Damages awarded to plaintiffs not to compensate them for harm caused but to prevent similar conduct by the defendants in the future.

dollars in compensatory damages for the lost resale value on his car. The jury then awarded him four million dollars in punitive damages, which the Alabama Supreme Court reduced to two million. The Supreme Court found the punitive damages award unconstitutional under the due process clause. In its holding, the Court said that there are three factors that determine if a punitive damage award is too high. First is the degree of reprehensibility of the defendant's conduct. Second is the ratio between the compensatory and punitive damage award; generally, this ratio should be less than ten. Finally, courts should compare the punitive damage award with civil or criminal penalties awarded for similar misconduct. The Court reiterated its holding again in a case involving a \$145 million punitive damage award against State Farm in a case where the compensatory award was one million dollars. *State Farm Mut. Automobile Ins. Co. v. Campbell*, 538 U.S. 408 (2003). Interestingly, Justices Scalia and Thomas, both conservative and generally seen as friendly to business interests, dissent from this view, finding that nothing in the due process clause prevents high punitive damage awards.

The final constitutional protection we'll consider here is the **Equal Protection Clause**⁴⁰ of the Fourteenth Amendment. The clause states that "No state shall deny to any person within its jurisdiction the equal protection of the laws." As discussed previously, this clause incorporates Constitutional protections against the states in addition to the federal government. Although drafted and adopted in response to resistance to efforts at integration of African Americans in the South after the Civil War, the promise of the Equal Protection Clause (enshrined at the Supreme Court building, [Figure 5.5 "U.S. Supreme Court Building"](#)) continues to find application in all manner of American public life where discrimination is an issue.

The Equal Protection Clause is implicated anytime a law limits the liberty of some people but not others. In other words, it operates to scrutinize government-sponsored discrimination. While the word "discrimination" has a negative connotation, in legal terms not all discrimination is illegal. A criminal law might discriminate against those who steal, for example, in favor of those who don't steal. The Equal Protection Clause seeks to determine what forms of discrimination are permissible.

Figure 5.5 U.S. Supreme Court Building



Source: Photo courtesy of UpstateNYer, <http://en.wikipedia.org/wiki/File:CourtEqualJustice.JPG>.

40. The portion of the Fourteenth Amendment requiring states to provide the equal protection of laws to persons within their jurisdiction.

To establish a guideline for courts to use in answering equal protection cases, the Supreme Court has established three standards of review when examining statutes that discriminate. The three standards are known as minimal scrutiny, intermediate scrutiny, and strict scrutiny.

In the **minimal scrutiny**⁴¹ test, think of the courts turning on a twenty-watt lightbulb to look at the statute. There's enough light to see the statute, but the light is so dim that the judges won't examine the statute in great detail. Under this standard, government needs to put forth only a rational basis for the law—the law simply has to be reasonably related to some legitimate government interest. If the judge is satisfied that the law is based on some rational basis (keeping in mind that with the twenty-watt lightbulb, the inquiry isn't very deep), then the law passes equal protection. Thus, a law that imprisons thieves easily passes minimal scrutiny, since there are many rational reasons to imprison thieves. As a matter of course, the vast majority of cases that are scrutinized under minimal scrutiny easily pass review. Most laws fall into this category of scrutiny by default—courts apply heightened scrutiny only in special circumstances. Even under this low standard, however, governments must be able to articulate a rational basis for the law. For example, in 1995 Colorado approved a state constitutional amendment that would have prevented any city, town, or county in Colorado from recognizing homosexuals as a protected class of citizens. The Supreme Court struck down the constitutional amendment, finding there was no rational basis for it and that it was in fact motivated by a “bare desire to harm a politically unpopular group.” *Romer v. Evans*, 517 U.S. 620 (1996).

The **intermediate scrutiny**⁴² test is reserved for cases where the government discriminates on the basis of sex or gender. Under this test, the government has to prove that the law in question is substantially related to an important government interest. Think of the courts turning on a sixty-watt lightbulb in this test, because they're expecting the government to provide more than just a rational justification for the law. Using this test, courts have invalidated gender restrictions on admissions to nursing school, laws that state only wives can receive alimony, and a higher minimum drinking age for men. In one important case, the Supreme Court held that the system for single-sex education at the Virginia Military Institute violated the Equal Protection Clause. *United States v. Virginia*, 518 U.S. 515 (1996). On the other hand, courts have been willing to tolerate gender discrimination in the male-only Selective Service (military draft) system.

The **strict scrutiny**⁴³ test is used when the government discriminates against a suspect class. Under this test, the government has to prove that the law is justified by a compelling governmental interest, that the law is narrowly tailored to achieve that goal or interest, and that the law is the least restrictive means to achieve that interest. Here, the courts are turning on a one-hundred-watt lightbulb in examining the law, so they can examine the law in great detail to find justification. The standard is reserved for only a few classifications: laws that affect “fundamental rights” such as the rights in the Bill of Rights and any government discrimination that affects a “suspect classification” such as race or national origin. In practice, when courts find that strict scrutiny applies, a law is very often struck down as

41. The standard of review in which government must provide rational basis for the law.

42. The standard of review in which government must prove the law is substantially related to an important government interest.

43. The standard of review in which government must prove the law is justified by a compelling government interest.

unconstitutional because it's so hard for government to pass this standard of review. Certainly, most laws that discriminate on the basis of race are struck down on this basis. There are a few exceptions, however, where the Supreme Court has held that racial discrimination may be permissible even under strict scrutiny. The first case rose in the height of World War II, when the federal government sought to intern Japanese Americans into camps on the basis that they may pose a national security risk. Fred Korematsu sued the federal government under the equal protection clause, arguing that as an American citizen the government was unfairly discriminating against him on the basis of race, especially in light of the fact that Americans of Italian and German descent were not treated similarly. In a 6–3 decision, the Supreme Court sided with the government. *Korematsu v. United States*, 323 U.S. 214 (1944). Although that decision has never been overturned, the U.S. government officially apologized for the internment camps in the 1980s, paid many millions of dollars in **reparations**⁴⁴, and eventually awarded Fred Korematsu the Presidential Medal of Freedom.

A second case involving the use of racial discrimination surrounds the issue of **affirmative action**⁴⁵ in higher education. Many elite colleges and universities would have no problem filling their entire entering class with stellar academic students with high grade point averages and standardized testing scores. If they did this, however, their classrooms would generally look quite similar, as these students tend to come from a largely white, upper-middle-class socioeconomic profile. In a belief that diversity adds value to the classroom learning experience, the University of Michigan added “points” to an applicant’s profile if the applicant was a student athlete, from a diverse racial background, or from a rural area in Michigan. When this practice was challenged, the Supreme Court found that this point system operated too much like a race quota, which has been illegal since the 1970s, and overturned the system. *Gratz v. Bollinger*, 539 U.S. 244 (2003). In a challenge by a law school applicant denied admission, however, the Supreme Court upheld the law school’s system, which rather than assigning a mathematical formula, used a system where race was only a “potential plus factor” to be considered with many other factors. *Grutter v. Bollinger*, 539 U.S. 306 (2003). After extensive briefing, including a record number of amicus briefs, the Court found that diversity in higher education is a compelling enough state interest that schools could consider race in deciding whether or not to admit students. The Court did caution, however, that schools should move toward race-neutral systems and that affirmative action should not last more than twenty-five more years.

44. Compensation for past injury.

45. The practice of providing affirmative action to targeted populations to achieve diversity goals.

KEY TAKEAWAYS

The Bill of Rights provides key civil liberties to all Americans and persons on U.S. soil. These liberties are never absolute, subject to competing interests that courts must balance in making their decisions. These rights also vary from time to time and are generally designed to protect the weakest in society rather than the strongest. Many, but not all, of the restrictions on government activity found in the Bill of Rights also apply to the states through incorporation. The First Amendment prohibits the government from establishing religion and from restricting the free exercise thereof. The First Amendment also prohibits the government from restricting the freedom of speech. Political speech is protected to the fullest extent by the First Amendment, while obscene and defamatory speech is not protected at all but subject to the doctrine of prior restraint. Corporations have some free speech rights under the corporate speech doctrine. Generally speaking, states may impose reasonable time, place, and manner restrictions on the delivery of speech. Procedural due process requires that the government use fair procedures anytime it seeks to deprive a citizen of life, liberty, or property. Substantive due process requires the government to articulate a rational basis for passing laws or, when fundamental rights are involved, to articulate a compelling reason to do so. Substantive due process has been used by the Supreme Court to limit punitive damage amounts. Equal protection requires the government to justify discrimination. In cases of racial discrimination, courts apply strict scrutiny to the law. In cases involving sex or gender discrimination, the courts apply an intermediate level of scrutiny, and in all other cases, courts apply a minimal basis of scrutiny.

EXERCISES

1. Although the First Amendment prohibits the government from establishing religion, there is no prohibition on spending money to support religious life generally. For example, the White House Office of Faith-based and Neighborhood Partnerships provides funding to several religious organizations, including organizations that maintain discriminatory policies toward gays and lesbians and routinely engage in proselytizing activity. Do you believe that public money should be used to fund these groups? Why or why not?
2. In 2006 Ohio passed a law requiring all public schools that receive a donation of a plaque or poster with Ohio's state motto, "In God We Trust," to display the donation prominently in a school cafeteria or classroom. Do you believe this law is a violation of the First Amendment? Why or why not?
3. During the 2004 Super Bowl halftime show, a performance by Janet Jackson and Justin Timberlake ended in a "wardrobe malfunction" when Janet Jackson's breast was exposed for a split second. CBS was fined more than half a million dollars for this violation after a record number of complaints were filed with the FCC. Do you believe that the government's action was fair?
4. In 1969 the Supreme Court ruled that school officials could not restrict students from wearing black armbands as a peace sign protesting the U.S. involvement in the Vietnam War, ruling that students do not shed their constitutional rights at the schoolhouse gates. *Tinker v. Des Moines Independent Community School District*, 393 U.S. 503 (1969). In 2007 the Supreme Court held that school officials could restrict students from engaging in speech that might undermine the school's zero-tolerance policy on drug use. What factors do you think might explain the Court's decisions in these two cases?
5. Try to find out if the Supreme Court has ever overturned *Buck v. Bell*. Do you believe that an attempt by the state to force sterilization on mentally disabled women would survive a due process challenge today? If the government is permitted to force sterilization, does that mean that the government also has the power to force women to have children if it can articulate compelling enough reasons to do so?
6. Laws discriminating on the basis of age fall into the minimal basis scrutiny category. A state that wishes to raise the drinking age to twenty-five or the driving age to twenty, for example, needs to put forward only a rational basis for that law. Do you believe that age should fall into this category or into one of the other two categories for heightened review??

7. Do you believe that public universities should be able to consider race as a factor in deciding whether or not to admit a student? If a university is unable to consider race, how else might it design an admissions program to achieve a diverse classroom? What would have been the impact if the *Grutter* case had been decided in favor of the plaintiff?

5.4 Concluding Thoughts

For being such a short document, the Constitution can be complex to interpret. The needs of a varied and diverse nation, as well as corporate enterprises, all demand a constitutional framework that is rigid enough to provide strict checks against tyranny by the majority, while flexible enough to adapt to new changing societal values and mores, as well as rapidly changing business conditions. Understanding the framework of government established by the Constitution, the powers of each branch of government, and the substantive rights afforded to individuals and companies is a critical part of being an informed citizen. As our nation faces a new century with both uncertain currents and a future brighter than the Founding Fathers could have envisioned, the Constitution will continue to provide bedrock principles to ensure the “blessings of liberty” to all.

Chapter 6

Contracts

LEARNING OBJECTIVES

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

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

Clint Eastwood had a long-term relationship with Sondra Locke. Sadly, the relationship deteriorated and, allegedly, ended on unfriendly terms. The couple never married, but they shared a household for many years, and they worked on many professional projects together. When the relationship ended, Locke sued Eastwood for various causes of action. To settle the case, Eastwood proposed, among other things, that if Locke dropped the lawsuit against him, he would secure a development deal for Locke at Warner Bros. Inc. Locke was not only an actress; she was also a director. No doubt assuming that this deal would advance her professional interests and, at the same time, bring a long-standing personal dispute to an end, Locke agreed. Locke entered into a settlement agreement with Eastwood, and as promised, she contemporaneously entered into an agreement with Warner

Bros. The agreement with Warner Bros. had two components. First, it required Locke to submit work that she was interested in developing, before she submitted it elsewhere. Warner Bros. was to accept or reject the work within thirty days. For this part of the contract, Locke would receive \$250,000 per year for three years. Second, the contract was a \$750,000 “pay or play” deal, which gave Warner Bros. a choice between using Locke’s services as a director and paying Locke a fee. Though Locke did not know this, Eastwood agreed to reimburse Warner Bros. for the cost of this contract if she did not have success in developing her projects or using her director services. Warner Bros. paid the \$1.5 million contemplated under the contract, but it did not develop any of Locke’s thirty proposed projects, and it did not hire her to direct any films.

Locke argued that the agreement had been a sham, because Warner Bros. had never intended to make films with her. She also argued that its only motivation for entering into the contract with her was to help Eastwood in settling her earlier claims against him. Locke sued Warner Bros. for a number of claims, including a breach of the **implied covenant**¹ of **good faith**² and fair dealing, and fraud. She alleged that she was deprived of the benefit of the bargain and that Warner Bros. had no intention of honoring its agreement with her. Warner Bros. won at trial, and Locke appealed.

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

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

1. A promise the law requires in all contracts, regardless of whether the parties state it or not.
2. Without deception; honest.
3. A legally enforceable promise.

Contracts are a fundamental part of doing business. A **contract**³ is a legally enforceable promise. As you know, breaking promises is a big deal. Ethical questions arise when promises are broken. For example, what if you promised to

mow your elderly neighbor's lawn because you wanted to help him, but then you never got around to doing it? Wouldn't you feel guilty about watching his grass grow into tall weeds?

When the promise is a legally enforceable promise, feeling guilty about breaking the promise is not the only fallout. When a legally enforceable promise is broken, the injured party can seek **damages**⁴. In contracts, this usually means that the party who breaches the contract must pay the injured party an amount that would make that party whole again. Also, some people disagree about whether breaching a legally enforceable promise—that is, a contract—carries any ethical implications. For instance, if a company decides that it is less expensive to pay damages than fulfill its promise by performing under a contract, it might make the decision to breach based on rational decision making. That is, since it will be less expensive to **breach**⁵, it makes sense to breach. Others disagree with this approach, pointing out that reliance on promises is an important part of business that provides necessary stability, regardless of whether keeping the promise makes economic sense or not.

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

Contracts are agreements between two or more parties. Generally speaking, contracts are a form of **private law**⁶, because the **terms**⁷ of the contract are binding on those parties but not on everyone. The contract represents **mutual assent**⁸ to a bargained-for exchange between parties.

Generally speaking, in the United States parties may enter into contracts for whatever they wish and under any terms that they agree on. In other words, parties may assent to agreements even if those agreements represent bad bargains.

However, there are certain external restrictions on our abilities to form contracts. Additionally, certain internal (to the contract) restrictions may exist on our abilities to exercise rights or to engage in other contracts.

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

There may also be restrictions that are internal to the contract. Imagine that you entered into an employment contract with a company to work for \$55,000 per year,

4. Compensable loss.
5. The failure to perform duties and obligations required by contract.
6. A legally binding agreement between consenting parties that does not apply to the public at large.
7. Elements of contracts that specify important matters, such as quantity, price, and time for performance.
8. In common-law contracts, comprises offer and acceptance.

plus benefits, and for a term of two years. You might be pretty happy about that. But what if, one month later, another company offered you the same position at its company, but for a salary of \$65,000 per year, plus benefits. The better offer does not invalidate your first contract. In fact, in such a case, your first contract would probably contain a **noncompete clause**⁹ that would prohibit you from working in a similar capacity for a specified length of time and geographic area. So even if you decided to breach your first contract to enter into the second, you would be prohibited from doing so under the noncompete clause.

Key Takeaways

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

9. A contract clause that restricts competition for a specified period of time, within a certain geographic region, and for specified activities.

6.1 Formation

LEARNING OBJECTIVES

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

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

This section explores contract **formation**¹⁰. We can examine the elements of formation to determine whether the contract is valid or whether it suffers some deficiency that renders it not legally enforceable.

In the United States, two primary sources of law govern our contracts: the common law and the Uniform Commercial Code. The **Uniform Commercial Code (UCC)**¹¹ article 2 governs contracts between a merchant and the sale of goods. Essentially, the UCC contains two sets of rules for contracts. One set involves rules for everyone, and the other set involves rules for merchants. In this section, we will explore the UCC as it applies to merchants. Chiefly, we will examine how the UCC requirements differ from common law in contract formation

However, we will first address common-law contracts. Common law governs contracts for services as well as contracts not otherwise governed by the UCC. It is important to recognize the elements of common-law contract formation because

10. In common-law, this refers to offer, acceptance, and consideration.

11. A model statute that seeks to provide uniformity to contracts law among the different states. It is not a law until state legislatures adopt it as law.

they are more stringent than the requirements for formation between merchants under the UCC. If all elements of common-law contract formation do not exist, then the contract may be **void**¹² or **voidable**¹³.

The elements of common-law contract formation include **offer**¹⁴, **acceptance**¹⁵, and **consideration**¹⁶. Offer and acceptance together form mutual assent. Additionally, to be enforceable, the contract must be for a legal purpose and parties to the contract must have **capacity**¹⁷ to enter into the contract.

An offer gives power of acceptance to another party, and it includes the agreement's essential elements, which must be definite and certain. For example, if an offeror says to you, "I offer to sell you my scooter for four hundred dollars," then that offer is valid. It contains the price, the person to whom the offer is made, and the object of the offer (i.e., the scooter). It creates a power of acceptance in you, the offeree.

12. Refers to a contract that is not valid on its face because it suffers from some fatal flaw.
13. Refers to the status of a contract that may be terminated due to some defect.
14. In common law, it creates the power of acceptance in another party and includes the agreement's essential elements, which must be definite and certain.
15. In common law, it must be a mirror image of the offer.
16. A bargained-for exchange.
17. The legal ability to enter into a contract.
18. The requirement for acceptance in common-law contracts; it means that the acceptance must be precisely the same as the offer.
19. A rejection of an offer. It is a new offer.
20. The retraction of an offer before it is accepted.

Importantly, in common-law contracts, the acceptance must be a **mirror image**¹⁸ of the offer to constitute valid acceptance. This means that the acceptance must be precisely the same as the offer. If the acceptance is not precisely the same, then it will fail to meet the requirements of an acceptance, and it will not constitute a valid element of formation in contract. To accept the offer, the offeree could say something like this: "I agree to buy your scooter for four hundred dollars." If a **counteroffer**¹⁹ is made, then that would not be acceptance, because the counteroffer would not be a mirror image of the offer itself. So, for example, if the offeree said, "I agree to buy your scooter for three hundred dollars," that would not be an acceptance. In fact, a counteroffer is a rejection of the offer. Once an offeree rejects an offer—either outright (e.g., by declining to accept) or through counteroffer, the offeror is free to walk away from the failed negotiation. In this example, he no longer has to sell his scooter at all, not even if the offeree changes his mind and agrees to pay four hundred dollars. Likewise, if the offeror revokes an offer before the offeree accepts, then the power of acceptance has been withdrawn by that **revocation**²⁰. The offeror would no longer have to sell the item originally offered. If the offeror wished to limit the time that an offer was valid, he could do so by limiting the time that the offer may be accepted. If the offer is not accepted during that time, then the offeror is not required to honor any acceptance that is made after expiration of the offer.

What if you saw an advertisement for a scooter for sale at a local shop? Perhaps the advertisement looked like this:

Figure 6.1



Do you think that this advertisement should create the power of acceptance in you, a potential customer? The fact is that an advertisement is not an offer. It is simply an **invitation to bargain**²¹. Advertisements are requests for people to make offers. This places the power of acceptance on the merchant, who is free to reject offers or to choose to whom he sells. Of course, certain statutory protections exist today to protect consumers against unscrupulous merchants who might engage in unethical behavior, such as bait-and-switch or false advertising, or race-based denial of services or refusal to contract. Specifically, consumer protection statutes and civil rights statutes, respectively, would protect consumers in such circumstances.

If an offer is valid, then the acceptance must be a mirror image, as mentioned previously. A **bilateral contract**²² is a contract in which both parties make a promise. The previous example is an example of a bilateral contract. The following is a promise for a promise:

21. When a party invites others to make offers to buy; advertisements are a prevalent example.

22. A contract in which both parties make a promise.

The offeror says, "I offer to sell you my scooter for four hundred dollars."

The offeree replies, "I agree to buy your scooter for four hundred dollars."

Specifically, it is a promise to sell the scooter in exchange for a promise to buy the scooter for four hundred dollars. Since this is a promise for a promise, then this is a bilateral contract.

A **unilateral contract**²³ is one in which the accepting party may only accept through an action. Here is an example:

The offeror says, “I will sell this scooter to the first person who puts four hundred dollars cash in my hands.”

The offeree says nothing but places four hundred dollars cash into the offeror’s hands.

This is a promise for an action. Specifically, it is a promise to sell the scooter in exchange for the action of placing four hundred dollars cash into the offeror’s hands.

Common-law contracts can be either bilateral or unilateral.

Additionally, all common-law contracts must contain valid consideration. This means that there must be a bargained-for exchange of acts or promises, and both parties must incur new **legal detriment**²⁴ or obligations as a result of the contract. Imagine that you have accepted a new position with a company. You have a valid employment contract that you’ve successfully negotiated prior to beginning work. All terms of the contract are valid, and both parties are bound to the contract. Basically, this means that you have agreed to work for a specified period of time, and your employer has agreed to compensate you with a specified salary and benefits in exchange for your work. So far, so good, right?

Now, imagine that during your first week, your boss appears in your office and asks you to sign a new contract that, in essence, is a **noncompete agreement**²⁵. This means that your employer now wants you to sign a new contract agreeing not to compete with the company if you decide to terminate your employment arrangement. The employer wants you to make this promise, but the employer does not offer anything additional in return. For the purposes of this example, let’s say that you sign the new agreement. Is this new agreement valid and binding on you? Probably not. Why? Because the company has not suffered any new legal detriment or obligation as a result of the contract. You have agreed to refrain from competing with the company if you leave, but the company itself has not given you anything in return for your promise. To make this contract binding against you, your employer should have provided consideration. For example, it could have asked you to sign

23. A contract in which the accepting party may accept only through an action.

24. An obligation or a duty enforced by law.

25. A contract or clause in a contract limiting the time, place, and scope of future competition.

the noncompete agreement in consideration of an additional one thousand dollars of salary per year. Then, the contract would have consideration and it would have a much greater chance of being found to be valid. Better yet, the company should have negotiated the noncompete agreement along with your original contract before you assumed your new position.

Let's continue our example of an offeror who offers to sell his scooter for four hundred dollars. He says, "I offer to sell you my scooter for four hundred dollars." If you reply, "I agree to buy your scooter for four hundred dollars, if I don't find one that I like more," then that does not constitute valid consideration. This is because you have placed a condition on the consideration. In essence, you have made what appears to be a promise to do something, but instead of being a promise, it is only an illusion of a promise. This is called an **illusory promise**²⁶, and it does not constitute valid consideration. There is no legal detriment to you here, because you might find a scooter that you like more than the one offered by the offeror. You have a way out. A legal detriment is a detriment (or burden or obligation) that is legally enforceable. You cannot "get out" of the promise without suffering legal detriment. The other party must be able to rely on the promise for it to constitute valid consideration. The thing bargained for can be an act or a promise (either to do something or to refrain from doing something.)

Additionally, for a contract to be valid, the subject matter of the contract must be for a legal purpose. If a distributor of illegal drugs hires a pilot to fly his illegal cargo to a particular place in exchange for payment, this is a contract for an illegal subject matter. If the drug dealer fails to honor his agreement to pay, or if the pilot fails to honor his agreement to transport the cargo, neither aggrieved party will find a remedy in our courts, even if the elements of contract are all present and perfectly formed.

Moreover, the parties to contract must have capacity to enter into the contract for its terms to be enforceable against them. Adults of sound mind have capacity. Minors lack legal capacity, but they may enter into contracts that they may cancel at their sole option. In other words, a minor who enters into a contract with a party who has capacity may void the contract, but the other party may not. This means that any contract with a minor is voidable by the minor under the **infancy doctrine**²⁷.

Let's compare common-law contract formation with UCC contract formation. Recall that common law governs contracts for services and contracts not governed by the UCC. Article 2 of the UCC governs the sale of **goods**²⁸, which is defined by §2-105 and includes things that are moveable, but not money or securities. It does not include land or houses. Contracts between merchants are also governed by article 2

26. A statement that looks like a promise but is actually only an illusion of a promise due to its conditional nature or its otherwise lack of a firm commitment.

27. A legal doctrine that allows minors to disaffirm contracts.

28. As defined in §2-105 of the Uniform Commercial Code (UCC), things that are moveable, but not money or securities. It does not include land or houses.

of the UCC. Generally speaking, §2-104 defines a merchant as a person who deals in goods or holds himself out as having special knowledge or skill regarding the practices or goods that are the subject of the transaction. Since contracts law is a state law issue, each state can have different laws related to contracts. The UCC seeks to provide uniformity to contracts law among the different states. However, like other uniform laws, the UCC does not become a law until state legislatures adopt it as law. All fifty states have adopted some version of the UCC.

As you can imagine, contracts between merchants do not always contain offers that include definite terms, and acceptances are not always mirror images. Merchants typically place a purchase order when they wish to purchase materials, and the seller often sends an invoice with the order when it ships. Merchants frequently use **boilerplate language**²⁹ in their individual purchase orders and invoices. Obviously, not every merchant's contract will contain the same language as those of other merchants. This can lead to discrepancies between terms that would be fatal in common-law contract formation, otherwise known as **battle of the forms**³⁰. However, the UCC provides more flexibility in contract formation than exists in common-law contracts, thereby accommodating the reality of business practices. The requirements for common-law contract formation would be too burdensome for merchants. Can you imagine if every merchant had to issue offers with definite terms and receive mirror image acceptances for every item that it sold or purchased to have valid, enforceable contracts? Such a burden might cause commerce to come to a screeching halt. Or it might lead to many contracts disputes.

The UCC also embodies some elements of the **Statute of Frauds**³¹. The Statute of Frauds requires certain types of contracts to be in writing to be enforceable. Specifically, it requires contracts to be in writing for goods priced at five hundred dollars or more *and* signed by the defendant, for those contracts to be enforceable. Other important types of contracts relevant to business that must be in writing and signed by the defendant to be enforceable include contracts for any interest in land, promises to pay the debts of another, and contracts that cannot be performed within one year. The types of contracts that are contemplated by the Statute of Frauds but are not captured by the UCC are often embodied in state statutes. The peculiar name—the Statute of Frauds—is derived from its early incarnation in seventeenth-century England, when a statute was passed by parliament to reduce or prevent fraud in property transactions and other important civil matters.

Of primary concern to students of business are the differences between common-law contracts and the UCC. When analyzing a contracts issue, identification of the type of law that governs the contract should be addressed first. This is because you cannot know which rule applies unless you know which type of law is applicable.

29. Standard legal language used in contracts or other legal documents.

30. A term that describes inconsistent elements of an agreement between merchants.

31. A statute that requires certain types of contracts to be in writing to be enforceable.

The primary differences between common-law contracts and the UCC are in the UCC’s relaxation of various common-law contract formation requirements. See Table 6.1 "Differences between Contract Formations by Type of Law" for a comparison between common-law and UCC contract formation requirements. When a battle of the forms ensues between merchants, for example, the conflicting terms are not fatal to the contract. This is a major departure from the mirror image rule required by common-law contracts. For the UCC, the primary issue is whether the parties intended to enter into a binding agreement. New or additional terms included in an offer will become part of the contract on acceptance. Terms that conflict with each other will “fall out” of the contract and be replaced by UCC **gap fillers**³², which can create the terms of the contract. Likewise, terms that are left open will be filled in. Gap fillers are terms provided by the UCC, and they can be inserted into a contract when those terms are not definite. While prices, delivery dates, warranties, and other terms can be “filled in” by the UCC gap fillers, quantity cannot. Quantity, therefore, is an essential term that must be specified in the contract for it to be binding.

Table 6.1 Differences between Contract Formations by Type of Law

UCC	Common Law
Any manner that shows agreement to contract (e.g., words, actions, writing)	Mirror image acceptance required
Quantity term required; other terms may be filled in with gap fillers	Essential terms must be definite
Contracts between merchants; contracts for sale of goods priced at \$500 or more	Contracts for services and for interest in real property

KEY TAKEAWAYS

A contract is a legally enforceable promise. Common law and the UCC are different sources of contract law. Common law is the appropriate type of law for service contracts and contracts that do not fall under the UCC, like real estate contracts. The UCC governs contracts involving the sale of goods with a price of five hundred dollars or more and in contracts between merchants. Common-law contract formation requires a valid offer, acceptance, and consideration. The parties must have capacity, and the subject matter must be a legal purpose. The UCC relaxes formation requirements by allowing the use of gap fillers for undefined or conflicting terms and by allowing a contract to be formed by any manner that shows agreement to contract. Quantity is a required term for contracts governed by the UCC.

32. In contracts governed by the Uniform Commercial Code (UCC), terms that can be inserted into a contract when those terms are not definite and certain.

EXERCISES

1. If a contract was not entered in good faith, do you think that fact alone should matter? Consider *Locke v. Warner Bros. Inc.*, which was discussed in the introduction to this chapter. All essential elements of the contract appear to have existed, and the parties performed as required by the wording of the contract. How can lack of good faith be shown?
2. Has anyone ever broken a promise to you? Were those promises legally enforceable promises? Why or why not? Be sure to analyze the agreement by checking to see if all elements of contract formation were present. Remember to first determine whether the promise was one governed by the UCC or by common law.
3. What are the dangers inherent to making a counteroffer? Imagine that you really wanted to sell your house. You receive an attractive offer, but you wondered whether you might be able to sell the house for a little more money. What types of things should you think about before submitting a counteroffer?

6.2 Performance and Discharge, Breach, Defenses, Equitable Remedies

LEARNING OBJECTIVES

1. Learn what constitutes performance.
2. Understand what it means to discharge obligations in a contract.
3. Explore different standards of performance.
4. Examine breach.
5. Explore defenses to breach.
6. Learn about equitable remedies.

A contract is an enforceable promise. When the promise is fulfilled, then the contract terms have been satisfied. This means that the parties are **discharged**³³ from the contract, because they have already fulfilled their legal duties under it. That is, they have satisfactorily performed their obligations under the contract. **Performance**³⁴ simply means undertaking the legal duties imposed on us by the terms of the contract. This is certainly what parties hope for when they enter into a contract—the successful execution of the terms of the contract and subsequent discharge from it.

But how do we know whether the contract terms have been performed? Sometimes it's easy to determine. For instance, if I offer to sell you my scooter for four hundred dollars, you agree to buy my scooter for four hundred dollars, and we exchange those items, then we have fulfilled our obligations under the terms of the contract. We formed a contract, we fully performed our obligations under it (known as **complete performance**³⁵), and we are subsequently discharged from further duties arising under that contract.

33. When parties to a contract have fulfilled their duties under the contract and they are released from further requirements to perform under the contract.

34. Undertaking the legal duties imposed on us by the terms of the contract.

35. Full and perfect performance of the promises, obligations, and duties contained in a contract.

In other cases, whether a party has performed can be trickier to determine. For example, imagine that you hire a builder to construct a new home for you. You specify all dimensions of the home, as well as your chosen building materials. Certainly this would be a very detailed contract. Imagine that all essential elements have been determined and that the contract is valid. In short, the builder agrees to build your specified home, and you agree to pay the builder the agreed on price. Imagine that everything goes according to plan. When your home has been constructed, you visit it for the first time. To your dismay, you see that the foyer has been tiled in red ceramic, even though you clearly specified—and the contract clearly reflected—that the foyer should be tiled in blue ceramic. However, on your further inspection, every other item specified in the contract has been completely

performed. Would we say that the builder has performed his duties under this contract? The item at issue is the problem with the foyer tile. Does this error rise to breach? More importantly, does this excuse your obligations under the contract to pay the builder for his work?

When a party fails to perform under the terms of the contract without a legally justifiable reason, the party is said to be in **breach**³⁶ of the contract. However, in a service contract—such as a service to build a house—the standard of performance is **substantial performance**³⁷. This means that the performing party acted in good faith and conveyed enough benefit of the contract to the other party so that the other party can use the benefit for its intended purpose, and the defects arising under the contract may be remedied by money damages. A material breach in a service contract is when a party has not substantially performed under the terms of the contract. A minor breach is when the party has substantially performed but has not *strictly* performed. In our example, installation of the red tile in the foyer would not rise to material breach, because presumably the builder acted in good faith, he produced a house that is capable of being used for its intended purpose, and the defects (the red tile) can be remedied through monetary damages. They simply need to be replaced by blue tiles. This was a minor breach. If this were your contract, you would have to pay the builder as required under the contract, less the cost of replacing the tile.

Consider the firing of Texas Tech’s head football coach, Mike Leach, in [Note 6.47 "Hyperlink: Coach Mike Leach"](#) to practice your analytical skills. Try to identify what additional information you would need to determine whether substantial performance exists, or whether the contract has been materially breached.

Figure 6.2



A Promise Kept? Or a Promise Broken?

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- 36. The failure to perform duties and obligations required by contract.
- 37. The standard for service contracts. It means that the performing party acted in good faith and conveyed enough benefit of the contract to the other party so that the other party can use it for its intended purpose and that the defects arising under the contract may be remedied by money damages.
- 38. A standard of performance in a contract that requires perfect performance.

Sometimes, substantial performance is not adequate. Adherence to a **strict performance**³⁸ standard requires express terms in the contract to that effect and circumstances where such a high standard is reasonable. In our scooter example, if you tried to give the offeror three hundred dollars in cash and one hundred dollars in postage stamps, then that would most likely not satisfy the terms of the contract. You might recall that the contract was a bargain for a scooter in exchange for four hundred dollars. Here, strict performance makes sense and is reasonable.

Performance to the standard of **personal satisfaction**³⁹ can be enforced if the contract expressly requires it. This means that the performance under the contract is scrutinized subjectively, either by one party to the contract or by a third-party beneficiary specified in the contract. If the subject of the contract is something for which approval is dependent on someone's subjective opinion, like personal taste, then assessment can be made on a subjective standard providing this standard is clearly specified in the contract. For example, if you owned a piano bar, and you wished to hire a truly inspired pianist for entertainment, you might enter into a contract with a pianist subject to a personal satisfaction standard. Even if that person could tickle the ivory flawlessly, you might decide that his or her music is technically accurate but not truly inspired. Providing that your contract with the pianist allows for personal satisfaction to be the standard of performance, you may terminate that contract based on his or her failure to meet the personal satisfaction standard. This standard is unlike the substantial performance standard, which requires an objective assessment based on the **reasonable person standard**⁴⁰. Referring again to [Note 6.47 "Hyperlink: Coach Mike Leach"](#), which standard appears to be controlling Texas Tech's decision to terminate Coach Leach's contract—personal satisfaction or substantial performance? Which standard is appropriate for a contract for coaching services?

39. A standard of performance in a contract that means that the performance under the contract is scrutinized subjectively, either by a party to the contract or by a third-party beneficiary specified in the contract.

40. An objective standard based on reasonableness, against which actions are measured to determine sufficiency.

Hyperlink: Coach Mike Leach

Head football coach Mike Leach of Texas Tech was fired for breach of contract. He had recently signed a \$12.7 million contract for five years, and he had been named by the Associated Press as the Big XII Coach of the Year in 2008. However, that didn't stop Texas Tech from firing him, citing breach of performance as the reason for the termination. Under the terms of his contract, he was to "assure the fair and responsible treatment of student-athletes in relation to their health, welfare, and discipline." Allegedly, Coach Leach forced a student athlete to stand in a shed after the athlete was diagnosed with a mild concussion. Leach's supporters argue that the "shed" was a comfortable garage-like room with a cooler and a fan and that Coach Leach was simply having the player stand inside, out of the sun, in accordance with medical orders. Others argue that this was a sadistic punishment that was inappropriately levied against an injured player. Was Leach being cruel, or was he being protective of his charge in accordance with his contract terms?

Underlying this controversy are allegations that the firing occurred because Leach interviewed with another university unbeknownst to Texas Tech and because he has a colorful personality that might offend some people. For instance, he allegedly blamed his players' "fat little girlfriends" for distracting them to their defeat against Texas A&M.

Coach Leach was fired just before receiving an alleged \$800,000 contractual bonus.

Check out the story here:

<http://www.cnn.com/2009/US/12/31/texas.tech.leach/index.html?iref=allsearch>

Check out the video of the story here:

<http://sports.espn.go.com/ncf/bowls09/news/story?id=4781981>

Watch Coach Leach here:

<http://sports.espn.go.com/ncf/bowls09/news/story?id=4781981>

Watch speculation about Coach Leach's likelihood of being hired here:

<http://sports.espn.go.com/ncf/bowls09/news/story?id=4781981>

See the exercises in this section for related questions and discussion.

As mentioned previously, when the promises in a contract have been fulfilled based on the appropriate standard—substantial performance, strict performance, or personal satisfaction—then the parties are discharged. However, when a material breach occurs, the injured party may bring a claim for damages. But that isn't necessarily the end of the story. The breaching party may have a valid reason for breaching the contract. These valid reasons are known as defenses to contract. These defenses include formation problems, lack of capacity, illegality of subject matter, impossibility, duress, unconscionability, undue influence, violation of the Statute of Frauds requirement that certain types of contracts must be in writing to be enforceable against the defendant, exceeding the statute of limitations, mistake, misrepresentation, fraud, commercial impracticability, and frustration of purpose. Bankruptcy discharge is a permanent legal excuse from performance, and it will discharge obligations that are dischargeable by law if the debtor successfully fulfills his obligations under the bankruptcy. Obligations that are not dischargeable by law will not be permanently discharged by a bankruptcy. However, during the bankruptcy, the performance of contract terms requiring payment of debt incurred prior to filing the bankruptcy petition is suspended by the court until the bankruptcy is terminated either by successful completion of the bankruptcy or by dismissal of the case.

Formation problems in common-law contracts relate to whether the offer, acceptance, and consideration were valid. For example, if the offer did not contain the essential terms in definite and certain form, then that offer will not be valid. If I offered to sell you my house for a fair price, it would not be a sufficient offer because the price term is an essential element, and in this offer it is vague. To say that a house will be sold "for a fair price" is not specific. Likewise, in a common-law contract, if the acceptance is not a mirror image of the offer, then the acceptance will not be valid. Similarly, if consideration does not firmly commit the parties to the deal, then consideration will fail, as is the case with an illusory promise. For example, if I offered to sell you my house for \$150,000, and you agreed to buy it "if you like it," then that is not a firm commitment. Consideration will fail, and the

contract has not formed. As a practical matter, how can this defense be used? The defendant simply needs to show that the contract was never formed in the first place, due to one or more deficiencies in formation. Keep in mind, however, that if the Uniform Commercial Code (UCC) is the relevant type of law, formation is much simpler than in common law. For example, all essential elements do not need to be stated in definite and certain terms (but quantity must be stated), and acceptance does not need to be a mirror image of the offer. Accordingly, in contracts in which the UCC is the relevant type of law, this defense can be more challenging to successfully mount.

Sometimes when all elements of the contract are not present, the court will enforce the promise through an **equitable remedy**⁴¹ to avoid a perceived injustice that would occur if the contract failed based on a formation defect. **Quasi-contract**⁴² and **promissory estoppel**⁴³ are two types of equitable remedies that a court may impose. When detrimental reliance is found, an equitable remedy can substitute for consideration. This allows the court to enforce the terms of the “contract,” even though, technically speaking, there was no contract to begin with.

Quasi-contract is determined when one party will receive a benefit from the other unjustly (**unjust enrichment**⁴⁴), and the party who tendered the benefit reasonably expected to be paid for it. The party who received the benefit knew that the other party reasonably expected to be paid. For example, imagine that your neighbor hired painters to paint his house, but the painters accidentally appeared at your house to work. Instead of sending them away, you decided to let them paint your house, but you did not tell them that they were at the wrong house. At the end of the job, they demanded payment. You point out that they never had a contract with you. While this would be true in fact, the issue is that you would be unjustly enriched by their painting of your house if you were not made to pay. Additionally, you knew that the painters would reasonably expect to be paid for their services, and you did nothing to stop them. This would be a good case for a court to impose the equitable remedy of quasi-contract. The damages awarded in such case are called **quantum meruit**⁴⁵, which means “as much as is deserved.” The painters will receive the value of their services in damages. Compare this situation with one in which you were on vacation when the painters painted your house. You knew nothing of their presence. In such a case, quasi-contract would not be imposed as an equitable remedy because you were not aware of their presence. In fact, you would have a potential claim against the painters for interfering with your property and entering your land without your permission. Promissory estoppel is another equitable remedy. It is imposed on parties when one party detrimentally relied on another’s promise, and to avoid injustice, the enforcement of the promise is required. Like quasi-contract, when promissory estoppel is used, there is some formation problem with the contract so, technically speaking, no contract exists.

41. A remedy imposed by the court to prevent injustice, which allows the court to enforce the terms of a “contract,” even though, technically speaking, there was no contract to begin with. An equitable remedy can substitute for lack of consideration.
42. A type of equitable remedy that may be imposed on parties to avoid unjust enrichment to one party at the expense of the other.
43. A type of equitable remedy that may be imposed on parties to avoid injustice, when one party detrimentally relied on another party’s promise.
44. A benefit that is conferred or expected to be conferred unjustly.
45. The name for damages awarded in quasi-contract cases, which means “as much as is deserved.”

The remaining defenses discussed in this chapter are relevant if the contract is valid. That is, there are no formation problems. For example, if a party lacks capacity to enter into a binding contract, that can be used as a defense. When people lack the mental ability to understand, they lack capacity. Sometimes, it may *seem* that someone understands, even though he or she might actually lack legal capacity. This is the case with minors. Though some may certainly understand the terms of a contract, they lack the legal capacity to be bound to it. That means that they can **disaffirm**⁴⁶ the contract if they wish. Likewise, someone who suffers from a temporary or permanent cognitive defect lacks capacity to be bound to a contract. This may be the case with an infant, a person who suffers from dementia, or a person who has other profound cognitive or mental impairment. Use of alcohol or drugs may impair capacity, but the courts are reluctant to find this as a convincing defense, particularly if the person voluntarily imbibed in the alcohol or drug use themselves. If they were involuntarily drugged, however, then lack of capacity can be a good defense. If someone does not read or speak the language in which the contract is written, that can also indicate a lack of capacity.

If the subject matter of a contract or the terms of the contract are illegal, then the contract may be void at the outset, or it may become void if the subject matter or the terms of the contract become illegal after the contract is formed. The former case can be illustrated by imagining a contract for the production of illegal drugs. A defense to performance is that the contract itself concerns an illegal subject matter. A court will not step in to such a contract to enforce its promises.

The latter case of illegality of the terms of the contract is an example of impossibility as a defense. Impossibility is a defense that can be used when performing the contract has become truly impossible. For example, if you entered into a contract to do business in a country that was subsequently placed on a no-trade list by the federal government, then you would be excused from performing your obligations under that contract, because it would violate federal law for you to perform as promised. It would be impossible, and impossibility would be a valid defense. Sometimes impossibility does not involve the legality of the subject matter or the terms of the contract. Instead, it might simply be a matter of the destruction of the subject matter of the contract. In our scooter example, imagine that before the transaction was completed, the scooter was crushed by the trash collector by accident. The subject matter of the contract was destroyed, and so it would be impossible for the offeror to perform. The offeror would not need to find another scooter to sell to fulfill the obligations under the contract. Instead, he or she would use the defense of impossibility.

46. An option that may be exercised by a minor who is a party to a contract to render the contract void.

Another defense to contract performance is duress. If a party suffers from duress when entering the contract, that party will have a valid defense. Duress means that the party had no other reasonable alternative but to enter into the contract. The

party was coerced into entering into the agreement. For example, imagine that you entered into a contract for automobile insurance. Part of your insurance contract requires your insurance company to defend you in the event of a lawsuit arising from a traffic accident. Imagine that you are involved in a traffic accident and your insurance company refuses to defend you. This is bad news, because you will still need to mount a defense. You will probably expend a great deal of money defending yourself, not to mention trying to launch a complaint against your insurance company for breach of contract. After spending all of your savings and borrowing just to pay your bills, imagine that your insurance company comes to you with an offer to pay you fifty thousand dollars if you sign a waiver that it has no liability to you. You will probably sign that waiver and take the money. Why? Because you have no reasonable alternative. This is an example of **economic duress**⁴⁷, and it is likely that no court would enforce the waiver for the benefit of the insurance company given such facts. The insurance company forced you into signing an agreement with it that you would not have signed if you had any other reasonable alternative.

Unconscionability is a defense used when the contract contains markedly unfair terms against the party with less bargaining power or sophistication than the party who created the terms and induced the other party to sign it. For example, imagine a biotech company discovering a cure for cancer from a plant growing on the private lands of an indigenous people. Imagine that the indigenous people did not understand the importance of the discovery, and they did not understand the value of it. If the biotech company offered to pay for the absolute and complete rights to the plant with ten dollars and a bag of flour, that contract might be said to be unconscionable.

Undue influence is a defense that can be used when one party ceases to be able to exercise his or her free will due to the superior power and influence exerted over that party by the other. For example, imagine an elderly person who is completely isolated from social contact due to poor health and remote living conditions. That person might be quite lonely and eager for company. Say that an unscrupulous person entered that elderly person's life and exerted influence over that person so that the elderly person really could not exercise his free will any longer. If, consequently, the elderly person entered into a contract with the other party to transfer all of his wealth to that person, we might say that this is a case of undue influence. How might this happen? Maybe the unscrupulous intruder is the only human contact that the elderly person has, and maybe he or she led the wealthy elderly person to believe that the only way to salvation is by handing over his assets.

Remember, too, that the Statute of Frauds requires certain contracts to be in writing and signed by the defendant to be enforceable against the defendant. If

47. A defense to contract that can be exercised when one party had no other reasonable alternative but to enter into a contract due to economic threat or pressure.

those types of contracts are not in writing, that can be used as a defense to performance. Contracts for any interest in land, in consideration of marriage, and to pay the debts of another that cannot be performed within one year and contracts for the sale of goods with a price of five hundred dollars or more are all examples of contracts that are required to be in writing to be enforceable according to the Statute of Frauds. If a contract exists for these items, but the contract is not in writing, it may be performed. However, if there is a dispute arising under the contract, it will not be enforced because it violates the Statute of Frauds requirement for a writing.

The statute of limitations is an affirmative defense that can be raised by a defendant to argue that the complaint is being brought too late, by law, to do anything about it. This means that if a dispute arises under a contract, then the plaintiff must bring a complaint concerning that dispute within a certain time period. Every state has different statutes of limitations for different types of disputes. Contracts statutes of limitations range from three to ten years, depending on whether the contract was oral or written, and depending on the jurisdiction.

Mistake is rarely a successful defense to contract, but it is a defense nonetheless. Mistake does not mean bad bargaining. After all, we have the freedom to bargain badly, and the courts will not step in to save us if we do so. For instance, if you agree to buy a house for \$170,000, but the house is only worth \$150,000, you may have bargained badly, particularly if the seller did not deceive you in any way. The court will not step in to rewrite the contract or allow you to use mistake as a defense to excuse your performance. Indeed, the court will enforce the terms of the contract if it is a valid contract. Mistake refers to something that is truly a mistake either by one party or by both. If the parties to a contract truly make a mistake with respect to essential terms of the contract, then that can be used as a defense to performance.

Misrepresentation and fraud are also defenses to contract. Misrepresentation is when a party makes a false statement that induces the other party to enter into the contract. Fraud is a closely related concept, and it simply means that one party has used deception to acquire money or property. Often, unscrupulous salespeople will commit fraud or misrepresent the subject matter of the contract in such a way that the other party will enter into the contract. However, fraud and misrepresentation both may be used as successful defenses in such circumstances.

Commercial impracticability is a defense that can be used when fulfilling a contract has become extraordinarily difficult or unfair for one party.

Frustration of purpose is when the contract has become essentially worthless to one party, though the event giving rise to that state was nonexistent or unknown to both parties to the contract at formation.

Finally, sometimes a party to a contract files for bankruptcy protection. When that party is required to pay a debt that was incurred before the bankruptcy was filed, that duty is suspended temporarily or permanently when the bankruptcy is filed through the court's **automatic stay**⁴⁸. In other words, the debt does not have to be paid during the course of the bankruptcy. At the conclusion of the bankruptcy, if the debtor is successful in bankruptcy and if the contract obligation is a dischargeable debt, then the debt will never have to be paid. The debt is, in fact, discharged. Bankruptcy is a defense to performance of contract for debtors who file for bankruptcy protection.

Remedies for breach of contract are typically monetary damages. Expectation damages, including compensatory and consequential damages, can be recovered. However, consequential damages may not be speculative. Indeed, they must be foreseeable to both parties at the time of the contract formation to constitute damages by breach. **Specific performance**⁴⁹ might be required under certain types of contracts, such as in contracts for land. For example, in contracts for real property, the assumption is that land is unique. Therefore, monetary damages are not adequate, because “replacement” land cannot be found that would be like the land that is the subject of the contract. Importantly, specific performance is not an appropriate remedy for service contracts, given the prohibition against involuntary servitude in the Thirteenth Amendment to the U.S. Constitution. Finally, it is important to note that on breach, the injured party has a **duty to mitigate**⁵⁰ his damages. This means that he must avoid damages by making reasonable efforts to do so. If a tenant breaches a contract by moving out of his apartment before the lease is over, the landlord will be able to recover damages from that tenant for breaking the lease (i.e., breaching the contract). However, the landlord also has a duty to mitigate those damages by trying to find another tenant.

48. An order by the court to stop all collection activities of prepetition debts owed by a debtor in bankruptcy.

49. A remedy that requires complete performance in a breach, rather than (or in addition to) monetary damages.

50. A duty placed on a party injured by breach, requiring that party to avoid damages by making reasonable efforts.

KEY TAKEAWAYS

A contract is an enforceable promise. Parties to the contract must perform according to the relevant standard—substantial performance for most service contracts, personal satisfaction, complete performance, or strict performance. Once parties have performed, they are discharged from further obligations under the contract. Failure to perform according to the requisite standard is a breach, which is a compensable injury. A breach may be minor or major. Several defenses exist to breach of contract.

EXERCISES

1. Referring to [Note 6.47 "Hyperlink: Coach Mike Leach"](#), what additional information would you need to determine whether Coach Leach's services fell below substantial performance and were a material breach or whether he substantially performed his contract so that he did not materially breach it? Should coaching services be evaluated based on substantial performance or personal satisfaction? Why?
2. In international business, it is very common for parties to contract not to read or speak the same language. If someone sought to enter into a contract with you, but that party could not read the language in which your contract was written, should you enter into that contract with that person? How can this problem be overcome so that both parties can form a legally binding contract with each other?

6.3 Assignment, Delegation, and Commonly Used Contracts Clauses

LEARNING OBJECTIVES

1. Learn about assignment and delegation.
2. Examine novation.
3. Explore restrictions on assignment, exculpatory clauses, noncompete clauses, mandatory arbitration clauses, acceleration clauses, and liquidated damages clauses.
4. Explore the parol evidence rule.

What if you formed a contract with a rock 'n' roll band for its services? Specifically, you wanted the band to play at your nightclub, because you thought that your customers would enjoy the band enough to pay to see it perform. You hired this specific band because you heard that it drew large crowds of paying customers. Imagine your surprise when, as you anticipate the band's performance, you discover that another band—one you have never heard of—has come to play instead of the original contracting band. On inquiry, you learn that the original band transferred its duties to perform to a lesser known band. Can it do that?

Figure 6.3



Let's do business.

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Contract elements—the terms of the contract—are important. They may, among other things, foreclose your ability to bring a complaint in court, they may render you unable to be hired in your profession (at least within certain boundaries), or they may limit liability to a party that had a role in causing injury to you. If you are not aware of these elements, then you may face an unpleasant surprise if you act in a way contrary to the restrictions imposed by those terms. Likewise, contracts possess certain qualities that prohibit parties from acting in certain ways, unless those qualities are expressly waived. This section identifies common properties of contracts, as well as commonly used elements of contracts. If you are negotiating a contract and you do not like a term, then you should not agree to it. In law, there is a presumption that you have read, understood, and agreed to each and every term of any contract to which you are a party. Arguing that you did not understand or that you did not approve of a particular term in the contract will not be a valid excuse to performance. You should know what you can expect when you enter into a contract. Are you getting the band that you wanted to

hire to play in your nightclub, or are you really getting any band that the original band happens to transfer its duties to?

As a preliminary matter, it is important to realize that contracts are, by law, assignable and delegable. This means that the rights conveyed by the contract may be transferred to another party by **assignment**⁵¹, unless an express restriction on assignment exists within the contract, or unless an assignment would violate public policy. Likewise, the duties imposed on a party may be transferred to another party by **delegation**⁵², unless the contract expressly restricts delegation, or there is a substantial interest in personal performance by the original party to the contract, or if delegation would violate public policy. In the case of a band hired to perform at a nightclub, an argument could be made that the original band cannot delegate its duties under the contract because there was a substantial interest in personal performance by the original band. This would render the contract nondelegable. To be on the safe side, your contract with that band should have had a clause expressly prohibiting delegation.

Many students have seen restrictions on assignment in the form of no-sublease clauses in leases with landlords. Do you have a no-sublease clause in your lease? If so, that is a **restriction on assignment**⁵³. This clause is necessary to prevent you from assigning your rights under the lease—your rights to inhabit the premises—to another party. It is necessary for the landlord to include that provision expressly if she wishes to prevent you from subleasing the unit, because there is a presumption in law that assignment is permitted unless it is expressly prohibited by the contract or unless the assignment would violate public policy. Since it is unlikely that letting someone else live in your housing unit in your absence would violate public policy, then the landlord must expressly prohibit the assignment within the original contract if she wishes to prevent tenants from subleasing. A landlord may have a very good reason to wish to prevent subleasing; she may wish to ensure that each tenant is creditworthy prior to allowing the tenant to live in the property.

- 51. The ability to transfer rights conveyed by a contract to another party.
- 52. The ability to transfer duties imposed on a party by a contract to another party.
- 53. A clause that prohibits parties from transferring the rights conveyed by a contract to another party.
- 54. An agreement that transfers all rights and duties to a new party to the contract and releases the previous party from any further obligation arising from the original contract.

Note that in delegation and in assignment, the original contracting party is not “off the hook” if it transfers its duties or rights to another party. For instance, if subleasing was not prohibited, and the new tenant assumed the rights and duties imposed by the original contract, the original party to the contract is still liable for the payment of rent. If the subleasing tenant does not pay the rent, the original party to the lease is still liable. The way to excuse oneself from this liability is to form a three-way **novation**⁵⁴ with the original party and the new party, thereby excusing the exiting party from future liability arising under the contract. A novation is essentially a new contract that transfers all rights and duties to the new party to the contract and releases the previous party from any further obligation arising from the original contract.

Restrictions on assignment or delegation are not the only common elements that can be found in contracts. For example, you have probably encountered exculpatory clauses. An **exculpatory clause**⁵⁵ is an express limitation on potential or actual liability arising under the subject matter of the contract. In short, exculpatory clauses are often employed when risk of injury exists. They seek to limit one party's liability to another. You most certainly have signed exculpatory agreements or contracts containing exculpatory clauses if you have participated in any potentially dangerous activity at a club or with an organized group that could incur liability from injuries suffered by its patrons or members. For example, if you join a kayaking club, you will most likely be asked to sign such an agreement to "hold harmless" the club in the event of any accident or injury. However, despite the existence of an exculpatory clause, liability will not be limited (that is, the liability limitations will be unenforceable) when the party who would benefit from the limitation on liability acted with gross negligence, committed an intentional tort, or possessed greatly unequal bargaining power, or if the limitation on liability violates public policy. Imagine that you signed an agreement to engage in kayaking activities with a kayaking group, but the leader of the group battered you with her oar because she was angry with you for mishandling your kayak. Since battery is an intentional tort, the exculpatory clause will not protect the kayaking organization from liability it incurred through the actions of its employee.

Another common contract element that you may have encountered is a noncompete clause. A **noncompete clause**⁵⁶ attempts to restrict competition for a specified period of time, within a certain geographic region, and for specified activities. Noncomplete clauses are generally valid against the party who signed it if the time, place, and scope are reasonable. These are very common clauses in employment contracts, particularly where the duties involved in employment are likely to involve trade secrets or other proprietary information that the company wishes to protect.

A **mandatory arbitration clause**⁵⁷ is very common in consumer contracts and employment contracts. You have certainly subjected yourself to the restrictions imposed by these clauses if you have signed a contract for a credit card. Mandatory arbitration clauses require parties to a contract that contains such a clause to submit to mandatory arbitration in the event of a dispute arising under the contract. Mandatory arbitration clauses frequently foreclose any possibility of appealing arbitration awards in court.

An **acceleration clause**⁵⁸ commonly exists in contracts where periodic payments are contemplated by the agreement. For example, if you signed a lease for your housing unit, then you most likely pay rent on a month-to-month basis. If you breached your lease, you would still owe rent for each subsequent month contemplated by the lease agreement. This means that your landlord would have

- 55. An express limitation on potential or actual liability arising under the subject matter of the contract.
- 56. A contract clause that restricts competition for a specified period of time, within a certain geographic region, and for specified activities.
- 57. A contractual clause that requires the parties to a contract that contains such a clause to submit to mandatory arbitration in the event of a dispute arising under the contract. Mandatory arbitration clauses frequently foreclose any possibility of appealing arbitration awards in court.
- 58. A type of clause that accelerates all payments due under the contract on breach.

new injury every month that you did not pay. An acceleration clause accelerates all payments due under the contract on breach. This allows the injured party—in this case, the landlord—to sue for all damages due for unpaid rent under that contract at once, rather than having to bring a new suit each month to seek monthly unpaid rent.

A **liquidated damages clause**⁵⁹ allows parties to set the amount of damages in the event of breach. Agreeing to a damage amount before any breach occurs can save money and time spent litigating. Providing that the liquidated damages clause does not look like a penalty, the clause will be valid and enforced by a court that hears a dispute arising under the contract. For example, imagine that you entered into a contract for the sale of your car. If the liquidated damages clause provided for two thousand dollars of damages in the event of breach, that will probably be a valid liquidated damages clause, providing that your car is an “average” car. However, if the liquidated damages clause provided for one million dollars of damages payable by the breaching party, then that would not be enforceable by the court because it looks like a penalty. The proposed liquidated damages far exceed the value of the car that is the subject of the agreement.

Of course, there are additional common elements to contracts. This is not an exhaustive study of possible provisions, though it is a list of commonly encountered elements. For example, time of performance is often included as a separate provision. However, time for performance is an essential element in common-law contract formation, and without it, the contract may fail due to lack of definite and certain terms in formation.

A major assumption made about a written contract is that it is **integrated**⁶⁰, which means that it contains the entire expression of the parties’ agreement. That means that any statements made before the parties signed the contract are not part of the contract, unless those statements are memorialized in the contract itself. In fact, any statements or actions that are not captured within the four corners of the contract are considered **parol evidence**⁶¹, and they will not be used to interpret the meaning of the contract.

59. A type of clause that sets the amount of damages in the event of breach.

60. The legal assumption made about contracts that they contain the entire expression of the parties’ agreement.

61. Statements or actions that are not captured within the four corners of the contract.

KEY TAKEAWAYS

Parties to contracts must not only take care to form the agreement so that it is legally enforceable, but they must also be aware of the properties of contracts in general, as well as specific provisions contained within contracts to which they are a party. Properties of contracts include ability to assign, delegate, and exclude parol evidence. Several types of contracts clauses are commonly used to restrict rights and limit liability.

EXERCISES

1. Think of an example of an exculpatory clause that you have signed. For what type of activity would you be unwilling to sign an exculpatory clause? If your refusal to sign the exculpatory clause or agreement prevented you from participating in that activity, would you still refuse to sign it?
2. Do you think that too many limitations and restrictions can be placed on parties in a contract? Should there be more government regulation and standardization of contract terms between private parties? Why or why not?

6.4 Concluding Thoughts

Contracts are an integral part of business. Without contracts, promises would not be enforceable, which would wreak havoc on our financial stability, both individually and professionally.

The law presumes that people who sign contracts have read the contract and understood its terms. Of course, contract language includes many terms of art, and simply reading a contract alone may not be enough to fully understand its implications. Contracts for important matters should be reviewed and explained by attorneys, so that parties who enter into contracts do not do so without understanding the agreement.

It's important to understand the implications of making promises. If those promises carry legal duties, then, barring a defense, the promise will need to be performed so that the obligation or duties arising under that promise can be discharged. If the promise is not performed, and if there are no defenses, then the contract has been breached. Breach is an actionable claim, with the goal of recovering the loss and placing the nonbreaching party back to the position that he or she would have been in if the contract had not been breached.

Recognizing fundamental elements of contracts and how to incorporate considerations important to you when entering into them can go far toward ensuring business success. Likewise, the failure to recognize the traps and tricks that can be incorporated into contracts can derail a good business idea.

Chapter 7

Torts

LEARNING OBJECTIVES

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

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

Look at the picture in [Figure 7.1 "A Typical Construction Site"](#). You've probably seen a similar picture of a construction site near where you live, with multiple orange traffic cones (with reflective stripes so they can be seen at night) and a large sign warning vehicles not to attempt to drive on the road. Now imagine the picture without the traffic cones, warning signs, or caution tape. If you were driving, would you still attempt to drive on this road?

Figure 7.1 A Typical Construction Site



Most of us would probably answer no, since the road is obviously under construction and attempting to drive on it may result in severe damage to property (our vehicles) and personal injury. Similarly, pedestrians, skateboarders, and bicyclists will likely steer clear of this road even if it wasn't clearly marked or roped off. So if the dangers associated with

this construction are obvious, why would the construction workers go through the time and expense of setting up the traffic cones, sign, and tape?

The answer has to do with **tort**¹ law. A tort can be broadly defined as a civil wrong, other than breach of contract. In other words, a tort is any legally recognizable injury arising from the conduct (or nonconduct, because in some cases failing to act may be a tort) of persons or corporations. The other area of civil law that corporations have to be concerned about is contract law. There are several key differences between torts and contracts.

First is the realm of possible plaintiffs. In contract law, only persons that you have a contract with, or you are a third-party-beneficiary to (such as when you are named the beneficiary to a life insurance policy and the company refuses to pay the claim), can possibly sue you for breach of contract. In tort law, just about anyone can sue you, as long as they can establish that you owe them some sort of legally recognized duty. The second key difference is damages, or remedies. In contract law, damages are usually not difficult to calculate, as contract law seeks to place the parties in the same position as if the bargain had been performed (known as **compensatory damages**²). Compensatory damages also apply in tort law, but they are much more difficult to calculate. Since money cannot bring the dead back to life or regrow a limb, tort law seeks to find a suitable monetary equivalent to those losses, which as you can imagine is a very difficult thing to do. Additionally, tort law generally allows for the award of **punitive damages**³, something never permitted in contract law.

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

You might recall from [Chapter 3 "Litigation"](#) that the standard of proving a criminal case (beyond a reasonable doubt) is far higher than the standard for

1. A civil wrong, other than breach of contract.
2. Money damages to compensate for economic losses, or losses stemming from injuries.
3. Money damages awarded to punish the defendant for gross and wanton negligence and to deter future wrongdoing.

proving a civil case (a preponderance of evidence). Therefore, if someone is convicted of a crime, he or she is also automatically liable in civil tort law under the **negligence per se**⁴ doctrine. For that reason, criminal defendants who wish to avoid a criminal trial are permitted to plead “no contest” to the criminal charges, which permits the judge to sentence them as if they were guilty but preserves the right of the defendant to defend a civil tort suit.

Perhaps more than any other area of law, tort law is a reflection of American societal values. Contracts are enforced because they protect our expectation that our promises are enforced. Criminal law is the result of elected legislatures prohibiting behavior that the community finds offensive or immoral. Tort law, on the other hand, is generally not the result of legislative debate or committee reports. Each tort case arises out of different factual situations, and a jury of peers is asked to decide whether or not the **tortfeasor**⁵ (the person committing the tort) has violated a certain societal norm. Additionally, we expect that when an employee is working for the employer’s benefit and commits a tort, the employer should be liable. Under the **respondent superior**⁶ doctrine, employers are indeed liable, unless they can demonstrate the employee was on a frolic and detour at the time he or she committed the tort.

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

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

4. Negligence due to a criminal violation.

5. A person who commits a tort.

6. Doctrine that holds employers liable for tortious acts committed by employees while acting within the scope of their employment.

Torts can be broadly categorized into three categories, depending on the level of intent demonstrated by the tortfeasor. If the tortfeasor acted with intent to cause the damage or harm that results from his or her action, then an **intentional tort**⁷ has occurred. If the tortfeasor didn't act intentionally but nonetheless failed to act in a way a reasonable person would have acted, then **negligence**⁸ has taken place. Finally, if the tortfeasor is engaged in certain activities and someone is injured or killed, then under **strict liability**⁹ the tortfeasor is held liable no matter how careful or careless he or she may have been. In this chapter, we'll explore these three areas of torts carefully so that by the end of the chapter, you'll understand the responsibilities tort law imposes on both persons and corporations. The chapter concludes with a brief discussion of other issues that affect torts, including tort reform.

Key Takeaways

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

7. A type of tort where the defendant acts with intent to cause a particular outcome.
8. The breach of the duty of all persons, as established by state tort law, to act reasonably and to exercise a reasonable amount of care in their dealings and interactions with others.
9. Liability imposed in certain situations without regard to fault or due care.

7.1 Intentional Torts

LEARNING OBJECTIVES

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

Examine [Figure 7.2 "A Coworker Attacks"](#). The office worker on the right has grabbed the office worker on the left and is strangling him. This conduct is clearly criminal, and it is also tortious. Since the tortfeasor here has acted intentionally by grabbing his colleague's neck, the tort is considered intentional. (It is, in fact, likely assault and battery.)

Figure 7.2 A Coworker Attacks



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

In addition to the physical pain that accompanies being strangled by a coworker, the victim may also feel a great deal of fear. That fear is something we expect to never have to feel, and that fear creates the basis for the tort of **assault**¹⁰. An assault is an intentional, unexcused act that creates in another person a reasonable apprehension or fear of immediate harmful or offensive contact. Note that actual fear is not required for assault—mere apprehension is enough. For example, have you ever gone to sit down on a chair only to find out that one of your friends has pulled the chair away, and therefore you are about to fall down when you sit? That sense of apprehension is enough for assault. Similarly, a diminutive ninety-pound woman who attempts to hit a burly three-hundred-pound police officer with her bare fists is liable for assault if the police officer feels apprehension, even if fear is unlikely or not present. Physical injuries aren't required for assault. It's also not necessary for the tortfeasor to intend to cause apprehension or fear. For example, if

10. An intentional, unexcused act that creates in another person a reasonable apprehension or fear of immediate harmful or offensive contact.

someone pointed a very realistic-looking toy pistol at a stranger and said “give me all your money” as a joke, it would still constitute assault if a reasonable person would have perceived fear or apprehension in that situation. The intentional element of assault exists here, because the tortfeasor intended to point the realistic-looking toy pistol at the stranger.

A **battery**¹¹ is a completed assault. It is any unconsented touching, even if physical injuries aren’t present. In battery, the contact or touching doesn’t have to be in person. Grabbing someone’s clothing or cane, swinging a baseball bat at someone sitting in a car, or shooting a gun (or Nerf ball, for that matter, if it’s unconsented) at someone is considered battery. Notice that assault and battery aren’t always present together. Shooting someone in the back usually results in battery but not assault since the victim didn’t see the bullet coming and therefore did not feel fear or apprehension. Similarly, a surgeon who performs unwanted surgery or a dentist who molests a patient while the patient is sedated has committed battery but not assault. Sending someone poisoned brownies in the mail would be battery but not assault. On the other hand, spitting in someone’s face, or leaning in for an unwanted kiss, would be assault and possibly battery if the spit hit the victim’s face, or the kiss connected with any part of the victim’s body.

When someone is sued for assault or battery, several defenses are available. The first is consent. For example, players on a sports team or boxers in a ring are presumed to have consented to being battered. **Self-defense**¹² and **defense of others**¹³ are also available defenses, bearing in mind that any self-defense must be proportionate to the initial force.

A battery must result in some form of physical touching of the plaintiff. When that physical touching is absent, courts sometimes permit another tort to be claimed instead, the tort of **intentional infliction of emotional distress (IIED)**¹⁴. In a sense, IIED can be thought of as battery to emotions, but a great deal of caution is warranted here. Many people are battered emotionally every day to varying degrees. Someone may cut you off in traffic, leading you to curse at him or her in anger. A stranger may cut in line in front of you, leading you to exclaim in indignation. A boyfriend or girlfriend may decide to break off a relationship with you, leading to hurt feelings and genuine grief or pain. None of these situations, nor any of the normal everyday stresses of day-to-day living, are meant to be actionable in tort law. The insults, indignities, annoyances, or even threats that we experience as part of living in modern society are to be expected. Instead, IIED is meant to protect only against the most extreme of behaviors. In fact, for a plaintiff to win an IIED case, the plaintiff has to demonstrate that the defendant acted in such a manner that if the facts of the case were told to a reasonable member of the community, that community member would exclaim that the behavior is “outrageous.” Notice that the standard here is objective; it’s not enough for the

11. Any unconsented touching.
12. Reasonable and proportionate force to defend oneself from harm or injury.
13. Reasonable and proportionate force used to defend another person from harm or injury.
14. Extreme and outrageous conduct (measured objectively) that intentionally or recklessly causes severe emotional distress to another.

plaintiff to feel that the defendant has acted outrageously. In some states, the concern that this tort could be abused and result in frivolous litigation has led to the additional burden that the plaintiff must demonstrate some physical manifestation of the psychological harm (such as sleeplessness or depression) to win any recovery.

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

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

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

Although the standard for outrageous conduct is objective, the measurement is made against the particular sensitivities of the plaintiff. Exploiting a known sensitivity in a child, the elderly, or pregnant women can constitute IIED. A prank telephone call made by someone pretending to be from the army to a mother whose

son was at war, telling the mother her son has been killed, would most certainly be IIED.

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

Another intentional tort is the **invasion of privacy**¹⁵. There are several forms of this tort, with the most common being **misappropriation**¹⁶. Misappropriation takes place when a person or company uses someone else's name, likeness, or other identifying characteristic without permission. For example, in 1986 model Russell Christoff posed for a photo shoot for Nestlé Canada for Taster's Choice coffee. He was paid \$250 and promised \$2,000 if Nestlé used his photo on its product. In 2002 he discovered Nestlé had indeed used his photo on Taster's Choice coffee without his permission (**Figure 7.3 "Russell Christoff"**), and he sued Nestlé for misappropriation. A California jury awarded him over \$15 million in damages. Jaime Holguin, "\$15.6M Award for Coffee 'Mug,'" *CBSnews.com*, February 2, 2005, <http://www.cbsnews.com/stories/2005/02/01/national/main670754.shtml> (accessed September 27, 2010). Misappropriation can be a very broad tort

Figure 7.3 Russell Christoff



because it covers more than just a photograph or drawing being used without permission—it covers any likeness or identifying characteristic. For example, in 1988 Ford Motor Company approached Bette Midler to sing a song for a commercial,

15. The intrusion into the personal life of another without legal justification.

16. Using another's name, likeness, or identifying characteristic without his or her permission.

which she declined to do. The company then hired someone who sounded just like Midler to sing one of Midler's songs, and asked her to sound as much like Midler as possible. The company had legally obtained the copyright permission to use the song, but Midler sued anyway, claiming that the company had committed misappropriation by using someone who sounded like her to perform the commercial. An appellate court held that while Ford did not commit copyright infringement, it had misappropriated Midler's right to publicity by hiring the sound-alike, *Midler v. Ford Motor Company*, 849 F.3d 460 (9th Cir. 1988). and a jury awarded her over \$400,000 in damages.

Source: http://www.sfgate.com/c/pictures/2005/02/02/mn_nestle_model2.jpg.

In addition to someone's voice, an identifying characteristic can be the basis for misappropriation. For example, Samsung Electronics ran a series of print advertisements to demonstrate how long-lasting their products can be. The ads featured a common item from popular culture along with a humorous tagline. One of the ads featured a female robot dressed in a wig, gown, and jewelry posed next to a game show board that looked exactly like the game show board from Wheel of Fortune (**Figure 7.4 "Samsung Advertisement"**). The tagline said, "Longest-running game show. 2012 A.D." An appellate court held that Vanna White's claim for misappropriation was valid, writing "the law protects the celebrity's sole right to exploit [their identity] value whether the celebrity has achieved her fame out of rare ability, dumb luck, or a combination thereof." *White v. Samsung Electronics America*, 971 F.2d 1395 (9th Cir. 1992). The lesson for companies is that in product marketing, permission must be carefully obtained from all persons appearing in their marketing materials, as well as any persons who might have a claim to their likeness or identifying characteristic in the materials.

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

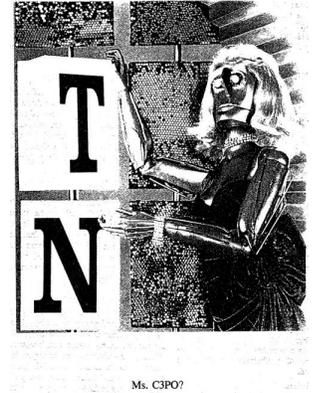
[\(click to see video\)](#)

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

Another important intentional tort for businesses is **false imprisonment**¹⁷. This tort takes place when someone intentionally confines or restrains another person's movement or activities without justification. The interest being protected here is your right to travel and move about freely without impediment. This tort requires an actual and present confinement. If your professor locks the doors to the classroom and declares no one may leave, that is false imprisonment. If the professor leaves the doors unlocked but declares that anyone who leaves will get an F in the course, that is not false imprisonment. On the other hand, a threat to detain personal property can be false imprisonment, such as if your professor grabs your laptop and says, "If you leave, I'll keep your laptop." Companies that engage in employee morale-building activities should bear in mind that forcing employees to do something they don't want to do raises issues of false imprisonment. False imprisonment is especially troublesome for retailers and other businesses that interact regularly with the public, such as hotels and restaurants. If such a business causes a customer to become arrested by the police, for example, it may lead to the tort of false imprisonment. In one case, a pharmacist who suspected a customer of forging a prescription deliberately caused the customer to be detained by the police. When the prescription was later validated, the pharmacist was sued for false imprisonment. Businesses confronted with potential thieves are permitted to detain suspects until police arrive at the establishment; this is known as the **shopkeeper's privilege**¹⁸. The detention must be reasonable, however. Store employees must not use excessive force in detaining the suspect, and the grounds, manner, and time of the detention must be reasonable or the store may be liable for false imprisonment.

Intentional torts can also be committed against property. **Trespass to land**¹⁹ occurs whenever someone enters onto, above, or below the surface of land owned by someone else without the owner's permission. The trespass can be momentary or

Figure 7.4 Samsung Advertisement



Source: Photo courtesy of the U.S. federal government, <http://commons.wikimedia.org/wiki/File:White-v-samsung-dissent-appendix-2.png>.

17. Intentionally confining or restraining another person's movement without justification.
18. The right of a business owner to detain a suspected shoplifter for a reasonable period of time and under reasonable conditions.
19. Intentional entry to land owned by another without a legal excuse.

fleeting. Soot, smoke, noise, odor, or even a flying arrow or bullet can all become the basis for trespass. A particular trespass problem takes place in suburban neighborhoods without clearly marked property lines between homes. Children are often regular trespassers in this area, and even if they are trespassing, homeowners are under a reasonable duty of care to ensure they are not harmed. When there is an **attractive nuisance**²⁰ on the property, homeowners must take care to both warn children about the attractive nuisance and protect them from harm posed by the attractive nuisance. This doctrine can apply to pools, abandoned cars, refrigerators left out for collection, trampolines, piles of sand or lumber, or anything that might pose a danger to children and that they cannot understand or appreciate. There may be times, however, when trespass is justified. Obviously, someone invited by the owner is not a trespasser; such a person is considered an invitee until the owner asks him or her to leave. Someone may have a license to trespass, such as a meter reader or utility repair technician. There may also be times when it may be necessary to trespass—for example, to rescue someone in distress.

Trespass to personal property²¹ is the unlawful taking or harming of another’s personal property without the owner’s permission. If your roommate borrowed your vehicle without your permission, for example, it would be trespass to personal property. The tort of **conversion**²² takes place when someone takes your property permanently; it is the civil equivalent to the crime of theft. If you gave your roommate permission to borrow your car for a day and he or she stole your car instead, it would be conversion rather than trespass. An employer who refuses to pay you for your work has committed conversion.

Another intentional tort is **defamation**²³, which is the act of wrongfully hurting a living person’s good reputation. Oral defamation is considered **slander**²⁴, while written defamation is **libel**²⁵. To be liable for defamation, the words must be published to a third party. There is no liability for defamatory words written in a secret diary, for example, but there is liability for defamatory remarks left on a Facebook wall. Issues sometimes arise with regard to celebrities and public figures, who often believe they are defamed by sensationalist “news” organizations that cover celebrity gossip. The First Amendment provides strong protection for these news organizations, and courts have held that public figures must show actual **malice**²⁶ before they can win a defamation lawsuit, which means they have to demonstrate the media outlet knew what it was publishing was false or published the information with reckless disregard for the truth. This is a much higher standard than that which applies to ordinary citizens, so public figures typically have a difficult time winning defamation lawsuits. Of course, truth is a complete defense to defamation.

- 20. Any item or condition on a property that would be attractive and dangerous to children, even if the children are trespassing.
- 21. Unlawful taking or harming of another person’s property without the owner’s permission.
- 22. Civil tort of stealing property from another person.
- 23. Publishing or saying untrue statements about a living person that harms his or her reputation.
- 24. Oral form of defamation.
- 25. Written form of defamation.
- 26. Conscious, intentional wrongdoing.

Defamation can also take place against goods or products instead of people. In most states, **injurious falsehood (or trade disparagement)**²⁷ takes place when someone publishes false information about another person's product. For example, in 1988 the influential product testing magazine *Consumer Reports* published a test of the Suzuki Samurai small SUV, claiming that it "easily rolls over in turns." Product sales dropped sharply, and Suzuki sued Consumers Union, the publisher, for trade disparagement. The case was settled nearly a decade later after a long and expensive legal battle.

Businesses often make claims about their products in marketing their products to the public. If these claims are false, then the business may be liable for the tort of **misrepresentation**, known in some states as **fraud**²⁸. Fraud requires the tortfeasor to misrepresent facts (not opinions) with knowledge that they are false or with reckless disregard for the truth. An "innocent" misrepresentation, such as someone who lies without knowing he or she is lying, is not enough—the defendant must know he or she is lying. Fraud can arise in any number of business situations, such as lying on your résumé to gain employment, lying on a credit application to obtain credit or to rent an apartment, or in product marketing. Here, there is a fine line between **puffery**²⁹, or seller's talk, and an actual lie. If an advertisement claims that a particular car is the "fastest new car you can buy," then fraud liability arises if there is in fact a car that travels faster. On the other hand, an advertisement that promises "unparalleled luxury" is only puffery since it is opinion. Makers of various medicinal supplements and vitamins are often the target of fraud lawsuits for making false claims about their products.

Finally, an important intentional tort to keep in mind is **tortious interference**³⁰. This tort, which varies widely by state, prohibits the intentional interference with a valid and enforceable contract. If the defendant knew of the contract and then intentionally caused a party to break the contract, then the defendant may be liable. In 1983 oil giant Pennzoil made a bid for a smaller oil rival, Getty Oil. A competitor to Pennzoil, Texaco, found out about the deal and approached Getty with another bid for a higher amount, which Getty then accepted. Pennzoil sued Texaco, and a jury awarded over \$10 billion in damages.

27. Publishing false information about another person's product.

28. The misrepresentation of facts (lying) with knowledge they are false or with reckless disregard for the truth.

29. Promotional statements expressing subjective views.

30. Intentional damage of another person's valid contractual relationship.

KEY TAKEAWAYS

Assault is any intentional act that creates in another person a reasonable fear or apprehension of harmful or offensive contact. A battery is a completed assault, when the harmful or offensive contact occurs. The intentional infliction of emotional distress (IIED) is extreme and outrageous conduct that intentionally causes severe emotional distress to another person. In some states, IIED requires a demonstration of physical harm such as sleeplessness or depression. This is a difficult tort to win because of its inherent clash with values embodied by the First Amendment.

Misappropriation is the use of another person's name, likeness, or other identifying characteristic without permission. False imprisonment occurs when someone intentionally confines or restrains another person's movement without justification. Trespass is the entry onto land without the owner's permission, while conversion is the civil equivalent of the theft crime. Defamation is the intentional harm to a living person's reputation, while trade disparagement takes place when someone publishes false information about someone else's product. Fraudulent misrepresentation is any intentional lie involving facts. Tortious interference is the intentional act of causing someone to break a valid and enforceable contract.

EXERCISES

1. Members of the Westboro Baptist Church claim that the First Amendment protects them from IIED lawsuits since they are expressing a political opinion by picketing at soldier funerals. The pickets take place on public property and in compliance with local picketing laws. If the plaintiffs win the case, the church is unlikely to have the money to satisfy the judgment and may seek bankruptcy. Do you believe that this conduct is extreme and outrageous enough to constitute a tort? Why or why not?
2. In 1983 *Hustler* magazine (owned by publisher Larry Flynt) ran a print advertisement patterned after a Campari liquor ad campaign. The real ad campaign featured celebrities “talking about their first time” in a question-and-answer interview format, slowly revealing that the celebrities were speaking about their first time drinking Campari. The *Hustler* advertisement featured fundamentalist preacher Jerry Falwell, who was running a campaign against pornography at the time, and insinuated that Falwell had lost his virginity to his mother. Falwell sued Flynt and the magazine, and a jury awarded Falwell \$150,000 in damages. The Supreme Court overturned the verdict on appeal on grounds of the First Amendment, holding that as a public figure, Falwell had to endure the advertisement. *Hustler Magazine v. Falwell*, 485 U.S. 46 (1988). Do you believe that celebrities and public figures should have a harder time winning IIED lawsuits? Why or why not?
3. Do you believe that an “identifying characteristic” should be protected by the tort of misappropriation, or do you believe that society has gone too far in recognizing property rights? A First Amendment exception exists for comedians who engage in satire and comedy (think of Tina Fey’s impersonation of Sarah Palin during the 2008 presidential campaign, for example). Does it make sense to you that comedians like Fey and John Stewart can make money through misappropriation, but other businesses cannot?
4. Look at the advertisement featured in [Note 7.21 "Video Clip: Is a Single Name a Likeness or Identifying Characteristic?"](#). Do you think that the ad is referring to Lindsay Lohan? Has the name “Lindsay” become so linked to Lohan that companies run the risk of being sued if they use the name Lindsay in advertisements? What if the advertisement had used a name like “Oprah” or “Cher”?
5. Defamation law only protects the living. Some legal commentators believe that defamation should also protect the dead. See, for example, law professor Jonathan Turley’s opinion in the *Washington Post* here: http://www.washingtonpost.com/wp-dyn/content/article/2006/09/15/AR2006091500999_pf.html. Turley points out examples of how the dead

have been defamed, such as the character of William Murdoch in the 1997 movie *Titanic*, where he was portrayed as a murderous nut. In reality, survivors reported he took heroic actions to save passengers. Do you believe defamation should be extended to protect the dead as well as the living?

7.2 Negligence

LEARNING OBJECTIVES

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

Video Clip: The Crash of Continental Flight 3407

[\(click to see video\)](#)

Ordinarily, we don't expect perfectly good airplanes to fall out of the sky for no reason. When it happens, and it turns out that the reason was carelessness or a failure to act reasonably, then the tort of **negligence**³¹ may apply. All persons, as established by state tort law, have the duty to act reasonably and to exercise a reasonable amount of care in their dealings and interactions with others. Breach of that duty, which causes injury, is negligence. Negligence is distinguished from intentional torts because there is a lack of intent to cause harm. If a pilot intentionally crashed an airplane and harmed others, for example, the tort committed may be assault or battery. When there is no intent to harm, then negligence may nonetheless apply and hold the pilot or the airline liable, for being careless or failure to exercise due care.

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

31. The breach of the duty of all persons, as established by state tort law, to act reasonably and to exercise a reasonable amount of care in their dealings and interactions with others.

To prove negligence, plaintiffs have to demonstrate four elements are present. First, they have to establish that the defendant owed a duty to the plaintiff. Second, the plaintiff has to demonstrate that the defendant breached that duty. Third, the plaintiff has to prove that the defendant's conduct caused the injury. Finally, the

plaintiff has to demonstrate legally recognizable injuries. We'll address each of these elements in turn.

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

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

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

Figure 7.5



Is it foreseeable that someone will slip if you carelessly discard a banana peel?

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

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

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

Figure 7.6



Stores must warn customers of hazardous conditions.

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Business professionals such as doctors, accountants, dentists, architects, and lawyers owe a special duty to act as a reasonable person in their profession. Professional negligence by these professionals is known as **malpractice**³². The government estimates that between forty-four thousand and ninety-eight thousand people die each year in hospitals due to medical mistakes, the vast majority of them preventable. U.S. Department of Health and Human Services, Agency for Healthcare Research and Quality, “Reducing Errors in Health Care: Translating Research Into Practice,” April 2000, <http://www.ahrq.gov/qual/errors.htm> (accessed September 27, 2010).

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

The third element of negligence is causation. In deciding whether there is causation, courts have to consider two questions. First, courts query as to whether there is causation in fact, also known as but-for causation. This form of causation is fairly easy to prove. But for the defendant’s actions, would the plaintiff have been injured? If yes, then but-for causation is proven. For example, if you are texting

32. Negligence committed by certain professionals.

while driving and you hit a pedestrian because your attention was diverted, then but-for causation is easily met, because “but for” your actions of texting while driving, you would not have hit the pedestrian.

The second question is tougher to establish. It asks whether the defendant’s actions were the proximate cause of the plaintiff’s injury. In asking this question, courts are expressing a concern that causation-in-fact can be taken to a logical but extreme conclusion. For example, if a speeding truck driver crashes his or her rig and causes the interstate highway to be shut down for several hours, causing you to become stuck in traffic and miss an important interview, you could argue that but for the truck driver’s negligence, you may have landed a new job. It would not be fair, however, to hold the truck driver liable for all the missed appointments and meetings caused by a subsequent traffic jam after the crash. At some point, the law has to break the chain of causation. The truck driver may be liable for injuries caused in the crash, but not beyond the crash. This is **proximate causation**³³.

Video Clip: Palsgraf v. Long Island Railroad Company

[\(click to see video\)](#)

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

In some cases it can be difficult to pinpoint a particular source for a product, which then makes proving causation difficult. This is particularly true in **mass tort**³⁴ cases where victims may have been exposed to dangerous substances from multiple sources over a number of years. For example, assume that you have been taking a vitamin supplement for a number of years, buying the supplement from different companies that sell it. After a while the government announces that this supplement can be harmful to health and orders sales to stop. You find out that your health has been affected by this supplement and decide to file a tort lawsuit. The problem is that you don’t know which manufacturer’s supplement caused you to fall ill, so you cannot prove any specific manufacturer caused your illness. Under the doctrine of **joint and several liability**³⁵, however, you don’t have to identify the specific manufacturer that sold you the drug that made you ill. You can simply sue one, two, or all manufacturers of the supplement, and any of the defendants are then liable for the entirety of your damages if they are found liable. This doctrine has been used in cases involving asbestos production and distribution.

The final element in negligence is legally recognizable injuries. If someone walks on a discarded banana peel and doesn’t slip or fall, for example, then there is no tort. If

33. An act from which an injury results as a natural and direct consequence.

34. A civil tort involving numerous plaintiffs against one or few defendants.

35. A doctrine under which the plaintiff may pursue a claim against any party liable for the claim as if they were jointly liable, and defendants then sort out their respective proportions of liability.

someone has been injured, then damages may be awarded to compensate for those injuries. These damages take the form of money, as there is nothing tort law can do to bring back the dead or regrow lost limbs, and tort law does not allow for incarceration. Money is therefore the only appropriate measure of damages, and it is left to the jury to decide how much money a plaintiff should be awarded.

There are two types of award damages in tort law. The first, compensatory damages, seeks to compensate the plaintiff for his or her injuries. **Compensatory damages**³⁶ can be awarded for medical injuries, economic injuries (such as loss of a car, property, or income), and pain and suffering. They can also be awarded for past, present, and future losses. While medical and economic damages can be calculated using available standards, pain and suffering is a far more nebulous concept. Juries are often left to their conscience to decide what amount of money can compensate for pain and suffering, based on the severity and duration of the pain as well as its impacts on the plaintiff's life.

The second type of damage award is known as **punitive damages**³⁷. Here, the jury is awarded a sum of money not to compensate the plaintiff but to deter the defendant from ever engaging in similar conduct. The idea behind punitive damages is that compensatory damages may be inadequate to deter future bad conduct, so additional damages are necessary to ensure the defendant corrects its ways to prevent future injuries. Punitive damages are available in cases where the defendant acted with willful and wanton negligence, a higher level of negligence than ordinary negligence. Bear in mind, however, that there are constitutional limits to the award of punitive damages.

A defendant being sued for negligence has three basic affirmative defenses. An **affirmative defense**³⁸ is one that is raised by the defendant essentially admitting that the four elements for negligence are present, but that the defendant is nonetheless not liable for the tort. The first defense is **assumption of risk**³⁹. If the plaintiff knowingly and voluntarily assumes the risk of participating in a dangerous activity, then the defendant is not liable for injuries incurred. For example, if you decide to bungee jump, you assume the risk that you might be injured during the jump. It's common for bungee jumpers to experience burst blood vessels in the eye, soreness in the back and neck region, and twisted ankles, so these injuries are not compensable. On the other hand, you can only assume risks that you know about. When a person bungee jumps, one of the first steps is for the jump operator to weigh the jumper, so that the length of the bungee can be adjusted accordingly. If this is not done properly, the jumper may overshoot or undershoot the expected bottom of the jump. While you can assume known risks from bungee jumping, you cannot assume unknown risks, such as the risk that a jump operator may negligently calculate the length of the bungee rope.

36. Compensation for actual injuries suffered by a plaintiff.

37. Money awarded to the plaintiff when the defendant acts wantonly, to punish the defendant and to deter future wrongdoing.

38. A response by the defendant that raises a justification or excuse for the defendant's conduct.

39. A defense in which the plaintiff is barred from recovery because the plaintiff voluntarily and knowingly assumed known risks.

A related doctrine, the **open and obvious**⁴⁰ doctrine, is used to defend against suits by persons injured while on someone else’s property. For example, if there is a spill on a store’s floor and the store owner has put up a sign that says “Caution—Slippery Floor,” yet someone decides to run through the spill anyway, then that person would lose a negligence lawsuit if he or she slips and falls because the spill was open and obvious. Use of the open and obvious doctrine varies widely by state, with some states allowing it to be used in a wide variety of premises liability cases and other states circumventing its usefulness.

Figure 7.7



What risks do you assume if you bungee jump?

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

The second defense to negligence is to allege that the plaintiff’s own negligence contributed to his or her injuries. In a state that follows the **contributory negligence**⁴¹ rule, a plaintiff’s own negligence, no matter how minor, bars the plaintiff from any recovery. This is a fairly harsh rule, so most states follow the **comparative negligence**⁴² rule instead. Under this rule, the jury is asked to determine to what extent the plaintiff is at fault, and the plaintiff’s total recovery is then reduced by that percentage. For example, if you jaywalk across the street during a torrential thunderstorm and a speeding car strikes you, a jury may determine that you are 20 percent at fault for your injuries. If the jury decides that your total compensatory damage award is \$1 million, then the award will be reduced by \$200,000 to account for your own negligence.

Finally, in some situations, the **Good Samaritan law**⁴³ may be a defense in a negligence suit. Good Samaritan statutes are designed to remove any hesitation a bystander in an accident may have to providing first aid or other assistance. They vary widely by state, but most provide immunity from negligent acts that take place while the defendant is rendering emergency medical assistance. Most states limit Good Samaritan laws to laypersons (i.e., police, emergency medical service providers, and other first responders are still liable if they act negligently) and to medical actions only.

40. A doctrine under which the landowner is protected from liability if an invitee is injured by an open and obvious danger or hazard.

41. An absolute defense in situations where the plaintiff contributed to his or her own injuries.

42. A partial defense that reduces the plaintiff’s recovery by the amount of the plaintiff’s own negligence.

43. State laws that shield those who aid the injured from negligence liability.

KEY TAKEAWAYS

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

EXERCISES

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

7.3 Strict Liability

LEARNING OBJECTIVES

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

Intentional torts require some level of intent to be committed, such as the intent to batter someone. Negligence torts don't require intent to harm but require some level of carelessness or neglect. **Strict liability**⁴⁴ torts require neither intent nor carelessness. In fact, if strict liability applies, it is irrelevant how carelessly, or how carefully, the defendant acted. It doesn't matter if the defendant took every precaution to avoid harm—if someone is harmed in a situation where strict liability applies, then the defendant is liable.

Since this rule can have harsh consequences, it applies in a only few limited circumstances. One of those circumstances is when the defendant is engaged in an **ultrahazardous activity**⁴⁵. An ultrahazardous activity is one that is so inherently dangerous that the risk to human life is great if anything wrong happens, so the person carrying out the ultrahazardous activity is held strictly liable for those activities. Transporting dangerous chemicals or nuclear waste, for example, is inherently dangerous. If the chemicals spill, it is very difficult, if not impossible, to prevent injury to property or persons. Similarly, businesses that use dynamite, such as building demolition crews, run the risk that no matter how careful they are, people or property could be damaged by intentionally igniting dynamite. Therefore, strict liability applies.

44. Liability without fault.

45. An activity so inherently dangerous that those who undertake the activity and cause injuries are strictly liable.

Strict liability also applies when restaurants, bars, and taverns serve alcohol to minors or visibly intoxicated persons. This activity is dangerous, and there is a high risk of probability that these patrons, if they drive, will injure others. Many states have **dram shop acts**⁴⁶ that impose strict liability in this circumstance.

You might wonder why defendants are held strictly liable if they are acting reasonably or are even being ultracautious. As with most issues in law, the answer lies in social policy. In essence, strict liability torts exist because businesses that engage in covered activities (such as transporting hazardous chemicals or operating bars) profit from those activities. They are also in the best position to ensure that every precaution can be taken to avoid an unexpected event, which may have catastrophic consequences. Victims of these events are often innocent members of the public who are not in any position to avoid being injured and therefore should not be denied a legal remedy simply because the defendant took prudent precautions. This social policy concern is also expressed in the most important area of strict liability application, **strict product liability**⁴⁷.

Figure 7.8



Strict liability applies to transportation of hazardous materials on public roads.

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In strict product liability, any retailer, wholesaler, or manufacturer that sells an unreasonably dangerous product is strictly liable. For example, Toyota recently disclosed that it had manufactured and sold several vehicle models with faulty accelerators, leading to several cases of unintended acceleration and subsequent deaths. Vehicles that accelerate unintentionally are clearly unreasonably dangerous. In this case, the manufacturer (Toyota Japan), the wholesaler or importer (Toyota's U.S. sales company), and the retailer (local dealers) are all strictly liable for injuries caused by these faulty accelerators. Note, however, that strict liability applies only to commercial sellers. If a private citizen sold his or her Toyota on Craigslist, for example, he or she would not be strictly liable for selling an unreasonably dangerous product.

To demonstrate that a product is unreasonably dangerous, plaintiffs have two theories available to them. First, they might allege that the product was defective because of a flaw in the manufacturing process. Under this theory, the vast majority of products being produced turn out fine, but due to some sort of production defect, a few samples or a batch turns out defective. If these defective samples are sold to the public, the manufacturer or seller is strictly liable. A light bulb factory that manufactures a million safe light bulbs, for example, and then manufactures one that explodes when it is turned on due to some production defect, is strictly liable for the injuries caused. Similarly, a frozen pizza factory that produces thousands of

46. State laws establishing strict liability for taverns, bars, and restaurants for serving alcohol to minor or visibly intoxicated persons who then cause death or injury to others.

47. Under strict product liability, manufacturers, distributors, and retailers are strictly liable for injuries caused by unreasonably dangerous products.

pizzas without any trouble would be strictly liable if one frozen pizza is produced that contains foreign contaminants because of a production defect such as an inattentive worker or machine breakdown.

Second, a product may be defective because of a design defect. Here, there is nothing wrong with the manufacturing or production of the product. Rather, the product is defective because it was designed incorrectly or in a manner that causes the product to be unreasonably dangerous. Engineers continually work to design products to be as safe as possible, but in some cases the product is nonetheless dangerous, and the manufacturer or seller is strictly liable. For example, starting in 1991 several Boeing 737 jetliners began experiencing unexpected movement in the rudder, leading to several high-profile crashes including a USAir flight in Pittsburgh that killed 132 people. “When Jets Crash: How Boeing Fights to Limit Liability,” *Seattle Times*, October 30, 1996, <http://seattletimes.nwsourc.com/news/local/737/part04> (accessed September 27, 2010). During the course of investigation, the government discovered that the part that controls the rudder gets very cold in flight, and when it is injected with hot hydraulic fluid, the part can jam and move the rudder in the opposite direction of what the pilot is calling for. This design defect was eventually fixed by upgrading the rudder control systems on all existing Boeing 737s worldwide.

Hyperlink: What's Wrong with the Tire?

<http://www.time.com/time/business/article/0,8599,128198,00.html>

In 1999 Ford customers in the Middle East began experiencing tread separation problems on Ford Explorer SUVs. The tires would disintegrate, leading to a loss of control and often a rollover crash. The company initially believed that the problem was limited to the Middle East because of unique characteristics there such as extremely hot weather, lowered tire inflation pressures for driving in sand, and harsh operating environments. Soon, however, vehicles in the United States, especially in hotter regions of the country, began experiencing the same problems. The death toll mounted to over 170 deaths and over 700 injuries from these accidents. Ford's investigation led the company to believe that certain fifteen-inch tires manufactured by Firestone were to blame; virtually all the accidents involved Firestone tires manufactured in one plant in Decatur, Illinois (now closed). Similar vehicles equipped with Goodyear tires rarely experienced tread separation problems. Firestone, on the other hand, blamed the Ford Explorer for being defectively designed. Firestone argued that the Explorer lacked critical safety features to lower the center of gravity, reduce the propensity to roll over, and lessen the chance of underinflating the tires. Firestone pointed out that the same tires did not experience any problems when installed on GM vehicles. Whether the fault lay with a production defect in Firestone tires or design defect in Ford Explorers, both companies were strictly liable. Ford spent over \$3 billion recalling the tires and ended its one-hundred-year relationship with Firestone. Congress also responded, passing a federal law requiring all vehicles to be equipped with tire pressure monitoring systems.

Many product liability cases arise from the defective design theory because courts have held that the warning labels on products, as well as accompanying literature, are all part of a product's design. A product that might be dangerous if used in a particular way, therefore, must have a warning label or other caution on it, so that consumers are aware of the risk posed by that product. Manufacturers must warn against a wide variety of possible dangers from using their products, as long as the injury is foreseeable. If consumer misuse is foreseeable, manufacturers must warn against that misuse as well. For these reasons, window blinds come with warnings about choking hazards posed by the rope used to raise and lower them, and hair dryers come with warnings about operating them in bathtubs and showers.

While you may think that these warnings are a little silly, keep in mind that products can harm or kill people who don't know how to use them correctly. For example, in one case, a woman traveling in the passenger seat of a GM SUV was killed in a low-speed collision in a parking lot when airbags deployed in a collision. The woman was killed because her seat was reclined and rather than being restrained by the seat and seatbelt, she "submerged" underneath the seat belt and hit the deploying airbag. When her family sued GM, the company argued that seats and seatbelts work only when the seat is in an upright position and that the owner's manual warns not to recline the seat when the vehicle is in motion. The family argued successfully that this warning was not clear and conspicuous enough, and that as a result many people travel with their seat reclined. Do you believe the lack of a clear and conspicuous warning about the danger of traveling with the seat reclined makes a vehicle's design defective?

Hyperlink: A Near-Fatal Mistake Due to Labeling?

http://www.usatoday.com/life/people/2007-12-04-quaid-lawsuit_N.htm

Figure 7.9



Should these labels be more distinctive to prevent mistakes?

Source: http://www.steadyhealth.com/articles/What_do_Anticoagulants_do_a667.html.

In November 2007 actor Dennis Quaid and his wife Kimberly were celebrating the birth of their newborn twins at Cedars-Sinai Medical Center in Los Angeles. The twins suffered a staph infection, and doctors prescribed a blood thinner to prevent blood clots. The blood thinner, Heparin, comes in two doses, with the heavier dose one thousand times more potent than the lower dose. However, the two doses come in similar packaging with blue labels. Nurses at the hospital inadvertently gave the twins the higher dose, nearly killing the twins. In Indianapolis earlier that year, three premature infants did in fact die from overdosing on Heparin. The Quaid family is suing the manufacturer, arguing that the labels on the drug represent a design defect because it is too easy to confuse the two doses. The manufacturer, Baxter Healthcare, has since changed the design to include a red warning label that must be torn off before the drug can be used.

There are several defenses to strict product liability. Since product liability is strict liability, the plaintiff's contributory or comparative negligence is not a defense. However, assumption of risk can be a defense. As in negligence, the user must know of the risk of harm and voluntarily assume that risk. For example, someone cutting

carrots with a sharp knife voluntarily assumes the risk that the knife may slip and cut him or her, meaning he or she cannot sue the knife manufacturer. However, if the knife blade unexpectedly detaches from the knife handle because of a design or production defect, and injures the user, then there is no assumption of risk since the user would not have known about that particular risk.

Product misuse is another defense to strict product liability. If the consumer misuses the product in a way that is unforeseeable by the manufacturer, then strict liability does not apply. Modifying a lawn mower to operate as a go-kart, for instance, is product misuse. Note that manufacturers are still liable for any misuse that is foreseeable, and they must take steps to warn against that misuse. A related defense is known as the commonly known danger doctrine. If a manufacturer can convince a jury that the plaintiff's injury resulted from a commonly known danger, then the defendant may escape liability.

KEY TAKEAWAYS

In areas where strict liability applies, the defendant is liable no matter how careful the defendant was in preventing harm. Carrying out ultrahazardous activities results in strict liability for defendants. Another area where strict liability applies is in the serving of alcohol to minors or visibly intoxicated persons. A large area of strict liability applies to the manufacture, distribution, and sale of unreasonably dangerous products. Products can be unreasonably dangerous because of a production defect, design defect, or both. A product's warnings and documentation are a part of a product's design, and therefore inadequate warnings can be a basis for strict product liability. Assumption of risk, product misuse, and commonly known dangers are all defenses to strict product liability.

EXERCISES

1. Is the risk of death from smoking a commonly known danger? It may be today, but in the fifties and sixties, the tobacco industry undertook an extraordinary campaign to convince the public that there was no harm in smoking cigarettes, and even suggested that smoking may have health benefits. See <http://tobacco.stanford.edu> for a collection of some of the print advertising from this era. Should older plaintiffs who grew up viewing these advertisements be allowed to sue tobacco companies under strict product liability? Why or why not?
2. Is fast food or restaurant food an unreasonably dangerous product? Many nutritionists and doctors believe that excessive consumption of fast food and restaurant food can lead to obesity, high blood pressure, heart disease, diabetes, and other health complications including premature death. You may be surprised at exactly how bad these food products can be for you. See <http://www.youtube.com/watch?v=MtgOmChwAm4> for an example of how unhealthy eating out at Italian restaurants can be. Should these food producers therefore take steps to make their product less dangerous or to warn about the dangers of overconsumption? Should Congress pass legislation such as the Personal Responsibility in Food Consumption Act to immunize the food industry from product liability suits?
3. Stella Liebeck, an elderly grandmother, received third-degree burns when she spilled coffee purchased at a McDonald's drive-through. At trial, experts testified that McDonald's coffee was too hot to be consumed at the point of purchase, was hotter than any other restaurant's coffee or coffee brewed at home, and was so hot that third-degree burns would result within three to five seconds of coming into contact with the skin. McDonald's also conceded that the coffee was brewed extremely hot for commercial (profit) reasons, because most customers wanted coffee to be hot throughout their commute. After finding the company liable, the jury awarded Mrs. Liebeck two days' worth of coffee sales at McDonald's, an amount equivalent to \$2.7 million, in punitive damages. The award, although reduced to much less than that, set off a firestorm of criticism that has not died down to this day. Do you believe that it's possible for coffee to be unreasonably dangerous? See <http://www.hotcoffeethemovie.com> for one filmmaker's perspective on this case.

7.4 Concluding Thoughts

Tort law is continually changing and adapting to societal expectations about the freedoms and interests we expect to protect. Although it has endured for many years, recent debates have sought to recast the viability of tort law in political terms. The Republican Party platform, for example, maintains that the rule of tort trial lawyers threatens America's "global competitiveness, denies Americans access to the quality of justice they deserve, and puts every small business one lawsuit away from bankruptcy." Republican National Committee, "2008 Republican Platform," 2008, <http://www.gop.com/2008Platform/Economy.htm#7> (accessed September 27, 2010). Many businesses see tort lawsuits as a nuisance at best and ruinous at worst, and would like to see them disappear altogether. Consumer rights activists, on the other hand (and often backed by plaintiff lawyer groups), believe that tort lawsuits are the most effective way to keep corporations honest and prevent them from putting profits before safety. This debate has led to several proposals for tort reform among the various states, or by the federal government.

These reforms can take several different forms. One common reform is to impose a statute of repose on product liability claims. These statutes function like a statute of limitations and bar plaintiffs from filing tort claims after a certain period of time has lapsed. For example, in 1994 President Clinton signed the General Aviation Revitalization Act into law, imposing an eighteen-year statute of repose on product liability claims brought against general aviation aircraft manufacturers such as Cessna and Piper. The law allowed these manufacturers to once again launch new light aircraft production in the United States. Another popular tort reform is a cap on punitive damages. President George W. Bush supported a nationwide punitive damage cap of \$250,000 for medical malpractice claims, but Congress did not pass any such law. Other reforms call for eliminating defective design as a basis for recovery, barring any claims if a product has been modified by the consumer in any way, and allowing for the state-of-the-art defense (if something was "state of the art" at the time it was produced then no strict liability can apply).

Occasionally Congress passes legislation that provides industry-wide tort lawsuit protection for certain industries. For example, in 2005 President George W. Bush signed the Protection of Lawful Commerce in Arms Act. The law shields firearm manufacturers and dealers from product liability lawsuits for crimes committed with their products. Many industries have tried to obtain this form of industry-wide protection, either from Congress or from judicial rulings. Most recently, drug manufacturers hoped for industry-wide protection by arguing that if the Food and Drug Administration approved drug labels, labeling lawsuits would be preempted by the Constitution. The Supreme Court rejected this argument in 2009. *Wyeth v.*

Levine, 555 U.S. ____ (2009), <http://www.law.cornell.edu/supct/html/06-1249.ZS.html> (accessed October 2, 2010).

In spite of these efforts at tort reform, torts remain an important and viable part of civil law. All businesses, of all sizes and across all industries, must maintain a keen understanding of the duties and responsibilities imposed by tort law. Being able to understand, and even embrace, these duties can help businesses thrive while keeping consumers and customers safe.

Chapter 8

The Property System

LEARNING OBJECTIVES

After reading this chapter, you should understand different classifications of property, including personal property and real property, as well as different types of interests in real property. You will also learn about methods of acquisition and transfer of real property. At the conclusion of this chapter, you should be able to answer the following questions:

1. What is the difference between real property and personal property?
2. How is ownership interest in personal property transferred?
3. What interests in real property exist?
4. How is real property acquired and transferred?
5. What legal relationships exist between landlord and tenants?

The concepts of property and ownership are fundamental to any society. **Property**¹ refers to tangible and intangible items that can be owned. **Ownership**² is a concept that means the right to exclude others. Disputes over both have been at the root of conflicts and wars since time immemorial. Without laws to protect property ownership, the stability of our society would be seriously undermined. For example, if law did not protect ownership interests in property, then people would have to protect their property themselves. This means that people would have to hire their own security forces to protect their property, or they would have to stand guard over their property personally. It would be difficult to get anything else done. Such a system would likely result in the development of powerful factions.

Those with the greatest power would dominate property ownership, and weaker members of society would be at their mercy. For example, one of the opening scenes of the movie *Black Hawk Down* illustrates a U.N. food distribution point in Mogadishu, Somalia. As depicted in that scene, people were waiting to receive the distribution of food, but a powerful, armed faction seized the cargo and opened fire on them. Obviously, such a system of property

Figure 8.1



A place to do business.

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1. Tangible and intangible items that can be owned.
2. The right to possess, and the right to exclude others from use or possession.

ownership would prove to be very unsettling, and it would lead to great instability in our economic system.

Our legal system creates a peaceful means to acquire, retain, and divest of property, and to settle property disputes. It punishes those who operate outside of those rules. Indeed, those who do not acquire property lawfully or who do not settle property disputes within the confines of our legal system are subjected to criminal and civil penalties.

In the United States, our legal system ensures the ability to own property to everyone that the system recognizes can own property. Of course, not everyone has always been able to own property. The history of the United States is replete with examples of exclusion from the property ownership system. For example, at various times and in different ways, married women, African Americans, and people of Chinese and Japanese descent have been subject to restrictions regarding the ownership of real property. Because property law is a state law issue, those restrictions and exclusions varied from state to state. Today, no such restrictions exist. Indeed, even a nonhuman **legal person**³, such as a corporation, can own property. However, some biological beings cannot own property. For example, nonhuman animals cannot own real or personal property in our legal system. This is because nonhuman animals are not legal persons. However, a nonhuman animal can be a **beneficiary**⁴ of a **trust**⁵ in many states.

Moreover, not everything is subject to ownership. For instance, the human body cannot be owned by another, though historically, in legal systems that recognized slavery, certain human bodies could be owned. Today, public policy discourages the treatment of human body as personal property, rendering “gifts” of body parts to specific individuals largely suspect. For example, organ donees may have a need for an organ destined for transplant into their own bodies after the donor’s body dies, but they do not have a legal right to it. *Colavito v. New York Organ Donor Network*, 2006 NY Slip Op. 09320 (NY App. Ct. 2006). Similarly, the question regarding whether human genes may be owned through patent is a hot topic. Check out [Note 8.7 "Hyperlink: When DNA Is Isolated from the Human Body, Is It Subject to Ownership by Patent?"](#) and consider whether the benefits of patentability of certain body parts, like genes, might outstrip the concerns surrounding ownership of the human body.

3. A human being or entity, such as a corporation or government, that is recognized as a possessor of certain legal rights.
4. A person or entity that receives the benefit of a contract, trust, or other legal instrument.
5. A legal instrument created for the benefit of a beneficiary.

Hyperlink: When DNA Is Isolated from the Human Body, Is It Subject to Ownership by Patent?

<http://www.nytimes.com/2010/03/30/business/30gene.html>

Before engaging in questions regarding the evolution of property ownership rights, it is necessary to lay the foundation for studying this fascinating area of law. It is this foundation to which we now turn. This chapter explores the differences between real and personal property, and the acquisition, transfer, and protection of real and personal property interests. Additionally, it examines different interests in real property.

Key Takeaways

The U.S. legal system protects the rights to own, acquire, protect, and divest of real and personal property. These protections are necessary for peaceful civil society. Historically, different groups of people have been subjected to discriminatory practices—both legal and illegal—regarding property ownership. Today, legal persons can own, acquire, transfer, and sell property. However, not everything is subject to property ownership concepts.

8.1 Personal Property

LEARNING OBJECTIVES

1. Distinguish between personal property and real property.
2. Understand classifications of property.
3. Examine methods of acquisition of personal property.
4. Understand the concept of bailment, and the legal duties associated with bailment.

Let's begin with an understanding of the differences between types of property. This is important, because different laws apply to different types of property. While it might be perfectly legal to destroy a piece of personal property—like a chair—without obtaining permission from the government, destruction of real property is a different matter altogether. For example, the owner of an office building who wishes to demolish it would be subject to many local laws, such as requirements to obtain the necessary permits. Such an activity might also be subject to further legal scrutiny, if the building in question holds particular historic value, for example. Let's compare this to the destruction of a chair, which is personal property. Even if the chair is the chair that Abraham Lincoln sat in while drafting the Emancipation Proclamation, as long as the chair is owned by the person who wishes to destroy it, the owner may simply load it into his or her truck and haul it to the dump. No special permission is required, because there are few legal restrictions to the destruction of private property.

Figure 8.2



The things we own.

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As you can see, property can be classified as real or personal. **Real property**⁶ is land, and certain things that are attached to it or associated with it. Real property is raw land, such as a forest or a field, as well as buildings, like a house, a condominium, or an office building. Additionally, things that are associated with land, like mineral rights, are also real property. People often talk about real property by using the term **real estate**⁷, which reflects both the concept of real property and the ownership interest concept of **estate**⁸.

6. Land, and certain things that are attached to it or associated with it.
7. A term that refers to real property.
8. A term that refers to ownership interests.

Many businesses, from grocery stores to coffee shops to hotels, rely on real property for customers or clients to visit to conduct business. Today, many businesses are also conducted virtually, and have only virtual shops. Virtual stores, such as those found on eBay, are *not* forms of real property. However, certain virtual real properties, such as those found on Second Life, are traded for real money. Check out the two links in [Note 8.13 "Hyperlink: "Unreal" Property"](#) to read about this “property” boom, where real business occurs over nonreal property.

Hyperlink: “Unreal” Property

<http://realestate.msn.com/article.aspx?cp-documentid=13107800>

<http://secondlife.com/land>

Personal property⁹ is property that is not real property. **Tangible property**¹⁰ is something that can be touched. Moveable, tangible personal property is **chattel**¹¹. Many businesses exist to sell personal property. For example, the primary purpose of retailers such as Wal-Mart, Amazon.com, and Sears is to sell personal property. Some property can also be described as **fungible**¹² property. Property that can easily be substituted with identical property is said to be fungible. For example, if you bought a pound of sugar from a container containing ten pounds of sugar, you wouldn’t care which specific grains of sugar made up your purchase, because all the sugar in the container is fungible. Other types of fungible goods include juices, oil, metals such as steel or aluminum, and physical monetary currency.

- 9. Property that is not real property.
- 10. Something that can be touched.
- 11. Moveable, tangible personal property.
- 12. Property that is not uniquely identifiable and is subject to easy mutual substitution.
- 13. Something that used to be personal property but has become attached to the land so that it is legally a part of the land.

Some personal property is intangible. Intangible property does not physically exist, but it is still subject to ownership principles, including acquisition, transfer, and sale. For instance, the right to payment under a contract, the right to exclude others from a patented product, and the right to prohibit others from using copyrighted materials are all examples of intangible property.

Sounds simple, right? Your iPod, your flash drive, and your computer are all personal property. Your dorm room, apartment, or house is real property. So far, so good. But imagine that you found a Jacuzzi for sale that you loved. You plunked down \$5,000 to buy it, and you have it delivered to your house. You pay for construction of a deck to surround it and plumbing to service it. Is the Jacuzzi personal property or is it real property? This is an example of personal property that becomes attached to the land as a **fixture**¹³. A fixture is something that used to

be personal property, but it has become attached to the land so that it is legally a part of the land. Fixtures are treated like real property. Accordingly, when real property is transferred, fixtures are transferred as a part of the real property. In our example, if you move, you will have to leave your beloved Jacuzzi behind, unless you make express provisions to remove it. What if you were just renting? Since removing a fixture would cause substantial harm to the property, that fixture remains with the land. The landlord might be very happy about that!

Some things that are attached to the land are not fixtures but are part of the real property itself. Imagine a farm with one thousand acres planted in corn. Is the corn crop personal property, or is it real property? Or imagine a forest. Maybe the owner has been thinking about timbering the forest for some extra money. Is the forest personal property, or is it real property? Both the corn crop and trees are examples of real property that can become personal property, if they are severed from the land. This means that when an ear of corn is picked from the stalk, the ear of corn becomes personal property, even though while it was growing and still attached the land, it was real property. Likewise, when a tree is felled, that tree is transformed from real property to personal property.

Besides property *types*, property can be *classified by ownership*, too. Personal property and real property can be private or public. **Private property**¹⁴ is owned by someone or something that is not the government. Individuals, corporations, and partnerships, for instance, can own private property. Private property can include real property like land or buildings, and personal property, such as automobiles, furniture, and computers. Property that is owned by the government is **public property**¹⁵. Yellowstone National Park and the Gifford Pinchot National Forest are both examples of public property that is real property. Public property can also include personal property, such as automobiles, furniture, and computers owned by state or local governments.

14. Property owned by someone or something that is not the government.
15. Property that is owned by the government.
16. A method of acquisition of personal property ownership, which involves creating the property.
17. A model statute that seeks to provide uniformity to contracts law among the different states. It is not a law until state legislatures adopt it as law.

Methods of Acquisition of Personal Property

Personal property may be acquired for ownership in several different ways. For example, if you produce something, then you may own it, unless you are producing it in the capacity of your work for someone else. If you buy four yards of wool fabric and sew a coat out of it, then you own that coat by virtue of having produced it with your own materials. This is ownership by **production**¹⁶. However, if you sew a coat as part of your job while working for your employer, then the employer will own the coat.

If you are in the business of producing coats to sell, then you may be a merchant, and the rules of the **Uniform Commercial Code (UCC)**¹⁷ would govern transactions

involving the sale of goods and the purchase of supplies from other merchants. Regardless of whether someone is a merchant or not, **purchase**¹⁸ is a means of acquiring ownership. Indeed, in today's world, purchase may be the most common method of acquiring property.

Property may also be gifted. A **gift**¹⁹ is a voluntary transfer of property. Generally, the **donor**²⁰ of the gift must intend to gift the property, the donor must deliver the gift, and the gift must be accepted by the intended recipient, known as the **donee**²¹. A conditional gift is a gift that requires a condition to be met before the gift will transfer. For example, if your parents said, "You can have a new car, if you graduate from school," then that would be an example of a conditional gift. If you do not graduate from school, then you cannot have the gift of the car.

18. A method of acquisition of personal property for ownership, involving trade of valuable consideration.
19. A voluntary transfer of property.
20. A person who gifts property.
21. A person who receives gifted property.
22. A category of personal property in which the owner has intentionally relinquished the property.
23. A category of personal property where the property has been unintentionally relinquished by its owners.
24. A category of personal property where the property has been placed by the owner for the owner's later retrieval, but the owner has forgotten where it is.
25. Intentional, substantial interference with the chattel of another.
26. A category of found property consisting of money or precious metals.

What if you find something? Dating at least to the Institutes of Justinian in Roman law, the concept of "finders keepers" is one known to every preschooler: *finders keepers, losers weepers*. However, in law, things are not quite so simple. Property that someone finds can be classified in several ways. A finder of personal property may claim ownership of the property if it is **abandoned**²². The owners of abandoned property must intend to relinquish ownership in it. For example, if you take your chair to the landfill, you have abandoned the chair. Someone may come along and take possession of it, which will place ownership of the chair in that person. If you change your mind later, that's too bad. The chair now belongs to the new owner. However, if the property is simply **lost**²³ or **mislaid**²⁴, then the finder must relinquish it once the rightful owner demands its return. If the finder refuses to return lost or mislaid property to its rightful owner, the owner can sue for **conversion**²⁵, which is a tort. Conversion is intentional, substantial interference with the chattel of another. Another classification of personal property applicable to found property is treasure trove. A **treasure trove**²⁶ is money or precious metals, like gold, for which the concept of "finders keepers" sometimes is applicable.

Imagine finding the next-generation iPhone just lying on a bar stool. It has not been released yet, but there you are with an actual prototype in your hands! This is valuable property because it embodies the cutting-edge intellectual property of Apple, both in utility and design. Brian Hogan found himself in this position. Apparently, an Apple software engineer had accidentally left the prototype on a bar stool one evening. Hogan decided to sell the prototype to Gizmodo, a tech site, which was willing to pay for it so that it could write an early and exclusive review of this soon-to-be hot item on the market. Gizmodo subsequently discovered that Apple had lost an iPhone prototype and wanted it returned. Regardless of that fact, Gizmodo dismantled the prototype and published photos on its Web site. Subsequently, it returned the property to Apple. Edward C. Baig, "Gizmodo: Lost Next-Gen iPhone Returned to Apple," *USA Today*, April 21, 2010,

http://www.usatoday.com/tech/products/2010-04-20-iphone_N.htm (accessed September 27, 2010).

Was the prototype of the next-generation iPhone abandoned, lost, mislaid, or a treasure trove? If Apple filed a civil lawsuit against Gizmodo, what would the claim be and who should win? Since we know that Apple wanted the property back, we know that it had no intention of relinquishing ownership of it. Therefore, the property was not abandoned. Since a next-generation iPhone is not money or precious metals—even though it is very valuable and worth a lot of money to Apple—the concept of treasure trove does not apply. A phone is not actual coin or cash. In this case, the property was either lost or mislaid, because it was unintentionally relinquished or set down for later retrieval, but the owner had forgotten where it was placed. In either case, if the phone had not been returned, Apple could have brought a suit for conversion. A successful conversion claim would have awarded damages to Apple. Just like any successful conversion claim, damages would not include a requirement to return the property itself. Incidentally, California has captured the duty to return lost or mislaid property in its criminal statutes, and the facts of this case are being investigated for possible theft charges. Check out [Note 8.32 "Hyperlink: Finders Keepers?"](#) for this story and two additional cautionary tales about claiming found property.

Hyperlink: Finders Keepers?

Be careful what you wish for. These stories might seem like a miracle to the cash-strapped, but they are cautionary tales.

Next-Generation iPhone

Gizmodo published the details of a found iPhone prototype here <http://gizmodo.com/5520164/this-is-apples-next-iphone>, but the prototype became the subject of law enforcement and an Apple complaint, as seen here: <http://www.cnn.com/2010/TECH/04/30/wired.iphone.finder/index.html?iref=allsearch>

Cold Cash, Hot Lead

This found “money” along an interstate might be abandoned, lost, or mislaid, but it is unlikely to be claimed by its rightful owner:

<http://www.cnn.com/video/#/video/us/2008/12/05/wa.found.money.KING?iref=allsearch>

A Renovator’s Fantasy

This found money in the walls of a house might be an example of a treasure trove, but the treasure was quickly dissipated by legal troubles:

<http://www.cbsnews.com/stories/2007/12/13/eveningnews/main3617369.shtml> and the epilogue: <http://www.nytimes.com/2008/11/09/us/09house.html>

Bailment

Sometimes it is necessary to intentionally leave personal property with someone else. For example, imagine that you own a cat. If your cat, which is considered to be chattel, needs to have surgery, you will need to leave her at the veterinary hospital. Clearly, taking your cat to a veterinary hospital does not constitute abandonment. Likewise, you have not lost or mislaid your cat. And, precious though she may be, your cat is not subject to the concept of treasure trove.

Instead, in this situation you will be known as **bailor**²⁷, and you will be seeking a bailment with your veterinarian. A bailor is someone in the rightful possession of personal property who gives the property to someone else to hold. A **bailment**²⁸ is the arrangement in which when the rightful possessor (such as the owner) of personal property gives the property to someone else to hold. The holding party, known as the **bailee**²⁹, agrees to accept the property and has the duty to return it. The bailee is someone who is in possession of someone else's property. In our example, you rightfully have possession of your cat because she is your personal property. You give your cat to the veterinarian to hold, who has agreed to accept the cat. You also rightfully expect that the cat will be returned to you on demand. Indeed, the veterinarian has a duty, by virtue of the bailment, to return the cat to you. Consider [Note 8.36 "Hyperlink: Lost Dog"](#), where Delta Airlines was the bailee of a dog, which it lost.

Figure 8.3



Bailment: Can you hold my property?

© Thinkstock

Hyperlink: Lost Dog

Check out this link. Do you think the remedy offered by Delta Airlines is adequate in this case? Why or why not?

<http://www.clickondetroit.com/news/23515167/detail.html>

27. Someone who is in the rightful possession of property who gives the property to someone else to hold.

28. An arrangement in which the rightful possessor of personal property gives the property to someone who has agreed to hold the property and who has a duty to return it.

29. Someone who is in the possession of someone else's property, and who agrees to accept the property and has a duty to return it.

The bailee has certain duties to the bailor. For example, a bailee has a duty to take reasonable care of the property while the property is in his or her possession. This means different things for different types of bailment. If the bailee is the only party who benefits from the bailment, then the bailee must take extraordinary care with the personal property. A common example of a bailee being the only party who

benefits is where the owner of the property loans the property to someone for his or her use. For instance, if you loan your neighbor a snow shovel without asking for something in return, then your neighbor receives the sole benefit of the bailment. His or her duty of care is that he or she must take extraordinary care with the snow shovel. However, when both parties receive benefit from the bailment, such as when you rent a DVD from Blockbuster, only the duty of ordinary care is imposed on the bailee. The bailee receives the DVD and Blockbuster receives a rental fee. When the benefit of the bailment exists for the benefit of the bailor only, then only minimum care is required. **Gross negligence**³⁰ will give rise to liability, but there is no great duty for the bailee to be as careful as he or she would be if he or she were receiving some benefit. If someone asks you to hold his or her books while he or she jumps into a swimming pool, you would have a minimum duty of care. If you lost the books, then you would not be liable. However, if you intentionally threw the books into the pool, then you would be grossly negligent and liable for damages.

An involuntary bailment is created when someone finds lost or mislaid property. The finder may not destroy the property, though the duties that he or she owes regarding the property may vary from state to state. A voluntary bailment is created when intention exists to create the bailment, as described in the previous paragraph.

As you can imagine, bailment is common in business. Examples of bailment in business include placing packages or goods with common carriers for delivery, warehousing goods with a third party prior to sale or delivery, or taking clients' or customers' automobiles in a valet service. Consider whether a business should be able to **disclaim**³¹ bailment (and the duties that go along with bailment). For example, if a hotel required its guests to sign a "no bailment created" clause on check-in, should that excuse the hotel from liability if the guests' personal property is damaged while the property is left in the hotel?

KEY TAKEAWAYS

Property is classified as real property or personal property, tangible or intangible, and private or public. Personal property can be transformed into real property when it is affixed to the land. Real property can be transformed into personal property when it is severed from the land. Personal property can be acquired for ownership through production, purchase, or gift or, in certain circumstances, by finding it. Bailments are legal arrangements in which the rightful possessor of personal property leaves the property with someone else who agrees to hold it and return it on demand.

30. Reckless disregard of a duty (in bailment).

31. To renounce.

EXERCISES

1. Classify the following as (1) personal property or real property, (2) tangible or intangible property, and (3) fungible property:
 - a. A prosthetic device, for example, an artificial leg
 - b. An expected inheritance of stock
 - c. Draperies hanging in a dining room
 - d. A bank account with a five-hundred-dollar balance
 - e. A fictional story that you created
 - f. A condominium on the thirty-second floor of a building in lower Manhattan
 - g. The right to receive payment for your work (e.g., wages, salary)
 - h. A wig that someone is wearing
 - i. A silo filled with wheat
 - j. The wheat in a silo
2. Would you be willing to pay real money for nonreal property in a virtual world like Second Life? Why or why not? What are people buying when they buy virtual real property? How does this differ from buying actual real property, like land?
3. If you found a prototype of the next-generation iPhone lying on a bar stool, what would you have done with it? What would be the consequences of your chosen action?
4. Think of an example of when you have asked for a bailment. Did you feel confident that you would receive your personal property when you demanded it? Did you worry that it would be damaged in any way? If it had been misdelivered, what would your legal remedies be?
5. Should bailees be permitted to disclaim liability for bailment agreements? Why or why not?
6. At major league baseball games, who do you think owns the baseball when it is being played, and who owns it when the ball enters the stands where members of the public sit? Who owns the ball if a member of the public picks it up?

8.2 Real Property

LEARNING OBJECTIVES

1. Understand the concept of real property.
2. Examine methods of acquisition of real property.
3. Understand different interests in real property, including ownership interests and scope of interests.
4. Examine the landlord-tenant relationship.

Real property³² is land, and certain things that are attached to it or associated with it. Real property includes undeveloped land, like a forest or a field, and it includes buildings, such as houses, condominiums, and office buildings. Real property also includes things associated with the land, like subsurface rights. **Fixtures**³³ are personal property that have become attached to the land, and they are transferred with the land. Fixtures in a house include things like the lights affixed to the ceiling, the furnace, and the bathtub. Plants and trees that grow on the land are real property until they are severed from the land. For example, farmers' crops are part of their real property until they are separated from the land, at which time they become personal property.

Methods of Acquisition

32. Land, and certain things that are attached to it or associated with it.
33. Something that used to be personal property but has become attached to the land so that it is legally a part of the land.
34. The ownership rights in property.
35. A tort in which the tortfeasor unreasonably interferes with the use and quiet enjoyment of the plaintiff's real property.
36. A method of acquisition of real property for ownership, involving trade of valuable consideration.

Real property may be acquired for ownership (the title may be obtained) in one of several ways. It may be purchased, inherited, gifted, or even acquired through adverse possession. Ownership rights are transferred by **title**³⁴. Ownership of real property means that the owner has the right to possess the property, as well as the right to exclude others, within the boundaries of the law. If someone substantially interferes with your use and enjoyment of your real property, you may bring a claim in **nuisance**³⁵ (a form of tort law). For example, if a neighbor decides to start burning tires on his property, the smell of the burning tires might substantially interfere with your use and enjoyment of your property, so you would have an actionable claim in nuisance. Similarly, if you own real property, you might rightfully seek damages against those who enter your land without your consent or permission. This would be a trespass to land claim. Owners of real property may also sell the real property, in whole or in part.

The most common way that real property is acquired is through **purchase**³⁶. Property law is a state law matter, and state laws vary regarding conveyance of

property. Typically, someone who is interested in acquiring real property will ask a third party, such as a real estate agent or a broker, to help locate a suitable property and to facilitate the terms of the deal. The buyer and seller will negotiate a contract, which will contain all essential terms of the sale, such as location of the real property, price, fixtures that will be excluded from sale, and the type of ownership interest that is being transferred. Both parties will perform their promises under the contract (e.g., the buyer will pay the seller, and the seller will transfer the title via deed) to close the deal (“closing”), and then the **deed**³⁷ will be recorded. A contract for any interest in property must be in writing to be valid against the defendant according to the **Statute of Frauds**³⁸.

Different types of deeds convey different types of interests. A quitclaim deed, for instance, conveys whatever interests in title that the grantor has in the property to the party to whom the quitclaim is given. Of course, that means if the grantor has no interests in the real property, a conveyance by quitclaim will not grant any interests in the property. For example, if you grant a quitclaim deed to your friend for the Empire State Building, then that means that you have transferred your interests in title to that building to your friend. If you have no interests in the title to the Empire State Building to begin with, then on conveyance of the quitclaim deed, your friend will not have any interests in the building either. You cannot convey interests that you do not have. On the other hand, many states allow a **warranty deed**³⁹, which conveys title and a warranty against defects in title as well as encumbrances. Buyers typically demand a warranty deed when they purchase property.

After title is transferred by the deed, the deed is typically recorded. Recording the deed is not necessary for ownership. However, recording a deed to property is important because it places others on notice that whoever has recorded the deed to the property owns the property. Some states favor the rights of those who record the deed first (under a **race statute**⁴⁰), while other states favor the rights of those who acquired the interest first without notice of other claims to the property (under a **notice statute**⁴¹). A **race/notice system**⁴², which has a race/notice statute, is one in which priority is given to the first **bona fide purchaser**⁴³ to record when there is a conflict in ownership claim. A bona fide purchaser is simply a purchaser who takes title in good faith, with no knowledge of competing claims to title.

Besides outright purchase, another common way in which real property may be obtained is through inheritance. Real property may be bequeathed through a will or may transfer per state statutes when a decedent dies intestate. Generally speaking, people have the right to dispose of their property as they wish when they die, providing that their will or other transfer instrument meets their state’s requirements for validity. When someone dies intestate, state statutes will

- 37. A writing that conveys title to real property.
- 38. A statute that requires certain types of contracts to be in writing to be enforceable.
- 39. Conveys title and a warranty against defects in title, and states that there are no undisclosed encumbrances.
- 40. A state statutory scheme that recognizes superior rights in real property to the party who records the interest in the property first.
- 41. A state statutory scheme that recognizes superior rights in real property to the party who acquired the interest first without notice of other claims.
- 42. A combination of race statute and notice statute concepts, where priority is given to the first bona fide purchaser on record when there is a conflicting claim to ownership.
- 43. A purchaser who takes title in good faith, with no knowledge of competing claims to title.

determine who among the decedent's relatives receives the property. For example, state statutes often specify that property will go to the spouse, and if there is no spouse, then to the children. If there are no children, then to the parents. If there are no living parents, then to the siblings, and so on. If no such person exists, the property may finally **escheat**⁴⁴ to the state.

Real property may also be acquired through a **gift**⁴⁵. Providing that the person who is giving the property actually intends to make the gift of title, delivers the deed to the recipient, and the gift is accepted, then the gift is valid. If one of these elements is not met, for instance, if the deed is not delivered to the intended party (or to a third party to hold for the intended party), then the gift has not been successfully made, and the title will not be conveyed.

A less common way to acquire real property is through the doctrine of **adverse possession**⁴⁶. Colloquially, this is often referred to as “squatter’s rights.” At its heart, this method of acquiring property captures the deeply held belief that a land’s value is in its use for profit. If a land sits idle at the owner’s hands but someone else puts it to use, then the law may—just may—favor the user’s claim to the land over that of the actual owner.

Adverse possession is when someone who is not the owner of real property has claimed the real property for his own. To be successful under this doctrine, several elements must be met. These include the following:

- The possessor must be in actual possession.
- The possession must be open and notorious, which means that it must be obvious to others (visible).
- The possession must be hostile, which means that it is against the actual owner’s interests.
- The possession must be continuous, which means that the possessor cannot have been evicted during the statutory length of time required to obtain title through possession.
- The possession must be exclusive.
- The state statutory length of time must be met, and this time varies from state to state. For example, some states, like Maine, require a twenty-year period, while other states, like Nevada, require only a five-year period.

Some states’ adverse possession laws also require that the possessor pay property taxes on the property during the course of the adverse possession. If all of these elements are met, then the possessor can bring a claim to **quiet title**⁴⁷. If successful,

44. When the state gains ownership of property when there is no owner, such as when a decedent has property but no heirs.

45. A voluntary transfer of property.

46. A method of acquiring ownership of the real property of another, which requires several elements to be met.

47. A civil action used to determine title to real property.

the possessor becomes the owner, without any compensation being made to the former owner.

Adverse possession and claims for quiet title often occur around property lines, where one party has routinely used another's property because a fence has been misplaced. Other instances involve claims concerning land owned by people who do not visit it, such as land owned in a remote area. Still other examples exist in cases of **ouster**⁴⁸, when a tenant in common constructively or actually evicts others with valid ownership interests. Remember that all elements of an adverse possession must occur for the entire statutory length of time for an action for quiet title to be successful. This means, for instance, if the owner checks on the property and finds someone there, the owner must interfere with those elements. The owner should evict the trespasser, and this can be accomplished by summoning the police. Doing so would break the continuity requirement.

A recent case in Boulder, Colorado, prompted the Colorado legislature to substantially alter the state's adverse possession laws. In that case, a married couple, composed of a judge and an attorney, met the requirements for adverse possession and successfully brought an action for quiet title. In that case, the adverse possessors were clearly versed in the law. The actual owners of the property had purchased the land many years before to build a future retirement home. Check out [Note 8.59 "Hyperlink: A Question of Ethics"](#) and see whether you think the Colorado legislature overreacted.

Hyperlink: A Question of Ethics

Is adverse possession a legally sanctioned form of theft?

http://www.denverpost.com/news/ci_7494276

48. The actual or constructive eviction of a lawful tenant.

Interests and Scope

Owning real property carries many responsibilities, as well as the potential for great profit and great liability. It is important to recognize the duties associated with property ownership, and learn how to protect yourself against potential liability associated with it. For instance, if a toxic waste site is discovered on your real property, you may very well be liable for its cleanup, even if you did not realize that such a site was there when you purchased the land. Each buyer of real property has a duty to exercise **due diligence**⁴⁹ when purchasing land. The idea is that you should have known about the site, if it was discoverable on inspection. Knowing this, along with familiarity with the federal **Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)**⁵⁰, helps us recognize that we should never agree to buy land “sight unseen,” or at least without a professional inspector that we trust. But what if an old toxic waste site is located on property that you wish to sell? You would have a duty to disclose such a defect in the land to prospective buyers before conveying ownership.

Figure 8.4



An emerging legal problem for the landowner.

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Additionally, we must consider duties that landowners have to other people who enter the land. What are our duties to people who visit our home? Or our retail establishment? What if they are not invited but instead are trespassers? These duties of landowners will vary depending on the status of the person who was injured.

What if a gold mine were discovered on land that you used to own? Can you profit from that discovery? Probably not, if you conveyed full ownership to someone else.

As these examples illustrate, it is important to know about the *duties of landowners*, how to *limit liability* associated with the ownership of land, and when severance of liability occurs. These types of questions can be considered more fully when we consider ownership interests.

Additionally, it is important to know how an owner of real property may use the property, or the *scope* of his or her rights. Consider these questions: If you owned a lot in the middle of a city, can you build an apartment building that blocks the neighboring landowner’s light? Or if you own a piece of raw land where you discover oil, can you drill on your land if it siphons oil from underneath your

49. A duty of care imposed on prospective buyers of real property to exercise reasonable judgment or prudence to inspect property for defects.

50. A federal statute commonly known as “Superfund,” which identifies and cleans up toxic waste sites.

neighbor's land, or if it causes your neighbor's land to collapse due to lack of subsurface support? If you live on a coastline and your neighbor builds a dyke that causes your waterfront property line to erode so that over the years your property is reduced in size, do you have an actionable claim against your neighbor? Conversely, if the ebb and flow of water along the coastline increases your property due to natural accretion, do you own the "new" property, even though it wasn't part of the original purchase? Consider water disputes, which are a very hot topic in the western states. If you live next to a river, can you divert the entire stream of water, even if you wanted to divert it for a capricious reason? Imagine that you dreamed of having a very large private water park for your family, but you needed all the water in a river that adjoined your property to make that dream a reality. If you diverted all that water, other riparian owners might very well have an actionable claim. What if it was a drought year and you relied on water from a river to irrigate your commercial crops, but endangered salmon in the river needed the water for their habitat? Can you take the water for your crop, or must the water be left in the river for the endangered salmon? These types of legal questions can be addressed when we consider the scope of rights.

The following sections address duties of landowners, ownership interests, and scope of interest in real property.

Duties of Landowners

Landowners owe different duties to different types of people who enter their land. These responsibilities vary, depending on whether the person is a trespasser, a licensee, or an invitee.

A **trespasser**⁵¹ is a person who voluntarily, intentionally enters the land of another without permission or privilege. A landowner has a duty not to intentionally injure a trespasser. For instance, booby traps, pitfalls, or anything of the sort are simply not permitted. Trespassers injured from such a trap have valid claims against the landowner for injuries.

A **licensee**⁵² is someone who has permission to be on the land. Landowners have a higher duty of care to such a person. Not only must a landowner not intentionally injure a licensee, but the landowner must also warn the licensee of known defects. For example, if a landowner knows that the steps to his or her porch are icy, he or she has a duty to warn a licensee—such as a visiting friend—that those steps are icy. Failure to do so may result in liability for the landowner.

An **invitee**⁵³ is someone who has entered real property by invitation. Businesses have issued invitations to the public. Public places have issued invitations to the

51. A person who voluntarily, intentionally enters the land of another without permission or privilege.

52. Someone who has permission to be on the land.

53. Someone who has entered real property by invitation.

public. Anyone who arrives at the invitation of an owner is an invitee. Landowners must inspect their property for defects, correct those defects when found, and warn invitees about such defects. This is why you will see a “caution” sign on the floor of a grocery store, after it has been mopped or after a liquid spill.

Ownership Interests in Real Property

Different types of interests may be owned in real property. For example, real property may be owned without restriction, subject only to local, state, and federal laws. Or ownership interests may be narrower, subject to conditions, the violation of which can lead to loss of those ownership interests.

The most complete ownership interest is represented by **fee simple absolute**⁵⁴. The owner of property in fee simple absolute has the greatest ownership interest recognized by law. Generally, if someone wants to buy real property, he or she is looking to buy property in fee simple absolute.

Figure 8.5 Ownership Interests



© Thinkstock

- 54. A form of ownership in real property in which the owner has absolute ownership, subject to legal restrictions on usage (e.g., zoning).
- 55. A form of ownership based on a condition or restriction, the violation of which can result in loss of ownership.
- 56. A future interest in real property.
- 57. A possessory interest in real property measured by the life of the person who has the life interest (grantee).
- 58. A type of mortgage that enables the seller of real property to realize the equity in the property while retaining possession until death, in exchange for ownership interest.

Compare that with a defeasible fee. A **fee simple defeasible**⁵⁵ is subject to a condition of ownership or to some future event. For instance, if you donated land to “the City of Nashville, so long as it is used as a public greenway,” then the land would be owned in defeasible fee by the City of Nashville, unless it decided to do something else with the land, besides maintain it as a public greenway. Once the condition is violated, the land would revert back to either the original owner or whoever owned the **reversion interest**⁵⁶, which is a future interest in real property.

Another ownership interest is a **life estate**⁵⁷. This interest is measured by the life of the owner in the life estate. If you wished to grant ownership rights in real property to your mother for the length of her life, but then expected the property to be returned to you upon her death, you might grant a life estate to her. Similarly, a common investment, known as a **reverse mortgage**⁵⁸, employs the concept of life estate. A reverse mortgage is an arrangement where the purchaser of real property agrees to allow the seller of the property to retain possession of the property for a specified period of time (such as the remainder of his or her life) in exchange for the ability to purchase the property at today’s price. This can be an attractive investment, if the investor believes that the value of the property will increase in the future, and if the investor does not need immediate possession of the property. These arrangements essentially gamble on life expectancies of the sellers of real

property by granting life estates to them in the property. However, sometimes this backfires. Check out [Note 8.70 "Hyperlink: Reverse Mortgage"](#) for an example of a seller who outlived her investor in such an arrangement.

Hyperlink: Reverse Mortgage

“In life, one sometimes makes bad deals,” said Jeanne Calment, the oldest living woman in history, concerning the investor who “reverse mortgaged” her apartment.

<http://www.nytimes.com/1995/12/29/world/a-120-year-lease-on-life-outlasts-apartment-heir.html>

Sometimes, more than one owner owns the interest in the property. Several types of co-ownership interests are recognized in law. These ownership interests are important for matters of possession, right to transfer, right to profits from the land, and liability. For example, **tenancy in common**⁵⁹ describes an ownership interest in which all owners have an undivided interest in the property, equal rights of possession, and a **devisable**⁶⁰ interest. Compare this to a **joint tenancy**⁶¹, which describes an ownership interest in which the surviving owner has the **right of survivorship**⁶². Imagine that you own a gold mine with your partner, Frank. Would you rather have a tenancy in common or a joint tenancy? You would rather have a joint tenancy because if Frank dies, then his interest in the gold mine would vest in you, rather than in his heirs. After all, you may not want to be a partner with Frank’s grandson (or whoever), but that is exactly what might happen with tenancy in common. Similarly, a **tenancy by the entirety**⁶³ includes the right of survivorship, but it can only occur between a husband and wife. This concept is recognized in some states, but not all states.

These different interests are created by specific wording in the instrument of conveyance. To create a tenancy in common, the language would be “To John and Frank,” if John and Frank were to be the co-owners. However, if a joint tenancy were intended, the conveyance would have to be more specific, like this: “To John and Frank, with rights of survivorship.” Note that John and Frank could not benefit from a tenancy by the entirety unless they lived in a state that recognized same-sex marriages, and unless they were, in fact, married. Moreover, such questions have not yet arisen in our courts because the legal concept of same-sex marriage is still nascent and, in many states, not yet recognized in law.

59. An ownership interest in which all owners have an undivided interest in the property, equal rights of possession, and a devisable interest.

60. An ownership interest that may be transferred upon death.

61. An ownership interest in which the surviving owner has the right of survivorship.

62. The power of a successor to acquire ownership interest in property upon the death of a joint tenant.

63. A type of joint tenancy that can only occur between a husband and wife.

Note that a tenant in tenancy in common may sell or transfer his or her rights without seeking permission from his or her cotenant. Imagine that you owned a farm with your best friend. At first, you agree to engage only in organic farming practices. Later, your friend wants to move to conventional farming practices. Since you do not want any part in the spraying of pesticides or herbicides on the land, you decide to sell your interests to someone else. Even if your friend opposes the sale, he or she cannot block it. This is because cotenants in a tenancy in common have the unilateral right to transfer their interests in property. Imagine, later, that someone working on that land becomes very sick from a pesticide sprayed there after you sold your interest. You would not be liable for any damages resulting from such an event, because your liability would be severed with the sale. Compare this to a joint tenancy, including tenancy by the entirety. To transfer one's interests, the consent and approval of the cotenant is required. In the case that joint tenants disagree about the use of the property or its disposal, the courts can step in to grant a **partition**⁶⁴ of the land, which essentially results in a separate parcels being granted to the individual tenants. This recasts the formerly joint tenants into adjacent landowners, and it allows them to dispose of or use their property as each sees fit, with no rights to the other's property.

Scope of Interests in Real Property

Scope of ownership matters, because it is determinative of what can (or cannot) be done with the land. The surface of the land and the buildings that are attached to the land are implicitly included when most people contemplate the scope of ownership of real property. However, other interests can be parsed and conveyed separately, including subsurface or mineral rights, and right to light or right to a view. Moreover, water rights are granted differently, depending on whether the property is in the western or the eastern United States. Additionally, easements and covenants grant certain rights to nonpossessors of land.

64. A method of dividing real property.

65. Rights beneath the actual surface of land, including rights to the minerals found there.

66. A right of a property owner adjacent to a water source to use the water and a duty to share that waterway with other property owners adjacent to the water.

67. A water allocation scheme that grants the rights to water to the first who uses the water.

Subsurface or mineral rights⁶⁵ are rights to the substances beneath the actual surface of the land. If you are interesting in drilling for oil, but you do not want to buy every piece of land where you might wish to speculate, then you probably are in the market to purchase or lease mineral rights. This would allow you the right to extract whatever you find under the surface of the land and sell it.

Water rights are determined in two different ways in the United States. Generally speaking, states east of the Mississippi River follow a **riparian water rights doctrine**⁶⁶, which means that those who live next to the water have a right to use the water. The water is shared among the riparian owners. In a quite different scheme, most western states use the concept of **prior appropriation**⁶⁷, which grants rights to those who used those rights "first in time." Moreover, under this concept, the use must be beneficial, but the owner of the right need not be an

adjacent landowner. This policy has led to some unnatural uses of land in western states, where water rights are highly valued due to the scarcity. For example, we see flourishing farmlands in extremely arid climates because the owners of the water rights want to make sure that they retain their prior appropriation rights to the water by putting it to beneficial use (e.g., crop irrigation). If water is not put to beneficial use under a prior appropriation doctrine, then those rights can be lost. Prior appropriation is basically a “use it or lose it” doctrine. Moreover, adjacent landowners in prior appropriation states may have no right whatsoever to use the water that runs through their land. Indeed, such an outcome is very common.

Easements and covenants are nonpossessory interests in real property. An **easement**⁶⁸ is created expressly or impliedly, and it generally gives people the right to use another’s land for a particular purpose. For example, an easement for utility companies to enter onto the land of others is common. This allows the utility companies to maintain poles, power lines, cable lines, and so on. Other examples include a landlocked property having an easement across another piece of property for the purpose of a driveway, or an easement granted to the public to walk along the property of another to gain access to the shoreline.

A **covenant**⁶⁹ is a voluntary restriction on the use of land. Common covenants are homeowners associations’ rules, which restrict the rights of the owners to use their land in certain ways, often for aesthetic purposes. For instance, such covenants might require houses subject to the covenant to be painted only in certain preapproved colors, or they might contain prohibitions against building swimming pools.

- 68. A nonpossessory interest in real property.
- 69. A voluntary restriction on the owner’s use of land.
- 70. Means that restrictions on real property will apply to subsequent owners of the real property.
- 71. A possessory interest in real property.
- 72. A possessory ownership or leasehold interest in land.
- 73. The owner of real property who leases the possessory interest to a tenant.
- 74. A contract for the possessory interest in land.

Some covenants and easements **run with the land**⁷⁰, which means that the restrictions will apply to subsequent owners of the real property. Whether a covenant or easement runs with the land depends on the type of interest granted.

Landlord-Tenant Relationships

A **leasehold interest**⁷¹ may be created in real property. For example, if you rent an apartment, house, or dormitory room from campus, you are a tenant with a leasehold interest. In such a relationship, you are the **tenant**⁷² and the property owner is the **landlord**⁷³. A leasehold is simply a possessory interest with certain rights and duties, which are typically specified in the **lease agreement**⁷⁴. For example, a tenant has the right to exclusive possession of the real property and the duty to follow the rules of occupancy set out by the landlord, and a landlord in a residential lease agreement has the right to be paid rent and the duty to ensure that the premises are habitable. If one party does not perform under the lease as required, the other party may seek legal remedy. For example, if a tenant does not

pay rent, then a landlord may lawfully **evict**⁷⁵ the tenant from the premises, even if the term of the lease has not run. Like other interests in real property, leases generally must be in writing to be enforceable against the defendant.

Different types of tenancies may be created. The most common tenancies are probably tenancies for years and periodic tenancies. **Tenancy for years**⁷⁶ is simply a tenancy that lasts for a particular, specified period of time. When you rent an apartment, you might sign a lease for nine months to reflect the school year. That would be a tenancy for years, even though the term of the lease is less than one year. A **periodic tenancy**⁷⁷, on the other hand, is a tenancy that simply runs for a particular period of time and then automatically renews if it is not terminated by the landlord or the tenant. For instance, a one-year lease may become a periodic tenancy if neither party terminates. Imagine that you had a one-year lease but you did not move out at the end of the year, and the landlord continued to accept rent payments and took no action to terminate the lease. A new lease—for a one-year period of time—would be created. Less common types of tenancies are **tenancy at will**⁷⁸, which is a tenancy for no particular fixed period of time and subject to termination at will by either the landlord or the tenant, and **tenancy at sufferance**⁷⁹, which is a tenancy that occurs when a tenant remains on the property after the right of possession has ended and without the landlord's consent.

- 75. To remove a possessor from land.
- 76. A tenancy that lasts for a particular, specified period of time.
- 77. A tenancy that simply runs for a particular period of time and then automatically renews if it is not terminated by the landlord or the tenant.
- 78. A tenancy for no particular fixed period of time and subject to termination at will by either the landlord or the tenant.
- 79. A tenancy that occurs when a tenant remains on the property after the right of possession has ended and without the landlord's consent.
- 80. The ability to transfer rights conveyed by a contract to another party.
- 81. A clause that prohibits parties from transferring the rights conveyed by a contract to another party.

Tenancies may be created for residential purposes or commercial purposes. Commercial leases typically last for longer periods of time than residential leases. For example, it is not uncommon to hear about commercial leases that last five, ten, twenty-five, or even ninety-nine years. Many of the same responsibilities and duties exist with commercial leases, but there are some important differences. For example, a commercial tenant may demand that the landlord refuse to rent to a competitor of the tenant within the same building. For example, if a golf shop locates in a strip mall, it may require as a term in the lease that the landlord refrain from renting other retail space to a competitor golf shop within the same strip mall.

Lease interests are assignable unless those rights are expressly restricted by the lease agreement. This means that the rights conveyed by the lease, which is a contract, may be transferred to another party by **assignment**⁸⁰, unless an express restriction on assignment exists within the lease. You may have seen restrictions on assignment in your own residential lease in the form of a no-subletting clause. Commercial leases routinely contain a **restriction on assignment**⁸¹ without permission from the landlord.

Just as the owner of real property may sell any or all of his or her interests, any ownership interest in real property may also be leased. For example, someone who

owns the subsurface rights of land may lease the right to drill for oil or gas to another.

KEY TAKEAWAYS

Real property may be acquired by purchase, inheritance, gift, or adverse possession. Owners of property must know the breadth and limits of their ownership interests to understand their rights to profits derived from the land and their liability resulting from use of their land. Interests in land may be absolute, conditional, or for a period of time. Additionally, co-owners may have different rights, depending on their kind of ownership. The scope of interest in land may include surface and the buildings attached to it, while other interests may be severed and conveyed separately, such as subsurface rights and water rights. Easements and covenants in real property convey nonpossessory interests. Leasehold interests are possessory, nonownership interests.

EXERCISES

1. Do you agree that a land's value is only its profits? If not, what makes land valuable? Does it have an "inherent" value, which has nothing to do with human profit?
2. Consider this contemporary take on the tort of nuisance. Some Gulf Coast landowners filed a nuisance suit against power companies for emitting carbon, arguing that the carbon led to global warming, which then led to increased sea levels, which then led to hurricane Katrina's unusual ferocity and strength. The district court dismissed the case, but a three-judge panel on the Fifth Circuit reversed, saying the landowners had standing to proceed and that the claim was justiciable. Do you think that this is a valid nuisance claim? Why or why not?
3. Do you think that adverse possession should be abolished? Why or why not? If you discovered a squatter on your land, what should you do to protect your title?
4. What type of due diligence can be performed to ensure that property does not contain a buried toxic waste dump?
5. Classify the following as trespasser, licensee, or invitee to determine the duty owed by a landowner:
 - a. The mailman
 - b. A customer in Wal-Mart
 - c. A person who cuts across your land to reach the other side, without your permission
6. Think of a situation in which you would grant a life estate to someone in property that you own. How does that situation differ from renting property to a tenant?
7. Find a story in the newspaper about liability resulting from the ownership of real property. Do you think that landowner should be liable in the case that you located? Why or why not?
8. What benefits can you see for both the landlord and the tenant for extremely long leases? What are the risks?

8.3 Concluding Thoughts

An understanding of the nature of property is imperative, because at the heart of many transactions is the acquisition, rights to possession or use, or sale of personal or real property. Clearly, these transactions are central to many businesses and the livelihoods of the people involved in business.

When thinking about acquiring property, it is important to know not only whether the property is “right” for your or for your business but also about the rights and duties associated with acquiring it, the protections afforded to you by law as the owner of it, and how to transfer it to another party at the time of sale, lease, or licensing the right to use it. Additionally, liability often attaches to property, and limiting one’s liability is at the heart of what your study of law should encourage you to do.

Chapter 9

Intellectual Property

LEARNING OBJECTIVES

No matter what industry a company operates in, or its size, a company's intellectual property is often more valuable than its physical assets. While factories and inventory can be rebuilt after a loss, losing control of intellectual property can be ruinous for companies. After reading this chapter, you should be able to apply intellectual property concepts to answer the following questions:

1. Why is it important for the law to protect intellectual property?
2. Under what authority does Congress regulate intellectual property?
3. How can intellectual property be protected?
4. What are the differences between the major forms of intellectual property protection?
5. What are some current ethical issues that arise under intellectual property law?

The Apple iPhone 4 is the latest model of Apple's do-it-all cell phone. Since its introduction in 2007, the iPhone has redefined the "smart phone" segment of the wireless phone industry and left its competitors scrambling to catch up. Its sleek lines, gorgeous full-color display, built-in GPS navigation and camera, visual voice mail, and Web surfing capability (either over Wi-Fi or 3G phone networks) made it an instant hit, with thousands of consumers lining up for hours to have their chance to buy one. Its revolutionary business model, where thousands of software programmers could write small programs called "apps" and sell them on the App Store through Apple's iTunes software, created a win-win-win business model for everyone who touched the iPhone. For software programmers, it was a win because small, untested, and first-time programmers could "strike it rich" by selling thousands of their apps directly to consumers without having to find a software publisher first. For Apple, it was a win because thousands of talented programmers, not on Apple's payroll, were developing content for their product and enhancing its appeal. Apple also wins because it collects a percentage fee from every app sold on its iTunes store. And finally, consumers win because they have access to all sorts of creative programs to help them do more on their iPhones than simply make a

phone call. The business has been a tremendous success for both Apple and AT&T, the exclusive service provider of iPhones in the United States.

There are quite a few companies in the industry that aren't doing as well, from Nokia to Motorola to Sony Ericsson. If they wanted to see how Apple makes the iPhone, all they'd have to do is buy one and then take it apart to see its components (a process known as **reverse engineering**¹). Or they could look at the reverse engineering conducted by iSuppli, an independent market intelligence firm.

Hyperlink: iPhone Teardown Analysis

You can see how iSuppli broke down the components in an iPhone 4 by reading this press release:

<http://www.isuppli.com/Teardowns-Manufacturing-and-Pricing/News/Pages/iPhone-4-Carries-Bill-of-Materials-of-187-51-According-to-iSuppli.aspx>

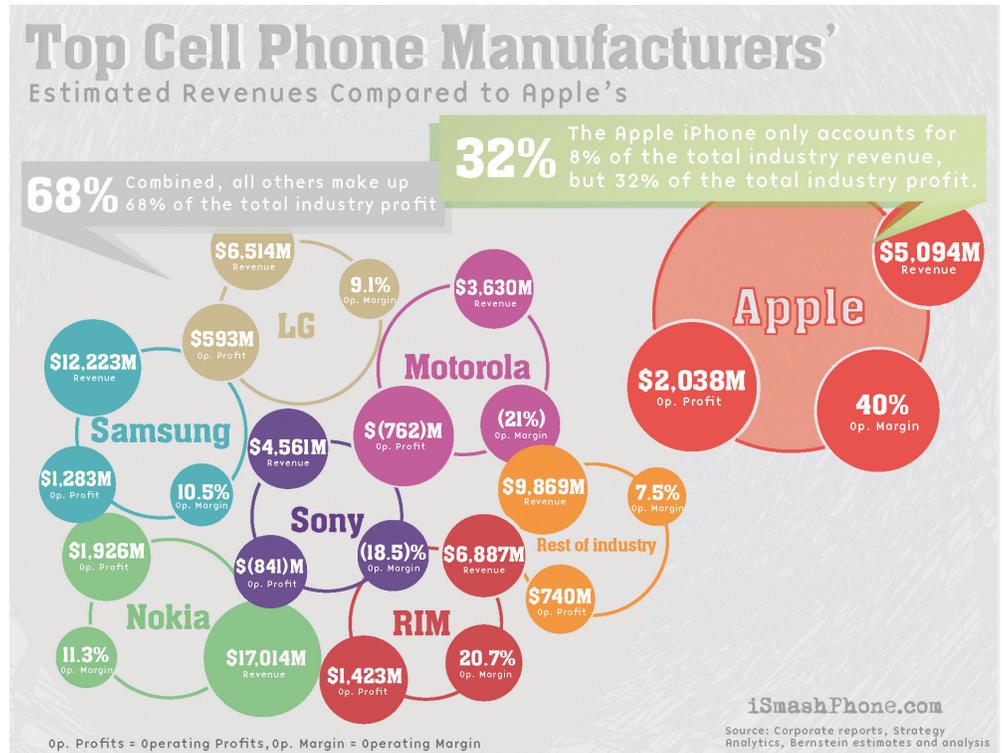
iSuppli found out that the **bill of material (BOM)**², or the breakdown of each component Apple purchased to assemble into an iPhone, is roughly \$187.51. The most expensive components are a \$27 16GB flash memory module from Samsung, a \$28.50 display module that includes the iPhone's glossy 3.5-inch screen, and a \$10 touch screen assembly that includes the touch-sensitive glass on top of the screen.

Apple makes a lot of money selling iPhones. Although the \$199 retail price of the 16GB iPhone 4 suggests that Apple makes only about \$12 profit per phone, in reality the "cost" of the iPhone is much higher than \$199, since each phone is sold with a two-year contract with AT&T service. Industry analysts estimate that AT&T pays Apple approximately \$300 for each iPhone sold with an AT&T plan, in return for Apple agreeing not sell the iPhone through any other phone network. M. G. Siegler, "AT&T iPhone Deal Extended to 2010. Did Apple Mortgage Its Future for a Subsidy?" *Social Beat*, August 1, 2008, <http://digital.venturebeat.com/2008/08/01/att-iphone-deal-extended-to-2010-did-apple-mortgage-its-future-for-a-subsidy> (accessed September 27, 2010). The result for Apple is staggering profitability, with a \$1.21 billion profit reported in the first three months of 2009, much of which driven by iPhone sales. Jim Dalrymple, "Strong iPhone and iPod Sales Drive Apple Profits to \$1.21 Billion," *Macworld*, April 22, 2009, <http://www.macworld.com/article/140162/2009/04/appleearnings.html> (accessed September 27, 2010). This chart (**Figure 9.1 "Estimated Revenues of the Top Cell Phone Manufacturers"**) shows, to scale, how

1. The process of tearing down a finished good to its components to figure out how it was designed or manufactured.
2. A list of components constituting an assembled good.

outsized Apple's profits are compared to those of the rest of the industry. Apple's profit margin, at an estimated 40 percent, is nearly double that of its nearest competitor, Research in Motion, maker of the BlackBerry. "A Visualized Look at the Estimated Revenues of the Top Cell Phone Manufacturers," *iSmashPhone*, August 11, 2009, <http://www.ismashphone.com/2009/08/a-visualized-look-at-the-estimated-revenues-of-the-top-cell-phone-manufacturers.html> (accessed September 27, 2010).

Figure 9.1 Estimated Revenues of the Top Cell Phone Manufacturers



Source: Courtesy of iSmashPhone, <http://www.ismashphone.com/2009/08/a-visualized-look-at-the-estimated-revenues-of-the-top-cell-phone-manufacturers.html>.

If you were a competitor in the cell phone industry, you'd be sorely tempted to try to duplicate Apple's success. After all, if it only costs \$187.51 to make an iPhone, and you could sell it for a \$320 profit, why not just make something that looks a lot like an iPhone? Behold the Air Phone No. 4 (Figure 9.2 "Air Phone 4"). Released in 2010, the Air Phone is made by a little-known Chinese manufacturer and looks virtually identical to the iPhone 4 and does not run on the iPhone's software platform, but at approximately \$150 in online stores, it is proving to be a popular alternative to the iPhone.

The reason that companies like Motorola and Nokia don't simply use the bill of material generated by iSuppli to make their own iPhones, of course, is that it's illegal. The BOM only lists the component costs to Apple; it does not capture the amount of money Apple spent in developing the product through the R&D process. The years of software and hardware development that Apple undertook to create the iPhone involve labor, just as building a skyscraper involves labor. In Apple's case, the product of its labor is not a skyscraper or other tangible property—it is intangible property known broadly as **intellectual property**³, or IP. The law protects Apple's IP just as it protects tangible things from being stolen, so any attempt by a competitor to make an iPhone clone would fail even if the technical ability to do so exists. To be legally sold in the United States, the Air Phone must be different enough from the iPhone that it doesn't actually **infringe**⁴, or step on, any of Apple's intellectual property rights in the iPhone.

Figure 9.2 Air Phone 4



In this chapter, we'll discuss how the law protects IP. We'll begin by examining how IP has been a part of the country's foundation from its very beginning. We'll then discuss the four major types of IP protected by the law: patents, trade secrets, trademarks, and copyright. By the end of this chapter, you'll understand the value that IP plays in a modern economy, the challenges that companies face in doing business in countries that don't value IP, and the devastating impact that IP infringement (including the downloading of music and movies by college students) has on copyright content holders. You'll also be able to distinguish among the various types of IP protection and how they are similar to, and differ from, each other.

Key Takeaways

Companies (such as Apple) invest tremendous resources in developing exciting and innovative new products and services. Reverse engineering means that it would be easy for competitors to quickly figure out how these new products are manufactured, and then copy them. Intellectual property law prevents this from happening and in doing so provides incentive for individuals and companies to create and innovate.

3. Intangible property, the product of human ingenuity, protected by law. Also known as IP.

4. To step on, or violate, someone else's property rights.

9.1 Constitutional Roots

LEARNING OBJECTIVES

1. Understand the constitutional roots for providing legal protection to intellectual property.
2. Explore the tension between content producers and the public good, and how Congress resolves this tension.

Anyone alive when the U.S. Constitution was adopted would be surprised at the size and scope of the U.S. federal government today. What would not surprise them, however, is the existence of the **U.S. Patent and Trademark Office (USPTO)**⁵, since the establishment of a system to protect patents is one of those few congressional powers enumerated in Article I, Section 8 of the Constitution. That clause, known as the **Copyright Clause**⁶, says that Congress may “promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries.” Keep the key words of this clause in mind, as we’ll come back to them later: “promote progress,” “limited times,” and “exclusive.”

Hyperlink: Patent and Trademark Database

The USPTO Web site is a treasure trove of information as it includes a searchable database for trademarks and patents. See if you can search these databases for well-known trademarks or patents.

<http://www.uspto.gov>

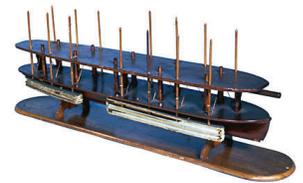
5. United States Patent and Trademark Office. This federal agency approves patent applications and officially grants trademark status to qualified marks, but only a court can finally determine the validity of a patent or trademark application.
6. The clause within Article I, Section 8 of the U.S. Constitution that authorizes Congress to pass laws protecting intellectual property.

Although the Constitution addresses only copyrights and patents, modern intellectual property (IP) law also includes trademarks (probably left out of the Constitution because of the relative unimportance of corporations and branding at the time) and trade secrets (a relatively new form of IP protection). Unlike other controversial portions of the Constitution, such as state rights and the role of the judiciary, the value of laws that protected authors and inventors was well accepted in 1787, when inventions of new machines were shaping up to be part of the fabric

of the new country. Indeed, the attendees at the Constitutional Convention took a break from their work to watch the first steamship in the Delaware River. One of the first patents granted was to Abraham Lincoln, who drew on his experience as a young man making his way from Indiana to New Orleans along the Ohio and Mississippi rivers on a flatboat to devise a system to lift and drop boats over shallow water without dropping off their cargo. A scale model of his invention is on display at the Smithsonian ([Figure 9.3 "President Lincoln's Patent"](#)). Lincoln, who many historians described as mechanically inclined and fascinated by engineering, felt that the patent system added “fuel of interest to the fire of genius.”

Essentially, the Copyright Clause permits (even commands) the federal government to protect certain products of the mind, just as much as it protects personal land or money. If someone trespasses on your property, you can call the police and have them removed or you can sue them in court for damages. In either case, the full force and power of government is involved. The same thing can be said about IP. On the other hand, you know from your economics classes that, in general, our capitalist economy frowns on monopolies. We believe that monopolies are immune from competitive pressures and can therefore charge exorbitant prices without any regard to the quality of their product. Efficiency suffers when monopolies are allowed to exist, and ultimately the consumer loses in choice and price. If you think about it, though, the Copyright Clause essentially allows the government to create a special kind of monopoly around IP. Take, for example, a pharmaceutical company that invents a certain kind of drug and applies for a patent on that drug. If the government grants the patent, then the company can charge as much as it wants (some drugs can cost tens of thousands of dollars per year for consumers) without any regard for competitors, since competitors are shut out of that drug market by virtue of the patent. If any competitor dares to copy the drug to compete against the inventing company, the full force and weight of the government will be brought down on the competitor. Violations of patent law carry extremely stiff penalties.

Figure 9.3 President Lincoln's Patent



Source: Photo courtesy of the Smithsonian National Museum of American History, <http://americanhistory.si.edu/collections/object.cfm?key=35&objkey=19>.

How can we say that monopolies are bad, and yet grant Constitutional protection to monopolies on IP? The answer lies in the genius of the Copyright Clause itself. As in all monopolies, there are two sides: the producer and the consumer. The producer always wants the monopoly to last as long as possible, while the consumer wants the monopoly to end as quickly as possible. The Copyright Clause strikes a compromise between the producer and the consumer in two ways.

First, the Clause states that Congress can grant the monopoly only to “promote the progress of Science and Useful Arts.” In other words, the monopoly exists for a specific purpose. Note that “making Beyoncé rich” or “allowing Pfizer to make billions of dollars” is not the purpose. Rather, the purpose is progress. Granting monopolies can encourage progress by providing a financial incentive to producers. Singers, songwriters, inventors, drug companies, manufacturers—they all invent and innovate in the hope of making money. If they knew that the law wouldn’t protect what they came up with, they’d either not invent at all or they’d simply do it for themselves and their families, without sharing the fruits of their labor with the rest of society.

Second, the clause states whatever monopoly Congress grants has to be for a “limited time.” In other words, at some point the monopoly will end. When the monopoly ends, science is once again progressed because then society can freely copy and improve upon the producer’s products. Society benefits greatly from the expiration of these IP monopolies. Important drugs such as aspirin and penicillin, for example, can now be purchased for pennies and are accessible to the entire human population. Grand literary works, such as Shakespeare’s *Hamlet* or Beethoven’s Fifth Symphony, can be performed and enjoyed by anyone at any time without seeking permission or paying any fees or royalties. These inventions and works are in the **public domain**⁷, to be enjoyed by all of us.

The Copyright Clause does not state how long the monopoly can last; it leaves that task to Congress. Congress must make the decision based on what’s best to promote progress. Remember, though, that producers want monopolies to last as long as possible. For example, consider how long copyrights last. Since 1976 copyrights have lasted for fifty years after the death of the author. After that, copyrighted works fall into the public domain (such as works by Shakespeare or Beethoven). In 1998, however, Congress began considering adding an extra twenty years to that term, for a total of seventy years after the author’s death. In the early part of the twentieth century, the United States experienced a cultural renaissance that accompanied the Industrial Revolution. The invention of the phonograph and cameras allowed the creative genius of Walt Disney, George Gershwin, and Charlie Chaplin (to name a few) to flourish. Under the 1976 copyright law, though, some of these early works (including early versions of Winnie the Pooh) were about to fall into the public domain by 1998. The United States was also under some pressure from international trading partners to increase the copyright term.

Video Clip: United Airlines Commercial

[\(click to see video\)](#)

7. Any intellectual property not protected by law and freely available for any member of the public to use.

As a result of these pressures, U.S. Representative Sonny Bono (himself a popular artist together with his former wife Cher) introduced the Copyright Term Extension Act to add twenty years to copyrights. During hearings on this bill, Congress heard testimony from Jack Valenti, then president of the Motion Picture Association of America, an industry group that represents film studios and corporations. When asked how long he thought copyrights should last, he answered “Forever minus a day.” Although Sonny Bono’s bill passed, whether or not “forever minus a day” will eventually become the law as Congress seeks to strike the right balance between protection and access and whether it satisfies the Constitution’s demand that the monopoly last for a “limited” time remain unresolved questions.

KEY TAKEAWAYS

The Constitution commands Congress to provide monopoly protection for intellectual property, but only for purposes of progressing science and useful arts, and only for a limited time. Content producers will always want legal protection to last as long as possible to maximize profits, while the public good benefits when content falls into the public domain. Congress is under intense pressure to resolve this tension.

EXERCISES

1. Why do you think the Founding Fathers decided to empower Congress to protect intellectual property, but only for a limited time?
2. How likely do you think it is that Congress may extend the term for copyright protection again in the future? Why?

9.2 Patents

LEARNING OBJECTIVES

1. Understand what a patent is, as well as the different types of patents that exist.
2. Learn the criteria required for an item to be patentable.
3. Explore controversial issues surrounding patents.
4. Examine patent infringement and its consequences.
5. Understand boundaries and limitations on patent rights.

Imagine that you invented the Apple iPhone 4. If you invent a patentable item that is useful, new, and nonobvious, and if you are capable of describing it in clear and definite terms, you may wish to protect your invention by obtaining a patent. A **patent**⁸ grants property rights to the inventor for a specified period of time, with a **utility patent**⁹ and a **plant patent**¹⁰ expiring twenty years following the original patent application and a **design patent**¹¹ expiring fourteen years afterward. A **patentee**¹² owns a patent.

However, if you invented the Apple iPhone 4 while employed to perform creative and inventive work, then any patents obtained with respect to your work would be assigned to your employer. Many inventors and designers work for employers in creative and inventive capacities. This arrangement allows innovative ideas to be adequately funded in trade for the property rights resulting from patents granted to those inventions.

Three patent types exist. Utility patents may be granted for machines, processes, articles of manufacture, compositions of matter, or for improvements to any of those items. The Apple iPhone 4 certainly is the subject of utility patents. A design patent may be granted for ornamental designs for an article of manufacture. A plant patent covers inventions or discoveries of asexually reproduced plants (e.g., plants produced through methods such as grafting).

Not all items are patentable. For instance, an idea alone (without a definite description) cannot be patented. So even if you dreamed up the idea of something that looked and functioned exactly like the Apple iPhone 4, you would not have been eligible for a patent on your idea alone. Likewise, physical phenomena, the laws of nature, abstract ideas, and artistic works cannot be patented. Note, however, that artistic works can be copyright protected. Additionally, otherwise

8. A federal right granted to inventors for processes, machines, and compositions of matter.
9. The most common type of patent, awarded for inventions or improvements to methods, processes, machinery, and compositions of matter.
10. A unique patent right granted to inventors of new forms of plants.
11. A unique patent right granted to protect the look, not functionality, of an invention.
12. Holder of a patent.

patentable subjects that are not useful, or items that are offensive to public morality, are not patentable.

So what does it mean to have a patent? Just like real property ownership, a patent confers the right to exclude others. If you owned a parcel of real property, your ownership interest would allow you to exclude others from your land. The rule of law would protect your right to exclude against the intrusions of others, which is the very essence of ownership. Likewise, a patent confers the legal right to exclude others from making, using, or selling the patented product. This is consistent with the Copyright Clause of the U.S. Constitution, which grants inventors the “exclusive Right to their...Discoveries.” For others to legally make, use, or sell the patented product, they would have to be granted permission by the patentee. This is often accomplished through a licensing agreement, in which the patentee authorizes others to sell, make, or use the product.

For instance, some genetically modified agricultural products are the subjects of utility patents. Monsanto Company patented *Genuity Bollgard II Cotton*, designed to resist worm damage, which can be a devastating problem for cotton farmers. This product reduces the need for farmers to spray insecticide. Patentees, such as Monsanto Company, hold many patents on agricultural products such as cotton, soybeans, canola, and corn. In the United States these patents typically protect new plant breeds as well as parts of the plants. In contrast, some countries, such as Canada, do not permit the patenting of life forms. In countries where the patenting of whole life forms is prohibited, the patents typically protect the genetically modified parts of the life form, such as the genes and the cells, as well as the process for inserting the genes into the cells.

Do genetically modified plants meet the threshold requirements to be the subject of a patent? Remember that to be a patentable item, the invention must be useful, new, and nonobvious. Genetically modified plants are useful because they possess some particular quality for which they were designed. For example, *Genuity Bollgard II Cotton* resists many types of damaging worms while reducing the need for farmers to use insecticide, and so this invention can be said to be useful. Likewise, some patented genetically modified agricultural products are resistant to herbicides, such as Monsanto Company's *Roundup Ready* line of agricultural products. *Roundup Ready* products are resistant to an herbicide known as glyphosate, which is the main active ingredient in the herbicide line marketed by the Monsanto Company under the *Roundup* brand. These are also useful inventions, because farmers that plant those patented herbicide-resistant products do not have to wait to plant their crops until their fields are cleared of weeds. They can plant their crops before they spray herbicides because the genetically modified crops will resist the herbicide and continue to grow. This allows the farmers to put their land to use for longer periods of time and with more confidence that they can kill weeds without damaging their crops. They can do so using inexpensive methods such as by spraying herbicides, rather than hand-weeding, which is very labor intensive.

Figure 9.4



Some cotton plants can be patented.

© Thinkstock

Genetically modified plants are new and entitled to be patented when no one else has applied for a patent for that particular invention. If, for example, some other company had invented the same product that eventually became known as *Genuity Bollgard II Cotton* before the Monsanto Company had invented that product, then the Monsanto Company would not have been permitted to patent that product, even if it had independently invented that product with no knowledge of the other invention. In this way, we can see that patents are granted in the United States by the “first to invent” rule. Many other countries follow the “first to file” rule, which means that the first applicant to file for a patent on a particular invention is eligible for the patent, regardless of who first invented it. There are legal movements to amend the U.S. Patent Act to change from “first to invent” to “first to file,” but no amendment has yet been passed.

Genetically modified plants are nonobvious inventions if they are different from what has been used before, so that someone with ordinary skill in genetically modified plant technology would not find the new invention to be obvious. For

example, if the “new” invention only changed the color of one tiny cell in the entire plant, that would probably not be a patentable invention.

You might be wondering how a patent can be granted over a living thing, like a plant. As mentioned earlier in this section, in the United States living things are patentable. Living things became the legal subjects of patents when, in 1980, the U.S. Supreme Court held that a bacterium designed by its inventor to break down crude oil components was the legitimate object of a patent. *Diamond v. Chakrabarty*, 447 U.S. 303 (1980). Indeed, as the Supreme Court noted in that case, congressional intent regarding the U.S. Patent Act was that “anything under the sun that is made by man” is patentable. Since then, we have seen many living organisms patented. For example, the OncoMouse was among the first patented mammals. The OncoMouse is useful in medical research for its extreme propensity to develop cancer.

The patentability of life forms is a contentious issue. While the usefulness of such inventions is proven (or else they would not be patentable inventions), ethical questions abound. For example, when considering the OncoMouse, legitimate questions include whether intentionally creating life to experience pain, sickness, and medical procedures is ethical. Moreover, many people find the idea of “creating” life in a laboratory morally repugnant, as well as owning the products of that creation. Many fear a slippery slope: Today a mouse; tomorrow, a human? Of course, humans are not patentable subjects today, but the slippery slope argument often arises in such discussions. With respect to genetically modified agricultural products, many people question the wisdom of placing control and ownership over items essential to life—like staple crop seeds—into the hands of few, especially when money must be traded for the rights to use those products. This issue is particularly complicated given the fact that genetically modified agricultural products may cross-pollinate with nongenetically modified agricultural products, resulting in progeny that contains the genes or cells that are patented. When this happens, courts routinely recognize that the patentee has the rights to those progeny by virtue of their patent ownership and that the unwitting possessor of those progeny has, in fact, committed patent infringement by being in possession of those patented products without permission.

Another controversial issue surrounds the patents granted to pharmaceutical drugs. Large drug companies rely on patent law to protect their massive investment in research and development into new drugs, the vast majority of which never make it to market. For the few drugs that eventually find government approval and commercial success, manufacturers seek to extract the highest possible price during the period of patent monopoly. For example, the introduction of antiretroviral drugs has greatly extended the lives of HIV/AIDS patients, but the drugs cost between \$10,000 and \$12,000 per year in the United States. In many

developing countries in Asia and Africa, the drugs would make a dramatic impact on human life. Some governments have therefore declared national health emergencies, a procedure under international treaties that permits those governments to force drug companies to license the formula to generic drugmakers (this is called **compulsory licensing**¹³). Cipla, a generic drug manufacturer in India, manufactures the same antiretrovirals for about \$350 a year, or less than one dollar a day.

The U.S. Patent and Trademark Office (USPTO) grants property rights to patentees within the United States, its territories and possessions. Patent law is complicated, and attorneys who wish to **prosecute**¹⁴ patents (file and interact with the USPTO) must have an engineering or science background and pass a separate patent bar exam. When an application is filed, the USPTO assigns a patent examiner to decide whether the patent application should be approved. While the application is pending, the applicant is permitted to use the term “**patent pending**¹⁵” in marketing the product to warn others that a patent claim has been filed. Even after a patent has been issued by the USPTO, however, the patent is merely “presumed” to be valid. If someone challenges a patent in a lawsuit, final validity rests with the U.S. federal courts. For decades, the U.S. Supreme Court routinely ignored patent appeals, allowing lower courts to develop patent law. In recent years, under Chief Justice John Roberts, the Supreme Court has dramatically increased its acceptance of patent disputes, perhaps as a sign that the Court believes too many patents have been issued.

In the last decade there has been an over 400 percent increase in the number of patents filed, resulting in a multiyear delay in processing applications. An increase in the number of **business method patents**¹⁶ contributed to this dramatic increase in patent applications. A business method patent seeks to monopolize a new way of conducting a business process. [Figure 9.5 "Patent Filing for One-Click Web Ordering"](#), for example, describes a method of e-commerce by which a customer can order an item and pay for it immediately with just one click of a mouse button. This **one-click patent**¹⁷ was granted to Amazon.com, much to the chagrin of other online retailers such as Barnes & Noble, who were prohibited from using a similar checkout mechanism. Amazon licensed the patent to Apple so that it could feature one-click on its Web site.

13. A scheme used by countries to force pharmaceutical drug licensing in light of a medical emergency.
14. To apply for, and argue on behalf of, patents before the U.S. Patent and Trademark Office (USPTO).
15. A label claiming patent protection for an application not yet granted.
16. Patents granted for a way of doing business.
17. A patent granted to Amazon.com that allows customers to use one mouse click to purchase items on the Internet.

Figure 9.5 Patent Filing for One-Click Web Ordering

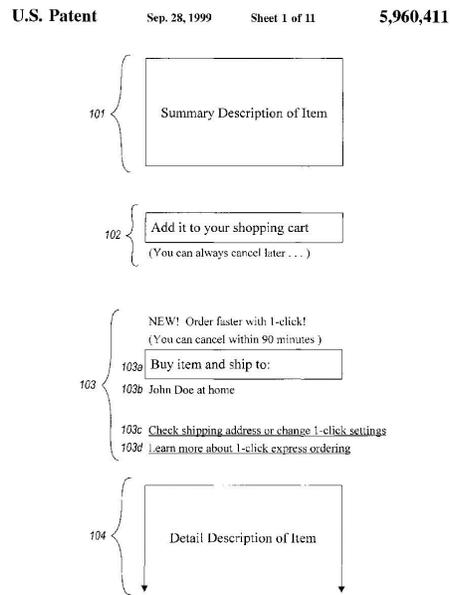


Fig. 1A

Source: Courtesy of Free Software Magazine, <http://www.freesoftwaremagazine.com/files/www.freesoftwaremagazine.com/nodes/1250/1A.jpg>.

Outside the United States, a patent granted by the USPTO does not protect the inventor's interest in that property. Other steps must be taken by the inventor to protect those rights internationally. If someone possesses the patented object without permission from the patentee, then the possessor can be said to have infringed on the patent owner's rights. **Patent infringement**¹⁸ is an actionable claim. A successful action may result in an injunction, treble damages, costs, and attorney's fees. One defense to a patent infringement claim is to challenge the validity of the patent.

18. Violation of a patent holder's rights.

Hyperlink: Wal-Mart Tries to Produce Shoes

Nike recently sued Wal-Mart stores for selling a shoe that Nike claims infringes on its patents. The shoe sold by Wal-Mart uses technology similar to Nike's Shox technology. Look at Nike's complaint here:

<http://online.wsj.com/public/resources/documents/nikepatentsuit.pdf>

Do you think that Nike has a good claim? What should Wal-Mart's defense be?

In recent years several companies that do nothing but sue other companies for patent infringement have emerged. These **patent holding companies**¹⁹, sometimes called **patent trolls**²⁰ by critics, specialize in purchasing patents from companies that are no longer interested in owning them and then finding potential infringers. One such company, NTP, sued Research in Motion (RIM), the maker of the BlackBerry device, for a key technology used to deliver the BlackBerry's push e-mail feature. Faced with a potential shutdown of the service, RIM decided to settle the case for more than six hundred million dollars.

EXERCISES

1. Do you think that life forms should be the subjects of patents? Does your answer change depending on whether we are talking about bacteria, plants, animals, or humans? What are the most persuasive arguments in favor of, and against, allowing the patentability of higher life forms?
2. How do patent rights encourage innovation?
3. If patents are protected monopolies, why do you think patent applications are a matter of public record?
4. Do you agree with compulsory licensing of lifesaving medications in response to national health emergencies? What are the consequences of compulsory licensing to the patentee? To the people in need of these medications in wealthy countries? To the people in need of these medications in poor countries?

19. A company whose sole purpose is to acquire patents and sue potential infringers. Known pejoratively as patent trolls.

20. Pejorative term for patent holding companies.

9.3 Trade Secrets

LEARNING OBJECTIVES

1. Understand what a trade secret is.
2. Learn the differences between trade secret and patent protection.
3. Learn how trade secrets may be lawfully discovered.
4. Explore the concept of misappropriation and the legal consequences.

Imagine that you are in an antique store and find a nineteenth-century ledger book for sale, originally from the W. B. Morrison & Co. Old Corner Drug Store in Waco, Texas. Among the recipes for hair restorers and cough syrups, something in particular catches your eye—a recipe entitled *D Peppers Pepsin Bitters*. What if you also knew that Dr. Pepper was first created and served in that very drugstore? What if you offered to pay two hundred dollars for the old ledger book, even though if it did contain the recipe for Dr. Pepper, it would be worth far more? After all, according to the company that manufactures Dr. Pepper, only three people know the recipe to that very closely guarded trade secret. Something very similar to this happened to Bill Waters. He found the ledger book in an antique store, and he paid two hundred dollars for it. However, at the time, he did not know that the book might date back to the exact time and place from which the popular soda was created. In fact, he did not even notice the recipe until later, and it took him several more days to recognize the possibility that it might be an early version of Dr. Pepper.

Unlike patents, a **trade secret**²¹ can last forever. That is, it can last forever if the owner of the secret can, well, keep it a secret. If someone uses lawful means to uncover the secret, then the secret is no longer protected by the secret's owners. Does this include reverse engineering? Yes. Reverse engineering is an absolutely legal means of discovering a trade secret. What about ferreting out secrets from an employer's safekeeping, while employed

21. Anything of value a company takes reasonable steps to protect from disclosure.

Figure 9.6 Dr. Pepper Bottle



and under a binding confidentiality agreement? No. That is an actionable claim for misappropriation, and the secret's owners can pursue damages.

Source: http://en.wikipedia.org/wiki/File:Dr_Pepper_bottle.JPG.

Trade secrets are unlike patents in another important way. With a patent, the inventor must specifically disclose the details of the invention when applying for a patent. This means that the inventor has not protected the secret of the invention. However, in exchange for this disclosure, a patent owner has a legal monopoly over the property for a specified period of time. So even if others discover the secret of the invention (not a difficult task since patent applications are public record), they are prohibited from making, using, or selling it without the patentee's permission. After the patent expires, then the patentee no longer has a property right to exclude others.

So what is a trade secret? It is, in short, secret information. This information may include a process, formula, pattern, program, device, method, technique, or compilation. For many companies, lists of suppliers, costs, margins, and customers are all trade secrets. Soft drink recipes, KFC's eleven spices, the donut mix sent to Krispy Kreme franchisees, the Big Mac's special sauce, and even the combination of wood that is used in the burning process to make Budweiser beer are all trade secrets. Additionally, the information derives actual or potential economic value from being a secret that is not readily discoverable by others, and the information is the subject of efforts to keep it a secret. While most states have adopted the **Uniform Trade Secrets Act (UTSA)**²², not all have, so the definition of trade secret can vary by jurisdiction. Unlike patents, trademarks, and copyrights, there is no federal law protecting trade secrets.

A claim for **misappropriation**²³ may be brought when a trade secret has been wrongfully obtained, such as through corporate espionage or bribery. Generally, according to the UTSA, misappropriation occurs if the secret was acquired by improper means, or if the secret was disclosed or used without permission from the secret's owner. Damages may include actual loss and unjust enrichment not captured by actual loss. Additionally, in cases of willful or malicious misappropriation, double damages may be awarded, as well as attorney's fees.

So what if you are never lucky enough to discover a multimillion-dollar secret recipe hidden away in an antique shop? As long as the recipe is not patented, you can try to reverse engineer it. If you succeed, you can use it immediately. However, if you are working for an employer in a creative capacity, working with others to develop the secret, and if you have agreed not to use trade secrets, then the right to the trade secret will belong to your employer, at least in most jurisdictions. Ask Peter Taborsky, an undergraduate student at South Florida University in 1988.

22. A model law to protect trade secrets, adopted by over forty states.

23. Appropriating wrongly or without justification.

According to Taborsky, while working in the university's chemical engineering lab, he began conducting experiments on his own. He discovered a highly effective method for treating sewage. The university demanded that he hand over his notebooks that contained the secrets of this invention. Taborsky refused and filed for a patent for his invention, which he received. However, the university pressed criminal charges for stealing trade secrets. Taborsky lost his case and found himself in a maximum-security facility working on a chain gang.

So does Bill Waters need to worry about Dr. Pepper's owners suing him for misappropriation or pressing criminal charges for stealing trade secrets? No. He lawfully obtained the ledger book by purchasing it in the open market. Additionally, according to a company spokesman, the ingredient list under *D Peppers Pepsin Bitters* is most likely an old remedy for a stomachache rather than any version of the recipe for Dr. Pepper. Even if Mr. Waters had accidentally stumbled on the exact Dr. Pepper recipe, he would have a good argument that the company did not take steps to keep the secret a secret. If it had, he could argue, the company never would have allowed the recipe out of its sight.

KEY TAKEAWAYS

Trade secrets last forever if the owner of the secret keeps the secret. However, if someone else discovers the secret through a lawful method, then the owner of the secret has no right to exclude others from using the secret. Unlawfully obtaining a trade secret is called misappropriation, which is an actionable claim. The Uniform Trade Secret Act has been adopted by most (but not all) states, so different jurisdictions have different rules of law concerning trade secrets.

EXERCISES

1. If you owned a trade secret, what methods would you employ to protect it?
2. If you invented something that was patentable or the subject of a trade secret, what types of issues would you consider when deciding whether or not to apply for a patent?

9.4 Trademarks

LEARNING OBJECTIVES

1. Understand what a trademark is.
2. Learn what can and cannot be trademarked.
3. Explore how companies protect trademarks from dilution and genericide.
4. Examine how the Internet poses new challenges to trademark owners.
5. Explore the tension between trademark protection and free speech.

Look at [Figure 9.7 "McDonald's, One of the Most Recognized Trademarks in the World"](#). It's obviously a McDonald's restaurant, but can you tell where this restaurant is? Is it in a mall or airport? Is it in Trenton, Toronto, or Tokyo (or, as it turns out, Messestadt Riem in Germany)? Without additional information, it may be impossible to tell. And yet, no matter where you are in the world, if you enter this McDonald's restaurant, there are certain standards that you expect. You would expect to find a Big Mac on the menu, perhaps Chicken McNuggets and french fries too. You would expect those menu items to taste the same as they do in your local McDonald's. Perhaps you'd expect a certain level of service from the employees, a certain value proposition for your money, a certain look from the uniform and fixtures, or perhaps a clean restroom. If you walked into this McDonald's restaurant and found out that it was in fact not McDonald's, you might be confused. The ultimate goal of trademark law is to prevent this consumer confusion. To prevent any other restaurant from using the name McDonald's, or from using a logo that looks like a stylized "M," McDonald's can trademark both its name and logo (and a lot of other elements of its brand as well). In this section, we'll examine how trademark law accomplishes this goal.

Figure 9.7 McDonald's, One of the Most Recognized Trademarks in the World



Source:
<http://commons.wikimedia.org/wiki/File:RiemArcaden.McD.JPG>.

24. Any logo, mark, sound, or other identifying characteristic that signifies the unique origin of particular goods or services.

A **trademark**²⁴ is any kind of name, logo, motto, device, sound, color, or look that identifies the origin of a particular good or service. Something begins to look like a trademark when a consumer *identifies* it with a particular origin. For example, someone buying a Diet Coke knows that he or she is getting a carbonated beverage from the Coca-Cola Company. If he or she bought a Diet Cola, on the other hand,

there's no association in the mind with any particular company, so it could be from Coca-Cola, Pepsi, or any number of other companies. The key is that consumer identification with a specific origin. If a consumer thinks of a class of goods rather than one specific origin, then it's not a trademark. So, for example, when a consumer hears "aspirin," he or she thinks of a class of goods with no particular origin because aspirin is not a trademark. But if a consumer hears "Bayer," he or she thinks of a specific aspirin from a specific source, making "Bayer" a trademark.

Hyperlink

<http://www.uspto.gov/go/kids/kidsound.html>

Can sounds be trademarked? Yes! Some sounds are instantly recognizable, such as AOL's "You've Got Mail" and Twentieth Century Fox's movie opening scene. Click the link to explore other trademarked sounds.

A federal law, the **Lanham Act**²⁵, protects trademarks. Unlike copyrights and patents, trademarks can last forever and are not subject to the Constitution's "limited time" restriction. Since the objective of trademark law is to prevent consumer confusion, the public good is best served by allowing companies to maintain their trademarks as long as consumers associate a trademark with a specific origin. The moment they no longer make that association, however, the trademark ceases to exist.

If you are considering marketing as a career, you will become intimately familiar with the concepts related to branding and the value of branding. At its core, marketing involves the science of relating to consumers, telling them an authentic story about your product and service, and satisfying their wants and needs. Having a brand is essential to carrying out this objective, and it can lead to startling profits. The Apple and iPhone brands, for example, are very strong and yield billions of dollars in profits for Apple. Luxury brands are particularly aware of this phenomenon, as often their brand alone can justify pricing far above a similar good. Gucci, such as this store in Hong Kong ([Figure 9.8 "Gucci Store in Hong Kong"](#)), trades on the value of its brand to command premium prices (and margins) in the marketplace. Brands such as Rolex, Hermes, Rolls-Royce, and Bentley have similar business models. These brands are all trademarks—indeed, all brands are either registered trademarks or are trademark-able because they share the common feature of consumer identification. Be careful, though. "Trademark" and "brand" are not interchangeable terms because not all trademarks are brands.

25. Federal law protecting trademarks.

So what can be a trademark? Obviously, words can be trademarked. When it comes to trademarks, distinctiveness is good. Therefore, an invented word is the best type of trademark. In 1997, for example, when Stanford grad students Larry Page and Sergey Brin were brainstorming names for their new Internet search engine, they settled on the word “Google,” a play on “googol,” which means 1 followed by 100 zeroes. They felt the name reflected their goal to organize the staggering amount of information available on the Internet. On the other hand, regular words can also become trademarks, as long as consumers identify them with a particular source. Amazon, for example, is the name of the world’s longest river, but it’s also the name of an online retailer. Since consumers now identify Amazon.com as an online retailer, the name can be trademarked. Another example is the phrase “You’re Fired” when used in a television program. The phrase was made popular by billionaire Donald Trump and has such lasting recognition now that it’s unlikely any other television show could use that phrase as a central part of its theme.

Figure 9.8 Gucci Store in Hong Kong



Trademark law is especially important for luxury brands such as Gucci.

Source: Photo courtesy of Maizeam, http://commons.wikimedia.org/wiki/File:HK_TST_Canton_Road_GUCCI_Shop.JPG.

Consider what would happen if you tried to trademark your name. If your name happens to be Sam Smith, you’d probably have a pretty hard time getting a trademark for your name. If, however, you called your business Sam Smith anyway, and started growing your business so that eventually, over time, consumers began to identify “Sam Smith” as your business, then your name has acquired secondary meaning and can be trademarked. Thus, Sam Adams is a trademark for a beer, Ben & Jerry’s is a trademark for ice cream, and Ford is a trademark for a motor vehicle.

Hyperlink:

<http://www.npr.org/templates/story/story.php?storyId=19227066>

Can a sportscaster trademark the phrase “Are you ready to rumble”? Can Paris Hilton trademark the phrase “That’s hot”? As long as the public associates these phrases with a distinctive origin, the answer is yes. Listen to this National Public Radio broadcast for more examples.

Note that when you get a trademark, it's typically granted for a specific category of goods. The same name can sometimes be used for multiple categories of goods. The name Delta, for example, is a trademark for both an airline and a brand of faucets. Since there is little chance that a consumer will be confused by an airline or faucet brand, trademark law allows these dual registrations. On the other hand, some brands are so strong that they would probably stop registration even for a completely different category of goods. McDonald's is a good example of this. The McDonald's trademark is one of the strongest in the world, meaning that it is instantly recognizable. In 1988, for example, hotel chain Quality Inns decided to launch a new line of budget motels called "McSleep." McDonald's sued, claiming trademark infringement. McDonald's claimed that consumers might be confused and believe that McDonald's owned the hotel chain. A federal judge agreed and ordered Quality Inns to change the name of the chain, which it did, to Sleep Inns.

Trademarks go beyond simply a company's name or its logo. A color can be trademarked if it's strong enough to create consumer identification. Pink, for example, is trademarked when used for building insulation by Owens Corning. All other insulation manufacturers must use different colors. Sounds can be trademarked too, such as MGM Studios' "lion's roar." Even a certain "look" can be trademarked if a consumer identifies it with a certain origin. Thus, the distinctive colors, materials, textures, and signage of a Starbucks or T.G.I. Friday's are considered **trade dress**²⁶ and cannot be copied. A bottle shape can be considered trade dress, too, such as the shape of a nail polish bottle ([Figure 9.9 "OPI's Nail Polish Bottle"](#)). OPI, a nail polish manufacturer, has registered this bottle shape with the U.S. Patent and Trademark Office (USPTO) and is suing other manufacturers that use a similarly designed bottle. Interestingly, courts have been reluctant to grant certain smells trademark protection, even though it can be argued that certain fragrances such as Old Spice or CK One are distinctive. Imagine the chaos that would ensue if one company claimed trademark protection for vanilla or strawberry scents—consumers would ultimately be robbed of choice if that were to happen.

A trademark is not limited to a name or logo used to sell goods. If a company provides a service (as opposed to selling goods), it too can receive trademark protection. In this case it's called a **service mark**²⁷. Facebook, for example, is a service mark. A trademark can also be used to demonstrate certification meeting certain standards, such as the Good Housekeeping Seal of Approval. If you study operations management, you'll learn about the International Organization for Standardization (ISO) and its various standards for quality management (ISO 9000) or environmental quality (ISO 14000). The Forest Stewardship Council (FSC) allows its logo to be used on paper products that come from sustainable forests, while certain foods can be labeled "Organic" or "Fair Trade" if they meet certain standards as established by governmental or nongovernmental organizations. Each

26. The distinctive and unique look, feel, or shape of a product or service that signifies unique origin.

27. Trademark for an entity providing services, as opposed to goods.

of these marks is an example of a **certification mark**²⁸. Finally, a mark can represent membership in an organization, such as the National Football League, Girl Scouts of America, Chartered Financial Analyst, or Realtor (**Figure 9.10** "**Realtor Certification Mark**"). Each of these is known as a **collective mark**²⁹. The rules that apply to trademarks apply equally to service marks, collective marks, and certification marks.

If a color or sound can be trademarked, is there anything that cannot be trademarked? The Lanham Act excludes a few categories from trademark registration, mainly for public policy purposes. Obviously, trademarks will not be granted if they are similar or identical to a trademark already granted. If you're starting a new company, it's a good idea to make sure that not only is a domain name available for your company's name, but that the name isn't already trademarked by someone else. Trademarks also cannot contain the U.S. flag, any government symbol (such as the White House or Capitol buildings), or anything immoral. Trademarks cannot be merely descriptive. (Thus every restaurant is allowed to offer a "Kid's Meal," but only McDonald's can offer a "Happy Meal.")

Figure 9.9 OPI's Nail Polish Bottle



A bottle's shape can be trademarked if it is distinctive enough.

Source: Photo courtesy Jessica Ta, <http://www.flickr.com/photos/bloggles/4288368487>.

28. A trademark representing a good or service meeting minimum standards established by owner of the certification mark.

29. A trademark representing membership in a group as established by owner of the collective mark.

Whether or not a region can be trademarked (a **geographic indicator**³⁰, or GI) is the subject of some controversy, especially with our trading partners. “Maine Lobster,” “Napa Valley Wine,” or “Florida Orange Juice,” for example, may indicate to some consumers the origin of a particular lobster or bottle of wine or orange juice, and thus may be of commercial value to distinguish the product from competitors from other regions. For the time being, these foods must come from Maine, California, or Florida to avoid liability under consumer protection statutes for fraud (lying) about their origin. What happens, though, if consumers lose the association with the region? For years, sparkling wine manufacturers in Champagne, France, have fought to prevent this from happening by requiring that only sparkling wine made in the Champagne region be called “champagne.” Now, food producers (especially in the European Union) are seeking similar protection under international trademark law for Feta, Parmesan, Gorgonzola, Asiago, and hundreds of other names.

Figure 9.10 “Realtor”
Certification Mark



Source:
http://upload.wikimedia.org/wikipedia/en/1/16/Realtor_logo.jpg

A trademark is valid as long as consumers believe that the mark is associated with a specific producer or origin. If the mark refers to a class of goods instead, then the trademark can no longer exist. This process is called **genericide**³¹. Many words today once started as trademarks: furnace, aspirin, escalator, thermos, asphalt, zipper, softsoap, cellophane, lite beer, Q-tip, and yo-yo are all examples of trademarks that are now generic and have therefore lost legal protection. To prevent genericide from occurring, trademark owners must take active steps, often costing millions of dollars, to educate consumers on the importance of using their trademarks properly and to prosecute infringers. For example, when you hear the word “Kleenex,” do you think of a brand of tissue owned by Kimberly-Clark, or do you think of tissues generally? Does “Rollerblade” refer to a brand of in-line skates, or to all in-line skates? In Southern states, does “Coke” refer to a Coca-Cola, or to soft drinks generally? When you run a “Xerox” photocopy, is it on a Xerox photocopier or some other machine? These trademarks, all currently active and worth billions of dollars to their owners, are in danger of becoming generic in the United States. If that happens, the companies will lose control of the marks and the public (and competitors) will be free to use those words just as they use “aspirin” and “yo-yo” today. Xerox has taken many steps to educate the public about its trademark, including running print advertisements in business periodicals. In one of these ads, the text says, “When you use ‘Xerox’ the way you use ‘aspirin,’ we get a headache.”

30. A system whereby names for products, especially foodstuffs, are reserved exclusively for products originating from a particular region.

31. A former or claimed trademark indicating a general class of goods, not eligible for trademark protection.

Trademark infringement occurs when someone uses someone else's mark, either completely or to a substantial degree, when marketing goods or services, without the permission of the mark's owner. Obviously, making your own pair of jeans and slapping a "Levi's" label on it, or making your own handbag and sewing a "Coach" label on it, constitutes trademark infringement. When Apple first released the iPhone, to its embarrassment it found out that "iPhone" was already a registered trademark belonging to Cisco, another company, for a phone used for placing phone calls over the Internet. To avoid trademark infringement liability, Apple had to pay Cisco an undisclosed sum to purchase the trademark. Ford found itself in a similar situation when it released a supercar called the "Ford GT." Ford made a similar racing car in the 1960s called the "GT 40" but lost control of the trademark after production ceased. Unable to reach agreement with the current trademark owners, Ford settled for releasing the new car as simply the "GT."

The law also permits trademark owners to sue infringers who use their marks to a substantial degree. For example, when Samsung announced its new smart phone, the Black Jack, the makers of the BlackBerry device sued for trademark infringement. When a software company released a product to eliminate unwanted e-mails called "Spam Arrest," it was sued by Hormel, makers of Spam canned luncheon meat. When a small coffee shop in Syracuse, New York, opened as "Federal Espresso," the shipping company FedEx filed a trademark infringement claim.

Even if a trademark owner doesn't believe a similar use of its mark would lead to any consumer confusion, it can protect its trademark through a concept called **dilution**³². Such was the case when an adult novelty store in Kentucky opened as "Victor's Secret" (the owner's name was Victor). The trademark owners of "Victoria's Secret" filed a dilution suit in response. Traditionally, trademarks are intended to prevent consumer confusion. Dilution permits a trademark owner to stop usage of a similar word or phrase even if consumers aren't confused. Under dilution concepts, the trademark owner only needs to show that its mark will be diluted or tarnished in some way.

Dilution is controversial in trademark law. When Congress passed the first dilution law in 1995, the Federal Trademark Dilution Act, many felt that Congress had gone too far in protecting trademarks, to the detriment of the public and small businesses. For one thing, the Act only protected "famous" trademarks. It also failed to clearly define "dilution," and what was required for trademark owners to win a lawsuit. Finally, when the Victor's Secret case reached the Supreme Court, *Moseley v. Secret Catalogue*, 537 U.S. 418 (2003)[0].[0] the Supreme Court issued some clarification. The Court ruled that to win a dilution case, a trademark owner had to show that it had suffered actual economic damage from the dilution, not merely the "likelihood" of dilution. This is a high standard for trademark owners to

32. The use of a famous trademark in a manner intended or designed to cause tarnishment of the mark.

meet, because it means that they (1) have to wait for the diluting mark to hit the market and be used in commerce and (2) must be able to prove that they suffered economic damage from the diluting mark. Unhappy with the Court's decision, corporations lobbied Congress to pass the Trademark Revision Dilution Act of 2006, which overturns the Moseley case. Now, trademark owners of famous trademarks only need to show a likelihood of dilution before filing a dilution lawsuit.

Companies or persons accused of trademark infringement have several defenses to rely on. The most obvious is arguing that no infringement has occurred because the two marks are sufficiently different that consumers won't be misled. For example, in 2002 Jeep sued General Motors for infringing on what Jeep called its trademark grill. GM's Hummer division released the H2 that year, with a similar seven-bar grill. A district court held that there was no trademark infringement because the grills were too dissimilar to cause consumer confusion. Look at the Hummer H2 grill ([Figure 9.11 "Hummer H2 Grill"](#)) and the Jeep grill ([Figure 9.12 "Jeep Grill"](#)). Do you think there is a chance of consumer confusion?

Figure 9.11 Hummer H2 Grill



Source: Photo courtesy of Ramchandran Maharajapuram, http://www.flickr.com/photos/me_ram/3157719487.

Another defense is **fair use**³³. The Lanham Act prohibits the use of someone else’s trademark when selling goods. It’s not uncommon to see various items such as laptop computers, telephones, soda cans, or other foods with their labels covered by stickers or blurred out on television shows and movies because of the trademark law. On the other hand, what if a company wanted to mention a competitor’s product to draw a comparison with its own product? This is called comparative advertising, and it’s considered fair use. Honda, therefore, is free to claim that its “Honda Accord is better than the Ford Taurus” in its advertising even though Ford and Taurus are both trademarks owned by Ford Motor Company.

Figure 9.12 Jeep Grill

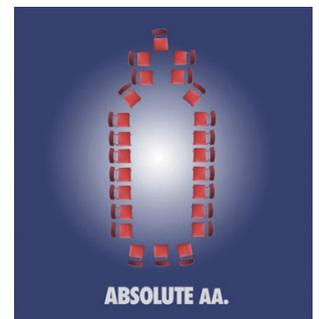


Source: Photo courtesy of 3obryans, <http://www.flickr.com/photos/3obryans/1017233>.

The First Amendment also recognizes the use of parody, comedy, or satire as fair use. Comedy skits on television that make fun of, or use, company logos are an example of this fair use. Canadian nonprofit Adbusters, for example, claims to be an organization seeking to advance “a new social activist movement in the information age.” Part of its work involves making fun of corporations and consumer spending, sponsoring “Buy Nothing Day” as an antidote to the annual holiday spending season. Making fun of corporations also involves spoofing their commercial messages, as the ad in Figure 9.13 "A Parody of the Well-Known Absolut Vodka Print Ads" illustrates. Although the ad undoubtedly infringes on a trademark, it is considered fair use because of the social commentary and satire behind its message.

An interesting aspect of trademark infringement arises through the use of domain names on the Internet. The practice of **cybersquatting (or domain name squatting)**³⁴ arises when a company registers a domain name containing a famous trademark in hopes of selling that trademark to its rightful owner for a large profit. The practice arose in the early days of the Internet, when domain name registration took place on a first-come, first-served basis. There is nothing wrong with registering a domain name for a generic word such as “shoes.com,” but incorporating a registered trademark into the domain name, for purposes of selling it later, is considered cybersquatting. This practice was made illegal in 1999 with the passage of the **Anticybersquatting Consumer Protection Act**³⁵. It is only illegal, however, if the domain name is registered

Figure 9.13 A Parody of the Well-Known Absolut Vodka Print Ads



- 33. The right of the public, under circumstances laid out in copyright and trademark law, to use protected intellectual property without permission.
- 34. The practice of registering Internet domain names for the sole purpose of selling the name to its rightful trademark owner.
- 35. A federal law outlawing cybersquatting.

to make a profit through later sale. It is not illegal if someone registers the domain name in “good faith.” A good example is the domain name registered by Canadian teenager Mike Rowe in 2003. An avid computer user, he registered “mikerowesoft.com” as a domain name. Software giant Microsoft launched legal proceedings against him, claiming violation of the cybersquatting statute and trademark infringement. Rowe’s defense was that the Web site merely reflected his name and his interest in computer programming and software and was being used for that purpose. After heavy negative publicity, Rowe and Microsoft settled the case with Microsoft taking control of the domain. Another example surrounds the Nissan.com domain. Uzi Nissan, a computer storeowner, had owned the domain for years before Nissan Motors attempted to gain ownership of the domain. Since the domain was registered in good faith, no cybersquatting has occurred. The First Amendment is also a defense to cybersquatting. Web sites run by consumer activists who seek to criticize or parody companies, such as “fordreallysucks.com” or “fordlemon.com” or “peopleofwalmart.com” are not cybersquatting in spite of their use of trademarks.

Source: Photo courtesy of Adbusters, <https://www.adbusters.org/gallery/spoofads/alcohol/absolutaa>.

KEY TAKEAWAYS

Trademarks are anything that identifies the unique origin or goods or services. Trademarks are granted under federal law by the U.S Patent and Trademark Office and can last forever. When a trademark is no longer associated with a specific origin, it becomes generic and loses legal protection. Trademark owners can take legal action against infringement and dilution of their marks. Fair use of trademarks includes comparative advertising and parody. Trademark protection extends to the Internet, where mark owners can prevent bad faith domain name squatting.

EXERCISES

1. Go to the U.S. Patent and Trademark Office at <http://www.uspto.gov>. Search the trademark database for the phrase “Let’s Roll.” Do you think that companies should be able to trademark phrases? Can you find other examples?
2. “Netbook” is an example of a term the USPTO recently rejected as being generic, even though it was at one point a registered trademark. Can you think of other recent examples of genericized trademarks?
3. Do you think that the rules of cybersquatting should extend beyond Internet domain names to other uses such as Facebook or Twitter account names? Why or why not?

9.5 Copyright

LEARNING OBJECTIVES

1. Understand what a copyright is.
2. Explore the requirements for copyright protection.
3. Learn how copyright owners can license their works for use by others.
4. Understand copyright infringement and the fair use defense.
5. Understand the Digital Millennium Copyright Act.

The final form of intellectual property (IP) protection is **copyright**³⁶. Like patents and trademarks, federal law protects copyright. Whereas trade secrets protect confidential company information, patents protect processes and inventions, and trademarks protect brands and identity, copyright is designed to protect creativity. It is one of the two types of IP specifically mentioned in the Copyright Clause of the U.S. Constitution. Of course, back then the only works copyrighted would have been songs, art, or works in writing. Today, copyright extends to any form of creative expression, including digital forms.

If asked to write down four numbers from one to fifty in random sequence, most of us would write four different numbers. The process of picking those numbers requires creativity, so the sequence of the four numbers you write down is copyrighted. Note that the numbers themselves aren't copyrighted, of course. It's just the unique sequence that you choose, the expression of your creativity, that is copyrighted. Since computer software is a compilation of binary code expressed in 1 and 0, all software is copyrighted. On the other hand, sequential page numbers or listings in a phone directory show no creativity and are therefore not copyrightable. Similarly, if a group of students were given a camera and each was asked to photograph the same subject, each student would come up with a different photograph. Each student would frame the subject differently, and that is an expression of creativity. Finally, consider the notes that you take in class for this course. A group of students could read the same textbook and listen to the same lecture, and come up with different sets of notes. Each work is unique and demonstrates creativity, so each is copyrighted.

A work must be original (not copied) and fixed in a durable medium to be copyrighted. Therefore, if you sing an original song in the shower in the morning and your roommate hears it and records it, the copyright to the song belongs to your roommate, not you. This requirement exists because it would be impossible to

36. The exclusive rights of authors to their respective works, to the exclusion of others.

prove, without a durable medium, who is the original author of a work. Ideas, by themselves, cannot be copyrighted. If you had an idea for a novel about a boy wizard who goes to a boarding school with his friends and battles evil monsters while growing up, that would not be copyrighted. If you wrote a novel featuring such a story line, however, you would run the risk of violating the copyrighted Harry Potter works. A similar dispute arose in 2006 after the blockbuster success of Dan Brown's novel, "The Da Vinci Code." Two authors, Michael Baigent and Richard Leigh, claimed the novel infringed on their copyrighted book, "Holy Blood Holy Grail." In their book, the authors theorized that Jesus survived his crucifixion, married Mary Magdalene, and had children. The British judge hearing the case dismissed the claims, holding that the theory was "too general or too low a level of abstraction to be capable of protection by copyright law." *Baigent v. Random House Group*, <http://www.scribd.com/doc/2473519/da-vinci-code-ruling-baigent-v-rhg-0406> (accessed October 2, 2010).

A copyrighted work is automatically copyrighted upon its creation. Unlike patents and trademarks, which must go through an expensive and rigorous application and approval process with the government, authors do not need to send their work to the government for approval. Although it's a good idea to write "Copyright" or place a © symbol on the work, it's not legally required.

Copyright protection lasts for seventy years after the death of the author. If there is more than one author, the copyright expires seventy years after the death of the last surviving author. If a company, such as a publisher, owns a copyrighted work, the copyright expires ninety-five years from the date of publication, or one hundred twenty years from the date of creation, whichever comes first. After copyright expires, the work falls into the public domain. The works of Shakespeare, Bach, and Beethoven, for example, are in the public domain. They may be freely recorded, performed, or modified without permission. If you were to record yourself reciting Shakespeare's "To be or not to be" speech from *Hamlet*, however, that recording is copyrighted even though the underlying work (*Hamlet*) is in the public domain as a new creative expression. Classical music recordings are similarly copyrighted under the same concept.

The owner of a copyright may allow members of the public to view or use a copyrighted work, for free or for a fee. This use is contained in a copyright license, sometimes called an **End User License Agreement**³⁷ (EULA) for software. A license is essentially permission from the copyright holder to violate the copyright, within the terms of the license. When you purchase a physical book or CD or DVD, for example, the copyright license allows you to view the movie, listen to the music, or read the book, in private. The license does not allow you to show the movie in class to a broad audience, or to record the music into your computer and then modify it, or to run photocopies of the book to give away or sell. These rights of reproduction,

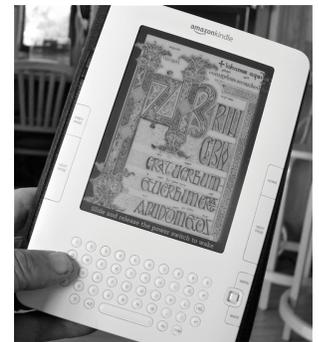
37. A contract between a copyright holder and user, typically used in software licenses.

exhibition, and sale are not part of the license you received and are reserved by the copyright holder. Of course, you may purchase those rights if you wish, but they will probably cost a lot more than the price of the book or disc. Some organizations advocate the creation of a common license that authors can easily refer to if they wish to distribute their work easily. The **General Public License (GPL)**³⁸ for software and **Creative Commons**³⁹ (CC) license for text and media are well-known examples. One right that you do have, however, in spite of any language in the license, is the right of **first sale**⁴⁰. Essentially this means that as the owner of the physical work, you can do with it as you please, including resell the original work.

Licenses in the digital arena can be very restrictive if you purchase digital media. Copyright holders may use schemes such as **Digital Rights Management (DRM)**⁴¹ to limit your ownership rights in digital media. DRM limits the number of copies and devices a digital file can be transferred to, and in some cases even permits the copyright holder to delete the purchased work. Amazon.com recently deleted digital George Orwell books from owners who had purchased the works for their Kindle reading devices (**Figure 9.14 "Amazon's Kindle E-reader"**), without any prior notification. This would have been impossible if the books were in a physical form. Although Amazon.com was within its rights to do so, the public outcry that followed made Amazon.com promise to not engage in such behavior again in the future.

Copyright infringement occurs when someone uses a copyrighted work without permission or violates the terms of a copyright license. For example, if a classmate takes your class notes without your permission and makes photocopies of them, the classmate has infringed on your copyright. It's also copyright infringement if you take someone else's work and simply repackage it as your own. This happened recently to Harry Potter author J. K. Rowling. Her books created a huge fan following, and many fans gather online to discuss the Potter series. One such site is the Harry Potter Lexicon, run by Steve Vander Ark, a former school librarian. The site serves as an encyclopedia to the Harry Potter world, with reference notes on characters, places, spells, and other details. When Vander Ark announced plans to publish the contents of the Lexicon in a book format, J. K. Rowling sued, claiming copyright infringement. The judge agreed and ordered the Lexicon rewritten so that it uses less material from the copyrighted work.

Figure 9.14 Amazon's Kindle E-reader



Source: Photo courtesy of Larry Page, <http://www.flickr.com/photos/igboo/3879913438>.

- 38. A widely used free software license.
- 39. A nonprofit organization dedicated to the free distribution of creative content, and publisher of several standard copyright licenses.
- 40. Doctrine under which the first owner of a piece of copyrighted work can do whatever he or she pleases with it, including resell the work.
- 41. A scheme to restrict the ability of an end user to copy or modify digital media.

Copyright infringement also occurs when you assist someone in violating a copyright, or create a device that assists in violating a copyright. Thus, Web sites such as the former Napster and Grokster, which existed solely for the purpose of facilitating illegal downloading of music, were held to be infringers even though the Web sites themselves didn't violate any copyrights. Similarly, if you make digital media available for download for others, you are not engaged in illegal downloading but still liable for contributory copyright infringement. The recording industry, which is battling for its very survival in a new file-sharing world, pursues these cases aggressively. In June 2009, a court in Minnesota ordered Jammie Thomas to pay \$80,000 per song for making twenty-four songs available for download, for a total fine of \$1.92 million. In September 2009, the industry won a \$675,000 verdict against a college student in Massachusetts for file sharing thirty songs. Devices that can be used for purposes other than violating copyrights (such as photocopiers, video/DVD burners, and peer-to-peer networks used for sharing research) are not considered infringing devices.

Copyright law makes a distinction between “fair” use and “infringing” use of a copyrighted work. A fair use includes copying a work for purposes of commentary, criticism, news reporting, teaching, or research. Just because a work is used in a news article or in a classroom, however, does not make its use fair. The law provides four factors that courts must consider in determining whether or not the use is fair. First, the court must consider the purpose and character of the use. Is it for educational purpose, or for making a profit? Second, the court must consider the nature of the copyrighted work. Is the work part of the “core” of the intended protection that copyright provides? Third, the court must consider the amount and substantiality of the portion used. This is an important factor—it's one thing for your professor to copy an excerpt from a journal or book for distribution in class (probably fair) and another to copy the entire journal or book (probably infringing). Finally, the court must consider the effect of the use on the potential market for the copyrighted work. If the use is considered fair, what would it do to the market for the copyrighted work? For example, if copying an entire textbook is fair, it would probably eliminate the market for new textbooks.

In an attempt to tackle the problem of copyright infringement on the Internet, Congress passed the **Digital Millennium Copyright Act (DMCA)**⁴² in 1998. One portion of the law helps Internet service providers by expressly stating that those providers can't be sued for copyright infringement if others use their networks for infringing uses. Another portion of the law helps Web sites by stating that if a Web site user uploads infringing material and the Web site complies with a copyright holder's request to remove the material, the Web site won't be liable for infringement. For example, if you upload a portion of a copyrighted song, movie, or television show to YouTube, you may find that YouTube has removed your clip at the request of the copyright holder. Finally, the DMCA makes it illegal to attempt to

42. A federal law outlawing any attempt to circumvent a copy protection device or scheme.

disable a copy protection device. DVD and Blu-ray Discs, for example, are copy protected to prevent them from being copied easily. Anyone who writes software (even if the software is distributed for free) that disables this copy protection device is violating the DMCA. In recent years the DMCA has been used by companies to prevent competitors from making replacement inkjet cartridges, replacement garage door openers, and other replacement parts on the grounds that the replacements circumvent a copy protection device.

KEY TAKEAWAYS

Copyright protects any creative work fixed in a tangible medium. Copyright protection is automatic without any prior government approval and generally lasts for seventy years past the death of the author. Copyright owners can license others to use their works while retaining full rights of ownership. Digital works are fully protected by copyright and may be encrypted with digital rights management schemes. Copyright infringement, both direct and contributory, is a serious civil violation that can result in heavy monetary penalties. Fair use is a defense to copyright infringement. The Digital Millennium Copyright Act prohibits any attempts to circumvent a copy protection device or scheme.

EXERCISES

1. How long do you think copyrights should last?
2. Do you think the use of copyrighted works in parody is fair use? Consider works by Weird Al Yankovic, or Mel Brooks movies, for example.
3. Do you think there is any difference between downloading a song on a peer-to-peer network versus walking into a store and putting a CD into your jacket and walking out without paying for it? What are those differences? Should the law treat those two acts differently?
4. Is downloading music justifiable because recording artists and companies make a lot of money? Can you think of other industries where this reasoning applies as well?

9.6 Concluding Thoughts

The framers of the Constitution recognized the value of intellectual property (IP) by drafting the Copyright Clause into Article I, Section 8 as part of Congress's duty to pass laws. As IP law evolved, laws that govern trade secrets, patents, trademarks, and copyright have emerged to protect different forms of IP. These legal protections provide a solid foundation for businesses, entrepreneurs, and artists to create useful, innovative, and inspiring works for society. Our lives are enriched by machines to make tasks easier, medicines to heal us, and songs and movies to inspire and entertain us. Without the financial incentives provided by IP law, innovation would grind to a halt and the U.S. economy would become unrecognizable.

On the other hand, the Constitution is explicit about the primary purpose of providing IP monopolies: to advance the progress of science and useful arts. This advance can take place when IP owners create IP, but it can also take place when the IP falls into the public domain at the end of its "limited time." Many legal scholars now believe that Congress has gone too far in pleasing copyright holders, mainly large corporations with billions of dollars in profits at stake. In a case discussed in [Chapter 7 "Torts"](#) involving Samsung's use of a robot that looked like Vanna White, Judge Alex Kozinski from the Ninth Circuit Court of Appeals ([Figure 9.15 "Judge Alex Kozinski"](#)) noted that sometimes the law does go too far in protecting IP:

Something very dangerous is going on here. Private property, including intellectual property, is essential to our way of life. It provides an incentive for investment and innovation; it stimulates the flourishing of our culture; it protects the moral entitlements of people to the fruits of their labors. But reducing too much to private property can be bad medicine. Private land, for instance, is far more useful if separated from other private land by public streets, roads and highways. Public parks, utility rights-of-way and sewers reduce the amount of land in private hands, but vastly enhance the value of the property that remains.

So too it is with intellectual property. Overprotecting intellectual property is as harmful as underprotecting it. Creativity is impossible without a rich public domain. Nothing today, likely nothing since we tamed fire, is genuinely new: Culture, like science and technology, grows by accretion, each new creator building on the works of those who came before. Overprotection stifles the very creative forces it's supposed to nurture. *White v. Samsung Electronics*, 989 F.2d 1512 (9th Cir. 1993).

Judge Kozinski thinks that overprotecting intellectual property is as harmful as underprotecting it. Do you agree? The challenge for policymakers and courts is to find the balance between the rights of IP holders, who would always like more protection, and the rights of the public, which are enhanced when material falls into the public domain. Corporations, policymakers, and members of the public will all benefit from a reasoned debate over how to find this balance.

Figure 9.15 Judge Alex Kozinski



Source: Photo courtesy of the Ninth Circuit Court of Appeals, http://www.ce9.uscourts.gov/chief_judge_bio.html.

Chapter 10

Criminal Law

LEARNING OBJECTIVES

After reading this chapter, you should understand the nature of criminal law, why it is important to business, and the potential consequences of committing criminal acts. You will become familiar with white-collar crimes, blue-collar crimes, and crimes committed by businesses. You will also learn about the constitutional protections afforded to those accused of committing a crime, and the purpose of punishments for committing crimes. This chapter will explore corporate liability as well as individual liability for corporate actions. It also will examine strategies to minimize corporate criminal liability exposure or losses attributed to criminal activities. At the conclusion of this chapter, you should be able to answer the following questions:

1. Why is crime relevant to business?
2. How does criminal law differ from civil law?
3. What constitutional protections are afforded to those accused of committing a crime?
4. What are some relevant defenses to crime?
5. What are the consequences of committing a crime?
6. What are the goals of punishment for committing a crime?
7. Which crimes must businesses be concerned about?
8. What strategies exist for businesses to minimize exposure to criminal liability or to loss associated with criminal activities?

Consider the photo in [Figure 10.1 "Businessperson in Trouble"](#). It is probably not the usual image conjured by most business students who dream of success in the business world. Yet it becomes a sad reality for too many managers and executives who commit crimes in the context of their professional lives. How can the path from business success lead to a criminal conviction? Click on any credible news source today, and you will find among the headlines a story in which this photo would fit.

Figure 10.1 Businessperson in Trouble



© Thinkstock

Of course, there are many reasons why something like this happens. People sometimes fall into the “wrong crowd” at work, and they do not know how to walk away. Sometimes corporate culture and leadership can contaminate a work environment, causing people to disregard ethical behavior or to flagrantly ignore the laws. If “everyone is doing it,” then someone might believe that it’s OK for him or her to do it, too. Being part of an organization has a way of making someone feel insulated and “safe” when committing wrongdoings. For example, some members of the Enron workforce seemed to be swept up in a culture of corporate greed, and they did not know how to walk away. Other people are opportunists, and their moral compass or ethics do not lead them away from temptation. Bernie Madoff may be a prime example of such an opportunist in today’s news. Sometimes, criminal behavior results from the emphasis of profit over ethical behavior. For example, we might think of corporate environmental crimes, in which corporations decide not to follow regulatory requirements regarding hazardous waste disposal or storage. In the end, of course, the reasons for the criminal behavior do not matter. When a crime is committed, others will be injured, and the wrongdoer will be subject to criminal prosecution.

Everyone must be diligent about crime. Crimes affect businesses both from the inside and from the outside. Even if individuals are honest in their dealings, that does not relieve them from the necessity to maintain a vigilant watch to protect not only their good name but also that of their business from the criminal activities of others. Criminal activity “from the outside” can be costly to businesses. Loss through property damage, theft, shoplifting, corporate espionage, fraud, and arson are real threats. Perhaps more insidiously, threats “from the inside” also pose tremendous risk of loss. These activities include crimes such as embezzlement, computer crimes, and fraud. Such “inside jobs” are perhaps more unsettling because the perpetrators are often trusted colleagues who would not ordinarily fall under the suspicion of others. Moreover, a corporation must also protect itself from the bad judgment or overzealous behavior of its employees. If an employee acting

within the scope of employment commits a crime from which the corporation itself will benefit, then the corporation can be convicted of the crime, too. Of course, not all corporations that are convicted on criminal charges are hapless victims of an overzealous employee who commits crimes on their behalf. Other businesses are actively involved in crime, whether through a corporate culture run amok or through outright organized crime, such as money laundering.

Let's explore criminal law in the business world. Not only do we need to understand basic criminal law and the nature of crime in business to understand everyday headlines, but we also must ensure that our own professional dealings and the people associated with our businesses are never the legitimate focus of such stories. This chapter explores the differences between criminal law and civil law, the nature of criminal law, the constitutional protections afforded to those accused of committing a crime, relevant defenses, consequences of committing crimes, and the goals of punishment. It also examines specific crimes relevant to business, including white-collar crime, blue-collar crime that harms businesses, and crimes committed by businesses. Last, it examines different strategies to minimize exposure to criminal liability.

Key Takeaways

Criminal law is relevant to business because crime presents real threats. When crimes are committed, people are injured. Criminal behavior is punishable by law. Risks to business posed by crime arise from the losses suffered from the criminal activities of those on the outside of the business organization, as well as those on the inside. Corporations themselves can be liable for crime when an employee working within the scope of employment commits crime that benefits the corporation, or when the corporation itself commits crime.

10.1 The Nature of Criminal Law, Constitutional Rights, Defenses, and Punishment

LEARNING OBJECTIVES

1. Understand what crime is.
2. Compare and contrast the differences between criminal law and civil law.
3. Understand the constitutional protections afforded to those accused of committing a crime.
4. Examine some common defenses to crime.
5. Learn about the consequences of committing a crime.
6. Explore the goals or purposes of punishment for committing a crime.

Imagine a bookkeeper who works for a physicians group. This bookkeeper's job is to collect invoices that are due and payable by the physicians group and to process the payments for those invoices. The bookkeeper realizes that the physicians themselves are very busy, and they seem to trust the bookkeeper with the task of figuring out what needs to be paid. She decides to create a fake company, generate bogus invoices for "services rendered," and send the invoices to the physicians group for payment. When she processes payment for those invoices, the fake company deposits the checks in its bank account—a bank account she secretly owns. This is a fraudulent disbursement, and it is just one of many ways in which crime occurs in the workplace. Check out [Note 10.4 "Hyperlink: Thefts, Skimming, Fake Invoices, Oh My!"](#) to examine several other common embezzlement schemes easily perpetrated by trusted employees.

Figure 10.2 Courthouse



© Thinkstock

Hyperlink: Thefts, Skimming, Fake Invoices, Oh My!

<http://www.acfe.com/resources/view.asp?ArticleID=1>

Think it couldn't happen to you? Check out common schemes perpetrated by trusted employees in this article posted on the Association of Certified Fraud Examiners' Web site.

When crime occurs in the workplace or in the context of business, the temptation might be to think that no one is “really” injured. After all, insurance policies can cover some losses. Sometimes people think that if the victims of embezzlement do not immediately notice the embezzlement, then they must not “need” the money anyhow, so no real crime has been committed. Of course, these excuses are just smoke screens. When an insurance company has to pay for a claim arising from a crime, the insurance company is injured, as are the victim and society at large. Similarly, the fact that wealthy people or businesses do not notice embezzlement immediately does not mean that they are not entitled to retain their property. Crime undermines confidence in social order and the expectations that we all have about living in a civil society. No crime is victimless.

A **crime**¹ is a public injury. At the most basic level, criminal statutes reflect the rules that must be followed for a civil society to function. Crimes are an offense to civil society and its social order. In short, crimes are an offense to the public, and someone who commits a crime has committed an injury to the public.

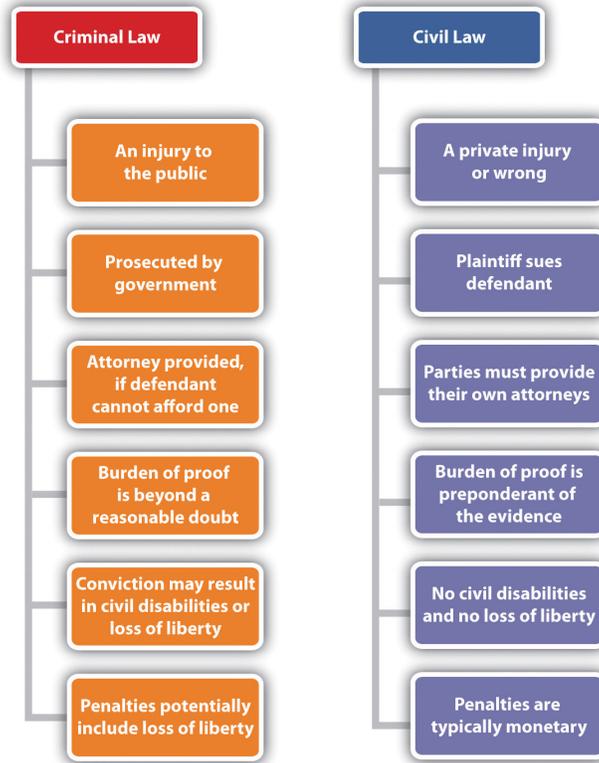
Criminal law differs from civil law in several important ways. See [Figure 10.3 "Comparison between Criminal Law and Civil Law"](#) for a comparison. For starters, since crimes are public injuries, they are punishable by the government. It is the government's responsibility to bring charges against criminals. In fact, private citizens may not prosecute each other for crimes. When a crime has been committed—for instance, if someone is the victim of fraud—then the government collects the evidence and files charges against the defendant. When someone is charged with committing a crime, he or she is charged by the government in an **indictment**². The victim of the crime is a witness for the government but not for the prosecutor of the case. Note that our civil tort system allows a victim to bring a civil suit against someone for injuries inflicted on the victim by someone else. Indeed, criminal laws and torts often have parallel causes of action. Sometimes these claims carry the same or similar names. For instance, a victim of fraud may

1. A public injury.

2. A formal document in which the government accuses a legal person of a crime.

bring a civil action for fraud and may also be a witness for the state during the criminal trial for fraud.

Figure 10.3 Comparison between Criminal Law and Civil Law



3. The presumption made about any criminal defendant prior to verdict. Criminal defendants do not have to prove their innocence.
4. To be found not guilty of a crime.
5. A duty to prove. In a criminal trial, the burden of proof is on the prosecution. In a civil trial, the burden of proof is usually the plaintiff's burden.
6. The standard of proof in a criminal trial. It means that the evidence must be so compelling that there is no reasonable doubt as to the defendant's guilt.
7. A guilty mind, or a criminal state of mind.
8. The guilty act, or the criminal action.
9. The standard of proof in a civil trial. It means that the evidence that supports the claim is more likely than not.

In a criminal case, the defendant is presumed to be innocent unless and until he or she is proven guilty. This **presumption of innocence**³ means that the state must prove the case against the defendant before the government can impose punishment. If the state cannot prove its case, then the person charged with the crime will be **acquitted**⁴. This means that the defendant will be released, and he or she may not be tried for that crime again. The **burden of proof**⁵ in a criminal case is the prosecution's burden, and the prosecution must prove its case **beyond a reasonable doubt**⁶. This means that the defendant does not have to prove anything, because the burden is on the government to prove its case. Additionally, the evidence must be so compelling that there is no reasonable doubt as to the defendant's guilt. To be convicted of a crime, someone must possess the required criminal state of mind, or **mens rea**⁷. Likewise, the person must have committed a criminal act, known as **actus reus**⁸.

Compare this to the standard of proof in a civil trial, which requires the plaintiff to prove the case only by a **preponderance of the evidence**⁹. This means that the

evidence to support the plaintiff's case is greater (or weightier) than the evidence that does not. It's useful to think of the criminal standard of proof—beyond a reasonable doubt—as something like 99 percent certainty, with 1 percent doubt. Compare this to preponderance of the evidence, which we might think of as 51 percent in favor of the plaintiff's case, but up to 49 percent doubt. This means that it is much more difficult to successfully prosecute a criminal defendant than it is to bring a successful civil claim. Since a criminal action and a civil action may be brought against a defendant for the same incident, these differences in burdens of proof can result in verdicts that seem, at first glance, to contradict each other. Perhaps the most well-known cases in recent history in which this very outcome happened were the O. J. Simpson trials. Simpson was acquitted of murder in a criminal trial, but he was found liable for wrongful death in a subsequent civil action. Check out [Note 10.14 "Hyperlink: Not Guilty Might Not Mean Innocent"](#) for a similar result in the business context.

Hyperlink: Not Guilty Might Not Mean Innocent

<http://www.bloomberg.com/apps/news?pid=20601103&sid=a89tFKR40evM>

Richard Scrushy of HealthSouth was acquitted of several criminal charges relating to accounting fraud but was found civilly liable for billions. He was subsequently found guilty in a later criminal case for different crimes committed.

This extra burden reflects the fact that the defendant in a criminal case stands to lose much more than a defendant in a civil case. Even though it may seem like a very bad thing to lose one's assets in a civil case, the loss of liberty is considered to be a more serious loss. Therefore, more protections are afforded to the criminal defendant than are afforded to defendants in a civil proceeding. Because so much is at stake in a criminal case, our **due process**¹⁰ requirements are very high for anyone who is a defendant in criminal proceedings. Due process procedures are not specifically set out by the Constitution, and they vary depending on the type of penalty that can be levied against someone. For example, in a civil case, the due process requirements might simply be notice and an opportunity to be heard. If the government intends to revoke a professional license, then the defendant might receive notice by way of a letter, and the opportunity to be heard might exist by way of written appeal. In a criminal case, however, the due process requirements are higher. This is because a criminal case carries the potential for the most serious penalties.

10. A constitutional guarantee of fairness by procedure.

Constitutional Rights Relevant to Criminal Proceedings

A person accused of a crime has several rights, which are guaranteed by the U.S. Constitution. Many crimes are state law issues. However, many provisions of the U.S. Constitution's Bill of Rights, which contains the rights of concern to criminal defendants, have been incorporated as applicable to the states. This is known as the incorporation doctrine.

The Sixth Amendment guarantees that criminal defendants are entitled to an attorney during any phase of a criminal proceeding where there is a possibility of incarceration. This means that if a defendant cannot afford an attorney, then one is appointed for him or her at the state's expense.

The Fifth Amendment guarantees the right to avoid self-incrimination. This right means that the government cannot torture someone accused of committing a crime. Obviously, someone under the physical and psychological pain of torture will admit to anything, and this might be a strong incentive to allow torture if the government wanted someone to confess to a crime. However, the Fifth Amendment guarantees that people can choose to remain silent. No one is compelled to testify against himself or herself to make self-incriminating statements.

The Eighth Amendment prohibits cruel and unusual punishment. We do not employ many techniques that were once used to punish people who committed crimes. For instance, we do not draw and quarter people, which was a practice in England during the Middle Ages. Recently, however, the question of the use of torture by the United States against aliens on foreign soil has been a hot topic. Many people believe that our Eighth Amendment protections should be extended to everyone held by U.S. authorities, whether they are on U.S. soil or not.

The Fourth Amendment provides a prohibition against illegal searches and seizures. This means that if evidence were obtained in violation of the Fourth Amendment, then it cannot be used against the defendant in a court of law. For Fourth Amendment requirements to be met, the government must first obtain a search warrant to search a particular area for particular items if there is a reasonable expectation of privacy in the area to be searched. The search warrant is issued only on **probable cause**¹¹. Probable cause arises when there is enough evidence, such as through corroborating evidence, to reasonably lead to the belief that someone has committed a crime.

11. The standard required for a search warrant to be issued. It arises when there is enough evidence, such as through corroborating evidence, to reasonably lead to the belief that someone has committed a crime.

If a valid search warrant is issued, then the government may search in the area specified by the warrant for the item that is the subject of the warrant. If a search occurs without a warrant, the search might still be legal, however. This is because

12. An exception to the warrant requirement, specifically when an emergency exists, such as a hot pursuit.
13. An exception to the warrant requirement, in which a person with valid authority permits a search to proceed without a warrant.
14. An exception to the warrant requirement, specifically when the vehicle is detained pursuant to a lawful stop.
15. An exception to the warrant requirement, specifically referring to a pat-down search permitted when someone is lawfully arrested.
16. An exception to the warrant requirement, specifically permitted when a person is stopped for some permissible purpose by law enforcement officers. Allows a pat-down search or a “frisk.”
17. A means to suppress evidence that was obtained illegally.

there are several exceptions to the requirements for a search warrant. These include the plain view doctrine, exigent circumstances, consent, the automobile exception, lawful arrest, and stop and frisk. The plain view doctrine means that no warrant is required to conduct a search or to seize evidence if it appears in the plain view of a government agent, like a police officer. **Exigent circumstances**¹² mean that no warrant is required in the event of an emergency. For instance, if someone is cruelly beating his dog, the state can remove the dog without a warrant to seize the dog. The exigent circumstances exception to the warrant requirement is used in hot pursuit cases. For example, if the police are in hot pursuit of a suspect who flees into a house, the police can enter the house to continue the pursuit without having to stop to first obtain a warrant to enter the house. **Consent**¹³ means that the person who has the authority to grant consent for a search or seizure has granted the consent. This does not necessarily have to be the owner of the location to be searched. For example, if your roommate consents to a search of your living room, which is a common area shared by you and your roommate, then that is valid consent, even if the police find something incriminating against you and you or your landlord did not consent to the search. The **automobile exception**¹⁴ means that an automobile may be searched if it has been lawfully stopped. When a police officer approaches a stopped car at night and shines a light into the interior of the car, the car has been searched. No warrant is required. If the police officer spots something that is incriminating, it may be seized without a warrant. Additionally, no warrant is required to search someone who is subject to **lawful arrest**¹⁵. This exception exists to protect the police officer. For instance, if the police could not search someone who was just arrested, they would be in peril of injury from any weapon that the person in custody might have possession of. Similarly, if someone is stopped lawfully, that person may be frisked without a warrant. This is the **stop and frisk**¹⁶ exception to the warrant requirement.

In the business context, it is also important to note that administrative agencies in certain limited circumstances may conduct warrantless searches of closely regulated businesses, such as junkyards, where many stolen cars are disassembled for parts that can be sold.

Defenses

If the government violates a defendant’s constitutional rights when collecting evidence, then the evidence gathered in violation of those rights may be suppressed at trial. In other words, it may not be used against the defendant in trial. This is because evidence obtained through an illegal search is “fruit of the poisonous tree.” The fruit of the poisonous tree doctrine is known as the **exclusionary rule**¹⁷. You should know, however, that lying to the defendant, or using forms of trickery and deceit, are not constitutional violations.

Another common defense arises under the exclusionary rule regarding confessions. This is when the government, while holding someone in a **custodial interrogation**¹⁸, questions that person without first reading the **Miranda warnings**¹⁹. If someone is subjected to a custodial interrogation, he or she must first be read the Miranda warnings, which you have probably heard in the movies. Though the U.S. Supreme Court did not script the warnings specifically, the warnings are usually delivered in language close to this: “You have the right to remain silent. Anything that you say can and will be used against you in a court of law. You have the right to an attorney. If you cannot afford an attorney, one will be provided to you by the state. Do you understand your rights?”

The purpose of the Miranda warnings is to ensure that people understand that they have the right not to make self-incriminating statements and that they have the right to have counsel. If someone wants to invoke his or her rights, he or she has to do so unequivocally. “Don’t I need a lawyer?” is not enough.

18. Occurs when a suspect is in custody, which means that the suspect cannot leave, and subject to interrogation, which means that words spoken or actions undertaken by government officials are likely to induce a response.

19. Read to persons in custody, so that they are made aware of some of their constitutional rights. Failure to read Miranda warnings when someone is subject to a custodial interrogation may render statements uttered by the suspect inadmissible under the exclusionary rule.

20. This means that the government may not prosecute someone twice for the same offense. It is prohibited by the Fifth Amendment to the U.S. Constitution.

21. A lack of capacity defense, specifically applicable when the defendant did not understand that his or her actions were wrong.

22. A defense that may be used by persons who have not yet reached the age of majority, typically eighteen years of age.

The Miranda warnings are not required unless someone is in custody and subject to interrogation. Someone in custody is not free to leave. So if a police officer casually strikes up a conversation with you while you are shopping in the grocery store and you happen to confess to a crime, that confession will be admissible as evidence against you even though you were not Mirandized. Why? Because you were not in custody and you were free to leave at any time. Likewise, if the police are not interrogating a person, then any statement made can also be used against that person, even if he or she is not Mirandized. Someone is being interrogated when the statements or actions by the police (or other government agent) are likely to give rise to a response.

Another defense provided by the U.S. Constitution is the prohibition against **double jeopardy**²⁰. The Fifth Amendment prohibits the government from prosecuting the same defendant for the same crime after he or she has already stood trial for it. This means that the government must do a very thorough job in collecting evidence prior to bringing a charge against a defendant, because unless the trial results in a hung jury, the prosecution will get only that one chance to prosecute the defendant.

Other defenses to crime are those involving lack of capacity, including insanity and infancy. **Insanity**²¹ is a lack of capacity defense, specifically applicable when the defendant lacks the capacity to understand that his actions were wrong. **Infancy**²² is a defense that may be used by persons who have not yet reached the age of majority, typically eighteen years of age. Those to which the infancy defense applies are not “off the hook” for their criminal actions, however. Juvenile offenders may be sentenced to juvenile detention centers for crimes they commit, with common

goals including things like education and rehabilitation. In certain circumstances, juvenile offenders can be tried as adults, too.

Last, the state may not induce someone to commit a crime that he or she did not already have the propensity to commit. If the state does this, then the defendant will have the defense of **entrapment**²³.

Punishment

If convicted in a criminal case, the defendant will be punished by the government, rather than by the victim. Once a defendant is convicted of a crime, he or she is a **criminal**²⁴. Punishment for criminal offenses can include fines, restitution, forfeiture, probation, civil disabilities, and a loss of liberty. Loss of liberty means that the convicted criminal may be forced to do community service, may be subject to house arrest, may be incarcerated or, in some states that have the death penalty, may even lose his or her life.

Length of incarceration varies depending on whether the conviction was for a **misdemeanor**²⁵ or a **felony**²⁶. A misdemeanor is a less serious offense than a felony, as determined by the legislative body and reflected in the relevant statutes. Even an **infraction**²⁷, such as a parking ticket, is a criminal offense, typically carrying a penalty of a fine. An infraction is considered less serious than a misdemeanor.

When someone is convicted of violating a state criminal statute—a felony, misdemeanor, or infraction—the penalty will be set by the statute. For instance, the statute might state that the punishment will be “up to \$5,000” or “up to one year in jail.” Often, the possible punishments are given in a range, which allows the judge leeway to take other matters into consideration when sentencing the offender. For example, if someone is convicted of a misdemeanor that carries a penalty of up to one year in jail, but that person is a first-time offender with no prior criminal history, the judge might impose a sentence of some lesser time in jail, such as thirty days, or no jail time whatsoever.

Historically, all judges had the leeway to use their judgment when sentencing convicted criminals. However, disparities in sentences gave rise to concern about unequal treatment for similar offenses. In the 1980s the U.S. Sentencing Commission established the **Federal Sentencing Guidelines**²⁸, which were understood to be mandatory guidelines that federal judges were expected to use when sentencing offenders. The mandatory nature of these guidelines led some to observe that extremely harsh penalties were mandated for relatively minor offenses, given certain circumstances. Today, however, the federal guidelines are only advisory, due to the U.S. Supreme Court’s decision in *United States v. Booker*,

23. A defense that may be raised by a criminal defendant. Entrapment occurs when the government induces someone to commit a crime that he or she had no previous propensity to commit.

24. A legal person convicted of a crime.

25. A criminal offense that is less serious than a felony but more serious than an infraction.

26. A serious criminal offense, punishable with a prison sentence of more than one year or, in some circumstances, death.

27. A criminal offense, which is less serious than a misdemeanor.

28. Created by the U.S. Sentencing Commission to provide advisory guidelines to federal judges when sentencing criminals.

which held that a wide range of factors should be taken into consideration when sentencing offenders. *United States v. Booker*, 543 U.S. 220 (2005). This opinion restored to federal district court judges the power to exercise their judgment when sentencing federal offenders. Several states, however, passed their own versions of sentencing guidelines, and state trial court judges in those states must rely on those guidelines when sentencing state offenders. This has led to controversial “three strikes” laws, which can also carry extremely harsh penalties—such as incarceration for twenty-five years to life—for relatively minor offenses.

Often, the convicted criminal will be subject to various civil disabilities, depending on the state in which he or she lives. For instance, a **felon**²⁹, which is a criminal that has been convicted of a felony, may be prohibited from possessing firearms, running for public office, sitting on a jury, holding a professional license, or voting. A felon may be subject to deportation if he or she is an illegal immigrant.

Besides loss of liberty and civil disabilities, other forms of punishment exist. Some of these are also appropriate in civil cases. Punishment for crimes also includes a **fine**³⁰, which is a monetary penalty for committing an offense. Fines can also be levied in civil cases. **Restitution**³¹, which is repayment for damage done by the criminal act, is a common punishment for property damage crimes such as vandalism. Restitution can also be an appropriate remedy in civil law, particularly in contracts disputes. **Forfeiture**³², which means involuntarily losing ownership of property, is also a punishment, and it is commonly used in illegal drug trafficking cases to seize property used during the commission of a crime. Check out [Note 10.39 "Hyperlink: Shopping, Anyone?"](#), which is the U.S. Marshall’s Assets Forfeiture page, to see forfeited property currently available for sale. Finally, **probation**³³ is a common penalty for committing crime. Probation is when the criminal is under the supervision of the court but is not confined. Typically, the terms of the probation require the criminal to periodically report to a state agent, such as a probation officer.

29. A legal person convicted of a felony.

30. A monetary penalty.

31. Penalty levied to repay to damages.

32. Involuntarily losing ownership of property that was used in criminal activities.

33. A common penalty for committing crime, which means that the criminal is under the supervision of the court but is not confined.

Hyperlink: Shopping, Anyone?

<http://www.usmarshals.gov/assets/assets.html>

Purpose of Punishment

Conviction of a crime carries criminal penalties, such as incarceration. But what is the purpose of punishment? We do not have a vigilante system, where victims may

bring their own form of justice to an offender. If we had such a system we would have never-ending feuds, such as the infamous and long-standing nineteenth-century dispute between the Hatfields and McCoys from the borderlands of West Virginia and Kentucky.

Several goals could be the focus of a criminal justice system. These could include retribution, punishment, rehabilitation, the protection of society, or deterrence from future acts of crime. Our criminal justice system's penalties ostensibly do not exist for the purpose of retribution. Rather, rehabilitation, punishment, the protection of society, and deterrence from committing future crimes are the oft-cited goals. The Federal Bureau of Prisons captures some of these concepts in its mission statement. Federal Bureau of Prisons, "Mission and Vision of the Bureau of Prisons," <http://www.bop.gov/about/mission.jsp> (accessed September 27, 2010). Sadly, rehabilitation programs are not always available or, when they are, they are not always considered appropriate—or, when appropriate, they do not always work. Additionally, the goal of deterrence is not always achieved, as reflected in high recidivism rates in the United States.

Punishment of Business-Related Crime

Punishments committed by "white-collar criminals" are the same as those committed by any criminal. **White-collar crime**³⁴ is a term used to describe nonviolent crimes committed by people in their professional capacity or by organizations. Individuals involved in white-collar crime are criminally liable for their own actions.

Additionally, since a corporation is a legal person, then the corporation can be convicted of committing crimes, too. Accordingly, corporations can be punished. However, not all constitutional protections afforded to individuals are available to corporations. For instance, a corporation does not have the right against self-incrimination.

One difficulty that arises is the question of how to punish a corporation for engaging in criminal activity. After all, as they say, a corporation does not have a soul to rehabilitate or a body to incarcerate. Albert W. Alschuler, "Two Ways to Think about the Punishment of Corporations," *American Criminal Law Review, Public Law and Legal Theory Series*, No. 09-19, 2009, p. 13, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1491263 (accessed September 27, 2010). This is a paraphrase of a remark first uttered by Lord Chancellor Thurlow between 1778 and 1792: "No soul to damn, no body to kick." This is very different from a human being, who will stand to lose his or her liberty or who might be subject to mandatory counseling.

34. A term used to describe nonviolent crimes committed by people in their professional capacity or by organizations.

We might argue that a criminal corporation should have its corporate charter revoked, which would be equivalent to a corporate death penalty. However, if that happened, a lot of innocent people who were not involved in the criminal activity would be harmed. For instance, employees would lose their jobs, and suppliers and customers would lose the goods or services of the corporate criminal. Entire communities could suffer the consequences of a few bad actors.

On the other hand, corporations must be punished to respect the goal of deterrence of future crimes. One way that corporations are deterred is by the imposition of hefty fines. It is not uncommon to base such penalties on some percentage of profits, or all profits derived from the ill-gotten gains of criminal activity.

Corporations that are criminals also lose much in the way of reputation. Of course, reputational damage can be very difficult to repair.

KEY TAKEAWAYS

Crime is a public injury. Criminal law differs from civil law in important ways, including who brings the claim, the burden of proof, due process, postconviction civil disabilities, and penalties. Those who are accused of committing a crime are afforded a high level of due process, including constitutional protections against illegal searches and seizures, and self-incrimination; guarantee of an attorney; and prohibition against cruel and unusual punishment. Several common defenses to crimes exist. If convicted, criminals can face loss of liberty, with sentencing structures based on statutory language and, in the federal system, guided by the U.S. Federal Sentencing Guidelines. The goals of imposing penalties for violating criminal laws include protecting society, punishing the offender, rehabilitating the offender, and deterrence from future acts of crime. Corporations can also be convicted of crimes, though unique questions relating to appropriate means of punishment arise in that context.

EXERCISES

1. Imagine a woman who suffers from dementia and lives in an assisted living facility. One day, she wanders into another resident's room and picks up an antique vase from the other resident's bureau. As she holds the vase, she forgets that it belongs to someone else and walks out of the room with it. Later, she places it on her own nightstand, where she admires it greatly. Has there been a crime here? Why or why not?
2. Consider the case of O. J. Simpson, in which a criminal jury acquitted him of murder, but a civil court found him liable for wrongful death. Both trials arose out of the same incident. Do you think that the burden of proof should be the same for a civil case as it is for a criminal case? Why?
3. What should be the goal of penalties or punishments for criminal offenses? Compare and contrast how our criminal justice system would differ if the goal of punishment was each of the following: retribution, rehabilitation, protection of society, or deterrence from future acts of crime.
4. Consider the difference between minimum security federal prison camps and medium or high-level securities facilities, described here: <http://www.bop.gov/locations/institutions/index.jsp>. Should white-collar criminals receive the same punishment as those convicted of committing a violent crime? Why or why not?
5. Before listening to the link in this assignment, write down your perceptions of "federal prison camp." Then, listen to an interview with a convicted white-collar criminal here: <http://discover.npr.org/features/feature.jhtml?wfid=1149174>. Compare your initial perceptions with what you have learned from this interview. How are they the same? How do they differ?
6. How should a corporation be punished for committing a crime? Find an example of a corporation that was convicted of a crime. Do you believe that the punishment was appropriate? Discuss.
7. What kinds of crimes do college students commit? While the vast majority of college students wouldn't even think of committing a violent crime, many students do engage in crimes they believe to be victimless, such as downloading movies or buying and selling prescription drugs like Adderall or Ritalin. Are these crimes actually victimless?
8. The exclusionary rule was created by the Supreme Court as a means of punishing the police for violating a defendant's constitutional rights. Some legal commentators, including several members of the Supreme Court, believe the exclusionary rule should be abolished. Without it, how do you think society can ensure the police will not violate a citizen's constitutional rights?

10.2 Crime

LEARNING OBJECTIVES

1. Examine white-collar crimes.
2. Examine blue-collar crimes that harm businesses.
3. Examine the crimes committed by businesses.

Imagine that you work in a publicly traded corporation as an accountant. One day, your manager calls you. You sense desperation in his voice as he whispers, “Quick! Shred the paper copies of the financial records!” Will you do it? After all, how can shredding paper be a crime? Not so fast. It may be a crime under the Sarbanes-Oxley Act, specifically if you destroy documents before the statutory length of time required to hold them. After studying this section, you should be able to recognize when the answer to such questions should be a resounding “No!” Indeed, after reading this section, you should be able to spot criminal activity, which may lead to tough decisions, such as whether you should be a whistleblower or not.

Figure 10.4



Disappearing evidence?

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This section addresses crimes relevant to business concerns. A business must be concerned about criminal activity from the inside, from the outside, and through its own actions.

White-Collar Crime

White-collar crime³⁵ is a term used to describe nonviolent crimes committed by people in their professional capacity, or by organizations. These crimes are committed for financial gain, often through deception. Historically, this term derives from a reference to the “white collars” that managers, executives, or professionals who committed these crimes wore as their everyday attire, rather than the “blue collars” of the factory workers and laborers. White-collar crimes are not typical street crimes, like burglary or robbery, and they are not person crimes, like murder or rape. Rather, the term is used to describe crime committed in the professional work environment, for the purpose of obtaining a financial reward

35. A term used to describe nonviolent crimes committed by people in their professional capacity or by organizations.

through the use of deception. White-collar criminals frequently commit their crimes on the job, in broad daylight, while sitting at a desk.

But what leads an otherwise successful businessperson or organization to commit a white-collar crime? After all, if someone is earning a good salary, or if a business is financially healthy, why would he or she choose to violate the law? While names like Kenneth Lay of Enron and Bernie Ebbers of WorldCom are virtually synonymous with corporate greed, lack of ethical decision making, and fraudulent behavior, these examples do not provide satisfactory answers to this question. Indeed, businesses must be vigilant against white-collar crime, because there is no absolute way to identify those who might turn to criminal behavior in the workplace. White-collar crime can involve fraud or larceny, organized crime, cybercrime, and environmental crime.

Fraud and Larceny

White-collar crimes generally involve the use of deception to acquire money or property. This is the very definition of **fraud**³⁶. Many white-collar crimes are versions of fraud. Sometimes, white-collar crime involves outright **larceny**³⁷, which is the trespassory taking of property with the intent to deprive the owner of the property. In both types of white-collar crime, the criminal is trying to take property for his or her own financial gain.

Fraud is found in many contexts. For instance, many regulatory violations, like **insider trading**³⁸, are forms of fraud. Specifically, these are **securities fraud**³⁹. Securities fraud is when someone uses deception to circumvent the regulations or statutes interpreted by the U.S. Securities and Exchange Commission (SEC) to acquire money or property. Goldman Sachs was recently charged by the SEC for securities fraud, because it allegedly misrepresented material facts to investors to gain financially. Check out [Note 10.49 "Hyperlink: SEC v. Goldman Sachs"](#) to review the complaint.

36. The use of deception to acquire money or property.

37. The trespassory taking of property with the intent to deprive the owner of it.

38. A form of securities fraud.

39. Fraud committed in the context of investments regulated by the SEC.

Hyperlink: SEC v. Goldman Sachs

One of Goldman Sachs's employees, Fabrice Tourre, self-named the "Fabulous Fab," was also named as a defendant in the complaint. Do you think that the Fabulous Fab should bear criminal liability for misleading investors, even if he did mislead investors?

<http://www.sec.gov/litigation/complaints/2010/comp21489.pdf>

The Fabulous Fab's testimony before Congress:

<http://www.cbsnews.com/video/watch/?id=6436867n&tag=related;photovideo>

Health care fraud⁴⁰ is also a common type of white-collar crime. A physician who submits false claims to health insurance companies to receive money is a common example. Check out [Note 10.51 "Hyperlink: Health Care Fraud's Epidemic"](#) to see the U.S. Department of Justice's comments regarding health care fraud.

Hyperlink: Health Care Fraud's Epidemic

<http://www.fbi.gov/news/videos/mp4/heat062409.mp4/view>

This link is a video of the U.S. Department of Justice's comments concerning recent indictments against several individuals accused of creating "straw patients" to submit claims to Medicaid to receive money. You can see how someone who creates fake patients to receive money has committed fraud, because he or she is using deception (fake patients) to acquire money (Medicaid payments).

40. Fraud committed in the context of the health care field.

41. The use of deception to receive insurance funds.

Insurance fraud⁴¹ is the use of deception to receive insurance funds. For instance, if someone falsely reports that her office was burglarized and her computer equipment was stolen, and asks her insurance company to cover the loss, then this constitutes insurance fraud. This is because the person is lying (using deception) to acquire an insurance payment (acquiring money). A common context for insurance

fraud is arson. If someone intentionally burns down his office building because he wishes to collect under his fire insurance policy, then he has committed insurance fraud by **arson**⁴². Arson is the act of intentionally setting fire to property.

Financial institution fraud⁴³ is fraud against banks and other similar institutions, such as credit unions. The IRS investigates financial institution fraud. Cases of financial institution fraud can involve people who falsify tax documents, or profit and loss statements to gain funding from banks, as well as those who commit **money laundering**⁴⁴. Check out Note 10.56 "Hyperlink: Financial Institution Fraud" for several financial institution fraud cases, most of which are excellent examples of white-collar crime.

Hyperlink: Financial Institution Fraud

<http://www.irs.gov/compliance/enforcement/article/0,,id=213770,00.html>

Consider another type of fraud, where the deception is perhaps better hidden. Bernie Madoff committed massive fraud in a scheme known as a **Ponzi scheme**⁴⁵. A Ponzi scheme is a pyramid scheme, where people pay in. Those at the top of the pyramid may receive something that appears to be a return on their investment, but those at the bottom do not. This is because the funds paid in by those at the bottom are used to pay the people at the top. Those who operate Ponzi schemes generally solicit investors, and those who invest in such schemes are expecting a legitimate return on investment (ROI). However, the master of the Ponzi scheme does not really invest the funds. He simply takes them, and keeps his early “investors” happy by bringing in new investors, whose money he gives to the old investors as their ROI. This allows the Ponzi scheme to continue, because it appears from the outside that investors are receiving a legitimate ROI. The problem is that the capital contributions eventually disappear, since they are never invested but are simply used by the criminal for his own purposes, including covering his tracks for as long as possible by paying investors with fake ROI payments as necessary. To continue, the pyramid must get bigger and bigger. That is because new investors must be attracted to keep the cash flow going. Eventually, of course, pyramids will eventually collapse under their own unsustainable structure. Check out Note 10.58 "Hyperlink: The Mechanics of a Pyramid Scheme" for an illustration of a pyramid scheme from the SEC.

42. The act of intentionally setting fire to property.

43. Fraud against banks and other similar institutions, such as credit unions.

44. Occurs when funds gained from illegal activities are processed through a seemingly legitimate business to “clean” the funds from association with criminal activities.

45. A pyramid scheme, which is a particular type of fraud.

Hyperlink: The Mechanics of a Pyramid Scheme

<http://www.sec.gov/answers/pyramid.htm>

Madoff was a wealth manager who defrauded investors out of billions of dollars. How does someone get away with this? Interestingly, Harry Markopolos, a financial analyst, flagged Madoff's actions to the SEC as statistically impossible long before Madoff was caught. Check out [Note 10.59 "Hyperlink: Too Good to Be True? Statistically Impossible Returns"](#) to watch Mr. Markopolos explain this by using sports analogies. This raises interesting legal questions regarding whether the SEC is proactive enough. The SEC actions are often reactive, responding to a situation after it happened.

Hyperlink: Too Good to Be True? Statistically Impossible Returns

<http://www.cbsnews.com/video/watch/?id=4834874n&tag=related;photovideo>

Investors aren't the only potential victims of white-collar crime. Owners of businesses are also potential victims. For example, **embezzlement**⁴⁶ is a common crime, and it occurs when someone takes property that was in his or her possession lawfully and then converts it to his or her own use. As you can see, Bernie Madoff was an embezzler because he lawfully had possession of his clients' money, but then he wrongfully converted those funds to his own use, rather than exercising his fiduciary duty to his clients. Embezzlement differs from larceny, because larceny requires the trespassory taking of property with the intent to deprive the owner of the property. In other words, in a larceny, the thief is not supposed to have possession of the property to begin with. Someone who embezzles something, however, has the right to be in possession of the property to start with but then wrongfully converts it (steals it) for his or her own use. Embezzlement strategies can involve **forgery**⁴⁷, which is counterfeiting someone else's signature or other document. It can also involve **wire fraud**⁴⁸ if the embezzlement uses electronic communications. 18 U.S.C. §1343. Refer again to [Note 10.4 "Hyperlink: Thefts, Skimming, Fake Invoices, Oh My!"](#) to learn about many different embezzlement schemes.

46. Occurs when someone takes property that was in his or her possession lawfully and then converts it to his or her own use.

47. A form of counterfeiting.

48. Fraud committed over interstate wire, such as by telephone.

Corporate espionage⁴⁹ and **misappropriation**⁵⁰ are crimes in which a competitor or would-be competitor has acted illegally to obtain trade secrets of another. The **Economic Espionage Act**⁵¹ is a federal statute that criminalizes the theft of trade secrets. In a recent case of corporate espionage, Starwood Hotels sued Hilton, claiming that Hilton, along with some of its executives, stole millions of dollars in confidential trade secrets that were used to compete with Starwood's successful chain of hotels.

Organized Crime

While the term "organized crime" often summons images of the mafia, that is not the only type of organized criminal activity in this country. Consider the recent case against Pfizer, which settled with the U.S. Department of Justice in 2009. Pfizer's subsidiaries, Pharmacia and Upjohn, had been selling pharmaceuticals "off-label" in doses and for uses not approved by the Food and Drug Administration (FDA), and it had been providing kickbacks to physicians to prescribe those drugs. The subsidiaries agreed to plead guilty to misbranding with the intent to defraud or mislead. They paid a criminal fine of more than one billion dollars and forfeited their profits from their illegal activities. Not only did they plead guilty to a criminal violation, but they also had to pay a hefty penalty for violating civil law, particularly related to paying kickbacks to physicians. FBI Press Release, "The Case Against Pfizer: A Record \$2.3 Billion Settlement," September 2, 2009, http://www.fbi.gov/page2/sept09/pfizer_settlement_090209.html (accessed September 27, 2010). **Kickbacks**⁵² are incentive payments that are given to someone who makes decisions to encourage others to pay for something. The repercussions of this conviction are certainly felt by those who were without knowledge of these acts, such as the shareholders and many employees, not to mention the patients who were subjected to off-label marketing in the contexts of what otherwise should have been trusting relationships with their physicians.

49. The use of deception to acquire the secrets of an economic competitor for financial gain.

50. Obtaining a trade secret by improper means.

51. A federal statute that criminalizes the theft of trade secrets, among other things.

52. Incentive payments that are given to someone who makes decisions to encourage others to pay for something.

53. A federal statute that penalizes racketeering activities.

The **Racketeer Influenced and Corrupt Organizations Act (RICO)**⁵³ is a federal statute that, if violated, can add substantial prison time to a convicted criminal's sentence. Even if someone is not per se involved with organized crime, RICO charges can be brought against a defendant who has violated the statute. This statute punishes those engaged in a pattern (at least two) of racketeering activities—which include a wide range of activities typically associated with organized crime—over a ten-year period, 18 U.S.C. §1961(5). when funds from those activities were used to maintain, operate, or acquire a legitimate business. Racketeering activities include crimes such as loan-sharking, bookmaking, money laundering, counterfeiting, smuggling, blackmailing, human trafficking, and other similar crimes. Although RICO was written to target traditional organized crime, less than 10 percent of RICO cases filed have been against the mafia. RICO is now used against insurance companies, stock brokerages, tobacco companies, banks, and

other large commercial enterprises. RICO also has a civil provision allowing a competitor to file RICO charges, which come with triple damages if the suit is successful.

Bribery⁵⁴ occurs when someone pays a government official to influence the official's decision or actions in his or her official capacity for the benefit of the person paying the bribe. The **Foreign Corrupt Practices Act (FCPA)**⁵⁵ outlaws bribery by U.S. companies doing business in foreign lands, though grease payments are permitted. **Grease payments**⁵⁶ are payments given to speed up a process that will occur, rather than to influence a decision. However, companies should be very careful in relying on the grease payment exception, since such payments are legal under the FCPA only if they are also legal under the laws of the country where the grease payments take place, and there are very few jurisdictions (if any) where they are indeed legal. States also have statutes against bribery.

Money laundering occurs when funds gained from illegal activities are processed through a seemingly legitimate business to “clean” the source of those funds. For example, someone who received \$10,000 for criminal activities will need to “clean” the money to be able to use it legitimately. One way this can be done is by setting up a business that handles a lot of cash, which appears to be a legitimate business. This business can overstate its earnings by \$10,000 over time by running the money through its books, thereby “cleaning” the funds. For example, if the business was a tavern, and the tavern grossed \$12,000 per month, the ill-gotten \$10,000 could be spread out over ten months by having the business claim that it grossed \$13,000 each month. In that way, the ten thousand would eventually be “laundered” or “cleaned,” because it will appear to be money received by the legitimate business itself.

In that example, if someone found out about this money laundering operation and threatened to go to the authorities unless a payment was given to him to keep quiet, then that would be a form of extortion known as blackmail. **Blackmail**⁵⁷ occurs when someone threatens to reveal a harmful truth, such as involvement in criminal activity, but agrees to remain silent if paid. **Extortion**⁵⁸ is when someone obtains property through coercion. Another example of extortion is when a neighborhood gang extracts “protection payments” from local businesses. Essentially, the gang requires payment from local businesses periodically, and if the business refuses to pay, then the gang injures the business or its owner in some way, such as through vandalism or battery.

In organized crime cases, there can be strong incentives for people not to do the right thing. Maybe they are afraid of punishment by the government. But they may also fear punishment from their organized crime communities. In such cases,

54. Occurs when someone pays a government official to influence his or her decision or actions in his or her official capacity for the benefit of the person paying the bribe.

55. A federal statute that, among other things, outlaws the payment of bribes.

56. Payments given to speed up a process that will occur, rather than to influence a decision.

57. A form of extortion that occurs when someone threatens to reveal a harmful truth, such as involvement in criminal activity, but agrees to remain silent if he is paid.

58. When someone obtains property through coercion by threat of some future action.

sometimes people do not tell the truth when they should. Someone who lies under oath, even if he or she thinks there's a good reason to do so, has committed the crime of **perjury**⁵⁹. Additionally, such a person might be charged with **obstruction of justice**⁶⁰, which is acting in a manner that creates obstacles to the administration of justice.

Antitrust laws⁶¹ seek to prevent activities that reduce or eliminate economic competition. Agreements "in restraint of trade" are prohibited. Sherman Act, 15 U.S.C. §1. These crimes involve things like collusion, allocating markets, price-fixing, and bid-rigging. Criminal convictions have been obtained for bid-rigging contracts for milk for school children, price-fixing for residential doors, and price-fixing for steel wool scouring pads. Anne K. Bingeman and Gary R. Spratling, "Criminal Antitrust Enforcement" (joint address, Criminal Antitrust Law and Procedure Workshop, American Bar Association Section of Antitrust Law, Dallas, TX, February 23, 1995), <http://www.justice.gov/atr/public/speeches/0103.htm> (accessed September 27, 2010). Check out **Note 10.76 "Video Clip: Who Said Antitrust Is Boring? Not Hollywood!"** for the movie trailer of *The Informant!*, which is based on an actual antitrust case involving illegal price-fixing.

Video Clip: Who Said Antitrust Is Boring? Not Hollywood!

Check out the movie trailer for The Informant!, which portrays the criminal price-fixing activities of senior executives at ADM Co., which is a major agribusiness. Which commodity was being price fixed? Lysine! Here is part of the trailer:

[\(click to see video\)](#)

Congress has addressed antitrust activities through the passage of several major pieces of legislation, though not all carry criminal penalties. Specifically, the **Sherman Anti-Trust Act**⁶² carries criminal penalties for antitrust violations, but other antitrust laws do not.

Cybercrime

Cybercrimes⁶³ are crimes that are committed virtually from a computer or over the Internet. These crimes are on the rise, and they include activities like hacking and identity theft. Cybercrime is a broad term that includes many white-collar crimes. Cybercrime is ubiquitous these days, because virtually every desk has a computer on it. These crimes can range from non-white-collar crimes (like possession of child pornography) to traditional white-collar crime, involving the use of deception to acquire money.

- 59. Lying under oath.
- 60. Acting in a manner that creates obstacles to the administration of justice.
- 61. Laws that seek to prevent activities that reduce or eliminate economic competition.
- 62. A federal statute prohibiting antitrust activities.
- 63. Crimes that are committed virtually.

The **Computer Fraud and Abuse Act**⁶⁴ is a federal statute that carries punishments for compromising computers used in interstate commerce or communication. It punishes those who access a computer to commit fraud, among other things. See **Table 10.1 "Summary of Computer Fraud and Abuse Act Compromising Confidentiality Provisions"** Computer Crime and Intellectual Property Section, United States Department of Justice, "Computer Fraud and Abuse Act," <http://www.justice.gov/criminal/cybercrime/ccmanual/01ccma.html> (accessed September 27, 2010). for a summary of the provisions that carry criminal punishments, as well as the statutory sentences.

Table 10.1 Summary of Computer Fraud and Abuse Act Compromising Confidentiality Provisions

Offense	Section	Sentence (Years)*
Obtaining national security information	(a)(1)	10 (20)
Compromising the confidentiality of a computer	(a)(2)	1 or 5
Trespassing in a government computer	(a)(3)	1 (10)
Accessing a computer to defraud and obtain value	(a)(4)	5 (10)
Knowing transmission and intentional damage	(a)(5)(A)(i)	10 (20 or life)
Intentional access and reckless damage	(a)(5)(A)(ii)	5 (20)
Intentional access and damage	(a)(5)(A)(iii)	1 (10)
Trafficking in passwords	(a)(6)	1 (10)
Extortion involving threats to damage computer	(a)(7)	5 (10)
* The maximum prison sentences for second convictions are noted in parentheses.		

The **Unauthorized Access to Stored Communications Act**⁶⁵ is a federal statute to protect the confidentiality of e-mail and voicemail. However, this act does not have as broad of a sweep as it might appear from its name. Courts have held that home computers, business computers, and Internet service providers (ISPs) are not "electronic communications devices" that are covered by this act. So hacking into an e-mail account *providerFTC v. Netscape Communications Corp.*, 196 F.R.D. 559, 560 (N.D. Cal. 2000). would be prohibited by this act, but not hacking into a home computer *United States v. Steiger*, 318 F.3d 1039, 1049 (11th Cir. 2003). or a business computer. *United States v. Steiger*, 318 F.3d 1039, 1049 (11th Cir. 2003). Due to the narrow reading of the statute by the courts, few prosecutions have occurred under this Act since its enactment. Computer Crime and Intellectual Property Section, United States Department of Justice, "Other Network Crime Statutes, Unlawful Access to Stored Communications, 18 U.S.C. §2701, 8. Historical Notes,"

64. A federal statute that carries punishments for compromising computers used in interstate commerce or communication.

65. A federal statute to protect the confidentiality of e-mail and voicemail.

<http://www.justice.gov/criminal/cybercrime/ccmanual/03ccma.html> (accessed September 27, 2010).

Identity theft⁶⁶ is also now codified into federal statute as a federal criminal violation. 18 U.S.C. §1028(a)(7) and 18 U.S.C. §1028A. This crime is rampant. Identity thieves obtain credit in an otherwise creditworthy person's name. The victim of these crimes can spend hundreds of hours repairing the damage. This is one of the primary reasons why it is very important not to reveal personal information on the Internet.

Finally, spamming is now subject to federal regulations, the violations of which are now a federal crime by virtue of the **CAN-SPAM Act**⁶⁷. This law serves as the vehicle to prosecute senders of large quantities of unsolicited e-mails if those e-mails do not meet the federal requirements. 18 U.S.C. §1037. Marketers, beware!

Environmental Crimes

Environmental crimes⁶⁸ are actions that violate federal or state statutes relating to the environment, which carry criminal sanctions. The Environmental Protection Agency enforces federal environmental statutes, including those that carry a criminal penalty. Many corporations have been convicted of environmental crimes. For instance, corporations that illegally dump toxic substances into waterways, illegally harm endangered species or those species' habitats, or trade in illegal substances that have been banned due to their propensity to cause great harm to the environment are all engaged in environmental crimes. U.S. federal environmental statutes that carry criminal penalties include the Clean Air Act; the Clean Water Act; the Resource Conservation and Recovery Act; the Comprehensive Environmental Response, Compensation, and Liability Act; and the Endangered Species Act. Additionally, state environmental law statutes frequently carry criminal penalties as well.

Recent examples of corporate convictions for environmental crimes can be found in Note 10.84 "Hyperlink: Federal Environmental Criminal Convictions".

66. The unauthorized use of someone else's identity, typically for financial gain.

67. A federal statute carrying civil and criminal penalties for spamming.

68. Actions that violate federal or state statutes relating to the environment, which carry criminal sanctions.

Hyperlink: Federal Environmental Criminal Convictions

<http://www.epa.gov/compliance/resources/cases/criminal/highlights/2010/index.html>

Check out this link to explore recent environmental crime convictions. Corporate convictions are not uncommon. For example, the Tulip Corporation of New York was convicted for illegally storing lead contaminated materials without a permit. Penalties included a \$100,000 fine and a \$25,000 to Buffalo Niagara Riverkeepers.

In another case, Mar-Cone Appliance Part Co. was convicted of purchasing and selling ozone depleting refrigerant gas, which was illegally smuggled into the United States in violation of the Clean Air Act. The sentence included a five-year probation for the business, a half-million-dollar criminal fine, and a four-hundred-thousand-dollar payment to a nonprofit organization. The company distributed this illegal substance throughout the United States, which was an action condemned as undermining global environmental efforts to reduce ozone damage for personal gain.

Blue-Collar Crime

Blue-collar crime⁶⁹ is a generic term used to describe crimes that are not white-collar crimes. In business, property crimes (rather than person crimes) are a primary concern. A property crime is a crime involving damage to property, while a person crime is a crime involving the injury to a person's body. Larceny is a major concern for many businesses. White-collar criminals are not the only ones who commit larceny. In retail, for instance, primary loss prevention concerns include **shoplifting**⁷⁰. Shoplifting is a serious and prevalent crime. Additionally, in any type of business, **employee theft**⁷¹ is a serious problem. Last, **vandalism**⁷² is unauthorized property damage, and any business with a physical presence can become the target of vandals.

69. A generic term used to describe crimes that are not white-collar crimes.

70. Larceny of goods in a retail establishment.

71. Larceny by employees.

72. Willful or malicious destruction of property.

KEY TAKEAWAYS

Crime is a very important consideration in the business world. White-collar crimes are particularly insidious because white-collar criminals work from the inside, can be difficult to spot since they often hold positions of trust, and use deception as their primary tool. Blue-collar crimes also pose substantial risk of loss for businesses. Fraud, cybercrime, environmental crime, organized crime, and various forms of property crimes are all serious threats to businesses. Crime carries high personal costs not only to the individuals involved in the misconduct but also to society at large, including the corporations and others who depend on those corporations.

EXERCISES

1. Consider the video in [Note 10.59 "Hyperlink: Too Good to Be True? Statistically Impossible Returns"](#) concerning Harry Markopolos's use of statistical modeling to identify Bernie Madoff's Ponzi scheme. What role should statistical analysis and probability modeling have played in the regulatory environment that could have identified the Madoff Ponzi scheme disaster earlier?
2. How can businesses protect themselves from embezzlement? What are some specific strategies that could be devised to ensure that bookkeepers or accountants do not skim money from the business?
3. If you caught an employee stealing one dollar's worth of office supplies, what would you do? What about twenty five dollars' worth of supplies? One hundred dollars'? One thousand? Should employees be trained not to even take a pencil home? Would that type of training be worth the cost of the training itself?
4. Check out [Note 10.76 "Video Clip: Who Said Antitrust Is Boring? Not Hollywood!"](#) to review some of the convictions against corporations. Are penalties payable to nonprofit environmental organizations appropriate penalties for corporate convictions for environmental crimes? Why or why not?

10.3 Minimizing Corporate Criminal Liability and Losses Attributed to Crime

LEARNING OBJECTIVES

1. Explore strategies for businesses to minimize criminal liability.
2. Examine whistleblower protections.

Businesses can engage in affirmative actions to reduce criminal liability. Likewise, individuals do not have to sit by passively if they know that criminal activity is afoot. This section addresses specific strategies and laws that can help combat crime in the business world.

Businesses should conduct annual training sessions, such as ethics training, to help ensure good workplace ethics. They should develop company-wide codes of ethics, which serve as the organizational commitment to ethical behavior. This can go far toward developing a corporate culture that values ethical behavior and condemns unethical actions, by providing leadership that serves as positive role models for all employees. Some companies, such as Boeing, have instituted an ethics hotline, which allows employees to anonymously report unethical behavior so that it can be investigated. Additionally, federal sentencing guidelines in place for organizations state that organizations that maintain a rigorous compliance program to detect and report violations of the law, and voluntarily disclose those violations when they occur, are eligible for significantly reduced sentences and fines.

Figure 10.5 Burglary



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Sometimes, of course, things still go wrong. A person who observes illegal behavior in the workplace may choose not to participate in that illegal behavior. Such a person can even choose to become a whistleblower. **Whistleblowers**⁷³ are people who report the illegal activity of their employers or of their organization to authorities. Typically, the whistleblowers have observed some wrongdoing that may harm others, and they decide to “blow the whistle” to protect the potential victims or to simply stop the wrongdoing.

73. People who report the illegal activity of their employers or of their organization to authorities.

Whistleblowers face many challenges in the workplace, not the least of which is the stigma associated with blowing the whistle. Paradoxically, even though the whistleblower may be preventing harm to innocent people, other employees may view the whistleblower as someone who has betrayed the organization. Because of this, whistleblowers are often placed in a terrible ethical dilemma, because while they may observe wrongdoing, they may not feel comfortable in reporting the illegal activity. They may fear losing their job or not being able to find a new job. Prospects of losing one's status, friends, or reputation can prevent many people from blowing the whistle, even though they may wish the behavior to stop.

Whistleblower protection laws prohibit retaliatory action against whistleblowers. Some statutes contain whistleblower protection provisions. For example, the Sarbanes-Oxley Act contains whistleblower protection, but the statute is not entirely devoted to whistleblower protection. The False Claims Act provides that anyone who blows the whistle on a federal contractor committing fraud on the government can personally receive a portion of any amount recovered, up to 25 percent. Despite these protections, many real-world whistleblowers have discovered that the laws are cold comfort for the realities that face them after whistle is blown. Check out [Note 10.93 "Hyperlink: Whistleblower Law Blog"](#), which lists many of the statutes under which whistleblower protections are offered.

Hyperlink: Whistleblower Law Blog

Check out the links on the right side of the Web page below. These are categories of blog entries, but they also represent a list of many federal whistleblower protections:

<http://employmentlawgroupblog.com>

Corporations can also avail themselves of safe harbor provisions in certain statutes. If they see criminal behavior and realize that they may be implicated in the criminal behavior, they can report certain actions to authorities, which will allow them to receive a lesser penalty, or no penalty at all. Only a few criminal statutes have safe harbor provisions, however.

KEY TAKEAWAYS

Businesses can encourage ethical behavior in the workplace to help employees avoid illegal behavior through training seminars, ethical leadership, and codes of ethics. Whistleblower protection laws and provisions prohibit retaliation against whistleblowers. However, whistleblowers often experience negative consequences when they report the illegal activities of their organization to the authorities.

EXERCISES

1. Find a corporate code of ethics by searching for “code of ethics” in your Internet browser. Is this a good code of ethics? How could it be changed? Do you think the employees pay attention to it? How would you ensure that your employees believed in and adopted your company’s code of ethics? Should employees who do not follow the code of ethics, but who do not break any laws or company policies, be terminated? Why or why not?
2. Should whistleblowing be encouraged by businesses? Why or why not?
3. Imagine a scenario in which you would choose to blow the whistle. How does that differ from a situation in which you would not blow the whistle?
4. Develop an outline of topics that you would present to employees to train them to be vigilant against criminal behavior in your organization. How could you ensure that employees understood the training?

10.4 Concluding Thoughts

Crime statistics in the United States illustrate the sobering reality that businesses must maintain vigilance against criminal activities. Threats arise from the inside—from employees, officers, directors, and employees—as well as from the outside, from professional or opportunistic criminals. It makes good business sense to practice both offensive and defensive strategies to stave off these threats. This can best be accomplished through proactive policies that encourage ethical behavior, encourage whistleblowing, and create disincentives for violating the law in the form of company policies, training programs, and codes of ethics.

Chapter 11

Business Organizations

LEARNING OBJECTIVES

Businesses must be organized in order to effectively conduct their operations. This organization can run from simple to complex and depends greatly on the needs of the business owners to structure their liability and taxes. In this chapter, you'll learn about the factors that go into organizing a business. Specifically, you should be able to answer the following questions:

1. What are the available entity choices when conducting business?
2. What are the factors that determine entity selection?
3. What are the traditional entity choices, and how are they different from each other?

Many of you may be reading this chapter on a laptop or desktop designed and manufactured by Apple Inc. You may own a phone from Apple, or perhaps a portable music device. The company's innovation, product development process, marketing capabilities in creating new and unthought-of markets, and ability to financially reward its owners are well known. While you might enjoy Apple products as a consumer, have you ever thought about Apple as a **corporation**¹? Its corporate headquarters in Cupertino, California (**Figure 11.1 "Apple's Headquarters in Cupertino, California"**), is the physical embodiment of this entity we call a corporation, but what does that mean? It might surprise you to learn that this building, or rather the legal concept of the entity that occupies it, is more like you than you realize. For example, just like you, this entity can own property. This entity can enter into contracts to buy and sell goods. This entity can hire and fire employees. This entity can open bank accounts and engage in complex financial transactions. This entity can sue others, and can be sued in court. This entity even has constitutional rights, just like you. Unlike you, however, this entity does not breathe, does not bleed, and in fact may be immortal. And most unlike you, this

Figure 11.1 Apple's Headquarters in Cupertino, California



Source: Photo courtesy of kalleboo, <http://www.flickr.com/photos/kalleboo/3614939469/sizes/o>.

1. A legal entity chartered by the state, with a separate and distinct existence from its owners.

entity has no independent judgment of its own, no moral compass or conscience to tell it the difference between right and wrong. In this chapter we'll explore corporate entities such as Apple Inc. in detail. We'll examine why human beings choose to organize into corporate entities in the first place, and why the law recognizes these entities for public policy purposes. We'll start by looking at the factors that go into making a decision about entity choice, and then examine the available choices in detail.

Try to recall the basic function of a **business**². At its most fundamental level, a business exists to make a profit for its owners. In a capitalist market-driven economy, a business that fails to make a profit ultimately ceases to exist, overtaken by **creditors**³ and competitors. The need to make a profit is one truism that binds all businesses together, but beyond that, it's hard to draw generalizations about business operations. The world of business is as varied as human experience itself, ranging from the neighborhood kids who shovel snow in the winter and sell lemonade in the summer, to the neighborhood pizza restaurant, to the small tool-and-die factory on the outskirts of town making machine tools, to the multinational corporation with hundreds of thousands of employees scattered throughout the globe. Some businesses make things in factories (manufacturers), other businesses sell things that other businesses make (retailers or **franchisees**⁴), and still other businesses exist to help both the makers and sellers make and sell better (business consultants). Some businesses don't make things at all, and instead profit by selling their services (think of an accounting or law firm, a house painting company, or a hotel) or by lending money at a higher rate of interest than it can borrow.

2. Any commercial enterprise, usually organized for profit of its owners, and typically involving the provision of goods or services to a customer.
3. Persons or entities to whom money is owed.
4. Persons or entities granted a franchise to market or sell a the franchisor's goods or services, usually under a franchise agreement.
5. Any type of investment where the investor's maximum possible losses is the amount invested. The investor's other assets are not reachable by creditors.

With this breadth and diversity, it's not surprising that there is no "one size fits all" approach to choosing a business organization. When choosing what form of entity is best, business professionals must consider several factors. First, they have to consider how much it costs to create the entity and how hard it is to create. Some entities are easy to create, while others are more complicated and have ongoing maintenance requirements that are important to consider. Second, they have to consider how easy it is for the business to continue if the founder dies, decides to retire, or decides to enter a new business altogether. Third, they have to consider how difficult it might be to raise money to grow or expand the business. Fourth, they have to consider what sort of managerial control they wish to keep on the business, and whether they are willing to cede control to outsiders. Fifth, they have to consider whether or not they wish to eventually expand ownership to members of the public. Sixth, they must give some thought to tax planning to minimize the taxes paid on earnings and income. Finally, and most importantly, they have to consider whether or not they wish to protect their personal assets from claims, a feature known as **limited liability**⁵.

It's important to remember that choosing a business organization is different from what kind of business you run. For example, some businesses are known as franchises because they operate under a license agreement (contract) whereby they agree to follow certain standards set by the franchisor, purchase their goods from the franchisor, and maybe share either a royalty fee or percentage of profits with the franchisor. Franchises are a very common type of business (especially in the food and services industries), but there is no typical form of business for a franchise. Depending on the needs of the franchise owners, a franchise could be a sole proprietorship, a limited liability company (LLC), or a corporation. Similarly, we sometimes refer to “nonprofit organizations” such as universities or charities as separate legal entities. Although they are nonprofit, some of these enterprises can be very large, with complex operations that spread across borders (for example, the Red Cross or Doctors Without Borders). For tax purposes, nonprofits do not have to pay any taxes if they meet strict qualifications under IRS guidelines to become a “501(c)(3)” organization (named for the section of the Internal Revenue Code that grants nonprofit status), but from a legal perspective, these entities can also take on any number of forms, from sole proprietorships to corporations.

If you are ever in a position to start a new business venture, your focus is typically on growing revenue and cutting costs so that you can maximize profit. You may not be very concerned with entity choice at the outset, since so many other considerations are competing for your attention. Once an entity choice is made, however, it is difficult (but not impossible) to change to another selection. Since entity choice can have a profound effect on these considerations, it is important to gain a basic understanding of the available choices so that you, the business professional, can focus on the business fundamentals rather than legal or accounting details.

Key Takeaways

Business organizations are an important part of a business's structure. Different organizations provide different advantages and disadvantages in creation cost and simplicity, ongoing maintenance requirements, dissolution and continuity, fundraising, managerial control, public ownership, tax planning, and limited liability. The type of business being conducted (for-profit, nonprofit, franchise) has little to do with the business organization in which the business is conducted. Many business organizations take the form of separate legal entities, which the law recognizes as nearly like persons for purposes of legal rights.

11.1 Sole Proprietorships

LEARNING OBJECTIVES

1. Understand the importance of sole proprietorships in our economy.
2. Explore the advantages presented by doing business as a sole proprietorship.
3. Assess the disadvantages and dangers of doing business as a sole proprietorship.

Lily, a college sophomore, is home for the summer. Unable to find even part-time work in a tough economy, she begins to help her parents by cleaning up their overgrown garden. After a few days of this work, Lily discovers that she enjoys doing this and is good at it. The neighbors see the work Lily is doing, and they ask her to help their gardens too. Within a week, Lily has scheduled appointments and jobs throughout the neighborhood. Using the money she has earned, she places orders for additional landscaping equipment and materials with a local retailer. Within a month, she is so busy that she has to hire workers to do some of the more routine tasks, such as mulching and lawn mowing, for her. By the middle of summer, Lily has applied knowledge she picked up in her business classes by developing a name for her business (Lily's Landscaping) and developing marketing materials such as a Facebook fan page, flyers to be posted at local stores, business cards, and a YouTube video showing her projects. By the end of the summer, Lily has earned a healthy profit for all her work and developed valuable know-how on how to run her business. She has to stop working when the weather gets cooler and she returns to school, but promises herself to restart the business next summer.

Figure 11.2



Entrepreneurs like Lily must decide what form to conduct business in.

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Lily is a **sole proprietor**⁶, the most common form of doing business in the United States. From a legal perspective, there is absolutely no difference between Lily and Lily's Landscaping—they are one and the same, and completely interchangeable with each other. If Lily's Landscaping makes a profit, that money belongs exclusively to Lily. If Lily's Landscaping needs to pay a bill to a supplier or creditor, and Lily's Landscaping doesn't have the money, then Lily has to pay the bill. When Lily's Landscaping enters into a contract to plant a new flower garden, it is actually

6. A type of business where there is no legal distinction between the business and its owner.

Lily that is entering into the contract. If Lily's Landscaping wants to open a bank account to accept customer payments or to pay bills, then Lily will actually own the account. When Lily's Landscaping enters into a contract promising to pay a worker to mow lawns or lay mulch, it is actually Lily that is entering into that contract. Lily can even apply for a "doing business as" or d.b.a. filing in her state, so that her business can carry on under the fictitious name "Lily's Landscaping." Note, however, that legally Lily's Landscaping is still no different from Lily herself. Any fictitious name therefore cannot have any words in it that suggest a separate entity, such as "Corp." or "Inc."

Hyperlink: Doing Business As

<http://www.business.gov/register/business-name/dba.html>

The legal name for a sole proprietorship is the owner's name. Some business owners are happy to use their own names for their business, but for marketing and branding reasons many business owners prefer to use a fictitious name. Using a fictitious name is permitted under state laws where the business operates, using a filing known as a d.b.a. filing. Explore this Web site to find out how to file a d.b.a. filing in your state.

There are many advantages to doing business as a sole proprietor, advantages that make this form of doing business extremely popular. First, it's easy to create a sole proprietorship. In effect, there is no creation cost or time, since there is nothing to create. The **entrepreneur**⁷ in charge of the business simply starts doing business, charging money, and providing goods or services. Depending on the business, some sole proprietors may need to obtain permits or licenses before they can begin operating. A pizza restaurant, for example, may need to obtain a food service license, while a bar or tavern may need to obtain a liquor license. A small grocery store may need a license to collect sales tax. Do not confuse these governmental permits with legal approval for a business organization; in a sole proprietorship, the license is granted to the individual owner.

Another key advantage to sole proprietorships is autonomy. Since the owner is the business, Lily can decide for herself what she wants to do to Lily's Landscaping. She could set her own hours, grow as quickly or slowly as she wants, expand into new lines of businesses, take a vacation, or wind down the business, all at her own whim and direction. That autonomy also comes with total ownership of the business's

7. A person who organizes a business and carries the risk of loss and reward of profit with it.

finances. All the money that Lily's Landscaping takes in, even if it is in a separate bank account, belongs to Lily, and she can do with that money whatever she wants.

These advantages must be weighed against some very important disadvantages. First, since a sole proprietorship can have only one owner, it is impossible to bring in others to the business. Lily cannot bring in her college roommate to work on Web site design as a partner in the business, for example. In addition, since the business and the owner are identical, it is impossible to pass on the business from Lily. If Lily dies, the business dies with her. Of course, she can always sell or give away the business assets (equipment, inventory, as well as intangible assets such as customer lists and goodwill).

Raising working capital can be a problem for sole proprietors, especially those early in their business ventures. Many entrepreneurial ventures are built on great ideas but need capital to flourish and develop. If the entrepreneur lacks individual wealth, then he or she must seek those funds from other sources. For example, if Lily decides to expand her business and asks her wealthy uncle to invest money in Lily's Landscaping, there is no way for her uncle to participate as a profit-sharing owner in the business. He can make a loan to her, or enter into a profit-sharing contract with her, but there is no way for him to own any part of Lily's Landscaping. Traditionally, most sole proprietors seek funding from banks. Banks approach these loans just like any other personal loan to an individual, such as a car loan or mortgage. Down payment requirements may be high, and typically the banks require some form of personal collateral to guarantee the loan, even though the loan is to be used to grow the business. Many sole proprietors resort to running their personal credit cards to the maximum limit, or transferring balances between credit cards, in the early stage of their business.

Hyperlink: Small Businesses Squeezed as Banks Limit Lending

<http://www.npr.org/templates/story/story.php?storyId=113816657>

During the Great Recession, many banks faced a liquidity crisis as loans they made performed poorly. Lending tightened, interest rates went up, credit lines went down, and standards became higher. The effect on many sole proprietors, including those featured in this National Public Radio story, has been very challenging.

In certain industries, entrepreneurs may be able to find financing through **venture capital**⁸. Venture capital firms combine funds from institutional investors and high net-worth individuals (known as **angel investors**⁹) to identify promising start-ups, and to fund them in a **private placement**¹⁰ offering until the start-up has developed its technology to a commercially feasible stage. At that point the venture capital firm seeks an exit strategy, typically through offering sale of the business to the public in an **initial public offering (IPO)**¹¹.

Tax planning can also be challenging for the sole proprietor. Since there is no legal distinction between the owner and the business, all the income generated by the business is treated as ordinary personal income to the owner. The United States has several income tax rates depending on the type of income being taxed, and ordinary personal income typically suffers the highest rate of taxation. Being able to plan effectively to take advantage of lower income tax rates is very difficult for the sole proprietor.

Finally, sole proprietors suffer from one hugely unattractive feature: **unlimited liability**¹². Since there is no difference between the owner and the business, the owner is personally liable for all the business's debts and obligations. For example, let's say that Lily's Landscaping runs into some financial trouble and is unable to generate planned revenue in a given month due to unexpectedly bad weather. Creditors of the business include landscaping supply stores, employees, and outside contractors such as the company that prints business cards and maintains the business Web site. Lily is personally liable to pay these bills, and if she doesn't she can be sued for breach of contract. Some proprietors are very successful and can generate many hundreds of thousands of dollars in profit every year. Unlimited liability puts all the personal assets of the sole proprietor reachable by creditors. Personal homes, automobiles, boats, bank accounts, retirement accounts, and college funds—all are within reach of creditors. With unlimited liability, all it takes is one successful personal injury lawsuit, not covered by insurance or exceeding insurance limits, to wipe out years of hard work by an individual business owner.

For these reasons, while sole proprietors are still the most common way of doing business in the United States, they are in many ways the most unattractive. Thankfully, modern business law creates real and viable alternatives for sole proprietors, as we'll discuss shortly.

8. Money invested in an unproven or new start-up business.
9. Affluent individuals (or groups of individuals) who provide capital to start-up and early-stage businesses.
10. A nonpublic offering in which a business sells securities to a few chosen and qualified investors to raise capital.
11. The first time a corporation sells its shares to members of the public.
12. An undesirable situation where if the debts of the business exceed its ability to pay, creditors may reach the personal assets of the business owners.

KEY TAKEAWAYS

Sole proprietorships are the most common way of doing business in the United States. Legally, there is no difference or distinction between the owner and the business. The legal name of the business is the owner's name, but owners may carry on business operations under a fictitious name by filing a d.b.a. filing. Sole proprietors enjoy ease of start-up, autonomy, and flexibility in managing their business operations. On the downside, they have to pay ordinary income tax on their business profits, cannot bring in partners, may have a hard time raising working capital, and have unlimited liability for business debts.

EXERCISES

1. Many household services professionals such as carpenters, plumbers, and electricians do business as sole proprietors. If they make a promise to their customers that their work (not the products themselves) will be free from defects for a certain period of time (i.e., a warranty), and then subsequently sell their business assets to another individual, is the buyer bound by the promises made by the seller? Why or why not?
2. D.b.a. statutes prohibit sole proprietors from using certain words such as "company," "Corp." or "Inc." in their fictitious names. Why do you think this rule exists?
3. If a sole proprietor dies suddenly, what do you think happens to the business run by the sole proprietor?

11.2 Partnerships

LEARNING OBJECTIVES

1. Learn about how general and limited partnerships are formed.
2. Explore the major differences between general and limited partnerships.
3. Understand major advantages and disadvantages to doing business as general or limited partnerships.

Let's assume that after her first summer running Lily's Landscaping, Lily decides that it's time to take her business to the next level. She has gathered a lot of expertise in running the operations in her business, from placing orders with suppliers to scheduling workers for client projects. She realizes, however, that she's not very good at marketing or accounting, and that if her business is to grow, she needs to bring someone on board who can create a strong brand and strategy for growth, as well as keep good records of her accounts so that she can plan for the future. Fortunately, her good friend Adam is a double major in accounting and marketing, and after a series of discussions, Adam and Lily decide to run Lily's Landscaping together.

Figure 11.3



Partnerships allow multiple individuals to conduct business together.

© Thinkstock

Lily and Adam have formed a **general partnership**¹³. The moment they agreed to run Lily's Landscaping together, and to share in the profits and losses of the business together, the partnership was formed.

Although they formed their partnership verbally, most general partnerships are formed formally, with partners writing down their agreement in a special type of contract known as the **articles of partnership**¹⁴. The articles can set forth anything the partners wish to include about how the partnership will be run. Normally, all general partners have an equal voice in management, but as a creation of contract, the partners can modify this if they wish. As in a sole proprietorship, there is no state involvement in creating a general partnership because there is no separation from the business and the partners—they are legally the same.

13. Association of two or more persons in an unincorporated entity to do business and share profits and losses.

14. Also known as a partnership agreement, a voluntary contract (typically written) in which two or more persons decide to conduct business together and share profits and losses.

General partnerships are dissolved as easily as they are formed. Since the central feature of a general partnership is an agreement to share profits and losses, once that agreement ends, the general partnership ends with it. In a general partnership with more than two persons, the remaining partners can reconstitute the partnership if they wish, without the old partner. A common issue that arises in this situation is how to value the withdrawing partner's share of the business. Articles of partnership therefore typically include a **buy/sell agreement**¹⁵, setting forth the agreement of the partners on how to account for a withdrawing partner's share, which the remaining partners then agree to pay to the withdrawing partner (or the spouse or heir if the partner dies).

Hyperlink: A Law Firm Partner Is Fired

http://www.law.cornell.edu/nyctap/196_0191.htm

After a nearly twenty-year career, Evan Dawson was a partner at a major New York City law firm, White & Case. In 1988 the firm tried to persuade him to withdraw as a partner, but he refused. In July 1988 the other partners in the firm voted to dissolve the partnership and then immediately re-formed again, without Dawson as a partner. He had effectively been fired as a partner from a general partnership. Dawson filed a suit against White & Case for an "accounting," claiming that the "goodwill" of the law firm should be part of the valuation of the partnership. The common law in New York at the time was that professional partnerships like law firms have no goodwill. The reasoning behind the rule is that as professionals, law firm partners develop and cultivate their own goodwill with clients, and if a partner leaves the firm then the goodwill leaves with that partner. The New York Court of Appeals, in its opinion on this case, held that unless the partnership agreement states otherwise, goodwill is indeed an asset of the partnership and has to be distributed when the partnership is dissolved.

15. An agreement between partners to value and sell a partner's portion of the business in the event the partner withdraws or dies.
16. For tax purposes, an entity that does not need to file its own tax return or pay taxes; profits and losses flow through disregarded entities to the owners.
17. Tax return that provides information only to the taxing authority.

A general partnership is taxed just like a sole proprietorship. The partnership is considered a **disregarded entity**¹⁶ for tax purposes, so income "flows through" the business to the partners, who then pay ordinary income tax on the business income. The partnership may file an **information return**¹⁷, reporting total income and losses for the partnership, and how those profits and losses are allocated among the general partners. As is the case for sole proprietors, tax planning opportunities are limited for general partners.

General partnerships are also similar to sole proprietorships in unlimited liability. Every partner in the partnership is **jointly and severally liable**¹⁸ for the partnership's debts and obligations. This is a very unattractive feature of general partnerships. One partner may be completely innocent of any wrongdoing and still be liable for another partner's malpractice or bad acts.

Let's assume that the general partnership formed by Lily and Adam flourishes and becomes profitable. To grow the landscaping business, they want to bring in Lily's wealthy uncle as a partner. The uncle, however, is worried about maintaining limited liability. In most states, they can form a **limited partnership**¹⁹. A limited partnership has both general partners and limited partners. In this case, Lily and Adam will remain as general partners in the business, but the uncle can become a **limited partner**²⁰ and enjoy limited liability. As a limited partner, the most he can lose is the amount of his investment into the business, nothing more. Limited partnerships have to be formed in compliance with state law, and limited partners are generally prohibited from participating in day-to-day management of the business.

KEY TAKEAWAYS

A general partnership is formed when two or more persons agree to share profits and losses in a joint business venture. A general partnership is not a separate legal entity, and partners are jointly and severally liable for the partnership's debts, including acts of malpractice by other partners. Income from a general partnership flows through to the partners, who pay tax at the ordinary personal income tax rate. In most states general partners can also bring in limited partners, creating a limited partnership. Limited partnerships must be formed in compliance with state statutes. Limited partners enjoy limited liability but generally cannot participate in day-to-day management of the business.

18. A form of liability where creditors or other claimants can pursue their entire claim against one, several, or all possible defendants, leaving defendants to sort out their respective proportions of liability and payment.
19. A form of partnership formed in compliance with state law that provides limited liability to certain limited partners who agree to refrain from management of the business.
20. A partner in a limited partnership given limited liability.

EXERCISES

1. John approaches his friend Kevin and offers Kevin 50 percent of the profits from his new online venture if Kevin designs the Web site for the venture. Kevin says nothing, and later that night begins work on the Web site, which he then sends to John for his approval. Have John and Kevin formed a general partnership? Why or why not?
2. Do you think it's ethical for a general partnership to fire a partner by dissolving the partnership and then re-forming without the dismissed partner? Why or why not?
3. Do modern professional firms such as law firms or accounting firms face the same problems as White & Case did in [Note 11.24 "Hyperlink: A Law Firm Partner Is Fired"](#)? Why or why not?

11.3 Corporations

LEARNING OBJECTIVES

1. Learn about the advantages and disadvantages of corporations.
2. Study roles and duties of shareholders, directors, and officers in corporations.
3. Explore issues surrounding corporate governance.
4. Understand how corporations are taxed.

So far in this chapter, we have explored sole proprietorships and partnerships, two common and relatively painless ways for persons to conduct business operations. Both these forms of business come with significant disadvantages, however, especially in the area of liability. The idea that personal assets may be placed at risk by business debts and obligations is rightfully scary to most people. Businesses therefore need a form of business organization that provides limited liability to owners and is also flexible and easy to manage. That is where the modern **corporation**²¹ comes in.

Figure 11.4 Apple Cofounder Steve Jobs



Source: Photo courtesy of acaben, <http://www.flickr.com/photos/acaben/541334636/sizes/o>.

21. A legal entity chartered by the state, with a separate and distinct existence from its owners.
22. Organized and created into a legal corporation.
23. The first time a corporation sells its shares to members of the public.
24. Capital raised by a corporation through issuance of shares entitling owners to an ownership interest.
25. Any negotiable instruments representing financial value, such as a bond or stock.

Consider, for example, tech entrepreneur and Apple cofounder Steve Jobs ([Figure 11.4 "Apple Cofounder Steve Jobs"](#)). As a young man, he was a college dropout without much ability for computer engineering. If doing business as a sole proprietor was his only option, Apple would not exist today. However, Jobs met a talented computer engineer named Steve Wozniak, and the two decided to pool their talents to form Apple Computer in 1976. A year later, the company was **incorporated**²² and in 1980 went public in an **initial public offering (IPO)**²³. Incorporation allowed Jobs much more flexibility in carrying out business operations than a mere sole proprietorship could. It allowed him to bring in other individuals with distinct skills and capabilities, raise money in the early stage of operations by promising shares in the new company, and eventually become very wealthy by selling **stock**²⁴, or **securities**²⁵, in the company.

Hyperlink: Great Things in Business

http://cnettv.cnet.com/60-minutes-steve-jobs/9742-1_53-50004696.html

Sole proprietorships are limiting not just in a legal sense but also in a business sense. As Steve Jobs points out in this video, great things in business are never accomplished with just one person; they are accomplished with a team of people. While Jobs may have had the vision to found Apple Inc. and maintains overall strategic leadership for the company, the products the company releases today are very much the result of the corporation, not any single individual.

Unlike a sole proprietorship or general partnership, a corporation is a separate legal entity, separate and distinct from its owners. It can be created for a limited duration, or it can have perpetual existence. Since it is a separate legal entity, a corporation has continuity regardless of its owners. Entrepreneurs who are now dead founded many modern companies, and their companies are still thriving. Similarly, in a publicly traded company, the identity of shareholders can change many times per hour, but the corporation as a separate entity is undisturbed by these changes and continues its business operations.

Since corporations have a separate legal existence and have many legal and constitutional rights, they must be formed in compliance with corporate law. Corporate law is state law, and corporations are incorporated by the states; there is no such thing as a “U.S. corporation.” Most corporations incorporate where their principal place of business is located, but not all do. Many companies choose to incorporate in the tiny state of Delaware even though they have no business presence there, not even an office cubicle. Delaware **chancery**²⁶ courts have developed a reputation for fairly and quickly applying a very well-developed body of corporate law in Delaware. The courts also operate without a jury, meaning that disputes heard in Delaware courts are usually predictable and transparent, with well-written opinions explaining how the judges came to their conclusions.

26. A court with jurisdiction to decide cases based on equity as well as law.

Hyperlink: How to Incorporate in Your State

<http://www.business.gov/register/incorporation>

Since corporations are created, or *chartered*, under state law, business founders must apply to their respective state agencies to start their companies. These agencies are typically located within the Secretary of State. Click the link to explore how to fill out the forms for your state to start a company. You may be surprised at how quickly, easily, and inexpensively you can form your own company! Don't forget that your company name must not be the same as another company's name. (Most states allow you to do a name search first to ensure that name is available.)

27. A legal document that creates a corporation when filed and approved by the relevant state authority.
28. An act in excess of designated legal power.
29. Units of account for a financial instrument, such as stocks.
30. The face value of a security as determined by the corporation. Par value has no relation to market value.
31. A corporation operating in the state in which it was incorporated.
32. A corporation incorporated in a state other than where it is seeking to operate.

To start a corporation, the corporate founders must file the **articles of incorporation**²⁷ with the state agency charged with managing business entities. These articles of incorporation may vary from state to state but typically include a common set of questions. First, the founders must state the name of the company and whether the company is for-profit or nonprofit. The name has to be unique and distinctive, and must typically include some form of the words “Incorporated,” “Company,” “Corporation,” or “Limited.” The founders must state their identity, how long they wish the company to exist, and the company's purpose. Under older common law, shareholders could sue a company that conducted business beyond the scope of its articles (these actions are called **ultra vires**²⁸), but most modern statutes permit the articles to simply state the corporation can carry out “any lawful actions,” effectively rendering ultra vires lawsuits obsolete in the United States. The founders must also state how many **shares**²⁹ the corporation will issue initially, and the **par value**³⁰ of those shares. (Of course, the company can issue more shares in the future or buy them back from shareholders.)

Unlike sole proprietorships, corporations can be quite complicated to manage and typically require attorneys and accountants to maintain corporate books in good order. In addition to the foundation requirements, corporate law requires ongoing annual maintenance of corporations. In addition to filing fees due at the time of incorporation, there are typically annual license fees, franchise fees and taxes, attorney fees, and fees related to maintaining minute books, corporate seals, stock certificates and registries, as well as out-of-state registration. A **domestic corporation**³¹ is entitled to operate in its state of incorporation but must register as a **foreign corporation**³² to do business out of state. Imagine filing as a foreign

corporation in all fifty states, and you can see why maintaining corporations can become expensive and unwieldy.

Video Clip: Monstrous Obligations

[\(click to see video\)](#)

Video Clip: The Pathology of Commerce

[\(click to see video\)](#)

Owners of companies are called **shareholders**³³. Corporations can have as few as one shareholder or as many as millions of shareholders, and those shareholders can hold as few as one share or as many as millions of shares. In a **closely held corporation**³⁴, the number of shareholders tends to be small, while in a publicly traded corporation, the body of shareholders tends to be large. In a publicly traded corporation, the value of a share is determined by the laws of supply and demand, with various markets or exchanges providing trading space for buyers and sellers of certain shares to be traded. It's important to note that shareholders own the share or stock in the company but have no legal right to the company's assets whatsoever. As a separate legal entity, the company owns the property.

Shareholders of a corporation enjoy limited liability. The most they can lose is the amount of their investment, whatever amount they paid for the shares of the company. If a company is unable to pay its debts or obligations, it may seek protection from creditors in bankruptcy court, in which case shareholders lose the value of their stock. Shareholders' personal assets, however, such as their own homes or bank accounts, are not reachable by those creditors.

33. Owners of a corporation.

34. A corporation whose stock is held by only a small number of shareholders.

35. A company wholly owned or controlled by another company.

36. A commercial enterprise with some sort of contractual or equity relationship with another commercial enterprise.

37. The liability of landowners and leaseholders for torts that occur on their real property.

Shareholders can be human beings or can be other corporate entities, such as partnerships or corporations. If one corporation owns all the stock of another corporation, the owner is said to be a parent company, while the company being owned is a wholly owned **subsidiary**³⁵. A parent company that doesn't own all the stock of another company might call that other company an **affiliate**³⁶ instead of a subsidiary. Many times, large corporations may form subsidiaries for specific purposes, so that the parent company can have limited liability or advantageous tax treatment. For example, large companies may form subsidiaries to hold real property so that **premises liability**³⁷ is limited to that real estate subsidiary only, shielding the parent company and its assets from tort lawsuits. Companies that deal in a lot of intellectual property may form subsidiaries to hold their intellectual property, which is then licensed back to the parent company so that the parent company can deduct royalty payments for those licenses from its taxes. This type of

sophisticated liability and tax planning makes the corporate form very attractive for larger business in the United States.

Corporate law is very flexible in the United States and can lead to creative solutions to business problems. Take, for example, the case of General Motors Corporation. General Motors Corporation was a well-known American company that built a global automotive empire that reached virtually every corner of the world. In 2009 the General Motors Corporation faced an unprecedented threat from a collapsing auto market and a dramatic recession, and could no longer pay its suppliers and other creditors. The U.S. government agreed to inject funds into the operation but wanted the company to restructure its balance sheet at the same time so that those funds could one day be repaid to taxpayers. The solution? Form a new company, General Motors Company, the “new GM.” The old GM was brought into bankruptcy court, where a judge permitted the wholesale cancellations of many key contracts with suppliers, dealers, and employees that were costing GM a lot of money. Stock in the old GM became worthless. The old GM transferred all of GM’s best assets to new GM, including the surviving brands of Cadillac, Chevrolet, Buick, and GMC; the plants and assets those brands rely on; and the shares in domestic and foreign subsidiaries that new GM wanted to keep. Old GM (subsequently renamed as “Motors Liquidation Company”) kept all the liabilities that no one wanted, including obsolete assets such as shuttered plants, as well as unpaid claims from creditors. The U.S. federal government became the majority shareholder of General Motors Company, and may one day recoup its investment after shares of General Motors Company are sold to the public. To the public, there is very little difference in the old and new GM. From a legal perspective, however, they are totally separate and distinct from each other.

One exception to the rule of limited liability arises in certain cases mainly involving closely held corporations. Many sole proprietors incorporate their businesses to gain limited liability but fail to realize when they do so that they are creating a separate legal entity that must be respected as such. If sole proprietors fail to respect the legal corporation with an **arm’s-length transaction**³⁸, then creditors can ask a court to **pierce the corporate veil**³⁹. If a court agrees, then limited liability disappears and those creditors can reach the shareholder’s personal assets. Essentially, creditors are arguing that the corporate form is a sham to create limited liability and that the shareholder and the corporation are indistinguishable from each other, just like a sole proprietorship. For example, if a business owner incorporates the business and then opens a bank account in the business name, the funds in that account must be used for business purposes only. If the business owner routinely “dips into” the bank account to fund personal expenses, then an argument for piercing the corporate veil can be easily made.

38. A transaction made by parties as if they were unrelated, in a free market system, each acting in its own best interest.

39. An equitable doctrine allowing creditors to petition a court to not permit limited liability to a corporate shareholder.

Not all shareholders in a corporation are necessarily equal. U.S. corporate law allows for the creation of different types, or classes, of shareholders. Shareholders in different classes may be given preferential treatment when it comes to corporate actions such as paying dividends or voting at shareholder meetings. For example, founders of a corporation may reserve a special class of stock for themselves with **preemptive rights**⁴⁰. These rights give the shareholders the right of first refusal if the company decides to issue more stock in the future, so that the shareholders maintain the same percentage ownership of the company and thus preventing **dilution**⁴¹ of their stock.

A good example of different classes of shareholders is in Ford Motor Company stock. The global automaker has hundreds of thousands of shareholders, but issues two types of stock: Class A for members of the public and Class B for members of the Ford family. By proportion, Class B stock is far outnumbered by Class A stock, representing less than 10 percent of the total issued stock of the company. However, Class B stock is given 40 percent voting rights at any shareholder meeting, effectively allowing holders of Class B stock (the Ford family) to block any shareholder resolution that requires two-thirds approval to pass. In other words, by creating two classes of shareholders, the Ford family continues to have a strong and decisive voice on the future direction of the company even though it is a publicly traded company.

40. Sometimes known as rights of first refusal, rights given to existing shareholders in a corporation to purchase any newly issued stock to maintain same proportion of their existing holdings.

41. The result when a corporation issues additional shares, resulting in a reduction of percentage of the corporation owned by shareholders.

42. Rules and regulations adopted by a corporation for its own internal governance.

43. A group of persons elected by shareholders of company to set high-level strategy for the company.

44. A person authorized to act on behalf of a shareholder at a shareholders' meeting.

45. A lawsuit brought by a shareholder on behalf of a corporation against a third party.

Shareholder rights are generally outlined in a company's articles of incorporation or **bylaws**⁴². Some of these rights may include the right to obtain a dividend, but only if the **board of directors**⁴³ approves one. They may also include the right to vote in shareholder meetings, typically held annually. It is common in large companies with thousands of shareholders for shareholders to not attend these meetings and instead cast their votes on shareholder resolutions through the use of a **proxy**⁴⁴.

Video Clip: Activist Shareholders at Wal-Mart

[\(click to see video\)](#)

Under most state laws, including Delaware's business laws, shareholders are also given a unique right to sue a third party on behalf of the corporation. This is called a **shareholder derivative lawsuit**⁴⁵ (so called because the shareholder is suing on behalf of the corporation, having "derived" that right by virtue of being a shareholder). In essence, a shareholder is alleging in a derivative lawsuit that the people who are ordinarily charged with acting in the corporation's best interests (the officers and directors) are failing to do so, and therefore the shareholder must step in to protect the corporation. These lawsuits are very controversial because

they are typically litigated by plaintiffs' lawyers working on contingency fees and can be very expensive for the corporation to litigate. Executives also disfavor them because oftentimes, shareholders sue the corporate officers or directors themselves for failing to act in the company's best interest.

One of the most important functions for shareholders is to elect the board of directors for a corporation. Shareholders always elect a director; there is no other way to become a director. The board is responsible for making major decisions that affect a corporation, such as declaring and paying a corporate **dividend**⁴⁶ to shareholders; authorizing major new decisions such as a new plant or factory or entry into a new foreign market; appointing and removing corporate officers; determining employee compensation, especially bonus and incentive plans; and issuing new shares and **corporate bonds**⁴⁷. Since the board doesn't meet that often, the board can delegate these tasks to committees, which then report to the board during board meetings.

Shareholders can elect anyone they want to a board of directors, up to the number of authorized board members as set forth in the corporate documents. Most large corporations have board members drawn from both inside and outside the company. Outside board members can be drawn from other private companies (but not competitors), former government officials, or academe. It's not unusual for the chief executive officer (CEO) of the company to also serve as chair of the board of directors, although the recent trend has been toward appointing different persons to these functions. Many shareholders now actively vie for at least one board seat to represent the interests of shareholders, and some corporations with large labor forces reserve a board seat for a union representative.

46. A portion of a corporation's net income designated by the board of directors and returned to shareholders on a per share basis.

47. A debt obligation issued by corporations to raise money without selling stock.

48. A legal assumption that prevents courts or juries from second-guessing decisions made by directors, unless they are proven to act with bad faith or corrupt motive.

49. Also known as Directors and Officers Liability Insurance, insurance that protects board members and senior officers of corporations from liability arising from their actions. D&O insurance is usually paid by the corporation.

Board members are given wide latitude to make business decisions that they believe are in the best interest of the company. Under the **business judgment rule**⁴⁸, board members are generally immune from second-guessing for their decisions as long as they act in good faith and in the corporation's best interests. Board members owe a fiduciary duty to the corporation and its shareholders, and therefore are presumed to be using their best business judgment when making decisions for the company.

Shareholders in derivative litigation can overcome the business judgment rule, however. Another fallout from recent corporate scandals has been increased attention to board members and holding them accountable for actually managing the corporation. For example, when WorldCom fell into bankruptcy as a result of profligate spending by its chief executive, board members were accused of negligently allowing the CEO to plunder corporate funds. Corporations pay for insurance for board members (known as **D&O insurance**⁴⁹, for directors and officers), but in some cases D&O insurance doesn't apply, leaving board members to

pay directly out of their own pockets when they are sued. In 2005 ten former outside directors for WorldCom agreed to pay \$18 million out of their own pockets to settle shareholder lawsuits.

One critical function for boards of directors is to appoint corporate **officers**⁵⁰. These officers are also known as “C-level” executives and typically hold titles such as chief executive officer, chief operating officer, chief of staff, chief marketing officer, and so on. Officers are involved in everyday decision making for the company and implementing the board’s strategy into action. As officers of the company, they have legal authority to sign contracts on behalf of the corporation, binding the corporation to legal obligations. Officers are employees of the company and work full-time for the company, but can be removed by the board, typically without cause.

In addition to being somewhat cumbersome to manage, corporations possess one very unattractive feature for business owners: **double taxation**⁵¹. Since corporations are separate legal entities, taxing authorities consider them as taxable persons, just like ordinary human beings. A corporation doesn’t have a Social Security number, but it does have an **Employer Identification Numbers (EIN)**⁵², which serves the same purpose of identifying the company to tax authorities. As a separate legal entity, corporations must pay federal, state, and local tax on net income (although the effective tax rate for most U.S. corporations is much lower than the top 35 percent income tax rate). That same pile of profit is then subject to tax again when it is returned to shareholders as a dividend, in the form of a **dividend tax**⁵³.

One way for closely held corporations (such as small family-run businesses) to avoid the double taxation feature is to elect to be treated as an **S corporation**⁵⁴. An S corporation (the name comes from the applicable subsection of the tax law) can choose to be taxed like a partnership or sole proprietorship. In other words, it is taxed only once, at the shareholder level when a dividend is declared, and not at the corporate level. Shareholders then pay personal income tax when they receive their share of the corporate profits. An S corporation is formed and treated just like any other corporation; the only difference is in tax treatment. S corporations provide the limited liability feature of corporations but the single-level taxation benefits of sole proprietorships by not paying any corporate taxes. There are some important restrictions on S corporations, however. They cannot have more than one hundred shareholders, all of whom must be U.S. citizens or resident aliens; can have only one class of stock; and cannot be members of an affiliated group of companies. These restrictions ensure that “S” tax treatment is reserved only for small businesses.

50. Senior management, often “C-Level,” or “Chief Level,” appointed by the board of directors of a corporation to execute strategy and manage day-to-day matters for the corporation.

51. The imposition of two or more separate taxes on the same pool of money.

52. A unique nine-digit number issued by the IRS to business entities for purposes of identification.

53. An income tax on dividend payments to shareholders.

54. A corporation that, after meeting certain eligibility criteria, can elect to be treated like a partnership for tax purposes, thus avoiding paying corporate income tax.

KEY TAKEAWAYS

A corporation is a separate legal entity. Owners of corporations are known as shareholders and can range from a few in closely held corporations to millions in publicly held corporations. Shareholders of corporations have limited liability, but most are subject to double taxation of corporate profits. Certain small businesses can avoid double taxation by electing to be treated as S corporations under the tax laws. State law charters corporations. Shareholders elect a board of directors, who in turn appoint corporate officers to manage the company.

EXERCISES

1. Henry Ford (Ford Motor Company), Ray Croc (McDonald's), and Levi Strauss (Levi's) were all entrepreneurs who decided to incorporate their businesses and in doing so created long-lasting legacies that outlive them. Why do you think these entrepreneurs were motivated to incorporate when incorporation meant giving up control of their companies?
2. Some corporations are created for just a limited time. Can you think of any strategic reasons why founders would create a corporation for just a limited time?
3. Recently some companies have come under fire for moving their corporate headquarters out of the country to tax havens such as Bermuda or Barbados. Which duty do you believe is higher, the duty of corporations to pay tax to government or the duty of corporations to pay dividends to shareholders? Why?
4. Some critics believe that the corporate tax code is a form of welfare, since many U.S. corporations make billions of dollars and don't pay any tax. Do you believe this criticism is fair? Why or why not?
5. It is very easy to start a corporation in the United States. Take a look at how easy it is to start a corporation in China or India. Do you believe there is a link between ease of starting businesses and overall economic efficiency?
6. Do you agree with filmmaker Achbar that a corporation might be psychopathic? What do you think the ethical obligations of corporations are? Discuss.

11.4 Limited Liability Entities

LEARNING OBJECTIVES

1. Learn about the development of limited liability entities.
2. Explore how limited liability entities are created.
3. Understand why limited liability entities are now heavily favored.

By now you should understand how easy yet dangerous it is to do business as a sole proprietor, and why many business organizations are drawn to the corporation as a form for doing business. As flexible as the corporation is, however, it is probably best suited for larger businesses. Annual meeting requirements, the need for directors and officers, and the unattractive taxation features make corporations unwieldy and expensive for smaller businesses. A form of business organization that provides the ease and simplicity of sole proprietorships, but the limited liability of corporations, would be much better suited for a wide range of business operations.

A **limited liability company (LLC)**⁵⁵ is a good solution to this problem. LLCs are a “hybrid” form of business organization that offer the limited liability feature of corporations but the tax benefits of partnerships. Owners of LLCs are called **members**⁵⁶. Just like a sole proprietorship, it is possible to create an LLC with only one member. LLC members can be real persons or they can be other LLCs, corporations, or partnerships. Compared to limited partnerships, LLC members can participate in day-to-day management of the business. Compared to S corporations, LLC members can be other corporations or partnerships, are not restricted in number, and may be residents of other countries.

Taxation of LLCs is very flexible. Essentially, every tax year the LLC can choose how it wishes to be taxed. It may want to be taxed as a corporation, for example, and pay corporate income tax on net income. Or it may choose instead to have income “flow through” the corporate form to the member-shareholders, who then pay personal income tax just as in a partnership. Sophisticated tax planning becomes possible with LLCs because tax treatment can vary by year.

55. A hybrid form of business that provides limited liability to owners while being treated as a partnership for tax purposes.

56. Owners of limited liability companies.

LLCs are formed by filing the articles of organization with the state agency charged with chartering business entities, typically the Secretary of State. Starting an LLC is often easier than starting a corporation. In fact, you might be startled at how easy it is to start an LLC; typical LLC statutes require only the name of the LLC and the

contact information for the LLC's legal agent (in case someone decides to file a lawsuit against the LLC). In most states, forming an LLC can be done by any competent business professional without any legal assistance, for minimal time and cost. Unlike corporations, there is no requirement for an LLC to issue stock certificates, maintain annual filings, elect a board of directors, hold shareholder meetings, appoint officers, or engage in any regular maintenance of the entity. Most states require LLCs to have the letters "LLC" or words "Limited Liability Company" in the official business name. Of course, LLCs can also file d.b.a. filings to assume another name.

Although the articles of organization are all that is necessary to start an LLC, it is advisable for the LLC members to enter into a written LLC **operating agreement**⁵⁷. The operating agreement typically sets forth how the business will be managed and operated. It may also contain a buy/sell agreement just like a partnership agreement. The operating agreement allows members to run their LLCs any way they wish to, but it can also be a trap for the unwary. LLC law is relatively new compared to corporation law, so the absence of an operating agreement can make it very difficult to resolve disputes among members.

LLCs are not without disadvantages. Since they are a separate legal entity from their members, members must take care to interact with LLCs at arm's length, because the risk of piercing the veil exists with LLCs as much as it does with corporations. Fundraising for an LLC can be as difficult as it is for a sole proprietorship, especially in the early stages of an LLC's business operations. Most lenders require LLC members to personally guarantee any loans the LLC may take out. Finally, LLCs are not the right form for taking a company public and selling stock. Fortunately, it is not difficult to convert an LLC into a corporation, so many start-up business begin as LLCs and eventually convert into corporations prior to their initial public offering (IPO).

A related entity to the LLC is the limited liability partnership, or LLP. Be careful not to confuse limited liability partnerships with limited partnerships. LLPs are just like LLCs but are designed for professionals who do business as partners. They allow the partnership to pass through income for tax purposes, but retain limited liability for all partners. LLPs are especially popular with doctors, architects, accountants, and lawyers. Most of the major accounting firms have now converted their corporate forms into LLPs.

57. An agreement (usually written) among LLC members governing the LLC's management, rights, and duties.

KEY TAKEAWAYS

The limited liability company (LLC) represents a new trend toward business organization. It allows owners, called members, to have limited liability just like corporations. Unlike corporations, however, LLCs can avoid double taxation by choosing to be taxed like a partnership or sole proprietorship. Unless a business wishes to become publicly traded on a stock exchange, the LLC is probably the most flexible, most affordable, and most compatible form for doing business today. The limited liability partnership (LLP) is similar to the LLC, except it is designed for professionals such as accountants or lawyers who do business as partners.

EXERCISES

1. Most small businesses in the United States are still run as sole proprietorships. Why do you think these businesses have not converted to the LLC form?
2. Take a look at some of the brands and businesses you are most familiar with. How many of them do business as an LLC?

11.5 Concluding Thoughts

Most economists and public policy officials believe that the American economy is a key anchor to American society and values. Private enterprise and the profit motive allow innovation and entrepreneurship to flourish, leading to prosperity and peace. Underlying the strength of American business enterprises is a flexible and easy-to-manage legal system that allows business owners many options in choosing how to organize their operations. The sole proprietorship, which provides autonomy and ease in creation, is a dangerous form to do business because of unlimited liability. The general partnership allows business partners to do business together but similarly carries unlimited liability. The corporation provides limited liability for its owners but can be unwieldy and cumbersome to manage, with numerous technical requirements in creation and ongoing management. Limited liability entities, such as the limited liability company and limited liability partnership, provide the most flexible choice for doing business, multiple options for tax planning, and limited liability for owners.

Chapter 12

Employment Discrimination

LEARNING OBJECTIVES

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

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

Figure 12.1 "An Abercrombie & Fitch Billboard in New York City" shows a billboard for Abercrombie & Fitch (or A&F, as it's sometimes known), a clothing retailer. The Columbus, Ohio-based company generates nearly \$2 billion in sales annually by selling clothes in retail locations throughout North America, Europe, and Asia. As the billboard suggests, A&F's marketing concept (which it calls "Casual Luxury") is based heavily on portraying a certain image. How would you characterize that image? If you used adjectives like athletic, young, all-American, sexy, or attractive, you would be correctly identifying the company's strategy. The strategy works as it has helped the company generate hundreds of millions in profits for its shareholders.

Figure 12.1 An Abercrombie & Fitch Billboard in New York City



Source: Photo courtesy of FaceMePLS, <http://www.flickr.com/photos/faceme/2536281153>.

A&F relies on a message that boils down to convincing its young consumers that by wearing A&F clothing, they will also be young, athletic, and attractive. If consumers don't believe that message, they will likely abandon the brand for another in this hugely competitive segment.

To maintain the authenticity of that marketing message, A&F rigorously hires only models that fit a certain image in print and Web advertising. It extends this practice to store workers so that any time a customer interacts with A&F, that brand image is reinforced.

Is it illegal for A&F to hire only “attractive” people to work in its stores? The answer is no, just as it’s not illegal for *Vogue* magazine to hire only attractive models, or for a cosmetics company to hire only salespeople with clear skin. Under the **employment-at-will**¹ doctrine, workers in the United States are free to work for whomever they want to (or not work at all), and employers are free to hire whomever they want to, and fire them at will. The vast majority of workers in the United States are covered by the at-will doctrine.

If you came in to work with green hair, you could be fired. If you came in to work with a visible body piercing or tattoo, you could be fired. If you get into an argument with your boss about whether baseball or basketball is a better sport, you could get fired. Companies can fire workers for smoking cigarettes, even at home. Companies can fire employees who say anything disparaging or negative about their bosses or the company, even on a private Facebook page. Narrow exceptions lie in the law, such as a company that enters into a written contract to hire a worker for a specified period of time. (Even then, many employment contracts specify at-will status for the worker.) If A&F wishes to engage in “looks-based” discrimination and refuses to hire workers who are overweight, ugly, or have pimples, then it is free to do so under U.S. law.

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

1. Legal doctrine that employees can be hired and fired at the will of the employer.

Hyperlink: Abercrombie & Fitch Settles Discrimination Suit

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

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

Discrimination, then, is not always illegal. A&F can discriminate against ugly people and *Vogue* can discriminate against fat people. When is discrimination illegal? Under what circumstances can employers draw lines of classification within the general population? When does a person fall into a **protected class**² that the law recognizes? What must a disappointed worker be able to prove to demonstrate illegal discrimination? In this chapter we'll explore these issues so that as future business professionals, you'll have a sense of what you can and cannot do when it comes to hiring, managing, and firing employees.

Key Takeaways

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

2. A legislatively created category of workers that are protected from unfavorable employment actions due to their membership in the protected class.

12.1 Overview of Title VII of the Civil Rights Act of 1964

LEARNING OBJECTIVES

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

Hyperlink: Kennedy Calls for Legislative Action on Civil Rights

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

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

In 1963 President Kennedy called for the passage of a sweeping civil rights bill in response to intransigent racial segregation. The bill was vehemently opposed by many in Congress, including avowed segregationists who saw the bill as an intrusion on states' rights. Kennedy was assassinated before he could see the bill passed into law, but his successor President Johnson carried Kennedy's wish forward through aggressive lobbying of Congress to pass the bill. At its core, the bill was designed to integrate African Americans into the mainstream of American society. Today, the Civil Rights Act of 1964 has broad significance for all racial minorities, religious organizations, and women.

Figure 12.2



President John F. Kennedy made passage of the Civil Rights Act a key part of his presidency.

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

- race,
- color,
- religion,
- sex,
- national origin.

Source: Photo courtesy of Abbie Rowe, National Park Service, <http://www.jfklibrary.org/Asset+Tree/Asset+Viewers/Image+Asset+Viewer.htm?guid={0AFA0FD7-9DBA-4467-B051-44A6DD69C48A}&type=Image>.

Any act of discrimination on any of these bases is illegal.

These acts may be a refusal to hire, a discharge or termination, a temporary layoff or retrenchment, compensation, an opportunity for advancement, or any other term or condition of employment. For example, employers are not permitted to maintain all-white or all-black work crews even if they can demonstrate that doing so is good for business or morale. Title VII also prohibits acts of **retaliation**³ against anyone who complains about, or participates in, any employment discrimination complaint. Employers need to be very careful about this provision, because while the employer may be innocent of the first charge of discrimination, taking any subsequent action after an employee has complained can be a separate charge of discrimination. Once an employee has made a complaint of discrimination, it is very important that the employer not alter any condition of his or her employment until the complaint has been resolved.

3. Any adverse employment action taken against an employee who has filed, or is contemplating filing, charges of illegal discrimination.

4. A legitimate reason for why an employer might discriminate against someone who belongs to a protected class.

The law does, however, allow discrimination on religion, sex, and national origin if there is a **bona fide occupational qualification (BFOQ)**⁴ reasonably necessary for normal business operations. For example, a Jewish synagogue may restrict hiring of

rabbis to Jewish people only, and a Catholic church can restrict hiring priests to Catholic men only. A nursing home that caters exclusively to elderly women and is hiring personal assistants to help the patients with personal hygiene and dressing may restrict hiring to women only as a BFOQ. Victoria's Secret can legally discriminate against men in finding models to advertise and market their products. A movie producer can legally discriminate between men and women when casting for certain roles such as a woman to play Bella and a man to play Edward in the popular *Twilight* series. Since BFOQ discrimination extends to national origin, a play producer casting for a role that specifically calls for a Filipino can legally restrict hiring to Filipinos only. A gentlemen's club can hire women only as a BFOQ.

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

Hyperlink: Men and Hooters

<http://www.time.com/time/magazine/article/0,9171,987169,00.html>

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

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

Note that race and color are not on the list of acceptable BFOQs. This means that in passing the law, Congress made a determination that there is no job in the United States where race or color is a bona fide occupational qualification. A country-and-

western-themed restaurant, for example, may not hire only white people as wait staff.

Title VII creates only five protected classes. Various other federal and state laws, discussed in [Chapter 12 "Employment Discrimination", Section 12.3 "Other Federal Antidiscrimination Laws"](#), create other protected classes. Many other classes, such as weight, attractiveness, and height, are not on the list of protected classes. Contrary to popular belief, there is also no federal law that protects against discrimination on the basis of sexual orientation. National restaurant chain Cracker Barrel, for example, for many years maintained an open policy of not hiring homosexuals and dismissing any person who came out at work. It was only under pressure from shareholder activists that the company finally rescinded its discriminatory policy.

Hyperlink: The Employment Non-Discrimination Act

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

Since 2007 Congress has been debating the **Employment Non-Discrimination Act (ENDA)**⁵. The law would specifically prohibit employment discrimination on the basis of sexual orientation. The House passed the bill in 2007, but it died in the Senate. In 2009 new attempts were made at passing the law, but strident partisanship once again ended chances of passage, as this NPR story explains. Do you believe this law should be passed? If it passes, do you see an inconsistency with the Defense of Marriage Act, which prohibits federal recognition of same-sex marriage?

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

Title VII is a federal law, but it does not give victims of discrimination the immediate right to file a federal lawsuit. Instead, Title VII created a federal agency, the **Equal Employment Opportunity Commission (EEOC)**⁶ to enforce civil rights in the workplace. The EEOC publishes guidelines and interpretations for the private sector to assist businesses in deciding what employment practices are lawful or unlawful. The EEOC also investigates complaints filed by workers who believe they

5. A proposed bill that would apply to nonreligious employers with more than fifteen employees and prohibit discrimination on the basis of sexual orientation or gender identity.

6. Federal agency established by the Civil Rights Act of 1964 to enforce antidiscrimination laws.

are victims of unlawful discrimination. If the EEOC believes that unlawful discrimination has taken place, the EEOC can file charges against the employer. Even if the employee has signed a predispute arbitration clause with the employer agreeing to send employment disputes to arbitration, the Supreme Court has ruled that the predispute arbitration clause does not extend to the EEOC, which can still file a lawsuit on the employee's behalf in federal court. *EEOC v. Waffle House, Inc.*, 534 U.S. 279 (2002).

Employees must file Title VII charges with the EEOC first before going to court. If the EEOC investigates and decides not to pursue the case any further, the EEOC can issue a "right to sue" letter. With that letter, the employee can then file a case in federal court within 90 days of the date of the letter. Any EEOC complaint must be filed within 180 days of the alleged discriminatory act taking place. This deadline is generally extended to 300 days if there is a state agency that enforces a state law prohibiting discrimination on the same basis. If employees wait beyond 180 or 300 days, their claims will be dismissed. The question of when the clock begins was the subject of much debate recently when a female manager at Goodyear, Lilly Ledbetter (**Figure 12.3 "Lilly Ledbetter"**), discovered she had been paid unequally compared to males for many years. She filed a Title VII lawsuit in federal court and won several million dollars in damages. At the Supreme Court, however, a narrow 5–4 majority opinion authored by Justice Alito held that she had to file her claim within 180 days of any decision to pay her unequally, which had happened many years ago. *Ledbetter v. Goodyear Tire & Rubber Co.*, 550 U.S. 618 (2007). She therefore lost her case and her damages award. In response, Congress passed the **Lily Ledbetter Fair Pay Act of 2009**⁷, which gives victims the right to file a complaint within 180 days of their last discriminatory paycheck.

Figure 12.3 Lilly Ledbetter



A jury found Lilly Ledbetter was the victim of regular pay discrimination at Goodyear because of her gender.

Source: Photo courtesy of aflcio, <http://www.flickr.com/photos/labor2008/2928072316/sizes/o/in/photostream>.

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

7. Federal law that resets the time to file a charge in unequal pay cases every time a discriminatory paycheck is received.

employees and rise to \$300,000 for employers with more than five hundred employees.

Anyone who files a Title VII claim in federal court must prove his or her claim using one of two possible theories. The first theory, known as **disparate treatment**⁸, alleges that the defendant employer acted intentionally to discriminate against the victim because of the victim's membership in a protected class. Winning a disparate treatment case is very hard because it essentially requires proof that the defendant acted intentionally, such as a statement by the defendant that it is not hiring someone because of that person's race, an e-mail to the same effect, or some other sort of "smoking gun" evidence. If a defendant wants to discriminate against someone illegally in the workplace, it is very unusual for it to say so explicitly since under the at-will doctrine, it is easy for an employer to find a lawful reason to discriminate.

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

8. Intentional discrimination against a member of a protected class.
9. A theory of liability under employment discrimination law that prohibits an employer from using a facially neutral policy that has an unfavorable impact on members of a protected class.
10. If a policy has a disparate impact on members of a protected class, the employer can justify the policy if it is essential to the employer and no alternative nondiscriminatory policy exists.

If a victim is unable to find proof of disparate treatment, he or she may instead use a theory called **disparate impact**⁹, where the discrimination is unintentional. Most Title VII cases fall into this category because it is so rare to find proof of the intentional discrimination required in disparate treatment cases. In a disparate impact case, the victim alleges that the defendant has adopted some form of race-neutral policy or employment practice that, when applied, has a disproportionate impact on certain protected classes. If a victim successfully demonstrates a disparate impact, then the employer must articulate a nondiscriminatory **business necessity**¹⁰ for the policy or practice. The Supreme Court first articulated this theory in 1971 in a case involving a power company that implemented an IQ test and high school diploma requirement for any position outside its labor department, resulting in very few African Americans working at the power company other than in manual labor. The Court held that the Civil Rights Act "proscribes not only overt discrimination, but also practices that are fair in form, but discriminatory in operation. The touchstone is business necessity." *Griggs v. Duke Power Co.*, 401 U.S.

424 (1971). In that case, the Court found that the power company could not prove a business necessity for having the IQ tests or high school diploma requirement, so those practices were ruled illegal.

Business policies that raise suspicions for disparate impact include educational qualifications, written tests, intelligence or aptitude tests, height and weight requirements, credit checks, nepotism in hiring, and subjective procedures such as interviews. Businesses that have these sorts of policies need to be very careful that the policies are directly related to and necessary for the job function under consideration. In one recent case, the city of Chicago received more than twenty-six thousand applications for firefighters in 1995 for only several hundred positions. The city required all the applicants to take a test, and it used that test to categorize applicants as failing, qualified, or well-qualified. Faced with so many applicants, the city decided to hire only candidates who received a well-qualified score. African Americans made up 45 percent of the qualified group, but only 11.5 percent of the well-qualified group, so the decision had an adverse and disparate impact on a protected class. More than ten years later and after an appeal all the way to the Supreme Court on the question of timeliness of their lawsuit, the plaintiffs are still waiting for a trial on whether the city acted illegally. *Lewis v. Chicago*, 560 U.S. ___ (2010), <http://www.law.cornell.edu/supct/html/08-974.ZS.html> (accessed September 27, 2010).

Proving a disparate impact case is not easy for victims of discrimination. It is not enough for the employee to use statistics alone to point out that a job policy or practice has a disparate impact on the victim's protected class. In addition, the 1991 amendments to the Civil Rights Act prohibited the use of **race norming**¹¹ in employment testing.

11. The practice of grading employment-related tests or qualifications differently, based on the race of the candidate or applicant.

KEY TAKEAWAYS

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

EXERCISES

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

12.2 Enforcement of Title VII

LEARNING OBJECTIVES

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

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

Figure 12.4



Difference in the workplace should be celebrated but can sometimes lead to illegal discrimination.

© Thinkstock

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

Hyperlink: Diversity Day at *The Office*

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

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

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

To correct past mistakes in treatment of women and minorities, many companies go beyond being equal opportunity employers by adopting **affirmative action**¹² programs. Companies are not required to undertake affirmative action programs, but many do. In some instances, they do so to qualify as a federal contractor or subcontractor. Under Executive Order 11246, most federal contractors or subcontractors must develop an annual affirmative action plan and take

12. Specific actions taken by employers to eliminate the effects of past discrimination.

“affirmative steps” to recruit, hire, and train females and minorities in the workforce. Even companies that do not seek to sell to the federal government may voluntarily undertake affirmative action programs, as long as those programs are meant to correct an imbalance in the workforce, are temporary, and do not unnecessarily infringe on the rights of nonbeneficiaries.

Affirmative action plans can be tricky to administer because white Americans can also be the victims of race discrimination or so-called **reverse discrimination**¹³. The provisions of Title VII are meant to protect all Americans from race discrimination. One of the earliest cases of reverse discrimination took place in 1981, when a white air traffic controller successfully sued the Federal Aviation Administration (FAA), claiming the FAA had hired women and racial minorities over him. In one recent case, the fire department in the city of New Haven conducted a management test to decide which firefighters to promote. When no black firefighters passed the test, the city decided to invalidate the test. Nineteen firefighters who did pass the test (all white or Hispanic) filed suit, alleging the city’s actions violated Title VII. The Supreme Court found in favor of the firefighters, holding that the city’s fear of a discrimination lawsuit from minorities if it went forward with the test was not enough justification to discriminate against the white firefighters. *Ricci v. DeStefano*, 557 U.S. ___ (2009), <http://www.law.cornell.edu/supct/html/07-1428.ZS.html> (accessed October 2, 2010).

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

13. Discrimination against a majority group.

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

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

Members of one of the world's oldest religions, Sikhism, do not cut their hair and wear their hair in a turban. Since 1984 this has been prohibited by the U.S. Army, which has standards for both hair and facial hair for recruits. In 2010 the army lifted this prohibition, resulting in the first Sikh Army officer, Captain Tejdeep Singh Rattan ([Figure 12.5 "Captain Tejdeep Singh Rattan, the First Sikh Army Officer"](#)), in more than twenty-five years, as this NPR story explains.

*Figure 12.5
Captain Tejdeep Singh Rattan,
the First Sikh Army Officer*



Source: Photo courtesy of the U.S. Army, <http://www.flickr.com/photos/soldiersmediacenter/4464653659/sizes/o>.

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

Additionally, employers must reasonably accommodate an employee's religious beliefs or practices as long as it does not cause an undue hardship on the employer's operation of its business. Typically, this would involve being flexible in schedule changes or leaves. A Muslim worker who asked for a few short breaks a day to pray, for example, might be reasonable for an administrative assistant but not for a police officer or air traffic controller. Issues of dress and appearance are often grounds for charges of religious discrimination. For example, if a Muslim woman wished to wear a *hijab*, or traditional headscarf, then she should be permitted to do so unless it places an undue hardship on operations. In 2010, UPS agreed to settle a case with the EEOC, paying \$46,000 in damages for firing a driver who refused to cut his hair or shave his beard, which the driver believes would violate tenets of his Rastafarian religion. U.S. Equal Employment Opportunity Commission, "UPS Freight to Pay \$46,000 to Settle EEOC Religious Discrimination Lawsuit," February, 17, 2010, <http://eeoc.gov/eeoc/newsroom/release/2-17-10.cfm> (accessed September 27, 2010).

Figure 12.6



Workplace accommodation includes allowing Muslim women to wear a hijab at work.

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

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

The prohibition on sex discrimination means that employers cannot categorize certain jobs as single-sex only unless a bona fide occupational qualification (BFOQ) applies. Customer preferences or market realities are not the basis for BFOQ. For example, a job that requires heavy lifting cannot be categorized as male-only since a woman may qualify after passing a physical test. As society has changed, much progress has been made in this area of equal employment opportunity. Airlines, for example, used to routinely hire predominantly single young women as flight attendants ([Figure 12.7 "An Advertisement for PSA Airlines"](#)). Male cabin crew could marry, but women could not. Those distinctions have now been erased, partially because of Title VII, and partially because of societal attitudes.

Figure 12.7 An Advertisement for PSA Airlines



Source: http://gulfnnews.com/polopoly_fs/an-airline-advertisement-of-the-1960s-1.564441!image/4155641854.jpg_gen/derivatives/box_475/4155641854.jpg.

The prohibition against sex discrimination also includes making stereotypical assumptions about women simply because they might be the primary caregiver to children at home. If there are two job applicants, for example, and both have young children at home, it would be illegal to give preference to the male candidate over the female candidate. Once a female employee has children, it would be illegal to assume that she is less committed to her job, or would like to work fewer hours. It's important to note that these protections extend to men as well. If an employer voluntarily provides time off to new mothers, for example, it must extend identical benefits to new fathers.

Discrimination on the basis of sex can also take the form of workplace sexual harassment. Contrary to popular belief, there isn't an actual statute that makes sexual harassment illegal. Instead, sexual harassment is the product of judicial interpretation of what it means to discriminate on the basis of sex. Courts have generally recognized two forms of sexual harassment. The first, known as **quid pro quo**¹⁴, involves asking for sexual favors in return for job opportunities or advancement. Courts reason that if a male worker asks a female worker for sex in return for favorable treatment, it is because that worker is female, and therefore a Title VII violation has occurred. If a supervisor fires a subordinate for breaking up with him or her, then quid pro quo harassment has taken place.

14. In sexual harassment law, asking for sexual favors in return for favorable job action.

15. Harassing actions that are so severe and pervasive that they alter the conditions of one's employment.

Another type of sexual harassment is known as the **hostile work environment**¹⁵. First recognized by the Supreme Court in 1986, a hostile work environment is one where hostile conditions in the workplace are severe and pervasive, unwelcome, and based on the victim's gender. *Meritor Savings Bank v. Vinson*, 477 U.S. 57 (1986). Courts are careful not to impose manners on workplaces, so an offhand remark or

dirty joke is unlikely to be sexual harassment. To be considered sexual harassment, the harassment must be so severe or pervasive that it alters the conditions of the victim's employment. In one recent case, the EEOC collected \$471,000 for thirteen female telemarketers from a firm providing basement waterproofing services. The harassment by male managers and coworkers at the firm included repeated requests for sex, frequent groping, sexual jokes, and constant comments about the bodies of women employees. U.S. Equal Employment Opportunity Commission, "EEOC Collects \$471,000 Jury Award after Winning Appeal from Waterproofing Company in Sex Harassment Case," May 5, 2010, <http://www.eeoc.gov/eeoc/newsroom/release/5-5-10.cfm> (accessed September 27, 2010). Similar cases involve workplace atmospheres where women are heckled with sexual comments, propositioned for sex, made to listen to crude sexual comments or comments about their bodies, subject to pornography in the workplace, or invited to after-work outings to strip clubs.

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

KEY TAKEAWAYS

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

EXERCISES

1. If a Jewish or Muslim worker asked for halal or kosher food in the employee cafeteria, should an employer accommodate this request? Why or why not? What factors do you think the employer should consider before making a decision?
2. In many countries it is common for résumés to contain photos of the job applicants. It is also common to classify jobs by sex (i.e., a job posting for a female secretary or male forklift driver). What do you believe the United States has gained or lost by moving away from this system of job applicant screening?
3. Do you believe that the school bus driver in Minnesota should be permitted to refuse driving a bus if it carries an advertisement that the driver believes promotes immoral lifestyles? Why or why not? Should a vegetarian driver be permitted to refuse to drive a bus with an advertisement for hamburgers? Should a Post Office delivery person be permitted to refuse to deliver copies of *Playboy* magazine on the same grounds?
4. Can you think of any jobs where speaking English without an accent may be very important or essential?

12.3 Other Federal Antidiscrimination Laws

LEARNING OBJECTIVES

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

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

The first statute is the **1866 Civil Rights Act**¹⁶. It was passed after the Civil War to guarantee freed slaves the rights of citizenship, and it is still in force today. It prohibits discrimination on the basis of race, including private discrimination. The 1866 Civil Rights Act provides victims of race discrimination several advantages over Title VII. Unlike Title VII, victims do not need to file a complaint with the Equal Employment Opportunity Commission (EEOC) first—they can go straight to federal court to file a complaint. In addition, the strict filing deadlines under Title VII do not apply. Finally, the statutory limits on punitive damages under Title VII do not apply, so higher damages are possible under the 1866 Civil Rights Act. Unlike Title VII, however, the 1866 Civil Rights Act only prohibits racial discrimination. In most race discrimination cases, plaintiffs file both Title VII claims and claims under the 1866 Civil Rights Act. These are commonly known as **Section 1983**¹⁷ claims, named after the section of the U.S. statute that allows victims of race discrimination to file their complaints in federal court.

16. Federal law that makes everyone born in the United States citizens and makes job discrimination on the basis of race illegal.
17. A federal lawsuit based on an alleged violation of the 1866 Civil Rights Act.

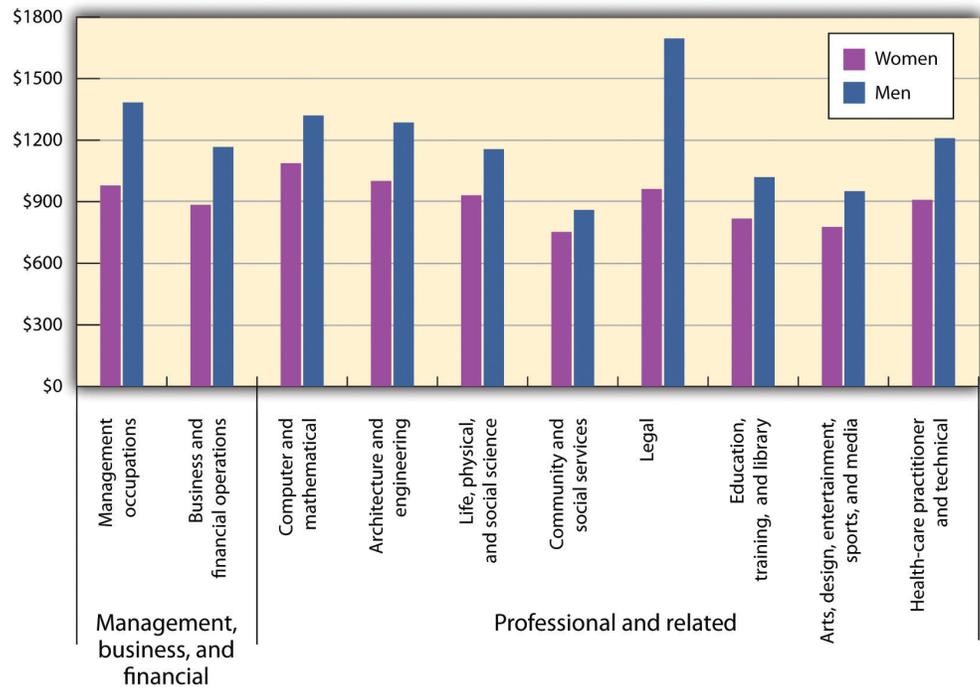
Figure 12.8



Older workers are protected from employment discrimination.

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Figure 12.9 Median Weekly Earnings of Women and Men in Management, Professional, and Related Occupational Groups, 2008



Women still make less than their male counterparts across all industries.

Source: Adapted from U.S. Bureau of Labor Statistics, "Women and Men in Management, Professional, and Related Occupations, 2008," August 7, 2009, http://bls.gov/opub/ted/2009/ted_20090807.htm (accessed September 27, 2010).

The **Equal Pay Act of 1963**¹⁸ seeks to eliminate the wage gap between women and men. In 1970 women earned roughly sixty-two cents for every dollar men earned. In 2004 that number had climbed to eighty cents. In 2008 women still earn less than their male counterparts in all sectors of the economy, as the chart from the Bureau of Labor Statistics demonstrates (Figure 12.9 "Median Weekly Earnings of Women and Men in Management, Professional, and Related Occupational Groups, 2008"). The Equal Pay Act demands that employers provide equal pay for equal work, and it applies to all employers. All forms of compensation are covered by the act, including benefits such as vacation and compensation such as salary and bonus. Victims do not need to file a complaint with the EEOC under the Equal Pay Act, but may instead go straight to federal court, as long as they do so within two years of the alleged unlawful employment practice. Victims typically also pursue Title VII claims at the same time they pursue Equal Pay Act claims.

18. Federal law that requires equal pay for equal work.

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

Hyperlink: Despite New Law, Gender Salary Gap Persists

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

In some part, women make less money than men because they voluntarily leave the workforce to raise children, or because women are directed to occupations with traditionally less pay. Even if these factors are eliminated, however, there is still a pay gap between women and men. This gap grows over time, leaving women with hundreds of thousands less at the end of a career when compared with a male’s comparable career. Now, Congress is considering new legislation to address the problem in the **Paycheck Fairness Act**¹⁹, as this NPR story explains.

19. A proposed federal law to increase damages under the Equal Pay Act and reduce the possible defenses for employers.
20. Federal law that amended Title VII to make it illegal to discriminate against a woman because she is pregnant or considering pregnancy or because of prejudices against pregnant women by coworkers or customers.
21. Federal law that prohibits discrimination on the basis of age, protecting workers over the age of forty.

The **Pregnancy Discrimination Act of 1978**²⁰ amended Title VII to make it illegal to discriminate on the basis of pregnancy, childbirth, or related medical conditions. This means employers cannot refuse to hire a woman because she is pregnant or is considering becoming pregnant, or because of prejudices held by coworkers or customers about pregnant women. A female worker who becomes pregnant is entitled to work as long as she can perform her tasks, and her job must be held open for her while she is on maternity leave. Furthermore, pregnancy-related benefits cannot be limited only to married employees.

The **Age Discrimination in Employment Act of 1967 (ADEA)**²¹ makes it illegal to discriminate against workers over the age of forty. It does not protect younger workers, who are of course subject to a form of discrimination every time they are told an employer is looking for someone with more experience. The ADEA applies to any employer with over twenty workers, including state governments. Partnerships such as law firms and accounting firms are also covered under the ADEA. In 2007 a major law firm, Sidley Austin, agreed to pay \$27.5 million to former partners the

firm had terminated because of their age, resulting in a median payout of over \$875,000 per terminated partner. U.S. Equal Employment Opportunity Commission, “\$27.5 Million Consent Decree Resolves EEOC Age Bias Suit against Sidley Austin,” October 5, 2007, <http://www.eeoc.gov/eeoc/newsroom/release/10-5-07.cfm> (accessed September 27, 2010). The ADEA prohibits employers from treating any covered person unfavorably in any term or condition of employment, including the hiring decision. It is illegal, for example, to hire an inexperienced twenty-five-year-old for a job when a fifty-year-old is better qualified and willing to work for the same conditions. An employer may, however, favor an older worker over a younger worker even if the younger worker is over forty years of age. Mandatory retirement age is illegal under the ADEA, except for very high-level executives over the age of sixty-five who are entitled to a pension.

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

Of course, older workers can still be dismissed for good cause, such as poor job performance or employee misconduct. Companies may also administer a layoff plan or early retirement plan that is evenly applied across all workers, and can offer early retirement incentives to induce workers to retire. Typically when companies ask a worker to retire early or take an incentive to leave the company, the worker is asked to sign an **ADEA waiver**²², giving up any claims the worker may have under the ADEA. These waivers are fully enforceable under the ADEA as long as they are “knowing and voluntary,” in writing, and provide the worker with at least twenty-one days to consider the waiver and seven days to revoke it after signing it.

Although it was passed around the same time as Title VII, for decades courts held that only disparate treatment cases under the ADEA were viable. That meant plaintiffs had to find proof of intentional discrimination to recover, so there were relatively few successful age discrimination cases. To make matters even harder for older workers, in 2009 the Supreme Court held that older workers suing under the ADEA had to prove that their age was a “but-for” reason for their termination, or the sole cause for termination. *Gross v. FBL Financial Services*, 557 U.S. ___ (2009), <http://www.law.cornell.edu/supct/html/08-441.ZS.html> (accessed October 2, 2010). This makes age discrimination much harder to prove than discrimination because of sex or race, where illegal discrimination only has to be one of several factors that motivated the employer. In fact, the 2009 decision made it all but impossible for older workers to prove intentional discrimination, and congressional efforts to

22. A waiver signed by an employee that he or she is voluntarily giving up his or her rights to file a claim under the ADEA.

overturn the decision in the form of the Protecting Older Workers Against Discrimination Act are pending.

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

After the major laws of the 1960s were passed, Congress did very little to protect civil rights in the workplace for many years. This changed in 1990, when Congress passed a major new piece of legislation known as the **Americans with Disabilities Act of 1990 (ADA)**²³, signed into law by President George H. W. Bush. With passage of the ADA, Congress sought to expand the promise of equal opportunity in the workplace to cover persons with disabilities. Unfortunately, the ADA was less than clear in many critical aspects when it was written, leaving courts to interpret what Congress may have meant with specific ADA language. An increasingly conservative judiciary, including the Supreme Court, began interpreting the ADA fairly narrowly, making it harder for people with disabilities to win their court cases. Congress responded with the **Americans with Disabilities Amendments Act of 2008 (ADAA)**²⁴, signed into law by President George W. Bush, which specifically overturned several key Supreme Court decisions to broaden the scope of the ADA.

23. Federal law that prohibits discrimination against persons with disabilities.

24. Federal law that amends the Americans with Disabilities Act and reverses several key Supreme Court opinions interpreting the ADA.

The ADA is broken down into several titles. Title III, for example, deals with requirements for public accommodations such as wheelchair ramps, elevators, and accessible restrooms for new facilities. Title II deals with the ADA’s applicability to

state and local governments. For employees, the most important provisions are located in Title I, which makes it illegal for employers with fifteen or more employees to discriminate against “qualified individuals with disabilities.”

It is a common misconception that the ADA requires employers to hire disabled workers over able-bodied workers. This is simply not true because the ADA only applies to the **qualified disabled**²⁵. To be qualified, the individual must meet the legitimate skill, experience, education, or other requirements for the position he or she is seeking and be able to perform the “essential functions” of the job without reasonable accommodation. In other words, the first step an employer must take is to define what the **essential functions**²⁶ of the job are, and then see if a disabled individual who has applied for the job meets the requirements for the job and can perform those essential functions. Obviously, someone who is legally blind will not be permitted to be a bus driver or airline pilot under this test. Similarly, a paraplegic will not be qualified to work as a forklift operator since that person will be unable to perform the essential functions of that job without reasonable accommodation. On the other hand, the “essential functions” test means that employers must be very careful in denying employment to someone who is disabled. If the reason for denying employment is the disabled person’s inability to perform some incidental task (rather than an essential function), then that is illegal discrimination. The ADA also permits employers to exclude any disabled individual who poses a direct threat to the health or safety to the individual or of others, if the risk of substantial harm cannot be reduced below the level of “direct threat” through reasonable accommodation.

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

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

25. A person who meets the minimum educational, skill, and experience requirements for the job posted, with or without reasonable accommodation.

26. Job functions whose removal would fundamentally change the nature of the job.

cancer patient recovers fully and has no physical sign of cancer, that patient is still considered protected by the ADA because he has a “record” of a qualifying disability.

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

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

Under the new ADAA and EEOC guidelines, a list of impairments that substantially limit a major life activity that will “consistently” result in a disability determination might include blindness, deafness, intellectual disability, missing limbs, mobility impairments requiring the use of a wheelchair, autism, cancer, cerebral palsy, diabetes, epilepsy, HIV/AIDS, multiple sclerosis, muscular dystrophy, major depression, bipolar disorder, posttraumatic stress disorder, obsessive compulsive disorder, and schizophrenia. U.S. Equal Employment Opportunity Commission, “Summary of Key Provisions: EEOC’s Notice of Proposed Rulemaking (NPRM) to Implement the ADA Amendments Act of 2008 (ADAA),” <http://www.eeoc.gov/laws/regulations/adaaa-summary.cfm> (accessed September 27, 2010). Other impairments that may require more analysis to determine if they substantially limit an individual’s major life activities include asthma, high blood pressure, back and leg impairments, learning disabilities, panic or anxiety disorders, some forms of depression, carpal tunnel syndrome, and hyperthyroidism. The impairment cannot be temporary or nonchronic (such as the common cold, seasonal influenza, sprained joint, minor gastrointestinal disorders, seasonal allergies, broken bones,

and appendicitis). However, an impairment that is episodic such as epilepsy or cancer would qualify if it limits a major life activity while it is active. Pregnant women are generally not considered disabled, although of course other civil rights statutes, such as Title VII, may protect them. Note that while current illegal drug users are not considered disabled, alcoholics may be considered disabled if the disease substantially limits a major life activity.

Although an employer is not required to hire the unqualified disabled, if it does hire a disabled individual it must provide **reasonable accommodation**²⁷ to any disabled worker who asks for it. Reasonable accommodation is any change or adjustment to the work environment that would allow the disabled worker to perform the essential functions of the job or to allow the disabled worker to enjoy the benefits and privileges of employment equal to employees without disabilities. Reasonable accommodation might include allowing the worker to work part-time or modified work schedules; reassigning the worker to a vacant position; purchasing special equipment or software; providing readers or interpreters; or adjusting or modifying exams, training materials, and policies. Employers do not have to undertake reasonable accommodation if doing so would cause them **undue hardship**²⁸, meaning it would require significant difficulty or expense, or significantly alter the nature or operation of the business. Among factors to be considered in whether an accommodation would pose an undue hardship are the cost of the accommodation as well as the employer's size and financial resources.

KEY TAKEAWAYS

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

27. Any requested reasonable change in the work environment of a disabled person that would permit that person to perform the essential functions of his or her job.
28. An excuse from providing accommodation because it represents a significant difficulty or expense to the employer.

EXERCISES

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

12.4 Concluding Thoughts

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

Hyperlink: A Class Divided

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

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

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

It is hard to prove an employment discrimination case, under either disparate treatment or disparate impact cases. For example, the Equal Employment Opportunity Commission (EEOC) collects statistics for each type of charge filed with the commission and how the case is resolved. In 2009, for race-based charges, 66 percent resulted in a finding of “no reasonable cause,” meaning the EEOC found no evidence of discrimination. U.S. Equal Employment Opportunity Commission, “Race-Based Charges FY 1997–FY 2009,” <http://eeoc.gov/eeoc/statistics/enforcement/race.cfm> (accessed September 27, 2010). For religion-based charges, 61 percent

resulted in a finding of “no reasonable cause.” U.S. Equal Employment Opportunity Commission, “Religion-Based Charges FY 1997–FY 2009,” <http://eeoc.gov/eeoc/statistics/enforcement/religion.cfm> (accessed September 27, 2010). The proof necessary to win these cases, as well as the reluctance of plaintiffs to come forward when they might be reliant on the employer for a continuing paycheck, mean that many instances of illegal discrimination go unreported. Often, those being discriminated against are among vulnerable populations with no independent means of living if they lose their jobs. To top it off, the low success rates mean that attorneys in employment discrimination cases rarely take their cases on contingency, so victims have to pay expensive hourly fees. The rise of predispute arbitration clauses in the employment setting also means that workers facing illegal discrimination face a huge chasm between the promise of equality under the law and the reality of pursuing that promise.

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

Chapter 13

Business in the Global Legal Environment

LEARNING OBJECTIVES

After reading this chapter, you should understand the foundational concepts of business in the global environment. You will learn about why it is important to understand the global legal environment, as well as some of the sources of international law that pertain to business. You will examine the concept of sovereignty and the unique challenges that concept poses, specifically in relation to ethical questions arising in the international business context. You will explore concepts critical to conducting business in the international environment, including trade regulations, international contract formation, and prohibited activities. At the conclusion of this chapter, you should be able to answer the following questions:

1. Why is the global legal environment important to all businesses?
2. What is international law?
3. What laws are relevant to businesses operating internationally?
4. What are some current ethical issues associated with the global environment of business?
5. What legal considerations exist with respect to trade regulations, international contract formation, employment and human rights issues, and prohibited activities in the international environment?

It's a globalizing world. If you are considering starting a small business, it may not occur to you to consider exporting your product. However, according to the Small Business Association, 96 percent of the world's potential customers live outside of the United States. U.S. Small Business Administration, "Take Your Business Global," June 2010, http://www.sba.gov/idc/groups/public/documents/sba_program_office/oit_sba_fast_facts.pdf (accessed September 27, 2010). So what's stopping you? Maybe you are not sure how to negotiate a contract with a supplier or manufacturer overseas. Or maybe you are uncertain about U.S. laws relating to importing and exporting. The international

Figure 13.1 Global Business



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market is lucrative, though the legal environment for operating in that forum is different from that for a business that operates exclusively within the borders of the United States. For this reason, it is important to be familiar with some of the basic concepts of doing business in the global economy.

You may be acquainted with challenges faced by U.S. businesses and workers when considering the questions associated with this new business environment. When we shop for food, computers, clothing, pet food, automobiles, or just about anything produced for the global market, we might very well purchase a final product from a different country, or a product composed of components or labor from many different parts of the world. Economists tell us that this represents the most efficient method of production and labor. After all, if a business can pay \$1 per hour to a worker overseas, why would it choose instead to pay \$12 per hour to a U.S. worker?

Of course, it's not necessarily a sunny picture for people whose jobs have been outsourced. Additionally, businesses operating in the international environment face unique questions. For instance, if the new labor force that is being paid \$1 per hour is composed of workers who are forced into sweatshop conditions, then there may be serious consumer backlash against the company that has chosen to do business with that particular manufacturer. Check out [Note 13.2 "Hyperlink: National Labor Committee"](#) to view current stories about modern sweatshops that produce goods that you may own.

Hyperlink: National Labor Committee

<http://www.nlcnet.org>

Click on Alerts or Reports at the top of the page. Do you recognize any products that you own or companies that you enjoy shopping with?

Even if the consumers do not respond negatively to business decisions that result in the use of child labor or sweatshop conditions for the production of goods, the question of ethics still remains. For instance, does a company wish to place profit over concerns that it might have about human rights? And, does a company have any long-lasting duties to its U.S. workforce, or is it all right to simply outsource jobs if it makes economic sense to do so?

Besides human rights issues, other concerns about doing business in the international environment exist. For example, it is not uncommon for polluting industries to locate to countries that have laxer environmental regulations than they would face at home. Environmental degradation, such as the overuse of natural resources, generation of pollution, and improper disposal of waste products, is a common by-product of global businesses.

International business includes not only trade in new goods but also the disposal of old ones. For example, the U.S. Government Accounting Office found, after an undercover investigation, that many U.S. companies were willing to export old electronic products that contain cathode-ray tubes (CRTs), each composed of several pounds of lead, to countries where unsafe recycling practices occur, without following U.S. regulatory law. Unsafe recycling of toxic electronic waste, known as **e-waste**¹, has serious effects on the environment and on human health. Additionally, some of the companies that were willing to do this have publically proclaimed their commitments to environmentally safe practices. U.S. Government Accountability Office, “Electronic Waste: EPA Needs to Better Control Harmful U.S. Exports through Stronger Enforcement and More Comprehensive Regulation,” GAO 08-1044, August 2008, <http://www.gao.gov/new.items/d081044.pdf> (accessed September 27, 2010). Check out [Note 13.4 "Hyperlink: E-waste: From the United States to China"](#) for a video concerning U.S. exporting of toxic waste.

Hyperlink: E-waste: From the United States to China

<http://www.cbsnews.com/video/watch/?id=5274959n&tag=related;photovideo>

Environmental degradation is much like sweatshop labor in the sense that some companies that engage in harmful practices will pay the price by suffering the fallout from consumer protests. Again, regardless of consumer reaction, the question of whether to engage in such practices is not only a legal question but also a question of ethics.

This chapter explores the nature of international law. Additionally, it reviews considerations that are relevant to businesses operating internationally, such as trade regulations, contract formation between international parties, and prohibited activities. It also examines some current ethical issues associated with the global environment of business.

1. Electronic waste, often containing toxic materials that are subject to regulation by the U.S. Environmental Protection Agency.

Exercises

1. Check out [Note 13.2 "Hyperlink: National Labor Committee"](#), the Web site for the National Labor Committee. Click on Alerts or Reports at the top of the page. Do you recognize any products that you own or companies that you do business with? Pick a story concerning a company that you do business with, or that you have considered doing business with. After reading the report, would you consider boycotting that company's products? Why or why not?
2. View the video in [Note 13.4 "Hyperlink: E-waste: From the United States to China"](#). What types of e-waste do you produce? Where does it go? For example, how did you dispose of your last cell phone? Your last computer? Your last iPod?

13.1 The Nature of International Law

LEARNING OBJECTIVES

1. Compare and contrast the structure of international law with that of domestic law.
2. Understand the difference between international law between states and law as it applies to businesses operating internationally.

Imagine hearing allegations that your company's products are being assembled overseas in working conditions that have resulted in extreme despondency among workers, including several suicides. This is precisely the situation that Apple, Dell, Hewlett-Packard, and others find themselves in. Foxconn, which is part of the Taiwan-based Hon Hai Precision Industry Co., operates a large electronics assembly complex in China. Allegations have arisen that harsh working conditions have led to a string of suicides. If true, should these U.S. companies find another electronics manufacturer to assemble their products? Do consumers have any voice in this matter?

Figure 13.2 International Law



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From your seat, it may seem like an obvious point that businesses should follow the laws and behave ethically in their business dealings if they wish to be successful for the long haul. However, when we look at the question of how a company might “follow the law,” we need to consider which laws we are referring to. When a U.S. company conducts business in another country, it must comply with applicable U.S. law, and with the law of the foreign nation where it is located. Several U.S. laws apply to the business activities of U.S. companies operating on foreign soil. However, it is perfectly legal for a U.S. company to contract with an overseas manufacturer for labor, without insisting that those workers are paid a wage equal to the U.S. federal minimum wage. In the case of Hon Hai and Foxconn, none of the U.S. companies can get into legal trouble regarding the fact that, until very recently, the average worker there made the equivalent of \$132 per week, which is, of course, far below the U.S. federal minimum wage. Ting-I Tsai, “Hon Hai Gives Workers a Raise,” *Wall Street Journal*, May 29, 2010, http://online.wsj.com/article/SB10001424052748703957604575272454248180106.html?mod=WSJ_hpp_sections_tech (accessed September 27, 2010). There are several reasons for this.

Imagine that Apple alleged that labor conditions were not contractually satisfied and, therefore, Foxconn and Hon Hai Precision Industry Co. breached the agreement that they had made with Apple. If this were the case, Apple may wish to terminate its relationship with these companies. However, it is unlikely that the Asian companies would agree. This means that a dispute could arise under a contract between international parties. If Foxconn and Hon Hai disputed this allegation, which rule of law should govern the dispute? In the United States, contracts laws are state law rather than federal law, so should the laws of a particular state, like California, be applied to this dispute? Or should Chinese law apply? This can be a complicated question for several reasons. However, it is necessary to first examine of the nature of international law to understand this complexity. Try to make a distinction between the nature of international law between nation-states and the nature of law as it applies to businesses operating in the international arena. In the next section, we will return to the question of which type of law should apply to disputes in international contracts.

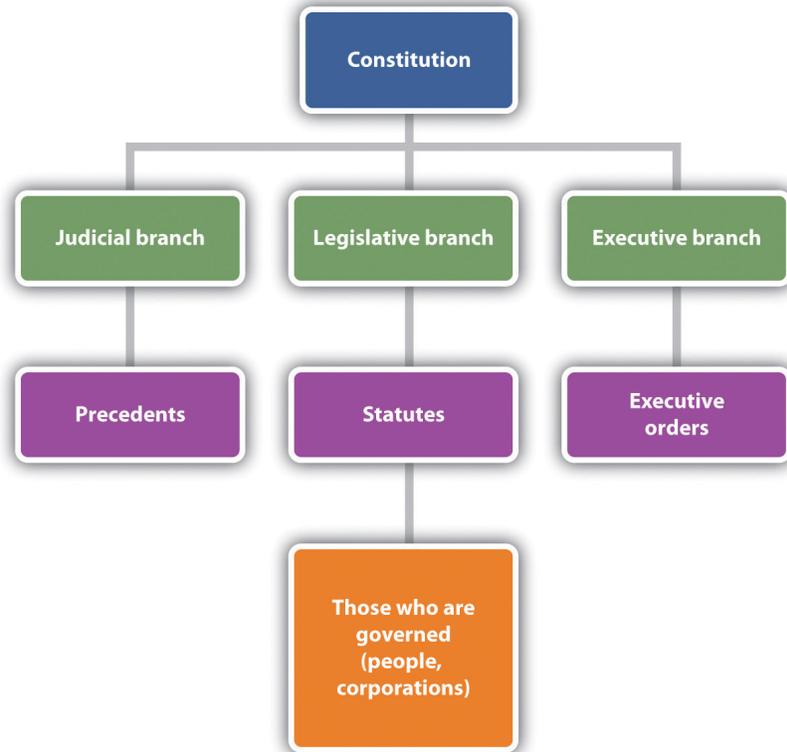
The Basics of International Law between Nation-States

We are all subject to domestic laws, because we all live in a **sovereign state**². A sovereign state is a political entity that governs the affairs of its own territory without being subjected to an outside authority. Countries are sovereign states. The United States, Mexico, Japan, Cambodia, Chile, and Finland are all examples of sovereign states. In **domestic law**³, or law that is applicable within the nation where it is created, some legitimate authority has the power to create, apply, and enforce a rule of law system. There is a legitimate law-creating authority at the “top,” and the people to be governed at the “bottom.” The law might be conceived of as being “handed down” to the people within its jurisdiction. This is a vertical structure of law, because there is some “higher” authority that imposes a rule of law on the people. In the United States, laws are handed down by the legislative branch in the form of statutory law, by the judicial branch in the form of common law, and by the executive branch in the form of executive orders, rules, and regulations. These government branches have legitimate authority to create a rule of law system, and this authority is derived from the U.S. Constitution. See [Figure 13.3 "The Vertical Nature of U.S. Domestic Law"](#) for a simple illustration of the vertical nature of domestic law in the United States. Of course, people can influence who become members of the branches of government through elections and which issues are brought before government to consider and possibly legislate, but that does not change the fact that people are subjected to laws that are handed down in a vertical nature.

2. A political entity that governs the affairs of its own territory without being subjected to an outside authority.

3. Law that is applicable in the nation in which it is created.

Figure 13.3 *The Vertical Nature of U.S. Domestic Law*



It's important to note, however, that not all law can be conceived as a vertical structure. Some laws, such as **international law**⁴, or law between sovereign states, are best thought of in a horizontal structure. For example, treaties have a horizontal structure. This is because the parties to international treaties are sovereign states. Since each state is sovereign, that means that one sovereign state is not in a legally dominant or authoritative position over the other. See [Figure 13.4 "An Illustration of the Horizontal Nature of International Law between Nation-States"](#) for an illustration of the horizontal nature of international law between nation-states, using the North American Free Trade Agreement as an example.

Figure 13.4 *An Illustration of the Horizontal Nature of International Law between Nation-States*



4. Law between sovereign states.

An obvious challenge to laws created in horizontal power structures that lie outside of any legitimate lawmaking authority “above” the parties is that enforcement of violations can be difficult. For this reason, many horizontal laws, like treaties, contain provisions that require the parties to the treaty to submit to a treaty-created dispute resolution panel or other neutral tribunal, such as the **International Court of Justice**⁵ (ICJ). Though it is common for treaties to set forth expectations that disputes will be heard before some predesignated tribunal, some international relations experts believe that the state of international law is one of persistent anarchy.

Examine the differences between vertical structure and horizontal structures of law. Consider the case of a criminal in the United States. The criminal can be prosecuted by the laws of the United States (federal or state, depending on the jurisdiction of the offence) and, if convicted, will have to submit to the authority of the United States for punishment. This is because we recognize that there is some legitimate authority in domestic law that allows the U.S. government to exact punishment against convicted criminals. Compare this to a sovereign state that violates a treaty agreement. For example, perhaps a member of a treaty has broken its treaty promise to refrain from fishing in a certain fishery. Since in the international arena there is no overarching power “above” the parties to a treaty, enforcement of treaty agreements can be difficult.

Another common challenge in international law is that the laws are applicable only to parties who voluntarily choose to participate in them. This means that a sovereign state cannot generally be compelled to submit to the authority of the international law if it chooses not to participate. Compare this with domestic law. Everyone within the United States, for example, is subject to the jurisdiction of certain state and federal courts, whether they voluntarily choose to submit to jurisdiction or not. This is why fleeing criminals can legitimately be caught and brought to justice in domestic law through extradition.

The Nature of Law as It Applies to Businesses Operating in the International Arena

Businesses are not involved in signing treaties or in creating law that applies between sovereign states. Indeed, the sovereign states themselves have the only power to conduct foreign affairs. In the United States, that power rests with the president, though Congress also has important roles. For example, the Senate must ratify a treaty before the treaty binds the United States and before its provisions become law for the people within the United States.

5. An international tribunal, located at The Hague, Netherlands.

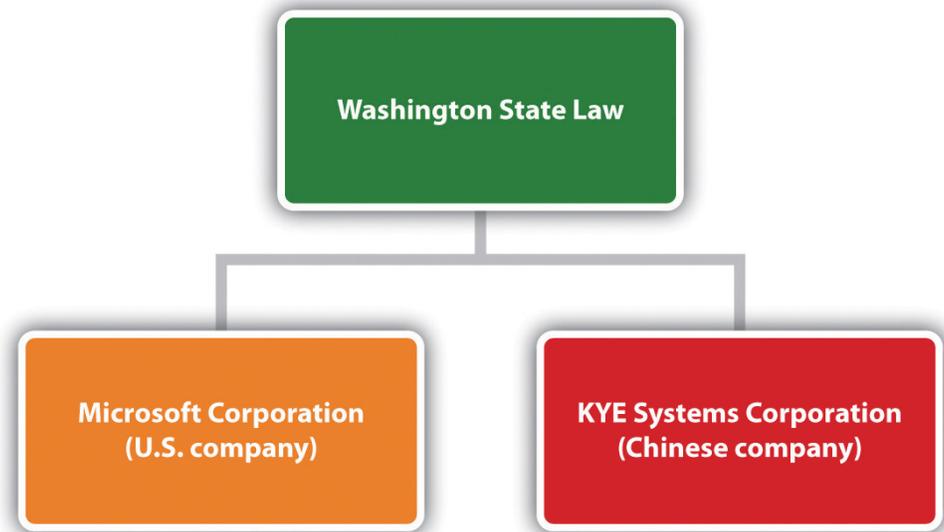
However, businesses are required to abide by their own applicable domestic laws as well as the laws of the foreign country in which they are conducting business. When domestic laws apply to businesses operating internationally, that is a vertical legal structure, such as is illustrated in [Figure 13.3 "The Vertical Nature of U.S. Domestic Law"](#). This is because there is a legitimate authority over the business that governs its behavior.

As noted in the example concerning U.S. companies doing business with Foxconn and Hon Hai Precision Industry Co., international business can involve creating contracts between parties from different nations. These contracts are horizontal in nature, much like a treaty. However, they are also subject to a vertical legal structure, because the parties to the contact will have chosen which laws will apply to resolve disputes arising under the contract. For example, if Microsoft, a U.S. company, has a contract with KYE Systems Corp., a Chinese manufacturer, to assemble its products, the contract might very well include a choice of law clause that would require any contract dispute to be settled in accordance with Washington State law. A **choice of law clause**⁶ is a contractual provision that specifies which law and jurisdiction will apply to disputes arising under the contract. The contract might contain such a clause because Microsoft's headquarters are in Washington State, and it would be more convenient for Microsoft to settle any disputes arising under a contract by using the laws in the state where it is located. This probably would be terribly inconvenient for KYE Systems Corp., but the benefits of obtaining a Microsoft contract probably outweigh the potential inconvenience of resolving disputes in the Washington State court system. Additionally, a well-established United Nations treaty, the **Convention on the Recognition and Enforcement of Foreign Arbitral Awards**⁷, provides for the enforcement of arbitral awards among member states. That means Microsoft and KYE Systems Corp. could agree in a predispute arbitration clause, perhaps in a purchase order or invoice, to arbitrate their disputes in Washington, using Washington contract law, and in English. The prevailing party in the arbitration could take the award to court in either Washington or China and convert it into a legally binding judgment under the treaty. Choice of law clauses have consequences regarding the way the contract will be interpreted in the event of a dispute, costs associated with defending a complaint arising under a contract, and convenience. See [Figure 13.5 "The Horizontal and Vertical Nature of Contract Relationships in the Global Legal Environment"](#) for an illustration of the horizontal and vertical nature of contract law in international business.

6. A contractual provision that specifies which law and jurisdiction will apply to disputes arising under the contract.

7. A treaty that provides for the enforcement of arbitral awards among member states.

Figure 13.5 *The Horizontal and Vertical Nature of Contract Relationships in the Global Legal Environment*



KEY TAKEAWAYS

While international law between sovereign states is relevant to business in many ways—for instance, it would be illegal for a company to ignore the terms of a treaty that its own country had ratified—the types of law that are relevant to businesses operating in the international environment are domestic laws. A choice of law clause within the contract designates which country’s law will apply to a dispute arising under an international contract.

EXERCISES

1. If you were creating a contract with a supplier in a different country, what types of things would you consider when deciding on the choice of law clause?
2. Check out <http://www.ustr.gov/trade-agreements/free-trade-agreements/north-american-free-trade-agreement-nafta>. How might this international law present opportunities for businesses in the United States that might wish to export or import products to or from Canada or Mexico?
3. Could a U.S. state enter into a treaty with a sovereign nation outside the United States? Why or why not?

13.2 Trade Regulations, Contracts, and Prohibited Activities in International Business

LEARNING OBJECTIVES

1. Examine U.S. trade regulations.
2. Explore considerations for contracts in the international environment.
3. Examine prohibitions of certain business activities in the international context.

Several U.S. laws apply to U.S. companies conducting business internationally. For example, trade regulations are relevant to importers and exporters of products. Also, some activities are prohibited to U.S. businesses, such as doing business with a terrorist organization. It is important for all companies contemplating doing business in the international environment to understand the laws that apply to their activities so that they can avoid criminal and civil liability, and maintain a commitment to ethics.

Figure 13.6



Law affects nearly all aspects of international business.

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Trade Regulations

The removal or reduction of trade barriers in accordance with the former **General Agreement on Tariffs and Trade (GATT)**⁸ and most recently the **World Trade Organization**⁹ presents opportunities for businesses. Likewise, multinational agreements that remove trade barriers to create largely duty-free and tariff-free trading zones, such as the **North American Free Trade Agreement**¹⁰, allow for freer flow of goods and services between specific countries. These agreements create tremendous opportunities for businesses because they lower the costs associated with importing and exporting, which is a primary consideration for many companies.

Companies wishing to export or import products are subject to federal trade regulations. **Export controls**¹¹ prohibit or restrict the export of certain types of products while limiting or restricting specific products from entering a country, perhaps by way of tariffs or quotas. The U.S. government views exporting as a privilege and not as a right and has the authority to impose a total ban on exporting

8. An international treaty that worked to reduced trade barriers.
9. Created by the GATT, it addresses trade between nations, including dispute resolution.
10. A trade agreement between Canada, the United States, and Mexico.
11. Controls that prohibit or restrict the export of certain types of products.

on U.S. companies for export control violations. Try to imagine what an export ban would do to companies such as Microsoft, Boeing, or Apple.

The activities of companies that ship products overseas are subject to federal export controls. To **export**¹² simply means to transport products to another country. Export controls are regulated by several departments of the federal government. For example, the Export Administration Regulations are administered by the U.S. Department of Commerce Bureau of Industry and Security, and they regulate items that may have a dual commercial or military use, such as computers and electronics. The U.S. Department of the Treasury Office of Foreign Assets Control regulates and enforces trade sanctions. The U.S. Department of State International Traffic in Arms Regulation prohibits certain types of trade, such as the unlicensed export of weaponry and certain chemicals.

Other federal agencies and programs exist in a supportive capacity, to assist U.S. businesses in their export endeavors rather than to regulate and enforce export controls. For example, the U.S. Department of Commerce's International Trade Administration supports U.S. exports and competitiveness abroad. Check out Note 13.21 "Hyperlink: Exporting?" for several short videos designed to teach companies how to engage in this lucrative and large marketplace.

Hyperlink: Exporting?

<http://www.census.gov/foreign-trade/aes/exporttraining/videos>

Check out these short training videos to learn about regulatory compliance.

Similarly, the National Export Initiative was created by the Obama administration, and it assists U.S. businesses to operate in the global market. Check out President Obama discussing the need to boost exports at a recent import/export conference.

12. To transport products to another country.

Hyperlink: President Obama Discussing the Importance of Export and the Creation of the National Export Initiative

<http://www.export.gov/nei/index.asp>

Companies wishing to import products are also subject to **import controls**¹³. Import controls take many forms including tariffs, quotas, and bans or restrictions. The U.S. Department of Homeland Security Customs and Border Protection Agency (CBA) has a primary role in import control administration and regulation. For example, it inspects imports to classify them to establish their tariff schedule.

A **tariff**¹⁴ applies to certain goods imported from other countries. Tariffs are import taxes. They are imposed to render the imported product more expensive and to keep the cost of nonimported products (domestic products) attractive to consumers. CBA customs officers classify the imported goods, which determines the applicable tariff. However, the Customs Modernization and Informed Compliance Act places responsibility for compliance with import laws on the importer.

Quotas¹⁵ apply to certain goods. Quotas are simply limits on quantity. No absolute quotas exist, but certain tariff rate quotas apply to certain items, such as specific types of textiles and dairy products. A **tariff rate quota**¹⁶ simply provides favorable tariffs on certain quantities of particular types of imports.

Bans¹⁷ apply to goods that are prohibited by law to import, because they are dangerous to public safety, health, the environment, or national interests. Other items are restricted from import. For example, it is illegal to import items of cultural heritage from other countries without permission. Check out [Note 13.28 "Hyperlink: What? These Old Rocks?"](#) to see a recent story about 525-million-year-old fossils that were illegally imported into the United States and have been returned to China.

13. Controls that limit or restrict specific products from entering a country.
14. An import tax.
15. Limits on quantity.
16. A favorable tariff on certain quantities of particular types of imports.
17. Prohibit importation of certain items by law.

Hyperlink: What? These Old Rocks?

http://www.cbp.gov/xp/cgov/newsroom/highlights/chinese_fossils.xml

18. When a foreign producer exports products to sell at prices less than its cost of manufacturing.
19. Products produced in a foreign land in which a government has provided financial assistance for the production.
20. A type of tariff imposed for subsidized products.
21. A type of tariffs imposed on dumped goods.
22. Limited duration growth restrictions that are imposed when domestic markets are threatened or injured from imports.
23. A treaty that applies to the sale of goods between parties from countries that are signatories to this treaty.
24. A model statute that seeks to provide uniformity to contracts law among the different states. It is not a law until state legislatures adopt it as law.

Along with the CBA, the U.S. International Trade Commission investigates import injuries to the United States, such as dumping and subsidized imports, and the need for safeguards. **Dumping**¹⁸ is when a foreign producer exports products to sell at prices less than its cost of manufacturing. **Subsidized imports**¹⁹ are products produced overseas for which a government has provided financial assistance for the production. When dumping or subsidized imports materially injure or threaten to injure domestic producers, the United States may impose a **countervailing duty**²⁰ for subsidized products or an **antidumping duty**²¹ for dumped products. These duties, which are particular types of tariffs, reduce the negative impact that such practices could have on U.S. companies. **Safeguards**²² are limited duration growth restrictions that are imposed when domestic markets are threatened or injured from imports. This allows for domestic markets to adjust to the surge from the import market. For example, the United States imposed safeguards on Chinese textiles in response to actual or threatened market disruption of the U.S. textile industry. U.S. Government Accountability Office, “U.S.-China Trade: Textile Safeguards Should Be Improved,” GAO-05-296, April 2005, <http://www.gao.gov/new.items/d05296.pdf> (accessed September 27, 2010).

Contracts

The **U.N. Convention on Contracts for the International Sale of Goods**²³ (CISG) applies to the sale of goods between parties from countries that are signatories to this treaty. Like the **Uniform Commercial Code (UCC)**²⁴, it creates a uniform law for the parties that adopt it. Specifically, the CISG applies to contracts for international sale of commercial goods. Additionally, like the UCC, it provides gap-fillers for terms that may not be expressly stated in the contract. However, important differences between the UCC and the CISG exist, particularly with respect to revocability of an offer, acceptance, the requirement for a writing to be enforceable, and essential terms. See [Figure 13.7 "A Comparison of Differences between the CISG and the UCC"](#) for a comparison between the CISG and the UCC. U.S. Department of Commerce, Office of the Chief Counsel for International Commerce, “The U.N. Convention on Contracts for the International Sale of Goods,” August 2002, <http://www.osec.doc.gov/ogc/occic/cisg.htm> (accessed September 27, 2010). The contracting parties may opt out of the CISG, providing that they do it expressly.

Figure 13.7 A Comparison of Differences between the CISG and the UCC

CISG	UCC
<ul style="list-style-type: none"> • Quantity and price are essential terms. • Generally, oral contracts are OK. • Acceptance generally must mirror offer. • Offer may be irrevocable in certain circumstances. 	<ul style="list-style-type: none"> • Quantity, but not price, is an essential term. • Generally, written contracts are required per Statute of Frauds. • Acceptance may include different terms than offer. • Offer is generally revocable unless it expressly contains language to the contrary.

The CISG does not limit the parties to a particular forum to resolve disputes, and it does not limit the terms of the contract itself. It is important for parties to choose which forum will apply to disputes arising under the contract. **Choice of forum**²⁵ clauses specify where complaints will be heard. If parties opt out of the CISG, then they must choose which law will apply to their contract by a choice of law clause. The parties will also need to agree on the official language of the contract. Given the precise language necessary for contractual agreements to be interpreted, this choice clearly matters to the interests of the contracting parties.

Employment Law and Human Rights

U.S. citizens that are working for U.S. companies overseas are protected by U.S. federal employment laws, such as **Title VII of the Civil Rights Act**²⁶ and the **Americans with Disabilities Act**²⁷. This means that U.S. companies may not illegally discriminate against U.S. employees with a protected characteristic simply because those employees happen to report to work for the company on foreign soil.

Additionally, the **Alien Torts Claims Act**²⁸ allows noncitizens to bring suit in U.S. federal court against U.S. businesses or citizens that have committed torts or human rights violations in foreign lands.

Prohibited Activities

Those engaged in international business must be aware of prohibited activities, because severe criminal penalties are possible. For example, paying bribes to get

- 25. Clauses and contract provisions that specify where complaints will be heard.
- 26. An important federal statute that prohibits illegal discrimination.
- 27. A federal statute that prohibits illegal discrimination.
- 28. A federal statute that allows noncitizens to bring suit in U.S. federal court against U.S. businesses or citizens that have committed torts or human rights violations in foreign lands.

things done is not permitted. The **Foreign Corrupt Practices Act (FCPA)**²⁹ prohibits the payment of bribes by U.S. companies and the employees of those companies. Violation of this law is a criminal offense. It does, however, permit **grease payments**³⁰, or facilitating payments, if such payments are permitted by the local government where the payments occurred. Since it is extremely rare to find a jurisdiction that legally permits grease payments (even in countries where corruption is rampant, it's probably still illegal), the grease payments exception provides false comfort to those who undertake to use it.

U.S. citizens and companies must refrain from doing business with prohibited people or entities. The U.S. Department of the Treasury Office of Foreign Assets Control (OFAC) maintains a list of Specially Designated Nationals and Blocked Persons, which is a list of persons, businesses, and entities with which U.S. citizens are forbidden from conducting business. Similarly, U.S. citizens are not permitted to engage in trade or business dealings with those in countries in which a U.S. embargo or U.S. imposed economic sanctions exists. Check out Note 13.42 "Hyperlink: Prohibited Parties" for these lists.

Hyperlink: Prohibited Parties

Specially Designated Nationals and Blocked Persons List

<http://www.treas.gov/offices/enforcement/ofac/sdn>

Economic Sanctions

<http://www.treas.gov/offices/enforcement/ofac/programs/index.shtml>

U.S. citizens are also blocked from conducting transactions with terrorists or terrorist organizations. U.S. Department of the Treasury, Office of Foreign Assets Control, "Terrorism: What You Need to Know about U.S. Sanctions," Executive Order 13224 §2(a), September 23, 2001, <http://www.treasury.gov/offices/enforcement/ofac/programs/terror/terror.pdf> (accessed September 27, 2010). Conducting transactions with prohibited persons, entities, or businesses can result in serious criminal violations, which carry financial penalties and long prison sentences.

29. A federal statute that prohibits the payment of bribes by U.S. companies and the employees of those companies.

30. Facilitating payments that are not bribes.

Finally, while the United States maintains economic boycotts against several countries, under U.S. **antiboycott laws**³¹ it is illegal for U.S. persons and companies to comply with any unsanctioned foreign boycott. The most important unsanctioned foreign boycott is the long-standing Arab League boycott of Israel. If a U.S. person or company receives a request to comply with the boycott of Israel (such as a request from a buyer in Saudi Arabia not to ship goods via Israel, or not to ship on an Israeli flag ship, or even to state whether the seller has any operations in Israel or to state the religious affiliations of each employee in the company), then the U.S. person or company must refuse to comply with the request and report it to the appropriate U.S. government agency within a specified period of time.

KEY TAKEAWAYS

International business opportunities are lucrative, and the global marketplace provides vast opportunities for growth. However, U.S. companies that engage in international business are subject to trade regulations, must be cognizant of the challenges inherent when forming international contracts, and are prohibited from engaging in certain activities.

31. Laws that prevent U.S. persons and companies from complying with any unsanctioned foreign boycott.

EXERCISES

1. Look at the clothing labels of the clothes you are wearing. Was anything that you are wearing produced in the United States? Besides garment appeal, what types of considerations might consumers weigh when deciding to buy apparel?
2. What are the benefits and drawbacks of import controls for domestic industries? Do you favor stronger controls? More lax controls? Why?
3. Several U.S. sanctions programs are limited to U.S. companies only. The decades-old sanctions program against Cuba, for example, has meant that Asian and European companies can do as much business as they wish in Cuba. How effective do you think a sanctions program like this can be? Who are the winners, and who are the losers?
4. Wal-Mart, as a U.S. company, does not do any business in Cuba and does not purchase from any Cuban suppliers. Wal-Mart Canada, a Canadian company, found out several years ago that a supplier outsourced the manufacture of pajamas to Cuba, and that these Cuban-made pajamas were being sold in Wal-Mart's Canadian stores. The U.S. parent company ordered the Canadian subsidiary to pull the product, but the Canadian subsidiary reported that doing so would violate Canadian law, which prohibits Canadian companies from complying with the U.S. boycott of Cuba. What should Wal-Mart U.S. do? What should Wal-Mart Canada do?

13.3 Concluding Thoughts

Tremendous opportunities exist for companies that wish to operate in the international markets. However, the international legal environment requires careful planning to avoid costly mistakes associated with violations of trade regulations, the formation of international contracts, and criminal prohibitions. Additionally, ethical considerations involving human rights and the natural environment are ever present.