FUNDAMENTALS OF BUSINESS LAW

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Book: Fundamentals of Business Law

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Introduction

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The Authors and Contributors

Melissa Randall is an attorney who teaches business law and Constitutional law at the Community College of Denver. Frustrated that the expensive textbook her business students were using contained legal errors, heavily edited case studies that confused students, and was a roadblock to their learning, Ms. Randall sought a better option, which ultimately led her down the OER path. Special thanks to Terence Lau and Lisa Johnson for their OER textbook "Introduction to Business Law," which served as the inspiration for several chapters of this book.

Ms. Randall's business law students edited, updated, and revised the chapters contained in this textbook. They are also responsible for the visual depictions of the material. Although Ms. Randall is the subject matter expert who ensured the accuracy of the material, her students ensured the effective delivery of the content to undergraduate business students. It was truly a collaborative effort. Special thanks to Lucy Reyes and Krissy Main who turned the students' rough visual concepts into professional quality graphics.

Thanks also to the Colorado Department of Higher Education (CDHE) for the grant that partially funded the development of this book. Without it, we could not have hired Lucy and Krissy to be our graphic designers. Nor would we have been able to have written so many chapters so quickly. The CDHE's support of OER and open pedagogy validated our classes' commitment to doing meaningful work and to contribute to the future of higher education.

Last, and certainly not least, thanks to the professionals who contributed their expertise to our book. Judges and attorneys filled our Counselor's Corner with practical insights and advice to business professionals. Their insight from "the trenches" was an invaluable contribution. Subject matter experts peer reviewed chapters and worked with our students to ensure accurate information in dynamic areas of the law. Kathy was our dedicated copy editor who thoroughly proofread anything we gave her. Special thanks to the professional who was in the trenches the most: Tom. A successful businessman, Tom put his MBA to use by tirelessly editing the entire textbook to ensure that it was consistent and accurate in a business context. Our professional contributors volunteered their expertise and gave enthusiastically to our project. Words cannot express our gratitude for accompanying us on this journey.

Feedback Requested

The authors seek content-related suggestions from faculty, students, and users of this book. Please email Ms. Randall at Melissa.Randall@ccd.edu with any suggestions or feedback you may have. Also, faculty are invited to contact Ms. Randall to discuss other OER used in the business law course, including judicial opinions we use as case studies in lieu of heavily edited excerpts in textbook dialogue boxes.

This textbook was finalized during the Spring 2020 semester. With the outbreak of covid-19, our collaborative efforts were curtailed. As a result, readers may find that some chapters are better edited than others. Please help us with any constructive feedback you may have to improve the book.

If you are an instructor reviewing, adopting, or adapting this textbook, please help us understand how this book is being used. This helps all of us in the OER community understand our impact and justify future grant money.

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CHAPTER OVERVIEW

1: Introduction to Law and Types of Legal Systems

Learning Objectives

- Understand the nature and sources of law.
- Know the types of modern legal systems in the world.
- Understand the various functions of a legal system.
- Learn the primary sources of law in the United States.

1.1: Introduction to Law and Types of Legal Systems

It is important for business people to understand the legal environment in which they are operating. To be successful, businesses must understand how law and economic principles influence each other. Businesses want to be successful, which usually means they want to be profitable. While a basic economic principle is that businesses act in their own self-interest, they must do so within the parameters of the law. Sometimes businesses 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.

Most people want to conduct their business legally. Following the rules saves money, time, and frustration, and it preserves individual and professional reputations. So, if businesses have an incentive to operate legally, why are do so many legal disputes occur? There are many reasons for this, including that many of our laws are poorly written, and reasonable people may disagree about what is "right." Legal injuries happen even under the best of circumstances, and parties need a method to be compensated for their damages.

A common theme in the study of law is responsibility. Law seeks to answer the questions:

1. Who is responsible, and what is their liability? and
2. How does a business limit exposure to liability in the first place?

A solid understanding of business law minimizes the risk of liability and avoids legal disputes. The law provides a reasonable expectation of how things will be in the future based on how they have been in the past. It provides predictability and stability.

This book does not teach how to practice law or conduct legal research. The goals of this book are practical. Think about studying business law as a map by which to navigate business dealings. We want to help you minimize the risk of legal liability and avoid serious legal disputes. This book serves as an introduction to legal topics that affect businesses. By understanding the legal landscape, you will have a better opportunity for business success.

Counselor's Corner Even if a business is not officially "international," it is important to understand the legal systems of the world because consumers come from all over. Consumers, business partners, and competitors are products of their environments, including their societies and legal systems. Therefore, their expectations and how they interact with each other are influenced directly by their legal systems of origin. The most successful businesses take this into account. Not only for avoiding legal liability, but also for enhanced consumer satisfaction. ~Arham M., attorney

1.2: What Is Law and What Functions Does It Serve?

Law is the system of rules which a particular nation or community recognizes as regulating the actions of its members and which it may enforce by the imposition of penalties. In a nation, the law can serve to (1) keep the peace, (2) maintain the status quo, (3) preserve individual rights, (4) protect minorities, (5) promote social justice, and (6) provide for orderly social change. Some legal systems serve these purposes better than others.

Although a nation ruled by an authoritarian government may keep the peace and maintain the status quo, it may also oppress minorities or political opponents (e.g., China, Zimbabwe, or Syria). Under colonialism, European nations often imposed peace in nations whose borders were created by those same European nations. With regard to the functions of the law, the empires may have kept the peace—largely with force—but they changed the status quo and seldom promoted the native peoples' rights or social justice.

In nations with various ethnic and tribal groups, it is often difficult for a single, united government to rule effectively. In Rwanda, for example, power struggles between Hutus and Tutsis resulted in the genocide of the Tutsi minority. In nations of the former Soviet Union, the withdrawal of a central power created power vacuums that were exploited by local leaders. When Yugoslavia broke up, the different ethnic groups—Croats, Bosniaks, and Serbs—fought bitterly rather than share power. In Iraq and Afghanistan, the blending of different groups of families, tribes, sects, and ethnic groups into an effective national governing body continues to be a challenge.

These situations highlight the struggle of a nation to implement and maintain the Rule of Law. The **Rule of Law** is a system in which laws are public knowledge, are clear in meaning, and apply equally to everyone. These systems uphold national political and civil liberties. 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 its primary goals. One of the greatest benefits of the Rule of Law is that it allows people to understand what is expected of them.

The United States is a Rule of Law System. The US Constitution is based on the principle that people have rights that cannot be taken away by the government. Instead, the role of the government is to protect the individual rights of its citizens. The US Constitution's preamble states, "We the People…in Order to…insure domestic Tranquility." This is just one example of how the US legal system was established to address the functions of a legal system.

1.3: Modern Legal Systems of the World

There are four main legal systems in the modern world:

1. Common law;
2. Civil law;
3. Religious law; and
4. Customary law/monarchy.

As the world becomes more interdependent, a fifth category of legal systems has developed — the hybrid legal system, which is a legal system that is a combination of two or more legal systems.

Type of Legal System	Characteristics
Common Law	• Written judicial decisions of appellate courts are binding legal authority on lower courts when interpreting and applying the same or similar questions of law • The legal system is adversarial • The outcome of a case is often decided by a jury of the parties' peers
Civil Law	• All legal rules are in comprehensive legislative enactments often called Codes • Written judicial decisions of appellate courts are not binding legal authority • The legal system is inquisatorial
Religious Law	• Religious documents are used as legal sources • All major world religions have a religious legal system • Most nations that have religious legal systems use them to supplement a secular national system
Customary Law	• Legal system used by a monarchy or tribe • Grants specific legal powers to kings, queens, sultans or tribal leaders as heads of state • Monarchs and leaders often seen to be "above the law"
Hybrid Law	• Combination of 2 or more legal systems within a nation

Common Law Systems

The legal system in the United States comes from the English common law tradition and the US Constitution. English common law is a system that gives written judicial decisions the force of law. As a result, the US legal system recognizes an appellate court's ability to interpret and apply the law to future litigants through precedent. **Precedent** is a judicial opinion that is considered legal authority for future cases involving the same or similar questions of law. The benefit of this system is consistency and resolution of disputes without requiring the parties to take legal matters to court.

A famous example of how precedent works is the US Supreme Court case *Brown v. Board of Education of Topeka*. In this landmark 1954 case, the Justices unanimously ruled that racial segregation of children in public schools is unconstitutional. *Brown v. Board of Education* is one of the cornerstones of the Civil Rights Movement and helped establish the precedent that "separate-but-equal" education and other services were not, in fact, equal at all. The case required all racially segregated public schools to integrate, not just in Topeka, Kansas. In addition, *Brown* has been cited as legal precedent in thousands of cases nationwide involving racial equality.

The common law legal system is adversarial. This means that the parties bring their cases to the court for resolution. The judge or jury hears the parties' evidence and arguments before making a final decision. It is the parties' burden to investigate the facts, argue the law, and present their best case. Judges and juries do not do independent investigations nor are they responsible for helping parties argue their cases. It is a party's responsibility to raise all legal issues.

Another characteristic of common law systems is that cases are often decided by juries of the parties' peers. In both civil and criminal matters, the parties usually have a right to have a jury pulled from local citizens to resolve the dispute. When a jury determines the outcome of a case, the judge acts as a "gatekeeper," who decides what evidence and legal arguments the jury can properly consider. The judge ensures the parties receive a fair trial while the jury decides the outcome of the trial.

The common law tradition is unique to England, the United States, and former British colonies. Although there are differences among common law systems (e.g., whether judiciaries may declare legislative acts unconstitutional and how frequently juries may be used), all of them recognize the use of precedent, and none of them relies solely on the comprehensive, legislative codes that are prevalent in civil law systems.

Civil Law Systems

Civil law systems were developed in Europe and are based on Roman and Napoleonic law. Civil law systems are also called code systems because all the legal rules are in one or more comprehensive legislative enactments. During Napoleon's reign, a comprehensive book of laws—a code—was developed for all of France. The code covered criminal law and procedure, non-criminal law and procedure, and commercial law. The code is used to resolve only cases brought to the courts, which are usually decided by judges without a jury.

Civil law systems are inquisitorial systems in which judges actively investigate cases. Judges have the authority to request documents and testimony, as well as to shape the parties' legal claims. In addition, judges are not required to follow the decisions of other courts in similar cases. The law is in the code, not in the cases. The legislature, not the courts, is the primary place to enact and modify laws.

Civil law systems are used throughout Europe, Central and South America, Asia and Africa. France, Germany, Holland, Spain, and Portugal had colonies outside of Europe, and many of these colonies adopted the legal practices that were imposed on them by colonial rule.

There are also communist and socialist legal systems that differ significantly from traditional civil law systems. Legal scholars debate whether this is a separate type of legal system or a subset of modern civil law systems. In a communist or socialist legal system, the nation has a code but most property is owned by the government or agricultural cooperatives. In addition, the judiciary is subservient to the Communist party and is not an independent branch of government.

Religious Law Systems

Religious law systems arise from the sacred texts of religious traditions and usually apply to all aspects of life, including social and business relations. In religious legal systems, a religious document is used as a primary legal source. All major world religions–Judaism, Christianity, Islam, Buddhism and Hinduism–have a religious legal system. The Islamic legal system (Sharia) with Islamic jurisprudence (Fiqh) is the most widely used religious legal system in the world. Most nations that have religious legal systems use them to supplement their secular national system. Only Saudi Arabia (Islamic) and the Vatican (Christian) are pure theocracies that have only a religious legal system in their nations.

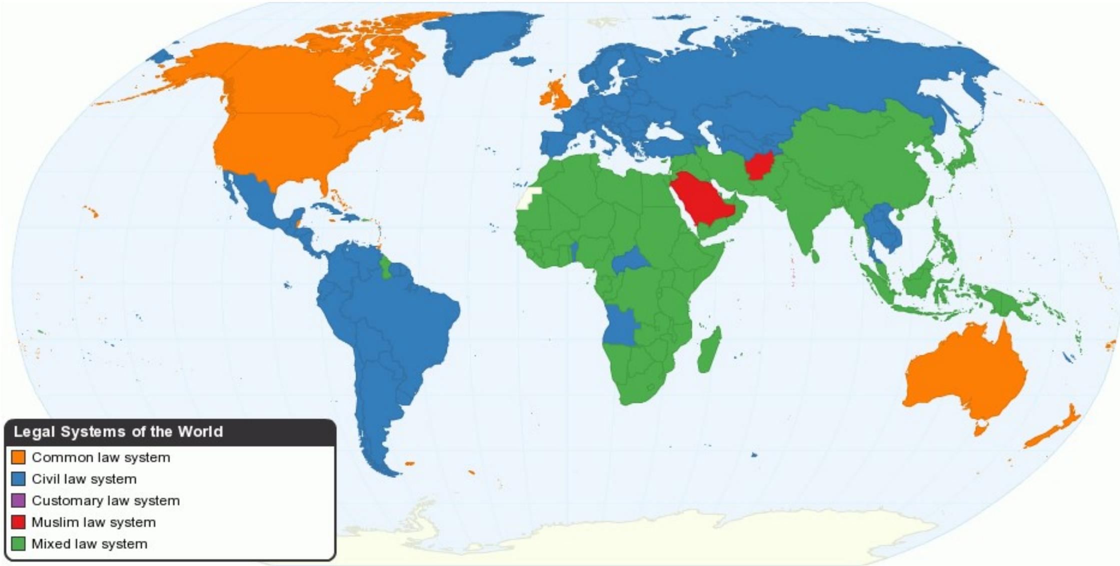
Customary Law Systems

Customary legal systems are becoming increasingly less common. A customary system is used by a monarchy and grants specific legal powers to the kings, queens, sultans or tribal leaders as heads of state. A challenge of a customary system is that the ruler is seen to be "above the law" because the laws do not apply equally to the ruler and subjects. There are only a handful of monarchies remaining in the world, and most of them have evolved into hybrid legal systems or have adopted a different type of legal system.

Hybrid Law Systems

Hybrid legal systems are a combination of two or more legal systems within a nation. India is a classic example of a nation with a hybrid legal system. As a former British colony, India has a common law legal system, which recognizes the power of the Supreme Court and High Courts to make binding judicial decisions as a form of precedent. However, most of its laws are integrated codes found in a Napoleonic code system. In addition, India has separate personal codes that apply to Muslims, Christians, and Hindus. As a result, India has a hybrid system made up of common law, civil law and religious law systems.

Figure 1.1 Legal Systems of the World Map


Legal Systems of the World
Common law system
Civil law system
Customary law system
Muslim law system
Mixed law system

1.4: Sources of Law

Where does law come from? How do individuals and businesses know right from wrong? Not all actions that are considered "wrong" or inappropriate are violations of the law. They simply may represent social norms. So what is the difference? There are two types of rules in our society—social norms and laws.

Social norms are the informal rules that govern behavior in groups and societies. Social norms and cultural expectations may be violated with negative social or professional consequences for doing so. However, no legal repercussions follow violating social norms alone.

Violations of law are different. Violating the law carries penalties, such as civil liability, fines, or loss of liberty. While it is optional to conform to social customs, people are compelled to obey the law under threat of penalty.

Laws are generally classified as public law or private law. **Public law** applies to everyone. It is law that has been created by a legitimate authority with the power to create law, and it applies 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 may be levied against violators. Examples of public law include constitutions, criminal laws, and administrative laws. For example, if someone steals items from a store, the thief is violating public law. He committed the crime of theft which affects the community as a whole (not just the store owners), and the crime is defined in public legislation.

Private law is 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 anyone else. If the parties have a contract dispute, the terms of the contract and the remedy for breach will apply only to the parties of the contract. In addition to contracts, other examples of private law include tort and property laws. For example, if someone installs an industrial smoker on his property and the smoke creates a dense haze in the neighbor's yard, there may be a violation of private law because the smoke is interfering with the neighbor's right to peacefully enjoy one's property.

Laws are also classified as civil or criminal. **Civil law** is usually brought by a private party against another private party. For example, one company decides to sue another for breach of contract. Or a customer sues a business when injured by the company's product. Most laws affecting businesses are civil.

Criminal law involves a governmental decision to prosecute someone for violating a criminal statute. If someone breaks a criminal law, he or she could lose their freedom (i.e. be sent to prison) or lose their life (i.e. if convicted of a capital offense). In a civil action, no one is sent to prison. Usually, liability results in the loss of property such as money or assets.

	Civil	Criminal
Source of Law	statute or common law	statutes defining crimes
Who files case?	business or individual suffering harm	the government (e.g. District Attorney)
Burden of Proof	preponderance of evidence	beyond a reasonable doubt
Remedy	damages, injunction, specific performance	punishment (e.g. fine or imprisonment)
Purpose	provide compensation or private relief	protect society

Additionally, some law is procedural and some law is substantive. **Procedural law** describes the legal process and rules that are required and must be followed. For instance, parties who are sued in court must receive notice of the lawsuit before the court can impose judgment against them. **Substantive law** refers to the actual substance of the law or the merits of the claim, case, or action. Substantive law embodies the ideas of legal rights and duties and is captured by different sources of law, including the Constitution, statutes, and common law.

For example, if someone drives fifty-five miles per hour in a forty mile-per-hour zone, she has broken the substantive rule of law of the speed limit. However, how and what gets decided in court related to the speeding ticket is a matter of procedural law. For example, whether the driver is entitled to a hearing before a judge, whether she has a right to be represented by legal counsel, whether the hearing takes place within a certain amount of time after the ticket was issued, and what type of evidence can be presented are procedural law issues.

Sources of Law

In the United States, our laws come primarily from:

- Federal and state constitutions;
- Statutory law from Congress, the state legislatures, and local legislative bodies;
- Common law from federal and state appellate courts;
- Administrative rules and regulations;
- Treaties and conventions; and
- Executive orders.

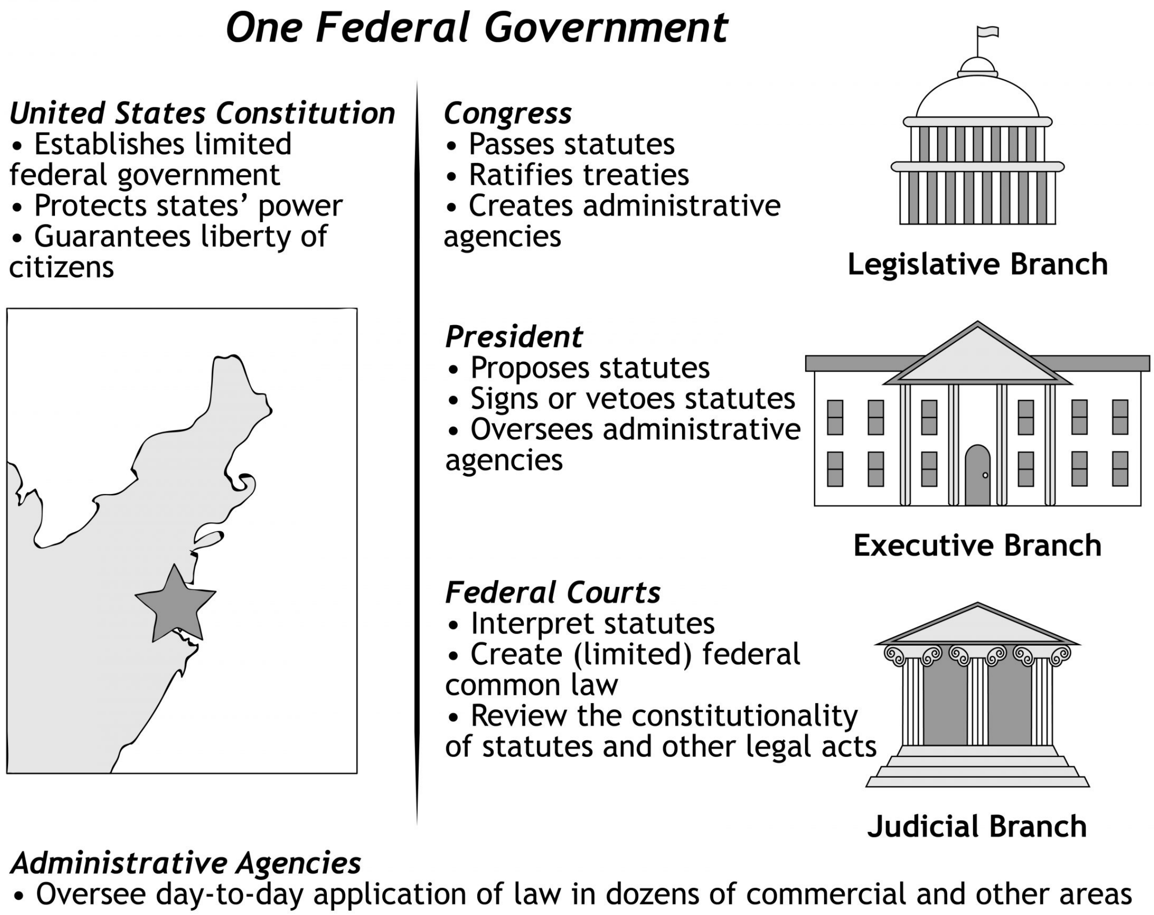
Constitutions

The most fundamental law in the United States is the US Constitution, which is the supreme law of the nation. Any law that conflicts with it is void. The Constitution serves three important functions. First, it establishes the structure of our national government and identifies the powers of the legislative, executive, and judicial branches. Second, it defines the boundaries of each branch's authority and creates "checks" on each branch by the other branches. For example, the president is the commander-in-chief of the armed forces, but does not have the power to declare war. That duty falls to Congress. And, third, the Constitution guarantees civil liberties and individual rights.

The power granted to the federal government by the Constitution is limited. Any powers not expressly granted to the federal government by the Constitution are reserved to the states. This means that if the Constitution does not give the federal government power over a particular area, then the states regulate it.

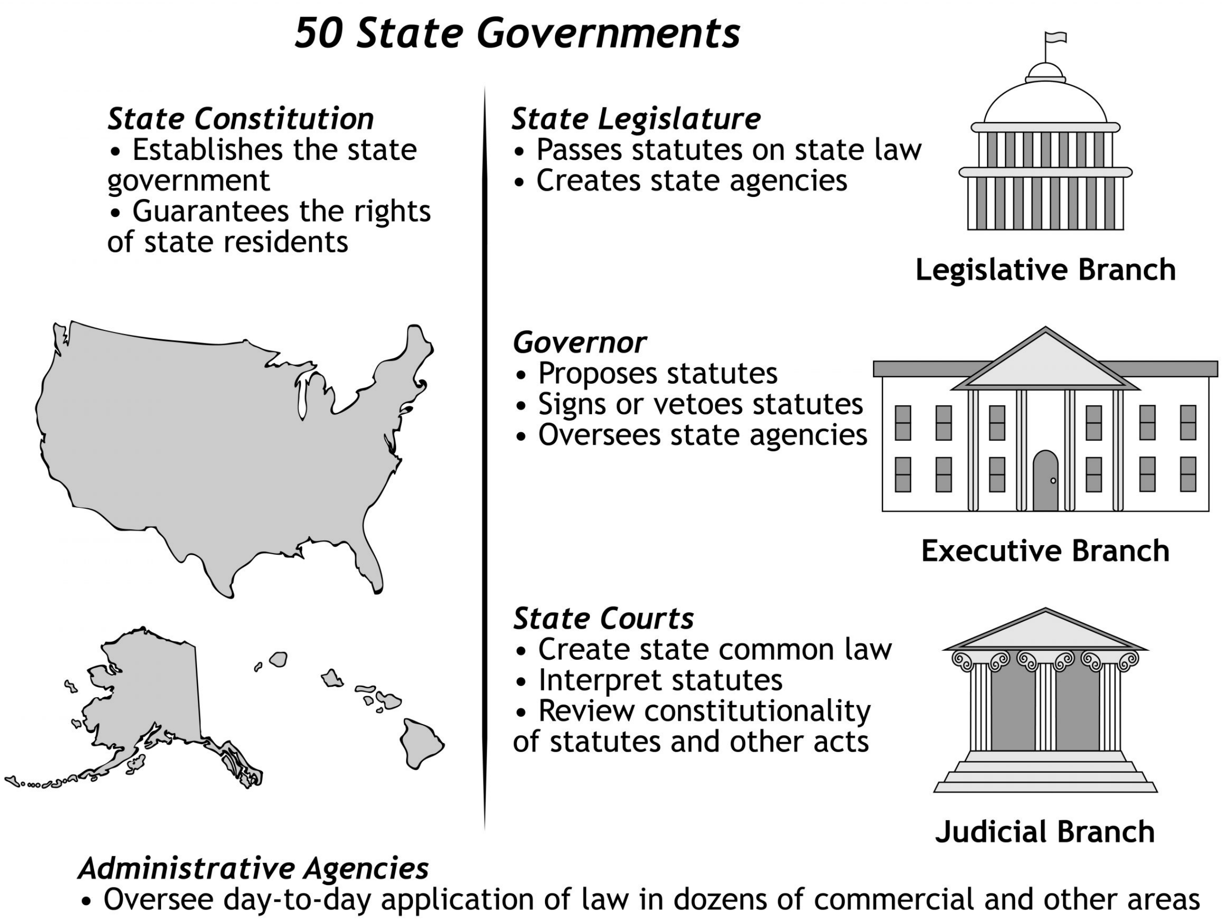
The first ten amendments to the Constitution are known as the **Bill of Rights**. Despite the limited power granted to the federal government by the Constitution, the Bill of Rights protects certain individual civil rights and liberties from governmental interference. These rights include the freedom of speech and religion, the right to bear arms, and the rights of individuals who are suspected and accused of crimes.

Figure 1.2 Separation of Powers of the Federal Government



Each state also has its own constitution, which serves essentially the same function for the state government as the US Constitution serves for the federal government. Specifically, they establish limits of state government power, establish the organization and duties of the different branches of government at the state level, and protect fundamental rights of state citizens. This dual system of government in the United States is called **federalism**, which is a governance structure whereby the federal government and the state governments coexist through a shared power scheme.

Figure 1.3 Separation of Powers of the State Governments



Statutes

Statutes are laws created by a legislative body. Congress is the federal legislative body, and each state also has its own legislative body. Almost all statutes are created by the same method. An idea for a new law is proposed in the legislature. This proposal is called a **bill**. The House of Representatives and Senate independently vote on a bill. If the majority of both chambers approves it, the bill is sent to the president or governor for approval. If the president or governor signs the bill, then it becomes a statute.

Local governments, such as counties, cities, and townships, may be authorized under a state constitution to create or adopt ordinances. An **ordinance** is a legislative act of a local government entity. Examples of ordinances include building codes, zoning laws, and misdemeanors such as jaywalking.

Common Law

Binding legal principles also come from the courts. When appellate courts decide a case, they may interpret and apply legal principles in a way that are binding on lower courts in the future. The process of applying a prior appellate decision to a case is called **precedent**. Simply put, precedent is when judges use past decisions to guide them. The benefit of precedent is that it makes the law predictable and furthers the rule of law by applying legal principles to the greater community, not just the parties to a lawsuit. Businesses value common law systems because they reduce the cost of business. For example, if a business is unsure of how its contract rights will be applied by the court, it can understand its rights by learning how courts interpreted similar contract provisions in past lawsuits. This allows businesses to assess their risks, determine their liability, and make rational business decisions without the expense of litigation.

Administrative Rules and Regulations

Administrative law is the collection of rules and decisions made by agencies to fill in particular details missing from constitutions and statutes. For example, the Internal Revenue Service (IRS) is the federal agency responsible for collecting national taxes and administering the Internal Revenue Code enacted by Congress. All businesses and individuals must follow the IRS rules and regulations about how to report, file, and pay applicable taxes that Congress levies. Congress passes statute defining "what" taxes need to be paid. The IRS adopts the rules about "how" those taxes are paid.

In the United States, many of the day-to-day regulation of businesses is done by administrative agencies. These agencies are created by the legislature to implement and enforce a particular statute. Agencies often report to the executive branch, but some are run by independent commissions. Legislative bodies give agencies the power to create rules and regulations that individuals and businesses must follow to comply with the statute. For example, the Environmental Protection Agency (EPA) was created to implement and enforce the Clean Air Act and the Clean Water Act.

Treaties and Conventions

A **treaty** is a binding agreement between two nations. A **convention** is a binding agreement among a group of nations. In the US, a treaty or convention is generally negotiated by the executive branch. To be binding, the US Constitution requires the Senate to ratify treaties by a two-thirds vote. Once ratified, a treaty becomes part of federal law with the same weight and effect as a statute passed by the entire Congress. Therefore, treaties and conventions have equal standing as statutes in US law.

Executive Orders

Article II, Section 1 of the US Constitution gives the president the power to "take care that the laws be faithfully executed." Under this power, the president may issue **executive orders** requiring officials in the executive branch to perform their duties in a particular manner. State governors have the same authority under state constitutions. Although they are not laws that apply directly to individuals and businesses, executive orders are important legal documents because they direct the government's enforcement efforts.

Hierarchy of Sources of Law

Priority	Source	Comment
1	Constitutions	Exist at both federal and state levels
2 (tie)	Statutes	Laws passed by the federal or state legislatures
2 (tie)	Treaties and Conventions	International agreements that have the same standing as statutes
4	Judicial Opinions	Court interpretation and application of constitutions, statutes, treaties, agency regulations, and executive orders
5	Agency Regulations	Rules and regulations adopted by administrative agencies at the federal, state, or local level
6	Executive Orders	Guidance from the president or governor to executive branch officials about how to perform their duty

1.5: Concluding Thoughts

Understanding business law is essential to successfully running any type of business because a solid understanding of laws and regulations helps avoid liability and minimizes risk. In business, it is not enough to conduct business ethically. Knowledge of business law is essential to successful business practices. Ultimately, business people should be able to recognize legal issues, minimize liability exposure, and know when to consult an attorney.

Legal systems vary widely in their aims and in the way they resolve disputes. Common law systems are adversarial, use juries and adhere to precedent. Civil law systems are inquisatorial, do not use juries and do not recognize precedent. All major world religions have a legal system, although only two nations have a purely national religious system. Many nations have hybrid legal systems that combine two or more legal systems.

The legal system in the United States is composed of multiple jurisdictions at the local, state and federal levels. 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, administrative law, treaties, and executive orders.

CHAPTER OVERVIEW

2: The United States Court System

Learning Objectives

- Understand the US court system and how it affects the conduct of businesses.
- Understand the three branches of government and how they check and balance each other's powers.
- Explore the state and federal court systems.

2.1: Introduction

In the United States, law and government are interdependent. The US Constitution establishes the basic framework of the federal government and imposes certain limitations on the powers of government. In turn, the various branches of government are intimately involved in making, enforcing, and interpreting the law. Most law comes from Congress and the state legislatures. Courts interpret the laws and apply them to cases.

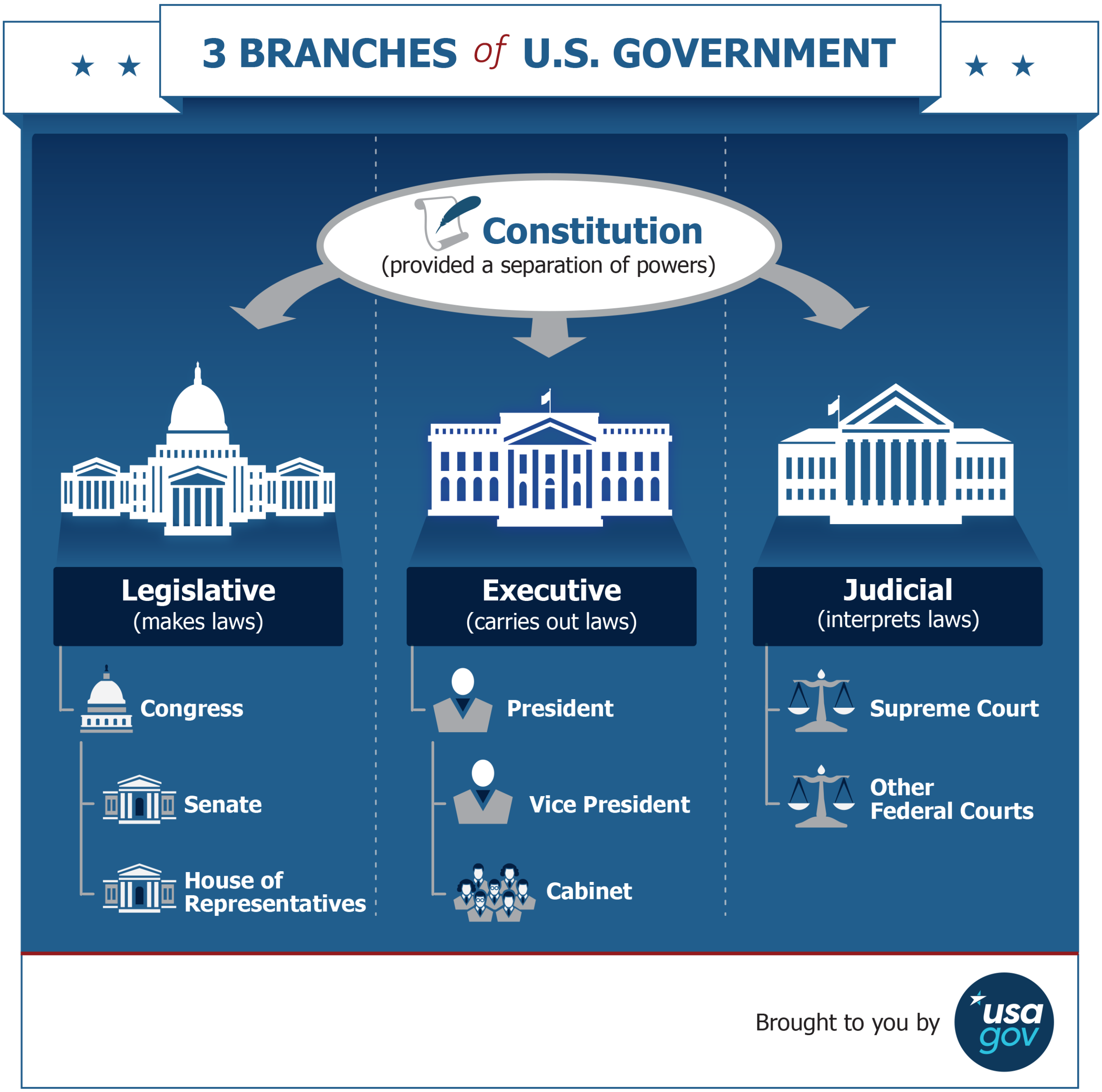
Laws are meaningless if they are not enforced. Companies have to make many decisions daily, from product development to marketing to maintaining growth. These decisions are based on financial considerations and legal requirements. If a company violates a law, it is often held accountable through litigation in courts.

Counselor's Corner Under the Supreme Court's *Citizens United* decision, business entities enjoy the same right as natural persons to influence the political process through contributions. Because federal judges are appointed for life, businesses cannot directly influence actions of the judicial branch. However, they can do so indirectly by lobbying Congress on laws that it considers and lobbying the president concerning enforcement priorities. While all states have a comparable three-branch system, in some states (not in Colorado), judges obtain office through partisan elections. In such states, businesses can seek to influence the judicial branch through supporting judges whose philosophy favors business generally or a particular industry. For these reasons, in choosing whether to litigate in state or federal court, businesses should consider that federal judges may be more likely to take politically unpopular actions. ~John W., judge

2.2: Separation of Powers

Under the US Constitution, power is separated among three branches of government. Article I of the Constitution allocates the **legislative** power to Congress, which is composed of the House of Representatives and the Senate. Congress makes laws and represents the will of the people. Article II of the Constitution creates the **executive** 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**, which is in charge of applying and interpreting the meaning of the law. The US Supreme Court is the highest court in the federal judiciary and consists of nine Justices.

Figure 2.1 Separation of Powers of the Branches of the Federal Government



The Constitution is remarkably short in describing the judicial branch. Under the Constitution, there are only two requirements to becoming a federal judge: nomination by the president and confirmation by the Senate. Article III provides: “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 Constitution also guarantees that how judges decide cases does not affect their jobs because they have lifetime tenure and a salary that cannot be reduced.

Separation of powers is discussed in more detail in Chapter 5.

Marbury v. Madison

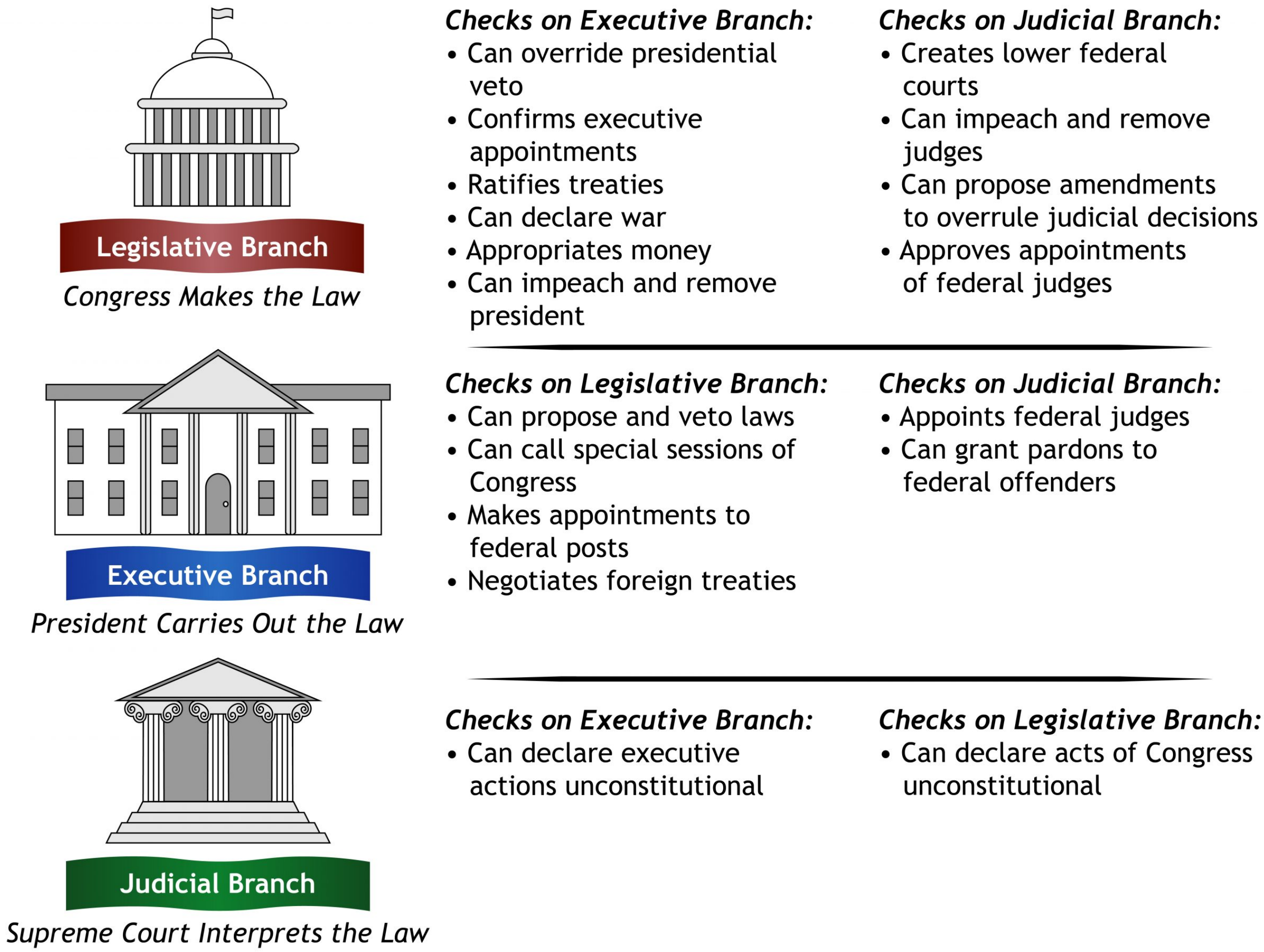
In 1800, the presidential election between John Adams and Thomas Jefferson nearly tore the nation apart. John Adams was the President and his Vice-President, Thomas Jefferson, ran against him. They were both Founding Fathers but were members of different political parties that had opposing visions for the future of the new nation. 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, official 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 federal judge from his Democratic-Republican Party, and he refused to expand the Federalist influence any further.

One Federalist judge, William Marbury, sued Secretary of State James Madison to deliver his commission. The case was filed in the Supreme Court, led by Chief Justice John Marshall, who was also a Federalist. In a shrewd move, Marshall ruled against Marbury while declaring that it was the Supreme Court's role to decide the meaning of the Constitution. This is called judicial review, and it makes the US Supreme Court an equal branch of government to the Executive and Legislative branches. Because President Jefferson won the case, he was willing to accept the Supreme Court's assertion of power as an equal branch of government.

Checks and Balances

The US Constitution establishes the three branches of the federal government as independent branches with their own authority. The Founding Fathers were fearful of setting up an **authoritarian regime**, where the rulers of the government are above the law and often rule arbitrarily. Therefore, the Founding Fathers ensured that each branch of government had a "check" on the other two branches in order to "balance" the power of the government among the branches. Therefore, if a president decided to become a dictator, the other two branches could prevent him.

Figure 2.2 Checks and Balances of the Federal Government



Judicial review means that any federal court can hold any act of the president or Congress to be unconstitutional. This is the power of the Judicial Branch to ensure that the Executive and Legislative branches do not overstep their powers and violate the Constitution.

The other branches each have a “check” on the judiciary. For example, the president (Executive branch) can control the judiciary by nominating judges. The president can also pardon those convicted by a federal court. A **pardon** is an executive order vacating a criminal sentence for a crime.

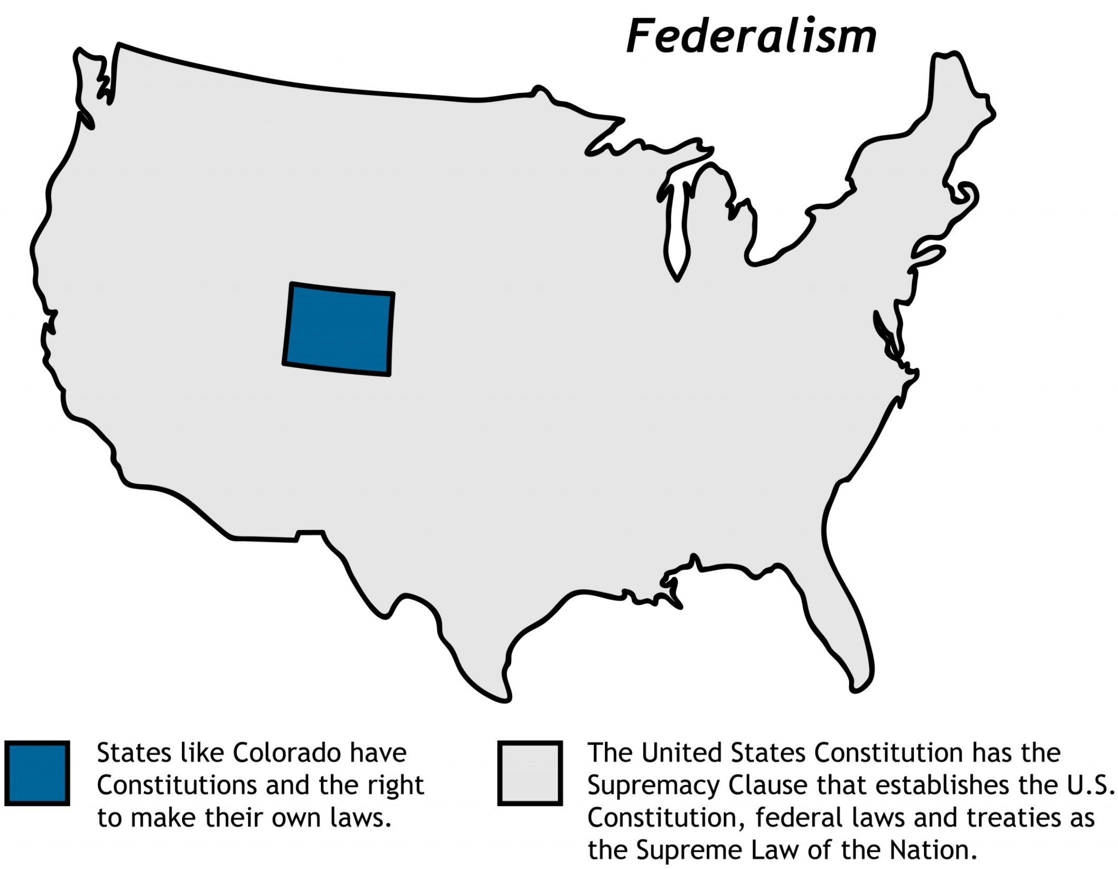
Congress also plays an important role in “checking” the judiciary. The most obvious role is in confirming judicial selections. In addition to confirmation, Congress also controls the judiciary through its annual budgetary process. Although the Constitution protects judicial salaries from any reductions, Congress is not obligated to grant any raises. Finally, Congress can control the judiciary by determining how the courts are organized and what kind of cases the courts can hear, except for the types of cases the Constitution lists as the original jurisdiction of the Supreme Court.

2.3: Federalism

There are fifty-six separate legal systems in the United States: those of the fifty states, the federal government, the District of Columbia, the military, and three territorial systems. Within each legal system is a complex interplay among executive, legislative, and judicial branches of government. This division of authority between a central, federal government and state governments is known as **federalism**.

In the United States, the federal government only has the authority given to it by the states via the US Constitution. If a power is not granted to the federal government, the states retain the power. For example, the federal government cannot tax the exchange of goods between states as “exports.” The Constitution limits the power of the federal government, and the state constitutions limit the power of the state governments.

Figure 2.3 Federalism Between Federal and State Governments



Federalism is discussed in more detail in Chapter 5.

Jurisdiction

The authority of a court to hear a particular type of case is called **jurisdiction**. State and federal 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 or criminal procedure.

The rules of **subject matter jurisdiction** dictate whether a case is heard in federal or state court. The vast majority of civil lawsuits are filed in state courts, including lawsuits involving state laws such as property, contracts, probate law, and torts. State laws also involve most criminal cases, and domestic issues such as divorce and child custody. **Torts** are any civil wrong other than a breach of contract and include a variety of situations in which people and businesses suffer legal injury. Some states are friendlier toward torts than others, and the resulting patchwork of tort laws means that companies that do business across the nation need to know the different standards they are held to based on the state their customers live in.

Given the wide array of subject areas regulated by state law, most businesses deal with state courts. Federal court subject matter jurisdiction is generally limited to **federal question jurisdiction**. In other words, federal courts hear cases involving the 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. Finally, lawsuits between states can be filed directly in the US Supreme Court.

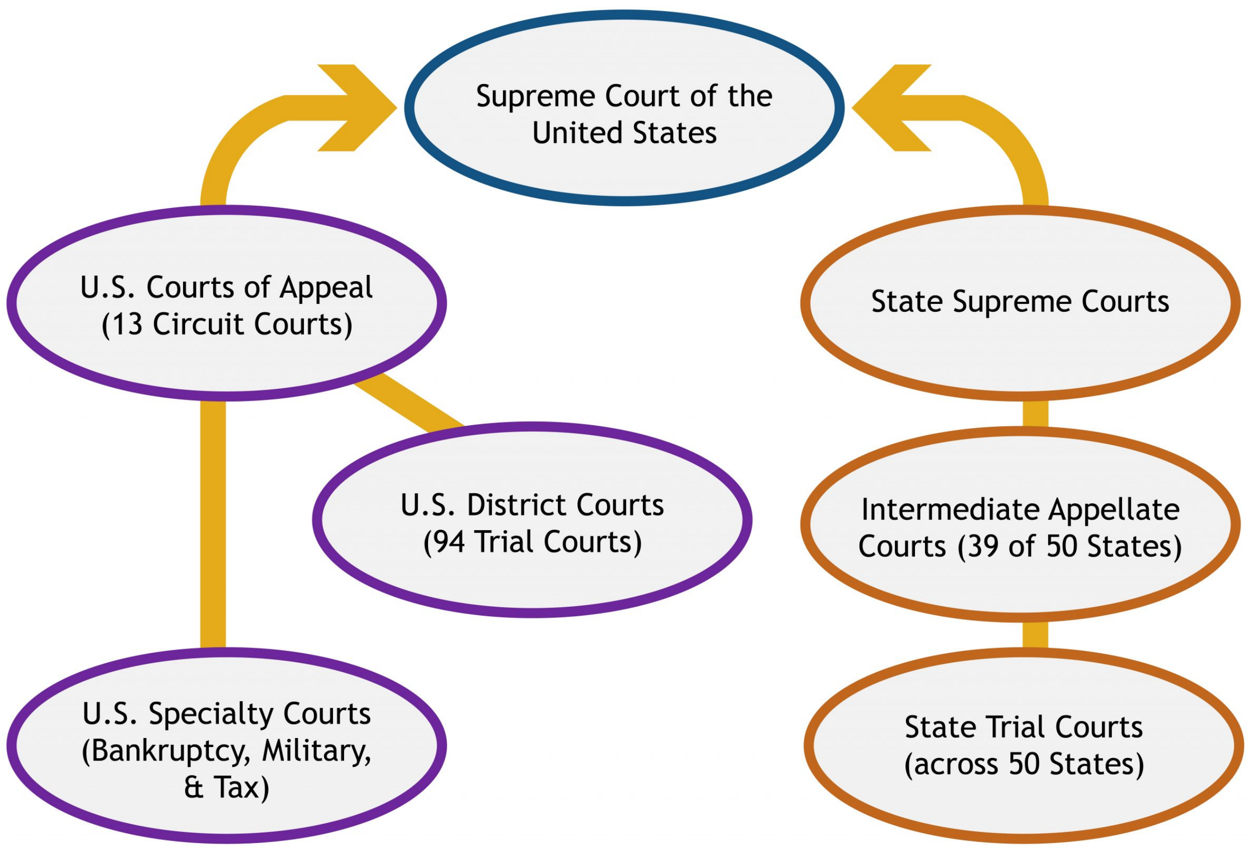
Sometimes a federal court may hear a case involving state law. These cases are called **diversity jurisdiction cases**, and they arise when all plaintiffs in a civil case are from different states than all defendants, and the amount claimed by the plaintiffs exceeds seventy-five thousand dollars. For example, a citizen of New Jersey may sue a citizen of New York over a contract dispute in federal court. But if both were citizens of New York, the plaintiff would be limited to the state court of New York. 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 neutral forum to try the case.

Type of Jurisdiction	Description	Minimum Dollar Requirement	Applicable Law
Federal Question	Cases involving the US Constitution, treaties, or federal laws & regulations	None	Federal law
Diversity of Citizenship	Cases brought between citizens of different states	$75,000	State law

2.4: Trial and Appellate Courts

Within the federal court and the state court systems, there are a hierarchy of courts. The first level of court is a trial court or a court of limited jurisdiction such as traffic court and small claims court. **Trial courts** accept evidence and testimony to determine what happened in a case. **Appellate courts** review the decisions of the trial court, without holding a new trial, to determine whether the parties received a fair trial and whether the appropriate law was applied.

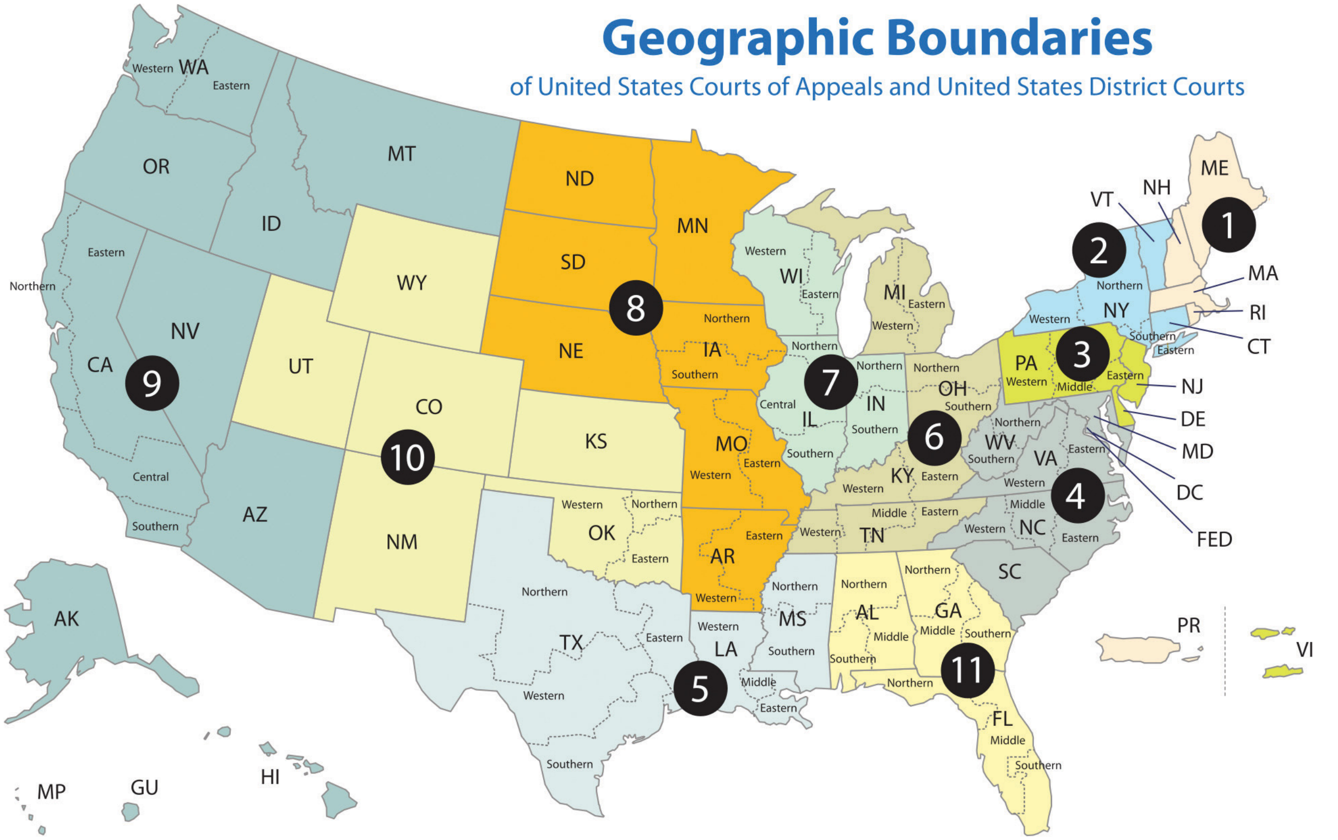
Figure 2.4 Court System Hierarchy



In the federal court system, cases are filed in the US District Court. There are ninety-four judicial districts in the nation, which are named for their geographical location. However, some states with low population have only one judicial district, while more populous states have multiple judicial districts. The US 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.

As a trial court, the US District Courts hear both civil and criminal cases. At trial, witnesses are called and their testimonies are recorded into a trial record. The losing party is entitled to appeal the case to the US Circuit Court of Appeals. There are thirteen circuit courts in the United States. A party losing an appeal at the circuit court level may ask the US Supreme Court to hear its case. However, the Constitution only requires the Supreme Court to hear a few types of appeals.

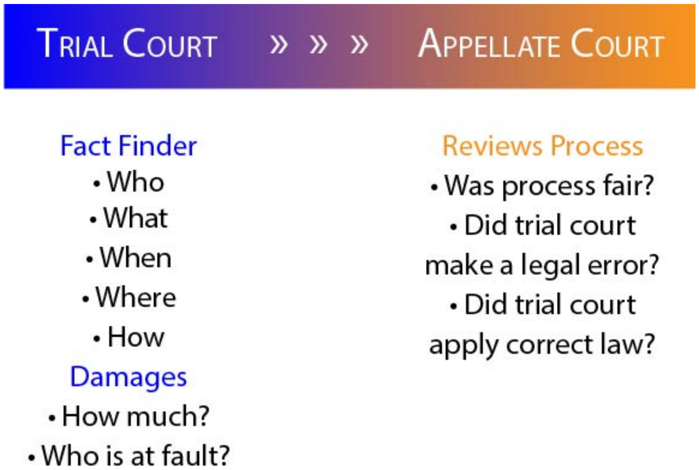
Figure 2.5 Map of Federal Circuit Courts



In the state court system, a trial court of general jurisdiction accepts most types of civil and criminal cases. These courts are called various names such as superior court, circuit court, or district court. There may be other courts of limited jurisdiction at the state level, such as traffic court, family court, or small claims court. Like their federal counterparts, state trial courts hold trials, and preserve a trial record for review by an appellate court. Finally, in certain state cases that involve a federal constitutional right, a party that loses at the state supreme court level can appeal to the US Supreme Court. These cases typically involve the application of the Constitution to criminal procedure, evidence collection, or punishment.

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, which is usually the jury. The issues on appeal are therefore limited to questions of law or legal errors. The deference to the fact finder means that, as a practical matter, appeals are hard to win.

Figure 2.6 Roles of Trial and Appellate Courts


TRIAL COURT
» » »
APPELLATE COURT
Fact Finder
• Who
• What
• When
• Where
• How
Damages
• How much?
• Who is at fault?
Reviews Process
• Was process fair?
• Did trial court make a legal error?
• Did trial court apply correct law?

2.5: Concluding Thoughts

The US Constitution establishes the three branches of the federal government and gives them the ability to check each other's authority. The Judicial branch oversees the actions of the Executive and Legislative branches through judicial review to ensure that they do not violate the Constitution. While not perfect, the US federalist system was designed to restrain governmental power and to prevent the rise of an authoritarian regime.

The Judicial Branch is the only unelected branch 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. The president can check the judiciary through appointments and the pardon power. Congress can check the judiciary through confirming judges, administrative control of court calendars and funds, and legislation about the types of cases a court can hear.

There are fifty-six separate legal systems in the United States. Subject matter jurisdiction is the authority of a court to hear a case based on the type of dispute. State law claims are generally heard in state courts, while federal question cases are generally heard in federal court. Federal courts may hear state law claims under diversity jurisdiction. Federal cases are filed in a US District Court and appealed to a US Circuit Court of Appeals. State cases are typically filed in a trial court and appealed to an intermediate court of appeals.

3: Litigation

3.1 Introduction

LEARNING OBJECTIVES

1. Identify the parties involved in litigation.
2. Explore the responsibilities of attorneys.
3. Understand the roles and types of juries.
4. Explore the standing requirement.
5. Follow a trial from opening statements to closing arguments.

Litigation provides an opportunity for each side in a dispute to tell their story to an impartial jury or judge to decide who wins. Business professionals have a responsibility to their company and stakeholders to avoid legal liability. Acting ethically helps achieve this goal. Agreeing to mediation or arbitration may help businesses avoid court. However, litigation may be the only dispute-resolution mechanism available or the one that is best for the situation.

Counselor's Corner Litigation is like any other business effort: you are trying to get someone to see things your way. The best way to do that is to be likable and persuasive to the judge, other lawyers, and the jury. Construct your theory of the case early on. Meet your deadlines. Maintain a strict ethical standard in your professional life. Work hard to explore both sides of the case, and develop a short and compelling statement about why your side should prevail. If you do all that, you will make it easy for others to want to find in your favor. Why does this work? Because as humans, we want good to prevail. Be good. ~Valerie M., magistrate

3.2 The Parties, Attorneys, and Jury

The Parties

The litigation system relies on parties to bring forth and defend their respective claims. The party that begins a civil lawsuit is called the **plaintiff**. The plaintiff sues the **defendant** to recover damages for, or to stop, a legal wrong. In a criminal trial, the party that initiates litigation is the prosecution, representing the people within a state or federal government. In a criminal trial the accused wrongdoer is also called the defendant.

Cases may involve multiple plaintiffs and multiple defendants. Civil procedure encourages parties to bring their complaints against each other at once. All parties, and every possible **claim** (each claim is a separate violation of law) arising out of a single incident or series of related incidents, should be identified and raised in a lawsuit.

Except in some small-claims courts, parties may hire attorneys to represent them. Individuals who represent themselves are called **pro se litigants**. The complexities of litigation require knowledge and objectivity to succeed. Courts hold pro se litigants to the same standards as they do attorneys. Therefore, a pro se litigant is expected to understand and follow all the rules of the court and applicable laws.

Attorneys

In the United States, law school is a graduate-level program that usually takes three years to complete. Law school graduates earn a Juris Doctorate degree, or JD. Graduates then take the bar exam in the state where they wish to practice. If they pass the exam and background check, they can apply to be licensed in that state. Because the practice of law in the United States varies widely by jurisdiction, attorneys are only permitted to practice in jurisdictions where they are licensed.

Attorneys are bound by a professional code of ethics that is overseen by the supreme court of the state where they are licensed. One of the most important 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 doctrine. 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 attorneys they intend to harm others or themselves. Attorneys must avoid violating the privilege because it 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.

In spite of an attorney's professional obligations to his or her client, it's important to remember that ultimately an attorney's first duty is to the administration of justice. The requirements for attorneys to be civil, honest, and fair are written to ensure that attorneys represent the very best aspects of the judicial system. For example, a client admits to his attorney that he is guilty of a crime. The client then wants to testify under oath that he is innocent. Although an attorney cannot reveal what her client has told her, the attorney is prohibited from knowingly suborning perjury. The attorney must either convince the client to not testify or withdraw from the case.

An attorney 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. Attorneys cannot assert legal claims or arguments that are not well-founded under existing law or through the modification or expansion of law. Attorneys are also prohibited from using the courts for a purpose unrelated to the resolution of a legitimate legal cause of action.

The Jury

In the US legal system, the jury has a very special role of 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. The litigation system is a process in which each side gets to present its case to a group of unbiased citizens, and then ask them to decide who wins the case.

There are two types of juries. A **grand jury** is a group of citizens convened by the prosecution in serious criminal cases to determine (1) whether probable cause exists to believe that a crime has occurred, and (2) whether it's more likely than not that the defendant committed the crime. If the grand jury decides probable cause exists, then the government may bring criminal charges against the defendant. The grand jury prevents prosecutors from abusing their powers of arrest and indictment. The grand jury requirement exists at the federal level and in most states. A grand jury typically meets for an extended period of time and hears several different cases.

The grand jury does not determine guilt or innocence. A **petit jury** 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 the facts of the case. 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. In a criminal trial, a jury must arrive at a unanimous verdict to convict a defendant of the crimes charged.

The jury system is incredibly important because ordinary citizens adjudicate all sorts of disputes. 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. 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 action against workers on jury duty, there is no legal requirement that an employer continue to pay a worker on jury duty. Some citizens, such as those who are self-employed, risk losing personal income by serving on juries.

Another potential problem arises in the composition of the jury. 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. The only professions that are automatically exempt are active-duty military members, police officers, firefighters, and public officers. In spite of these administrative problems, the jury system remains a cornerstone of the US legal system.

3.3 Standing

Standing is a constitutional requirement. Article III of the US Constitution grants the judiciary the power to hear "cases" and "controversies." This means actual cases and controversies, not merely hypothetical ones. The standing requirement means that courts are unable to give advisory opinions. Standing is a doctrine that limits judicial overreach by limiting the types of cases that are litigated in court.

To demonstrate **standing**, a party has to prove 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 is not yet ripe. If it's brought too late, then the case is moot.

The case also has to be brought by the right person. To show standing, a plaintiff has to demonstrate that he or she has an actual stake in the litigation, or something of value that would be lost if he or she loses the case. It's important to note that standing is not related to the merits of the case. It only means that a party may proceed with litigation.

3.4 Subject Matter and Personal Jurisdiction

In order to hear a case, courts must have subject matter jurisdiction over the type of dispute and personal jurisdiction over the parties. As discussed in Chapter 2, subject matter jurisdiction is the legal authority to hear and decide a case or controversy. The court must dismiss a case if it lacks either form of jurisdiction.

Personal jurisdiction is the power of the court to compel the parties to appear in court. Personal jurisdiction requires litigants to have some form of minimum contacts with the state where the case is filed. Personal jurisdiction seeks to avoid inconvenient litigation, even if the case has merit.

A court obtains personal jurisdiction over the plaintiff when the plaintiff files a lawsuit. The court obtains personal jurisdiction over a defendant when he or she is served with process or waives service.

Obtaining personal jurisdiction over the defendant requires some connection between the defendant and the state where the court is located. Businesses that incorporate, have a physical location, or do business in a state create personal jurisdiction through their actions within the state. Owning property in a state also creates personal jurisdiction.

Personal jurisdiction, like standing, is a constitutional requirement. Most states have **long-arm statutes** that set forth the procedure by which out-of-state defendants can be required to appear before a court. The statutes provide for how service of process occurs. **Service of process** is the process by which a defendant is notified that it is being sued. Service of process typically requires a copy of the notice to appear before a court to be personally delivered to the defendant or the defendant's agent. In the case of businesses, service of process is usually delivering a copy of the notice to appear to their registered agent. Service can be more challenging with individuals.

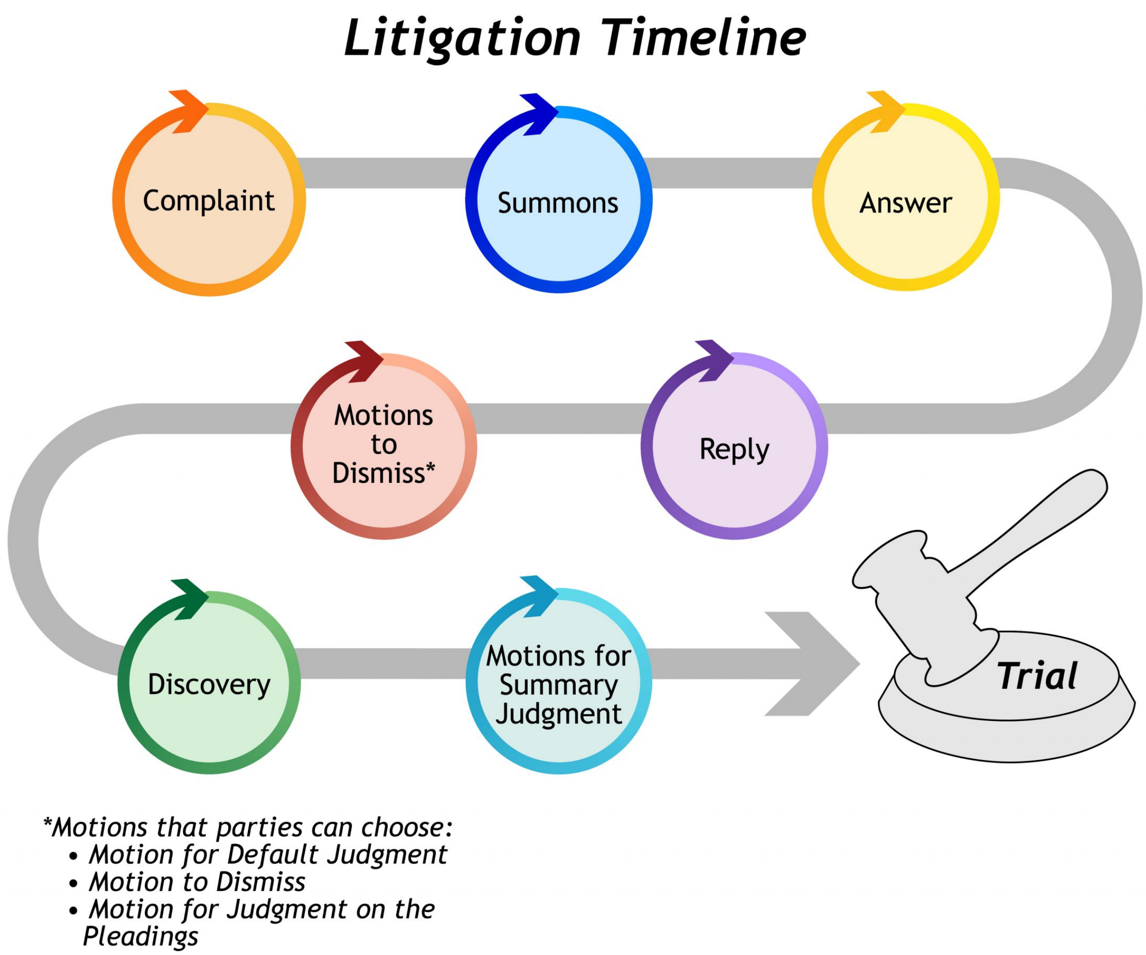
Basis of Personal Jurisdiction	Description
Consent	• A business or individual agrees to the jurisdiction of the court
Residence	• A business or individual resides in the state
Service of Process	• The defendant is served a summons and complaint within the state
Long-arm Statute	• A resident business or individual was involved in an incident in another state; or • A non-resident business or individual was involved in an incident within the state

3.5 Venue

Venue is the proper geographic location of the court to hear a case because the place has some connection with the events that give rise to the lawsuit. While multiple courts may have subject matter and personal jurisdiction over a dispute, only a few may be the proper venue. For example, by doing business in Colorado a company is subject to the jurisdiction of Colorado courts. However, the court in the county where the plaintiff was injured or where the business maintains an office would be the proper court to hear the dispute.

3.6 Pretrial Procedures

Figure 3.1 Litigation Flowchart



Pleadings

In civil cases, litigation begins with the filing of a complaint by the plaintiff. The **complaint** is a legal document setting forth who the parties are, the facts of the case, and what laws the plaintiff claims defendant has violated. The complaint ends with a prayer for relief. The plaintiff may be seeking damages (money), specific performance in certain types of contract cases, or an injunction.

The complaint is filed with the clerk of the court where the lawsuit is to be heard. The clerk will issue a **summons**, which is an official notice that a lawsuit has been filed with the court and summons the defendant(s) to court to defend against it. To be effective, the defendant(s) must be served the summons and a copy of the complaint.

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. In these cases, several lead plaintiffs may attempt to form a class in a **class action lawsuit** against the defendant(s). Under federal civil procedure rules, class actions may be granted when:

1. There are so many plaintiffs that
2. It is impractical for them to file separate lawsuits;
3. There are questions of law or fact that are common to members of the class; and
4. The lead plaintiffs will fairly and adequately protect the interests of the class.

The defendant must file an **answer** to the complaint within a specified period of time, usually thirty days. The answer is a paragraph-by-paragraph response to the complaint, admitting certain allegations and denying others. 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. The answer may also contain any affirmative defenses and counterclaims the defendant wishes to pursue. Taken together, the complaint and answer are known as the **pleadings**.

Discovery

After pleadings are filed, litigation moves into the discovery phase. **Discovery** is a process in which each side finds out information about the other's case. Discovery is designed to prevent trial by surprise, where either side may suddenly produce a damning piece of evidence. Because 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 broad. Relevant evidence is discoverable even if it is later ruled to be inadmissible at trial by the judge. Parties are also obligated to turn over material that supports their case, without demand from the other side unless it is protected by the attorney-client privilege.

Type of Discovery	Description
Request for Admission	• There are four types of discovery. The simplest is a **request for admission**. Remember that a complaint contains a series of claims the plaintiff is making against the defendant. The parties may ask each other to admit that certain facts are true or that a contested claim is true. Doing so narrows the issues for trial because it is one less thing that the jury has to decide. Even if the parties dispute legal liability, if they agree upon the facts that caused the dispute, the case may take less time and money to resolve. The second type of discovery is an **interrogatory**. These are written questions addressed to the other party. The questions tend to be simple and straightforward. Interrogatories seek to gather information about what happened, who was involved, a company's structure, and the names and addresses of witnesses. A third form of discovery is a **request for production**. A party can request another party produce relevant documents to the lawsuit, including internal company reports, emails, product manuals, and employee records. In some cases physical evidence may also be produced. For example, if a consumer sued a vehicle manufacturer because a wheel fell off while driving, the manufacturer may ask the consumer to produce the vehicle so that its engineers can inspect it. Failure to preserve and produce key evidence in litigation can lead to charges of spoliation, which may result in severe sanctions against the offending party. Finally, discovery can take the form of a deposition. 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 is attended by the witness being deposed, attorneys from all the parties, and a court reporter who keeps a written or video transcript of the deposition. There is no judge present, so there is great latitude for parties to ask questions, even if the answers are not admissible in court. Depositions help prepare for trial by knowing everything a witness may say in court. They also serve to pin down a witness's testimony, because a witness who changes testimony between a deposition and trial can be impeached. **Motions** At any point in litigation, either party may file motions with the court. A **motion** is a request to the court to rule on an issue or claim. If a defendant is properly served and does not answer the complaint, the plaintiff can file a **motion for default judgment**. In essence, the plaintiff asks the court to enter judgment in his or her favor because the defendant refused to show up to court to defend against the case. The alleged facts are admitted by default and the plaintiff may receive all the relief requested. At the beginning of a lawsuit, a party can file a **motion to dismiss for failure to state a claim**. In this motion, the defendant argues that even if everything in the complaint is factually true, the plaintiff is not entitled to legal relief. In other words, the defendant's conduct has not broken any laws. 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**, which requires lawsuits to be brought within a specified period of time. Statutes of limitations exists to encourage parties to file their lawsuits quickly, while evidence is still fresh and relevant witnesses remember what occurred. As time passes, evidence may be destroyed, witnesses may die or move away, and those who can be located can't remember what they saw or heard. In other words, the quicker a lawsuit is filed, the more likely that the truth will be discovered through litigation. For businesses, a statute of limitations also allows it to "close the books" on past liabilities. Another motion that is filed before discovery and trial is a **motion for judgment on the pleadings**. This motion asks the court to determine whether a genuine issue of material fact exists that allows the case to proceed. These motions are not as common as motions to dismiss but they are an important tool to dismiss lawsuits that are fatally flawed before the parties spend too much money. For example, if a business is sued by several parties for injuries resulting from a common cause but the complaints allege conflicting facts, the business may file a motion for judgment on the pleadings. In other words, the defendant is asking the court to dismiss the complaints because

they contradict each other in a way that it is impossible to reconcile. If dismissed, the plaintiffs may file new complaints that are not flawed.

Similar to a motion for judgment on the pleadings, a **motion for summary judgment** asks the court to enter judgment in a party's favor instead of trying the case. Filed after discovery, this motion asks the court to rule that there are no genuine issues of facts for trial. For example, if a plaintiff admits during his deposition that he lied about being involved in an accident, the defendant may bring a motion for summary judgment because the plaintiff brought a fraudulent lawsuit. Although any party may file a motion for summary judgment, defendants file and win many more motions for summary judgment than plaintiffs.

Pretrial Motion	Description
Motion for Default Judgment	◦ A party may submit an affidavit in support of any motion. An **affidavit** is a written statement made under oath. 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.

3.7 The Trial and Appeal

After discovery is completed, the case is scheduled for a trial. In civil litigation, well over 90 percent of cases filed are resolved or settled before trial. If a case goes to trial, it means there are genuine issues of fact that the parties cannot resolve, and both sides are determined to win.

The first step in this process is to select a jury. The process of selecting a jury is called **voir dire**. 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 to determine if he or she has any biases against upholding the law and whether he or she can keep an open mind during the trial.

After a jury has been selected and sworn in, the trial begins. The plaintiff or prosecution begins by giving an **opening statement** that is a preview of the trial. Attorneys inform the jury during opening statements what they expect to prove at trial. Attorneys do not make any arguments during the opening statement; they simply lay out what jurors can expect from the trial ahead. After plaintiff's opening statement, the defendant may give an opening statement.

After opening statements, the trial moves into the examination phase. The plaintiff presents evidence first. Evidence may be in the form of documents and witness testimony. The other parties have the right to cross-examine witnesses who testify at trial. 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.

Once the plaintiff has called all their witnesses and introduced all their evidence, the plaintiff will rest their case. The defendant then has an opportunity to present witnesses and evidence on their behalf. After the defense has rested its case, the attorneys once again address the jury in **closing arguments**. 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.

After closing arguments are made, the judge instructs the jury on the relevant law. The jury then deliberates. During deliberations, the jury will decide what facts are true. Then it will apply those facts to the law as outlined in the jury instructions.

Central to the jury's deliberations is the burden of proof applicable to the case. In civil cases the burden of proof is **preponderance of the evidence**. This standard requires the scales of justice to tilt ever so slightly toward one party. 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 an easy standard to meet because it only requires a party to prove that its side is more likely than not telling the truth.

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 arrives at a decision, it is called a **verdict**.

The judge enters the jury's verdict as a **judgment** of the court. After that, the losing party has the right to file an appeal. The appellate court only reviews the record for legal errors and cannot call new witnesses or substitute its judgment on the facts for the jury's.

Once all appeals are exhausted, the winning party may collect the judgment entered in its favor. This process is called **execution**. If a party is unable or unwilling to pay the judgment, the court can order the party's assets to be sold to satisfy the judgment.

A party cannot refile a lawsuit once it has been decided in the hopes of a more favorable outcome. The doctrine of **res judicata** holds that once a dispute is litigated and resolved, the parties are barred from relitigating the issue again. Res judicata is a Latin phrase that means "the thing has been decided" and it is a rule of finality in the legal system.

3.8 Concluding Thoughts

Litigation is a method for parties who cannot resolve their disputes to have a judge or jury determine what happened and whether legal liability exists. Although it may be challenging to keep the names of the parties, motions, and parts of the process straight, businesses need to understand the process to navigate it successfully. Litigation is a long and expensive process, but is often a part of a business's activities.

The goal of civil litigation is to find the truth. An attorney's highest duty is to the administration of justice. Attorneys are ethically bound to represent their clients with zealous advocacy. A grand jury acts as a body of citizens to prevent abuse by prosecutors. A petit jury sits in trials as the trier of fact to ascertain the truth through their observations of the presented evidence.

3.1: Introduction

3.2: The Parties, Attorneys, and Jury

3.3: Standing

3.4: Subject Matter and Personal Jurisdiction

3.5: Venue

3.6: Pretrial Procedures

3.7: The Trial and Appeal

3.8: Concluding Thoughts

4: Alternative Dispute Resolution

4.1 Introduction

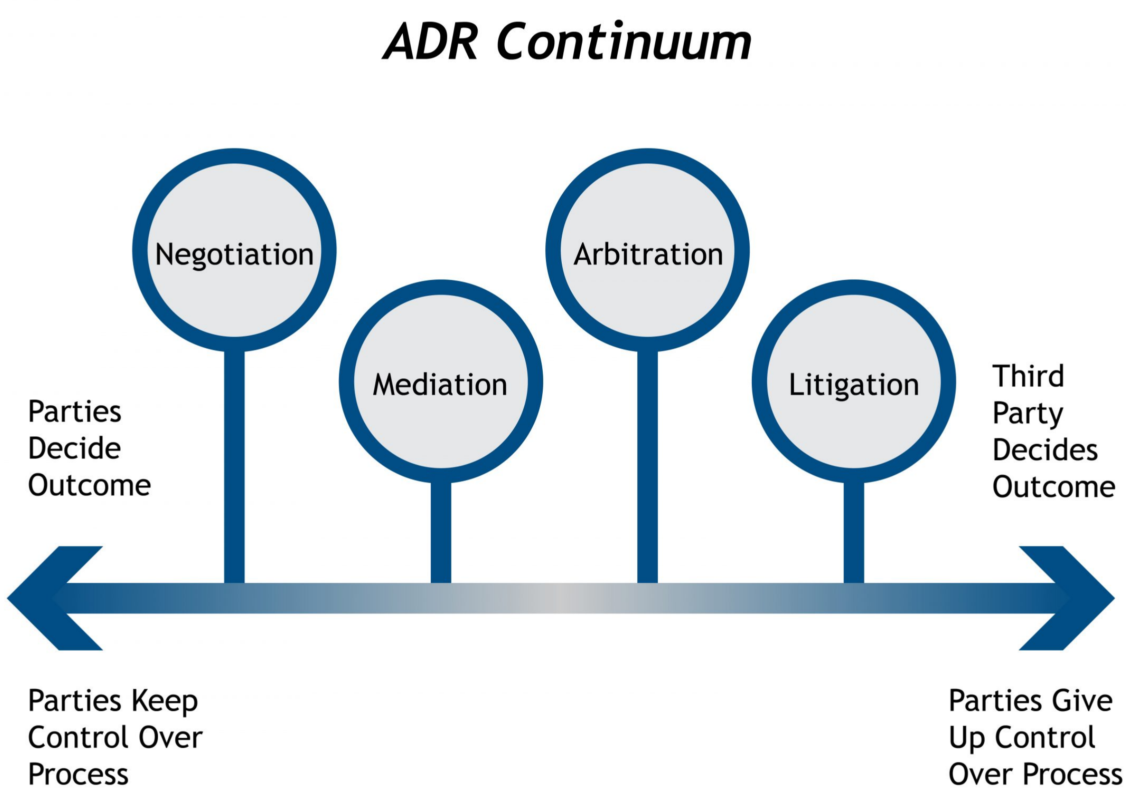
LEARNING OBJECTIVES

1. Understand alternative dispute resolution (ADR) methods.
2. Learn the benefits and drawbacks of different methods of dispute resolution.

Imagine that someone has a legal claim against a supplier, employer, or a business where he or she is a customer. What will happen? They probably don't want to immediately initiate litigation because litigation is very expensive and time consuming. Besides, they may want to continue doing business with the supplier, employer, or business. Perhaps the matter is of a private nature, and they do not want to engage in a public process to determine the outcome. They would like the dispute to be resolved, but do not want to engage in a public, time-consuming, expensive process like 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)** encompasses many different methods of resolving disputes outside of the judicial process. Some ADR methods vest power to resolve the dispute in a neutral third party, while other strategies vest that power in the parties themselves.

Figure 4.1 Alternative Dispute Resolution Continuum



The most common methods of ADR are negotiation, mediation, and arbitration. ADR is often used to resolve disputes among businesses, employers and employees, and businesses and consumers.

ADR methods are used outside of the courtroom, but 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 go to court. The **Federal Arbitration Act (FAA)** is a federal statute that requires parties to participate in arbitration when they have agreed by contract to do so, even in state court matters. The FAA preempts state power to create a judicial forum for disputes arising under contracts with mandatory arbitration clauses. The FAA encompasses transactions within the broadest permissible exercise of congressional power under the Commerce Clause in the US Constitution. This means that the FAA requires mandatory arbitration clauses to be enforceable for virtually any transaction involving interstate commerce, which is very broadly construed. This is an example of federal preemption exercised through the Supremacy Clause in the US Constitution.

Counselor's Corner "Alternative dispute resolution." The term suggests that litigation is the primary means of dispute resolution and that mediation, arbitration, and other means are "alternatives." But, actually, negotiation is the primary means of dispute resolution and the others are the alternative means—with litigation being the last (legal) alternative. In negotiation and mediation, the participants make decisions based on their values and predispositions, needs, criteria for satisfying those needs, pertinent information they are aware of, and available ways to satisfy their needs. Negotiation is the most used means of resolving disputes. It is an invaluable life skill. Don't wing it—learn how to do it well. ~Russell C., judge

4.2 Negotiation

Imagine that Han is a tent manufacturer. Han's supplier of tent fabric routinely supplies him with appropriate water-resistant fabric to construct tents, so that he can make and sell them. After many years of a good working relationship, Han's fabric supplier delivered nonconforming goods. Specifically, the fabric delivered was not water-resistant, despite the need for water-resistant fabric to make tents. However, when Han notified the supplier of the problem, the supplier denied that the fabric was nonconforming to his order. Han refused to pay for the goods. The fabric supplier insisted on payment before future delivery of any additional fabric. Without water-resistant fabric, Han cannot continue to make tents.

This is an example of a **business to business dispute**. Despite the problem, Han wants to continue working with this supplier, since they have a good, long-standing relationship. This problem seems to be a "hiccup" in the regular business relationship so they want to resolve this dispute quickly and without hard feelings. It is very unlikely that Han will immediately hire an attorney to file a formal complaint against his supplier. However, that does not change the fact that there is a dispute that needs to be resolved.

One of the first strategies that Han and his supplier are likely to use is negotiation. **Negotiation** is a method of alternative dispute resolution in which the parties retain power to resolve their dispute. No outside party is vested with decision-making power. Negotiation requires the parties to define the conflict and agree to an outcome. Often, this can take the form of a compromise. Note that a compromise does not mean that anyone "loses." If both parties are satisfied with the result of the negotiation and the business relationship can continue moving forward, then both parties will likely consider the settlement a "win."

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. In a negotiation, there is no neutral third party to ensure 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.

In addition, the parties may not have equal bargaining power. If Han's business and the supplier are both dependent on each other for roughly equal portions of their businesses, then they are most likely relatively equal with respect to bargaining power. However, if Han has a small business but his supplier has a large business, then negotiation is potentially unbalanced, since one party has a much more powerful bargaining position than the other. For example, if Han needs that particular type of fabric, which is only available from one supplier. But the supplier does not need Han's business because he do not provide a significant amount of its profit. This would be an example of **unequal bargaining power**.

4.3 Mediation

Mediation is a method of ADR in which parties work to form a mutually acceptable agreement to resolve their dispute with the help of a neutral third party. Like negotiation, parties in mediation do not vest authority in a third party to decide the dispute. Instead, this authority remains with the parties themselves, who are free to end mediation if it is not working. Often, when parties end mediation, they pursue another form of ADR, such as arbitration, or they choose to litigate their claims in court. Like negotiation, mediation seeks a "win-win" outcome for the parties involved. Additionally, mediation is confidential, which may be attractive to people who wish to avoid the public nature of litigation. Discussions during a mediation are not admissible as evidence if the parties proceed to litigation. This encourages parties to be open with each other when trying to resolve their dispute. Finally, the mediation process is usually much faster than litigation, and the associated costs can be substantially less.

Unlike negotiation, a third party is involved in mediation. Indeed, a neutral **mediator** is crucial to the mediation process. Mediators act as a go-between for the parties, seeking to facilitate the agreement. Mediators do not provide advice on the subject matter of the dispute. Mediators might not possess any subject-matter expertise concerning the nature of the dispute. The value of mediators, however, is their training and experience in conflict resolution, which they use to facilitate an agreement between the parties.

Advantages of Mediation	**Drawbacks of Mediation**
• Parties often enter into a legally binding contract that embodies the terms of the resolution immediately after a successful mediation. Therefore, the terms of the mediation can become binding if they are reduced to a contract. Mediation is often required by courts as part of the litigation process. In an effort to reduce the court's docket and encourage the parties to settle their own disputes, parties to lawsuits often must mediate their disputes after discovery and before trial. If the parties cannot settle their dispute with the help of a mediator, the case will proceed to trial before a judge or jury who will determine the outcome of the case.	

4.4 Arbitration

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

An arbitrator presides over arbitration proceedings. **Arbitrators** are neutral decision makers who are often experts in the law and subject matter at issue in the dispute. Arbitrators act like judges during 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). However, their decisions do not form binding precedent like appellate court decisions.

Participation in the arbitration proceeding is sometimes mandatory. Parties must arbitrate if they signed a contract requiring mandatory arbitration for that type of dispute. Arbitration is also mandatory when state law requires it.

Voluntary arbitration 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 arbitration in hopes of a speedy and relatively inexpensive outcome.

In binding arbitration, the arbitration award is final. Therefore, appealing the merits of a binding arbitration award to court is not available. An arbitration award may be converted to a judgment by the court, thereby creating the legal mechanism through which the judgment can be collected. This process is called **confirmation**.

Although courts review arbitration awards, their review is very limited and all doubts are resolved in favor of the validity of the award. Courts review whether (1) the arbitration award covered matters beyond the issues submitted; (2) the arbitrator failed to apply the law correctly; and (3) fraud occurred. Courts do not review the merits of the award.

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.

The rules of procedure during arbitration are often less formal or less restrictive on the presentation of evidence than in litigation. 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, arbitration adheres to rules, but those rules are not the same as the rules for litigation.

Arbitration can be more expensive than negotiation or mediation, but it is often less expensive than litigation. Parties must pay the costs of the arbitrator, and they often hire attorneys to represent them. Additionally, in mandatory arbitration clause cases, the arbitration may be required to take place far from one of the parties. This means that a party may have to pay travel costs during the arbitration proceeding. Arbitration is also faster than litigation.

A common issue 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)** arbitration is 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 resolve the dispute, and they both understand the issues involved.

However, issues of fairness often arise in **business to employee (B2E)** and **business to consumer (B2C) disputes**, 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. In B2E contexts, unequal bargaining power alone is insufficient to hold arbitration agreements unenforceable.

In B2C cases, different issues of fairness exist. As noted previously, when the parties possess unequal power, these issues can be magnified. Consumers tend to fare better in litigation than in arbitration. Incentives exist to favor businesses over consumers in the arbitration process, including the lack of appeal rights to the courts, the limits on consumers' remedies, prohibitions against class-action suits, limitations on access to jury trials, limitations on abilities to collect evidence, and greater out-of-pocket expenses.

Not all binding arbitration clauses have been upheld by courts in B2C cases. The FAA does not prevent the courts from applying state law, including the unconscionability of contract terms. In other words, if the terms of the contract make it unreasonable to enforce the arbitration provision, then a party may still bring claims to court for resolution.

Similarly, arbitration agreements may be rescinded on the same grounds as other contracts. Fraud, mutual mistake, and lack of capacity are grounds for voiding arbitration contracts. Revocation is also possible in the event of death or bankruptcy of one of the parties, as well as destruction of the subject matter of the underlying contract.

4.5 Concluding Thoughts

ADR is the 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 may be the preferred dispute resolution method, particularly when an ongoing relationship between parties is desired. Common methods of dispute resolution are negotiation, mediation, and arbitration. Mandatory arbitration clauses are common in contracts, and such clauses are usually enforceable against the parties even if they wish to litigate their claims.

4.1: Introduction

4.2: Negotiation

4.3: Mediation

4.4: Arbitration

4.5: Concluding Thoughts

5: The Constitution

5.1 Introduction

LEARNING OBJECTIVES

1. Explore how the US 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 US Constitution resolves conflicts between state and federal laws.
3. Explore how the US Constitution grants Congress the power to regulate interstate commerce.
4. Understand how the US Constitution protects the civil liberties of business entities.

Our first national constitution was the Articles of Confederation. The Articles granted limited authority to the federal government, including the power to wage wars, conduct foreign policy, and resolve issues regarding claims by the states on western lands. Many leading statesmen, known as Federalists, thought 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. Larger states resented the structure under the Articles, which gave small states an equal vote as 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. Because the federal government was too weak to function, the Articles were abandoned and the current Constitution was adopted in 1787.

Counselor's Corner The Constitution is the fundamental law of our nation and is extremely powerful. It's also beautiful in its simplicity. The Constitution in action, though, is often messy. People's rights conflict with each other. Branches of government clash over which has the power to act. Federal and state governments argue over who has ultimate authority to govern. But as long as we continue to cherish the values instilled in the document, the Constitution will remain a living protection against tyranny. We must protect it at all costs if we expect it to protect us. Tyranny starts when our dedication to Constitutional principles ends. ~John K., judge

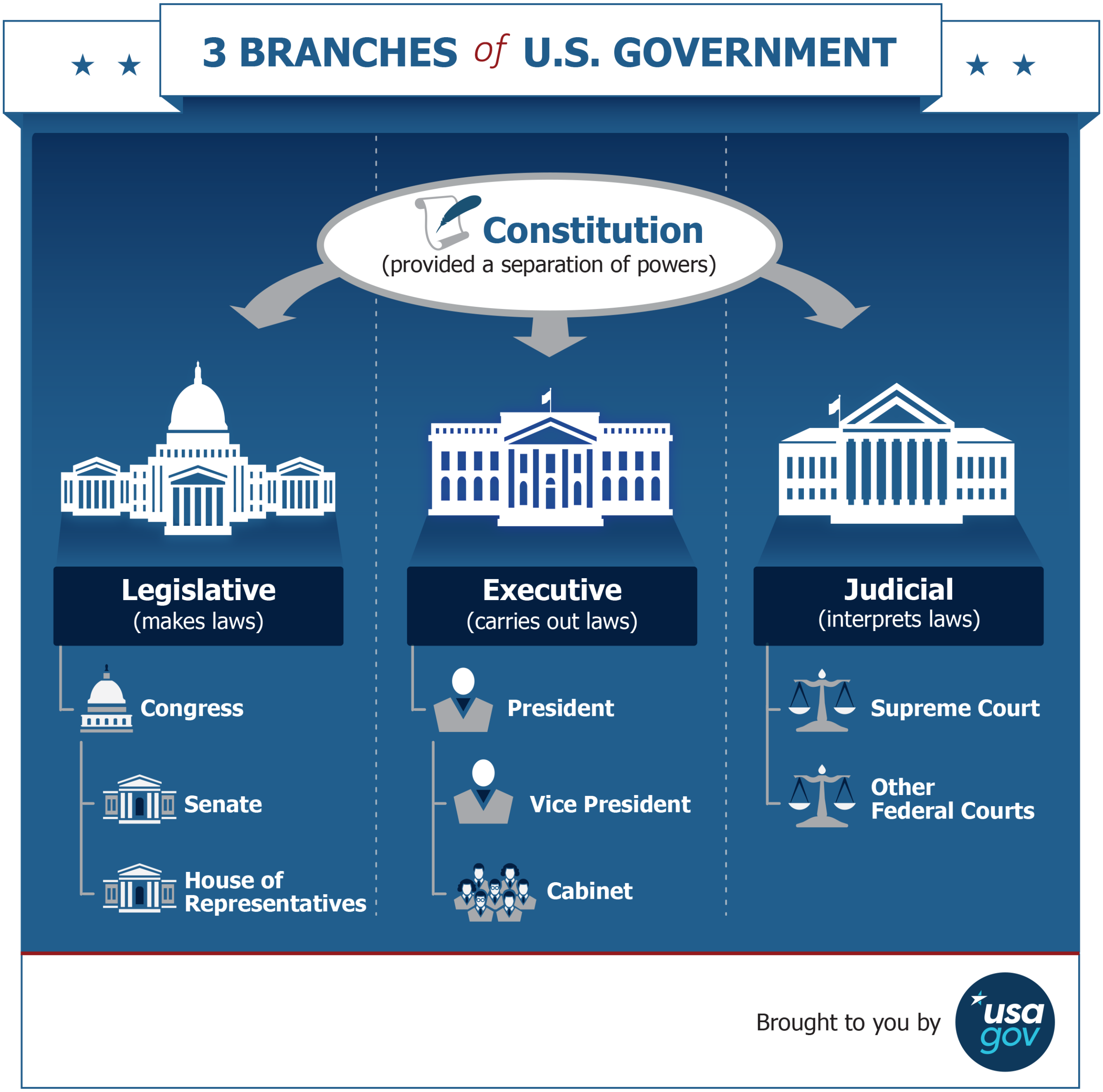
5.2 Federalism and Preemption

Much of the Constitution 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. The Constitution is a document of prohibition, outlining what government cannot do as opposed to what government must do. This is the result of the Founders' distrust of authoritarian regimes.

Separation of Powers

The Constitution provides for the **separation of powers**, which requires each branch of government to play its own unique role in governing the people.

Figure 5.1 Separation of Powers of the Branches of the Federal Government



Article I of the Constitution establishes the legislative branch through a bicameral legislature. The House of Representatives, with elections every even-numbered year, has 435 members, with representation determined proportionately by state population as determined by a census every decade. The most populous state, California, has fifty-three representatives, while several states have only one representative. The House is led by the Speaker of the House, typically from the party that holds the majority seats 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 deliberative body to ensure debate of significant issues and prevent hastily rushed law. The makeup of the Senate means that citizens from smaller states, representing many fewer people, may 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 ratify treaties.

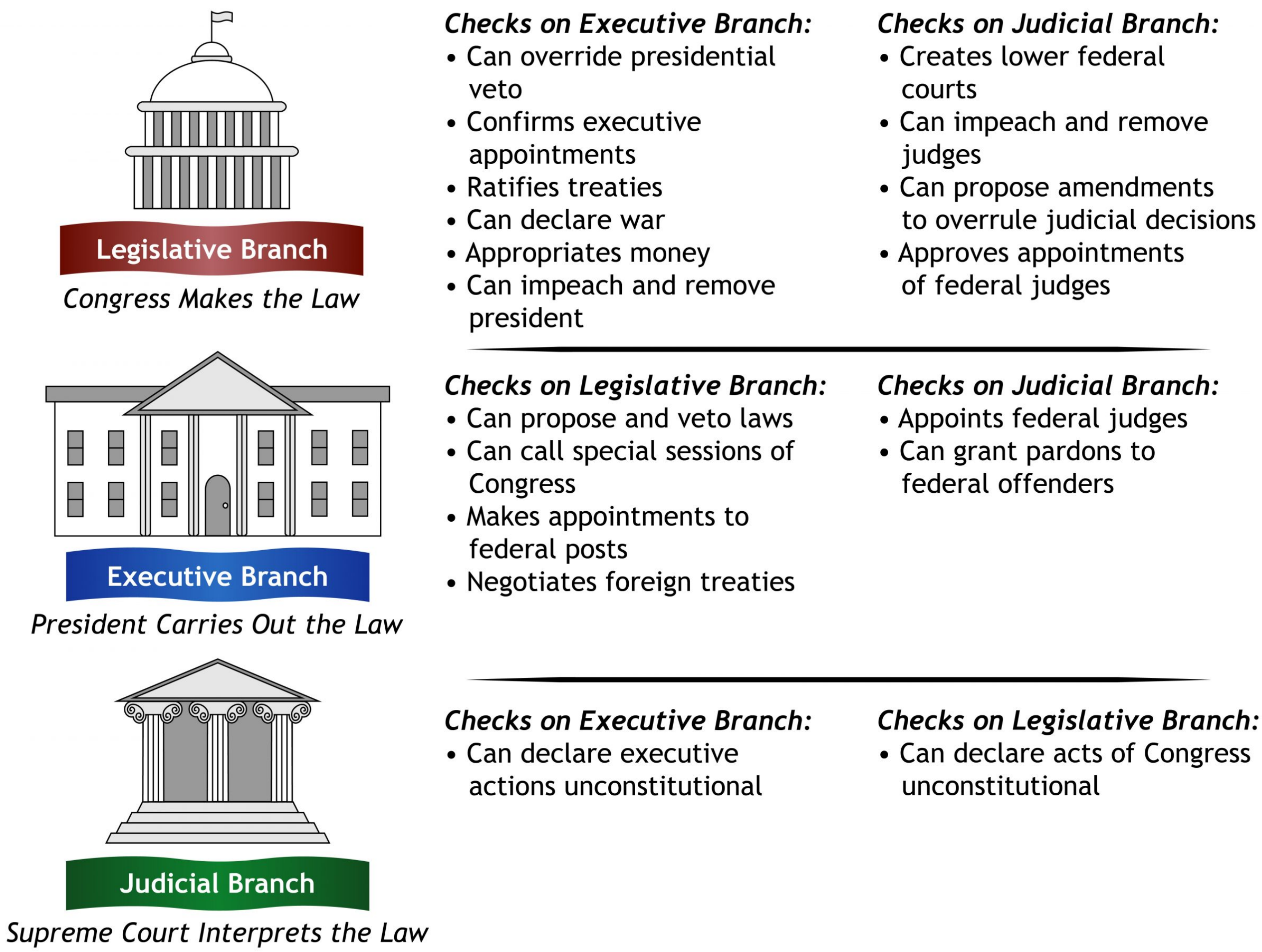
Article II of the Constitution establishes the executive branch of government. It sets forth some of the mechanisms for becoming president—and is the only place in the Constitution that prescribes a specific oath of office. Article II grants the president power to be the primary architect of foreign affairs, including the power to negotiate treaties and appoint ambassadors. The president is also commander-in-chief of the armed forces. The president is mainly responsible for enforcing the laws of the nation. Through prosecutorial and police functions, the president ensures that the will of the people, as expressed through Congress, is carried out.

Article III of the Constitution establishes the judicial branch of the federal government. The judicial branch plays a critical role in interpreting the Constitution and outlining the powers of the legislature and executive branches. The power to adjudicate disputes is given to the Supreme Court and any other lower courts established by Congress. Federal courts have the power to hear disputes under the Constitution, federal laws and treaties. Also, if disputes arise between citizens of different states, a federal court may have diversity jurisdiction. Federal judges are nominated by the president and confirmed by the Senate. Federal judges serve for life, which helps insulate them from political pressures.

Checks and Balances

The Constitution establishes a system of **checks and balances** among the legislative, executive, and judicial branches. Under this system, each branch of government restrains the power of the other two branches of government. For example, the president may veto a bill passed by Congress. And Congress can override a presidential veto by a two-thirds vote.

Figure 5.2 Checks and Balances of the Federal Government



The judicial branch has the power of **judicial review** of executive and legislative actions to determine whether they violate the

Constitution. Although not expressly written in the Constitution, judicial review was established in 1803 in a landmark case, *Marbury v. Madison*. Judicial review also includes review of state action for violations of the US Constitution. As a result, judicial review ensures that the US Constitution is the supreme law of the land and that the judicial branch has the authority to interpret the Constitution.

Federalism

Another aspect of the separation of powers is the separation of power between the federal and state governments, known as **federalism**. To avoid tyranny, the Constitution grants certain powers to Congress, reserving all other powers to the states. This is a result of the Founders' distrust of a central government and their effort to address the failures of the Articles of Confederation. These powers are listed in Article I, Section 8 and are called **enumerated powers**.

Congress has the power to borrow money, lay and collect taxes, regulate interstate commerce, establish a uniform law on bankruptcy and naturalization, make money and establish its value, punish the counterfeiting of US money, and establish a uniform system of weights and measures. Congress also has the power to establish post offices and to protect intellectual property in copyrights and patents. Congress can 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.

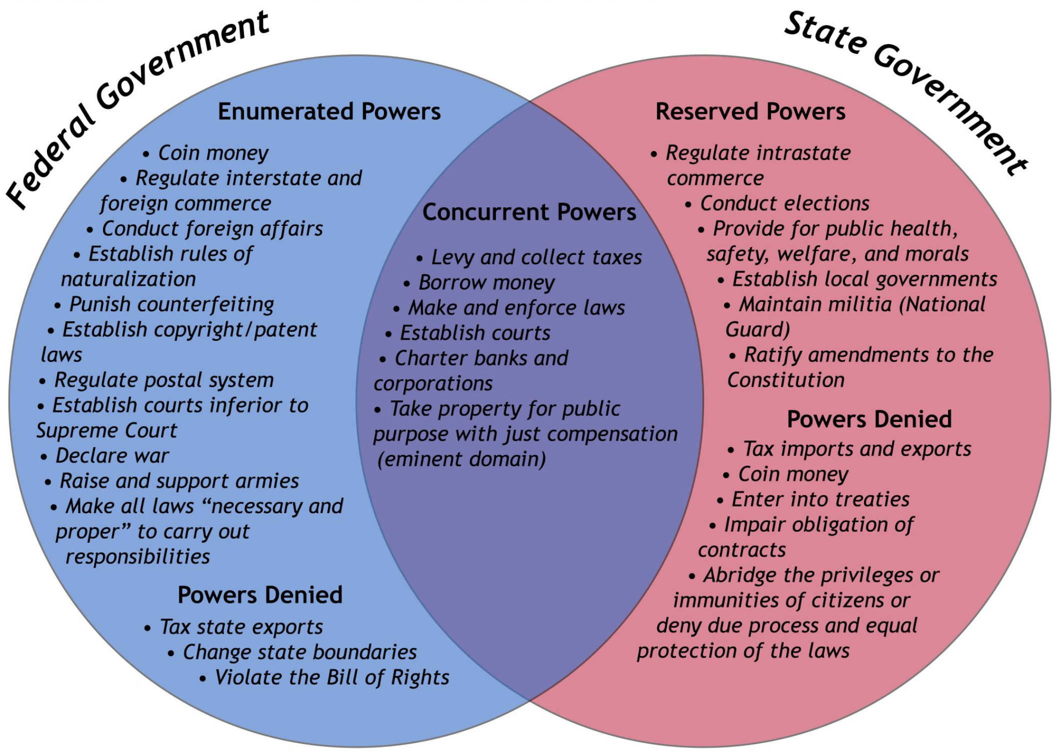
State Police Powers

The Constitution reinforces that states have **police power**, which is the authority to regulate public safety, health, welfare, and morals. States may grant more civil rights to its citizens than the federal government does. For example, some states have passed anti-discrimination laws that protect more minority groups than are recognized by the federal government. States are permitted to do so as long as the exercise of their power does not violate the US Constitution. Generally, this means the state legislation must be reasonable and applied fairly rather than arbitrarily.

Concurrent Powers

The federal and state governments have some of the same powers, which are called **concurrent powers**. For example, both federal and state governments may tax businesses and individuals. States are permitted to tax, but only if the activity taxed has a nexus to the state. A transaction (such as a sale) that takes place inside the state creates a nexus for a sales tax. Working in the state 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.

Figure 5.3 Venn Diagram of the Powers of the Federal and State Governments



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. 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 state sales tax. In June 2018, the US Supreme Court ruled that states may impose sales tax on e-commerce sales on businesses that do not have a physical presence within the states' boundaries. If the business has a clear connection to state consumers and generate a certain threshold of sales, a state can collect sales tax.

Preemption

What happens when state and federal laws exist on the same subject matter and they contradict each other? Under the Constitution's **Supremacy Clause** (Article VI, Section 2), the Constitution, federal laws and treaties are the "supreme law of the land" and judges in every state "shall be bound" by those laws. This means that federal laws are superior to state laws. Therefore, when a federal law conflicts with a state law, the federal law prevails.

When Congress states its intent to regulate an area completely, this is called **express preemption**. **Implied preemption** occurs when Congress intends to completely regulate an area but does not say so explicitly. Instead, Congress passes laws that "occupy the field" so much that no room for state regulation exists. Finally, some areas of the law allow both state and federal governments to regulate together. For example, both federal and state governments have laws to protect consumer rights.

Constitutional Rules Between the States

There are several important Constitutional provisions that ensure our federalist system works properly. The first is the **Privileges and Immunities Clause** in Article IV. This Clause ensures that people in different states are treated equally by the government. For example, the federal government cannot pass laws that subject citizens in the West to more regulations than citizens in the East. Federal laws must be applied equally across the nation. The Founders included this provision to encourage travel and business between the states.

Another important Constitutional provision is the **Full Faith and Credit Clause** in Article IV. This Clause requires states to "respect the public acts, records, and judicial proceedings of every other state." This is important for businesses because it ensures that state courts respect the judgments of courts from other states. Therefore, a judgment won in Colorado may be enforced in another state, without relitigating the underlying issues. This facilitates business because litigation can be finalized without subjecting a company to endless liability across states.

5.3 The Commerce Clause

The most important Constitutional provision related to the federal regulation of business is the **Commerce Clause**, which grants Congress the power to "regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes" (Article I, sec. 8). Over time, the Commerce Clause has been interpreted to apply to more and more businesses and industries. In addition to business transactions across state lines, the Commerce Clause now applies to business activity within one state that substantially affects or impacts commerce in other states. The growth of e-commerce, the internet, and federally-insured banks results in most businesses today being subject to federal regulation under the Commerce Clause.

Dormant Commerce Clause

States cannot interfere with Congress's power to regulate interstate commerce. This concept is known as the **Dormant Commerce Clause**. This clause 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 on interstate commerce, violates the dormant commerce clause. For example, if a state required out-of-state corporations to pay a higher tax or fee than an in-state corporation, that is unconstitutional. However, 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. For example, a state may weigh trucks on highways to ensure they do not exceed maximum weight rules, even if the trucks came from out of state, as long as all trucks on the highways are weighed.

5.4 Business and the Bill of Rights

During the debate surrounding the Constitution, there was much discussion about whether an explicit protection of civil liberty was necessary. Some believed that the common law system adequately protected civil liberties, so a written declaration of rights wasn't necessary. Others believed that a written declaration of rights was necessary to protect the people from government overreach. In 1791, the first ten amendments to the Constitution were ratified and became known as the **Bill of Rights**.

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," Congress has defined "person" to include "corporations" so many civil rights also apply to business entities.

It's worth making some observations about civil liberties in general. 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. People 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 individual rights lie. The right of the public to know information about the lives of politicians and other high-profile figures, for example, must often be balanced by the right those citizens have to their own privacy.

Second, 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. Other than the right to vote, the civil liberties protected by the Constitution extend to all persons physically on US soil, not just citizens or legal immigrants. Persons visiting the United States temporarily, such as tourists and students, as well as undocumented aliens, are also entitled to the full protections of the US Constitution.

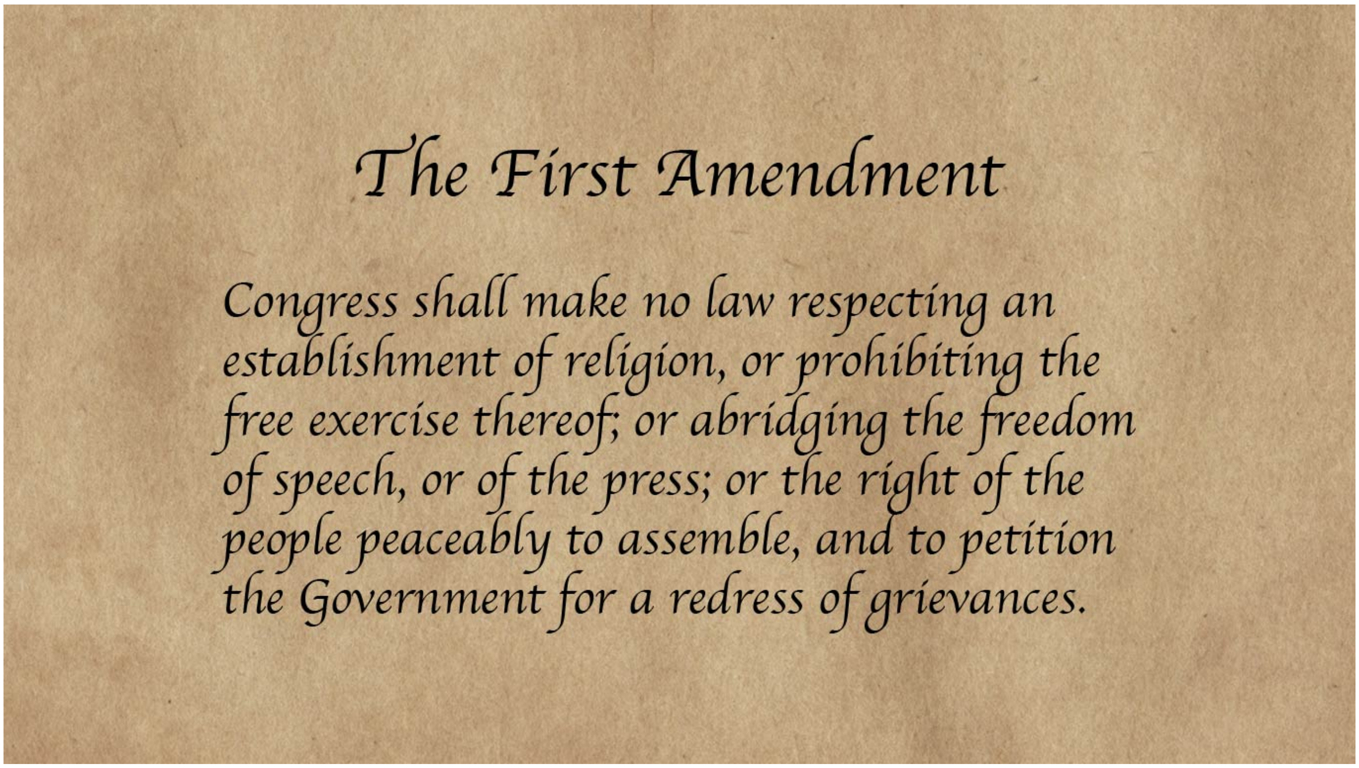
Third, the extent of civil liberty protections vary from time to time. Society evolves with progress and challenges. The Founders could not contemplate a digital world where an act of defamation on social media can spread to millions of people in a matter of minutes. The Eighth Amendment illustrates how time shifts the meaning of a right. 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, the First Amendment states "Congress shall make no law respecting an establishment of religion." States were not similarly restricted, and many states established official churches.

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, the Supreme Court developed a doctrine called **incorporation**, 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.

First Amendment

Figure 5.4 Language of the First Amendment



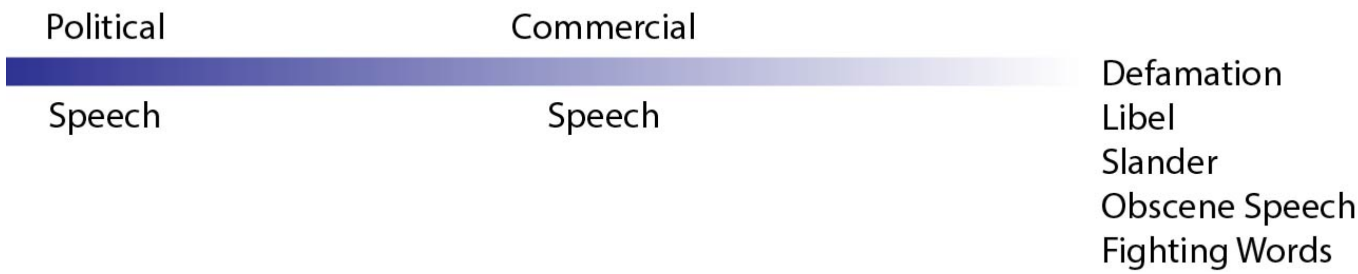
The First Amendment contains several important clauses pertaining to speech and religion. The two different clauses on religion may conflict with each other in some circumstances. On the one hand, the First Amendment prohibits the government from establishing any religion—this is called the **Establishment Clause**. On the other hand, the First Amendment prohibits the government from restricting the free exercise of religion—this is called the **Free Exercise Clause**. In theory, this allows individuals the right to freely practice their religion while prohibiting the government from doing so. Conflict arises when people choose to practice their religion freely and openly on government property, such as in a public school or city hall.

As is often true in Bill of Rights cases, courts have had to fashion a test to draw the line between the Establishment and Free Exercise Clauses. The use of public funds for religious purposes and the public display of religious life is 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, is permitted to do so as part of a general holiday-themed cultural display that also includes a menorah.

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.

Not all speech is protected by the First Amendment, and the type of speech drives its level of protection. **Political speech**, which relates to matters of public interest, receives the most protection. Political dissent, displeasure with the government, party membership, and even speech advocating the overthrow of government, all deserve extraordinary protection under the First Amendment.

Figure 5.5 Spectrum of First Amendment Protection of Speech



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 (e.g. yelling "Fire" in a crowded theater when there is no fire). Defamation, libel and slander are all actionable torts. Obscene speech and fighting words are also not protected under the First Amendment.

In the middle of the spectrum is commercial speech, which relates to business transactions. Commercial speech is entitled to some protection under the First Amendment as long as it is not false or misleads consumers. If the information is false or misleading, it is not protected at all. Under an intermediate level of scrutiny test, freedom of commercial speech is not violated as long as (1) there is a substantial government interest in restricting or regulating speech; (2) the restriction directly advances that interest, and (3) the restriction is no more extensive than necessary.

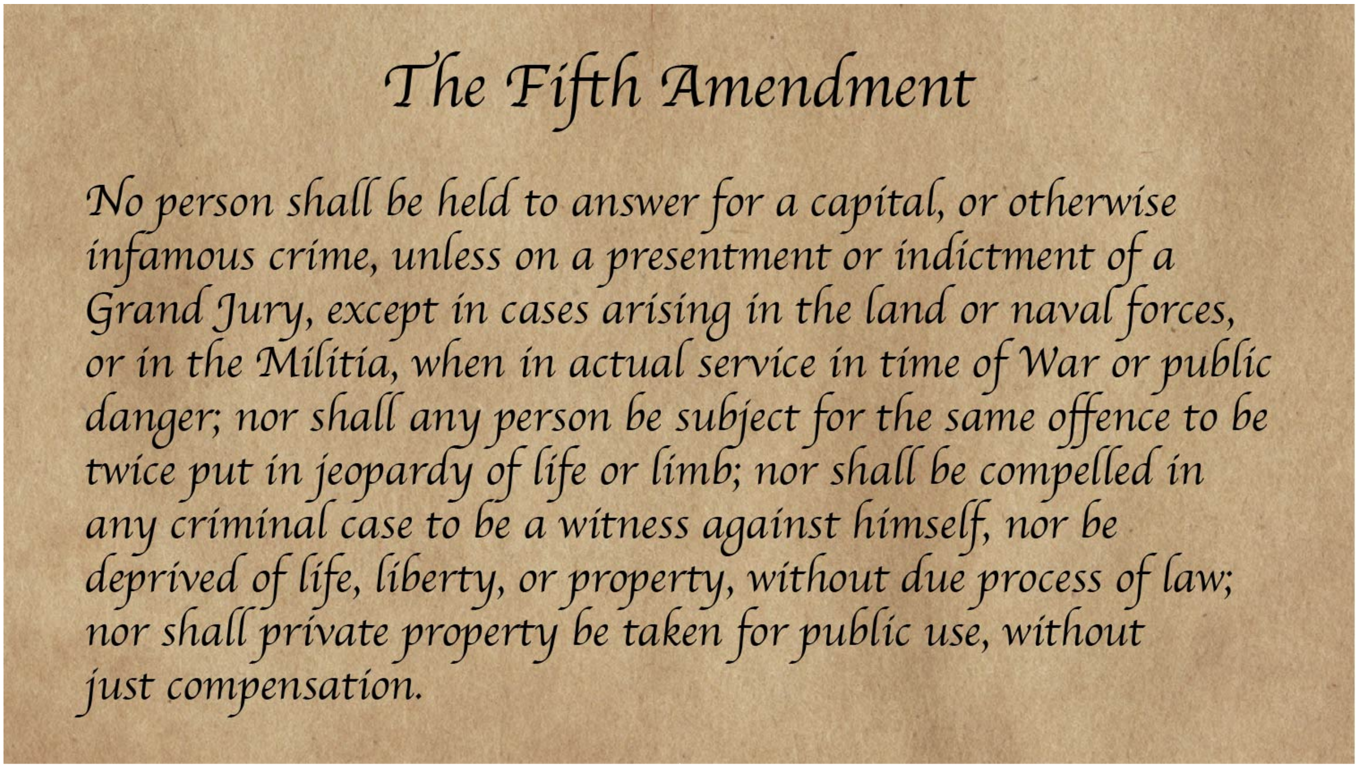
The **prior restraint doctrine** prohibits formal censorship before the publication of speech. In other words, the government cannot restrict speech or publications before their actual expression. Prior restraints violate the First Amendment unless the speech is obscene, is defamatory, or creates a clear and present danger to society.

The US Supreme Court has ruled that corporations are "persons" entitled to First Amendment rights to speech and religion. 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. Similarly, Congress defined "persons" to include corporations, companies, associations, firms, partnerships, societies, and joint stock companies. As a result, those types of businesses have religious rights that allow them to opt out of providing healthcare insurance to their employees that violates the businesses' religious beliefs.

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 content neutral, and any restriction on First Amendment freedoms is no greater than that necessary to further governmental interests (i.e. the restriction is not overbroad). Thus, for example, courts have upheld restrictions on posting signs on city-owned utility poles, as well as picketing and protest permit requirements.

Fifth Amendment

Figure 5.6 Langue of the Fifth Amendment



Another important restriction on governmental authority actually appears twice in the Constitution. The **due process 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 to the states. 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.

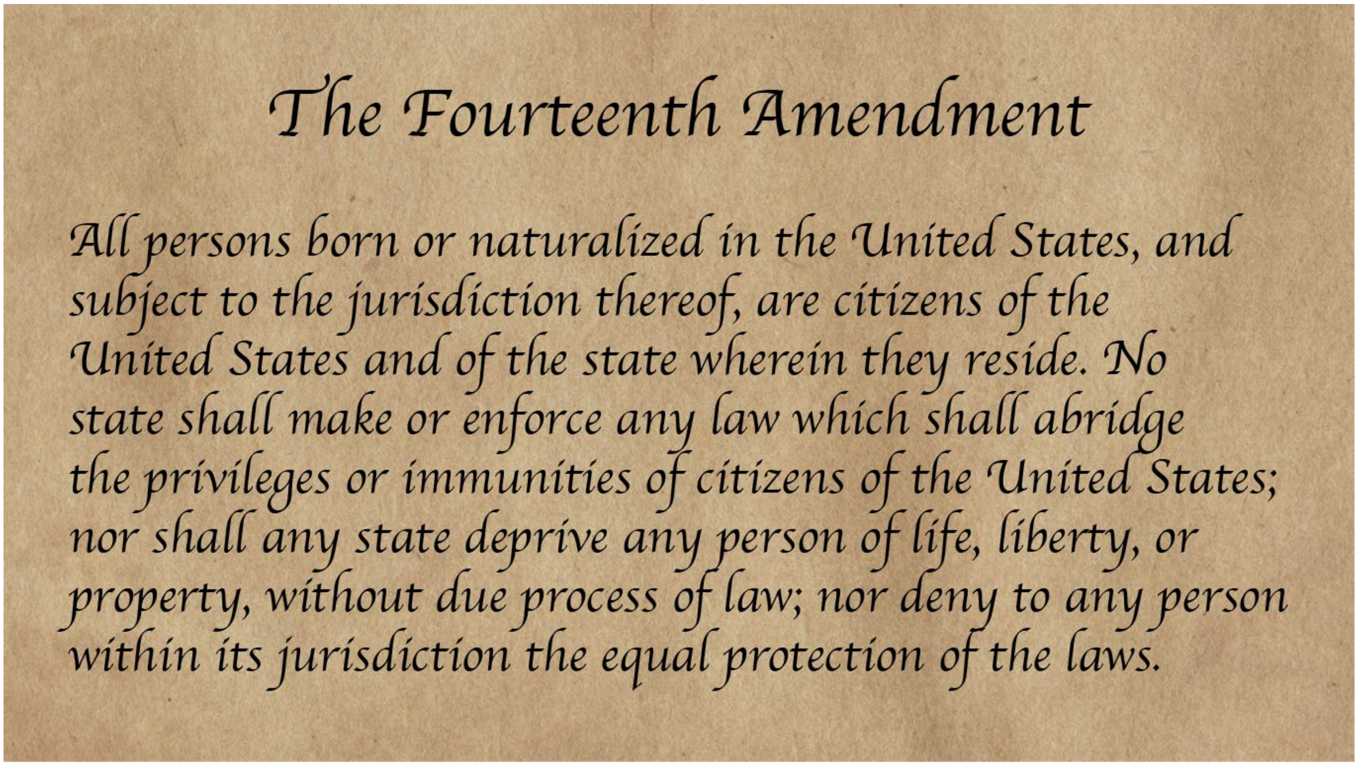
Due process contains two components. The first is called procedural due process. **Procedural due process** requires that any government action that takes away life, liberty, or property must be made fairly and using fair procedures. Procedural due process includes: (1) notice that the government is going to act and why; (2) a hearing prior to the governmental action; and (3) the ability to appeal the determination made at the hearing. This ensures those affected by a government action have a fair chance to oppose it.

The second type of the due process is substantive due process. **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. Substantive due process is often used as a basis for any lawsuit challenging government procedures or laws that affect an individual's or company's civil liberties.

Governments have the power of **eminent domain**, which is the power to take privately owned property and convert it for public use. The **Takings Clause** of the Fifth Amendment prohibits the government from taking private property for public use without just compensation. A law or regulation that denies all beneficial use of property is a taking that requires compensation. A common issue in eminent domain cases is what constitutes "just compensation." What the value of the property was before the government announces its intent to take the property or after? Property includes land, intellectual property, and personal property.

Fourteenth Amendment

Figure 5.7 Language of the Fourteenth Amendment



The **Equal Protection Clause** of the Fourteenth Amendment states that "No state shall deny to any person within its jurisdiction the equal protection of the laws." In other words, it requires the government to treat people equally. This clause incorporates Constitutional protections against the states in addition to the federal government.

The Equal Protection Clause is implicated anytime a law limits the liberty of some people but not others. It scrutinizes government-sponsored discrimination. While the word "discrimination" has a negative connotation, not all discrimination is illegal. For example, a criminal law discriminates against those who steal. The Equal Protection Clause seeks to determine what forms of discrimination are permissible.

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

Under the **minimal scrutiny test**, the government needs only a rational basis for the law—the law simply has to be reasonably related to some legitimate government interest. If the law is based on some rational basis, 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. The majority of cases that are scrutinized under minimal scrutiny pass review.

The **intermediate scrutiny test** applies to cases where the government discriminates on the basis of gender. Under this test, the government has to prove that the law in question is substantially related to an important government interest. 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.

The **strict scrutiny 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. 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, the government has a hard time meeting this burden.

Test	Relationship	Governmental Interest	Likely Result
Strict Scrutiny	Necessarily relates	Compelling	Governmental action is likely unconstitutional
Intermediate Scrutiny	Substantially relates	Important	Case-by case determination
Rational Basis	Reasonably relates	Legitimate	Governmental action is likely constitutional

There are a few cases where the Supreme Court has held that racial discrimination may be permissible even under strict scrutiny. For example, cases challenging affirmative action policies in higher education have held that admission preferences for underrepresented racial groups does not violate the Constitution. The Supreme Court has found that diversity in higher education is a compelling state interest, and that schools could consider race in deciding whether to admit students, as long as race is a “potential plus factor” considered with other factors.

5.5 Concluding Thoughts

The US Constitution is the most important and fundamental law in the nation. The Constitution establishes our government structure, identifies the powers of the branches, and identifies our fundamental rights. In this age of e-commerce, the vast majority of businesses are engaged in interstate commerce and are, therefore, regulated by Congress under the Commerce Clause. The Dormant Commerce Clause prevents states from unfairly burdening interstate commerce. Although the Bill of Rights is often thought of as applying to individuals, it also grants civil liberties to businesses.

The Constitution is mainly a structural document, setting forth the allocation of power among the three branches of the federal 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. Article I of the Constitution establishes a bicameral legislature, with the House of Representatives and Senate. Both chambers must agree before legislation can be passed. Article II of the Constitution establishes the executive power in the president, who must enforce the laws passed by Congress. 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 or occupies the field. The Constitution also provides rules to facilitate state laws across state lines.

The Bill of Rights provides key civil liberties to all people on US soil. These liberties are not absolute. Many 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. Generally speaking, the government 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.

5.1: Introduction

5.2: Federalism and Preemption

5.3: The Commerce Clause

5.4: Business and the Bill of Rights

5.5: Concluding Thoughts

6: International Law

6.1 Introduction

LEARNING OBJECTIVES

1. Define international law.
2. Understand sovereignty and the principles of international jurisdiction.
3. Know what types of laws apply to businesses operating internationally.
4. Understand the types of international jurisdiction.

According to the Small Business Association, 96 percent of the world's customers live outside of the United States. The international market is lucrative but the international legal environment is different from the US legal environment. Therefore, it is important to be familiar with the basic concepts of doing business in the global economy.

Any business that operates across a national border is an **International Business Entity (IBE)**. IBEs may be large, such as Samsung, or they may be small, such a souvenir stand that sells products across the border at Niagara Falls. When an IBE conducts business in another nation, it must comply with applicable laws in its nation of origin, in all nations where it does business, and applicable international laws. For example, if the Molson Coors Brewing Company, which is headquartered in Colorado, wants to sell its products in Mexico, it would need to comply with all applicable US, Mexican, and international laws, such as the US-Mexico-Canada Agreement (USMCA). This includes local and state laws within both the US and Mexico.

US Laws	Foreign Laws	International Laws
• International law consists of rules and principles that apply to the conduct of nations, international organizations, and individuals across borders. There are two types of international law: public and private. **Public international law** governs the relations among governments and international organizations. It includes the law of war, the acquisition of territory, and the settlement of disputes among nations. Public international law also includes agreements governing property rights, trade, outer space, and natural resources, such as the seas and mineral rights. For businesses, public international law is important because it defines human rights, such as the prohibition against child labor, slavery, and trafficking in people and stolen goods. **Private international law** applies to private parties engaged in international commercial and legal transactions. Essentially, private international law identifies what law applies to an agreement and how the parties will settle any disputes with parties in other nations. **Counselor's Corner** US nationals and businesses need to understand that they are subject to the laws of the nations where they travel and operate. For example, many US nationals do not understand that they are restricted in what they can say and publish within China. The US Constitution's freedom of speech does not		

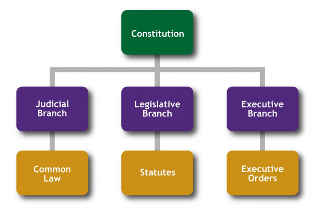
apply when visiting or working in other nations, especially communist ones. It is worth the time to understand the culture of the nation a business wants to work in before investing too much time and resources into developing operations there. Culture is just as important as finances when developing a business plan to expand into another nation. If the culture is not one that the business is comfortable with, then it should look at business opportunities elsewhere. ~Wei Z., attorney

6.2 The Nature of International Law

A **sovereign state** is a political entity that governs the affairs of its own territory without being subjected to an outside authority. Nations are sovereign states. Sovereign states have **sovereign immunity**, which is the principle that courts of one nation lack the jurisdiction to hear cases against foreign governments. In the US, this principle is enacted in the Foreign Sovereign Immunities Act (FSIA) which prohibits US courts from hearing cases against foreign governments. Two exceptions are: (1) when the foreign government waives its right to immunity and agrees to the jurisdiction of the US court; and (2) when the foreign government is engaged in commercial, not political, activity.

In **domestic law**, or law that is applicable within the nation where it is created, some 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." 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 made by the legislative branch (statutory law), by the judicial branch (common law), and by the executive branch (executive orders, rules, and regulations). This authority is derived from the US Constitution.

Figure 6.1 Vertical Nature of Domestic Law



It’s important to note, however, that not all law can be conceived as a vertical structure. Some, such as international laws, are best thought of as a horizontal structure. Treaties have a horizontal structure because sovereign nations are parties to international treaties. Since each nation is sovereign, that means that one nation is not legally dominant over another.

Figure 6.2 Horizontal Nature of International Law

If a party to a treaty has breached the agreement, enforcement can be difficult because no overarching power “above” the parties to a treaty exists. For this reason, many horizontal laws, like treaties, contain provisions that require the parties to submit to a treaty-created dispute resolution panel or other neutral tribunal, such as the International Court of Justice (ICJ).

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 nation 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 is subject to the jurisdiction of certain state and federal courts, whether they voluntarily choose to submit to the jurisdiction or not. This is why fleeing criminals can legally be caught and brought to justice through extradition.

6.3 Sources of International Law

There are two main sources of international law: customary international law and treaties. It is important for all companies to understand the laws that apply to their activities so they can avoid criminal and civil liability.

Customary International Law

A **custom** is a widely accepted way of doing something. Before treaties and conventions started to become common during the 1900s, custom was the primary way international law was created. **Customary international law** is a body of international rules that has become binding through the pattern of consistent, long-standing behavior through a sense of legal obligation. For example, granting diplomatic immunity to visiting heads of state is customary international law. Historically, customary international law governed the rules of war, treatment of prisoners of war, and human rights. After World War II, many areas of customary law became the basis for UN Conventions. While customary international law still exists, the modern trend is to reduce legal obligations to writing and have nations expressly agree to their terms.

Treaties

A **treaty** is an agreement between two or more nations governed by international law. In essence, a treaty is a contract between sovereign nations. A **bilateral treaty** is an agreement between two nations. A **multilateral treaty** is an agreement between three or more nations. A **convention** is a multilateral treaty on a specific issue that concerns issues of worldwide importance, such as human rights, property rights, and international trade rules. For businesses, one of the most important conventions is the UN Convention on Contracts for the International Sale of Goods (CISG). This convention sets the global standard for international trade.

Treaties are **adopted** when the parties agree to its final form. Then the treaty needs to be **ratified** by the nations' governments. To take effect in the US, treaties must be approved by two-thirds of the Senate. At that point, the treaty becomes part of US law. Finally, a treaty **enters into force** when it becomes legally binding on the parties. This may be a specific date identified in the treaty or when it is ratified by the parties.

Although many treaties may impact businesses, a few are particularly important to international trade.

GATT

The **General Agreement on Tariffs and Trade (GATT)** is a multilateral treaty to promote international trade by reducing or eliminating trade barriers, such as tariffs and quotas, between the member nations. GATT has been negotiated on and off since the 1940s as nations have sought to grow their economies through global commerce. In 1995, GATT members created the **World Trade Organization (WTO)** to stimulate international commerce and resolve trade disputes.

GATT and WTO are founded on three principles:

1. Free trade. The major purpose of the treaty is to reduce trade barriers to increase global trade.
2. Most Favored Nation Status. Member nations agree to treat every other member nation equally. If one nation receives a special discount on customs duties, then the discount must be extended to all other member nations.
3. National Treatment. Member nations agree to treat imported goods the same as domestic ones after they have entered the nation. In other words, members cannot discriminate against foreign goods by imposing additional taxes after being subject to import taxes and duties.

The WTO resolves trade disputes between member nations and has the power to impose trade sanctions for non-compliance with GATT. If a member nation refuses to comply with a WTO ruling, affected members may retaliate by imposing punitive tariffs or other sanctions. For example, in the famous "banana battle," the US and four Latin American nations filed a complaint with the WTO alleging that the European Union (EU) placed unfair restrictions on imported bananas and showed favoritism to their former colonies by buying bananas from them in violation of GATT. The WTO agreed and granted the US and the Latin American nations the right to impose sanctions on EU imports to their nations. The banana battle ended in 2009 after 20 years of trade restrictions.

CISG

The **United Nations Convention on Contracts for the International Sale of Goods (CISG)** promotes international trade by making sales law uniform and predictable across international boundaries. The US and most of its trading partners (except the United Kingdom) have adopted CISG, which results in the convention governing over two-thirds of the world's trade. Some of its provisions include:

- CISG applies to contracts for the sale of commercial goods between merchants. It does not apply to the sale of goods to consumers for personal use.
- CISG applies automatically to contracts between parties located in different signatory nations. The convention does not depend on nationality; it depends on location.
- Contract parties can opt out. Parties can contract to be governed by a nation's laws instead of CISG but they must

expressly state their intention to not be bound by CISG.
  - CISG does not require a written contract.
  - CISG requires parties to negotiate in good faith and to modify contracts in the case of unforeseen circumstances.
  - A buyer can avoid payment only after giving the seller notice and an opportunity to remedy the problem.

Regional Trade Agreements

Regional trade agreements promote international commerce by reducing trade barriers among member nations that are located near each other. One of the most famous is the European Union (EU) but more than half of international trade is covered by regional trade agreements throughout the world. An important trade bloc agreement is the Association of South East Asian Nations (ASEAN), which is a ten-nation trade bloc in Southeast Asia. ASEAN + 3 includes the ASEAN nations, as well as China, Japan and South Korea.

The US is part of the **United States-Mexico-Canada Agreement (USMCA)**, which was formerly the North American Free Trade Agreement (NAFTA). USMCA reduces trade barriers among the three nations and updated NAFTA provisions, especially as it relates to e-commerce, labor, and intellectual property rights. These agreements create tremendous opportunities for businesses because they lower the costs associated with importing and exporting within the region.

Trade Regulations

Companies wishing to export or import products are subject to federal trade regulations. To **export** simply means to transport products to another nation. **Export controls** prohibit or restrict certain products from leaving a nation.

Companies wishing to import products are also subject to import controls. **Import controls** take many forms including tariffs, quotas, bans and restrictions. The US 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 and to establish their tariff schedule.

Tariffs are import taxes that apply to certain goods imported from other nations. They make the imported product more expensive and keep the cost of domestic products attractive to consumers. CBA customs officers classify the imported goods, which determines the applicable tariff. The importer is responsible for complying with all import laws.

Quotas are simply limits on the quantity of particular imported goods. To protect domestic industries, a nation may limit the number of a competitor's goods that are sold within the nation.

Bans apply to goods that are illegal to be imported, because they are dangerous to public safety, health, the environment, or national interests. For example, it is illegal to import items of cultural heritage from other nations without permission.

Along with the CBA, the US International Trade Commission investigates import injuries to the United States, such as dumping and subsidized imports. **Dumping** occurs when a foreign producer sells products for less than the cost of manufacturing. **Subsidized imports** are produced overseas for which a government has provided financial assistance. When dumping or subsidized imports materially injure or threaten to injure domestic producers, the United States may impose a countervailing duty for subsidized products or anti-dumping duty for dumped products. These duties, which are particular types of tariffs, reduce the negative impact that such practices could have on US companies. **Safeguards** 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 US textile industry.

6.4 US Laws that Apply to US Nationals Abroad

Extraterritoriality is the power of a nation's laws to reach activities outside of its physical borders. In other words, it is the power of a nation to impose its laws in other nations. Congress expressly applies several important laws to US nationals working abroad.

US citizens working for US companies overseas are protected by US federal employment laws, such as Title VII of the Civil Rights Act and the Americans with Disabilities Act. This means that US companies may not illegally discriminate against US employees because those employees happen to work for the company on foreign soil rather than within the United States.

Business practices abroad are also regulated by the US government. For example, price-fixing conducted abroad by US companies is a violation of the Sherman Antitrust Act. Similarly, the Alien Torts Claims Act allows non-citizens to bring suit in US federal court against US businesses or citizens that have committed torts or human rights violations in foreign nations.

The Foreign Corrupt Practices Act

The Foreign Corrupt Practices Act (FCPA) is an anti-corruption law that prohibits the payment of bribes by US companies and their employees to foreign officials. Violation of this law is a criminal offense. It does, however, permit **grease payments**, or facilitating payments. Grease payments are only allowed to individuals who are not decision makers. For example, a small payment to a clerk to process paperwork, after a project has already been approved, is a grease payment.

US citizens are also prohibited from conducting transactions with terrorists or terrorist organizations. Conducting transactions with prohibited persons, entities or businesses can result in serious criminal violations, which carry significant financial penalties and long prison sentences.

6.5 Concluding Thoughts

Tremendous opportunities exist for companies that wish to operate in 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 and civil liability.

6.1: Introduction

6.2: The Nature of International Law

6.3: Sources of International Law

6.4: US Laws that Apply to US Nationals Abroad

6.5: Concluding Thoughts

7: Administrative Law

7.1 Introduction

LEARNING OBJECTIVES

1. Understand the roles and functions of administrative agencies.
2. Explore judicial review of agency actions.
3. Learn how administrative agencies impact the daily operation of businesses.

An **administrative agency** is a governmental body with the authority to implement and administer particular legislation. They also are called government agencies or regulatory agencies.

The day-to-day operations of businesses across industries are shaped primarily by the actions of administrative agencies. This is because Congress and state legislatures often create agencies to regulate and enforce important legislation. Agencies exist at all levels of government and have considerable power to achieve their regulatory objectives.

Counselor's Corner The most important thing about interacting with any government agency is not to ignore the communication sent to you by that agency. If an agency asks you for information, send it. If the agency asks you to do something, or provide documentation, or to respond to a request, do that thing, provide that documentation, and respond to the request. The agency is not making those requests aimlessly, or to cause you angst and frustration. The agency is doing so because its own rules and regulations require it to gather more information, which the agency needs from you. Your reluctance or failure to respond will only cause delay, or have negative consequences. So, ignore those letters at your peril. ~Sara C., attorney

7.2 Creation of Administrative Agencies

Administrative agencies are created by Congress or state legislatures through an enabling act. An **enabling act** is a statute that creates an administrative agency and determines the scope of power granted to that agency. Some enabling acts are quite general and grant the agency a lot of discretion. Other enabling acts are more limited and identify the specific type of power an agency has.

While the legislative branch creates administrative agencies, they are usually part of the executive branch because their primary purpose is to enforce the law. Agencies in the executive branch are called **executive agencies**. At the federal level, these agencies are within the president's cabinet. The president is granted the power to appoint and oversee the leadership of executive agencies, including replacing existing leadership when the president is sworn into office. A governor has similar power over executive agencies at the state level.

An **independent agency** is an agency, commission, or board that is not under the direction of the president or governor. Congress and and state legislatures create independent agencies when they want to insulate the work of the agencies from politics and to address concerns that go beyond the scope of ordinary legislation. These agencies are responsible for keeping the government and economy running smoothly, especially when different political parties come to power. Examples of independent agencies include the Federal Trade Commission and the Central Intelligence Agency.

Independent agencies are often run by boards or commissions made up of five to seven members, who are from both major political parties, as well as political independents or smaller political parties. The term of board members and commissioners is usually four to nine years, with terms being staggered to prevent complete turnover all at once.

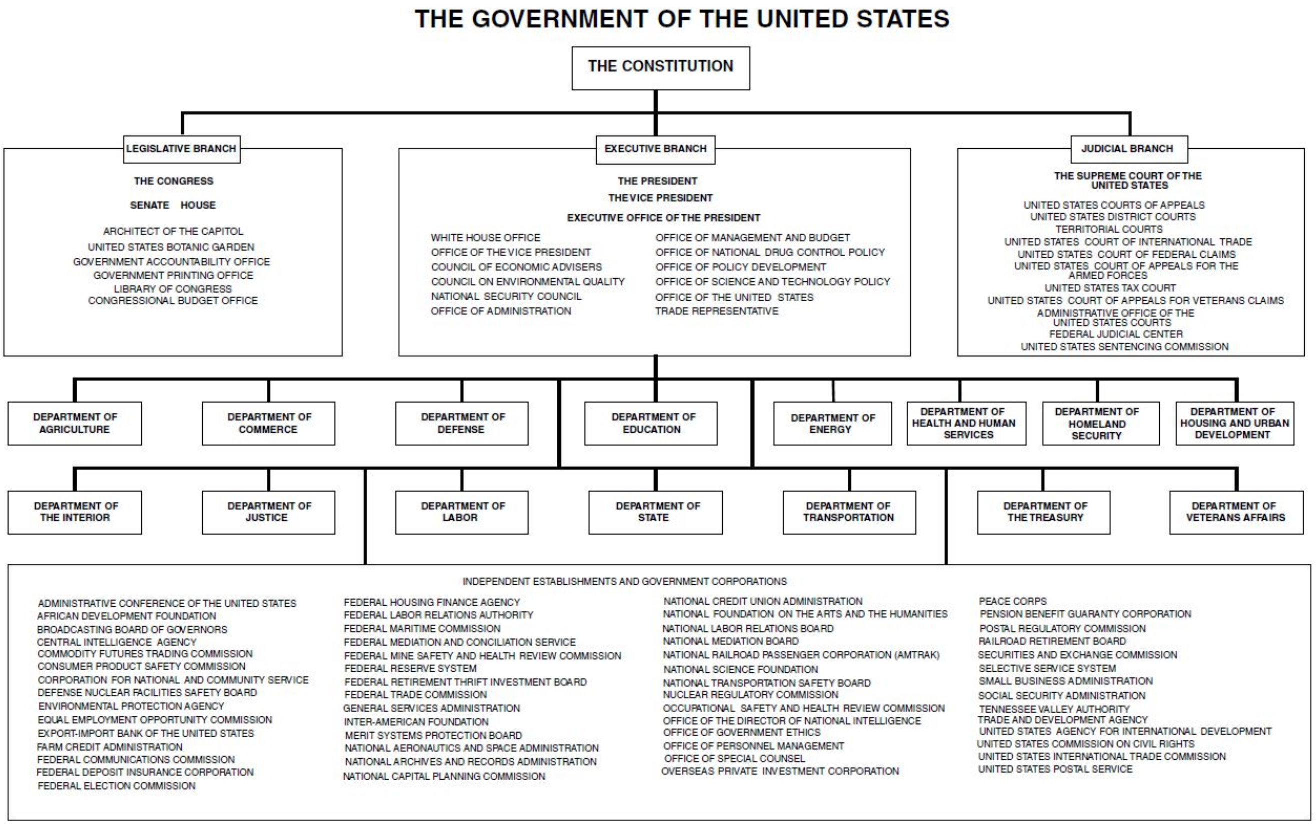
Figure 7.1 Differences Between Executive and Independent Agencies

Executive vs. Independent
Agencies

Executive branch	Not under direction of president or governor
Within president's cabinet	Responsible for keeping government and economy running
President can replace existing leadership when sworn into office	Run by boards and commissions
Governor has similar power	Staggered terms to prevent turnover all at once

Congress passed the **Administrative Procedures Act (APA)** to ensure the rights of businesses and individuals are protected when interacting with federal agencies. The APA is a very complex statute that controls all aspects of agency activity to guarantee uniformity and fairness across agencies. For example, the APA establishes the mechanisms for rulemaking, conducting adjudications, and giving notice to the public. The APA also establishes the process for judicial review of agency decisions. Most states have similar statutes to regulate state and local agencies.

Figure 7.2 Organizational Chart of Federal Agencies

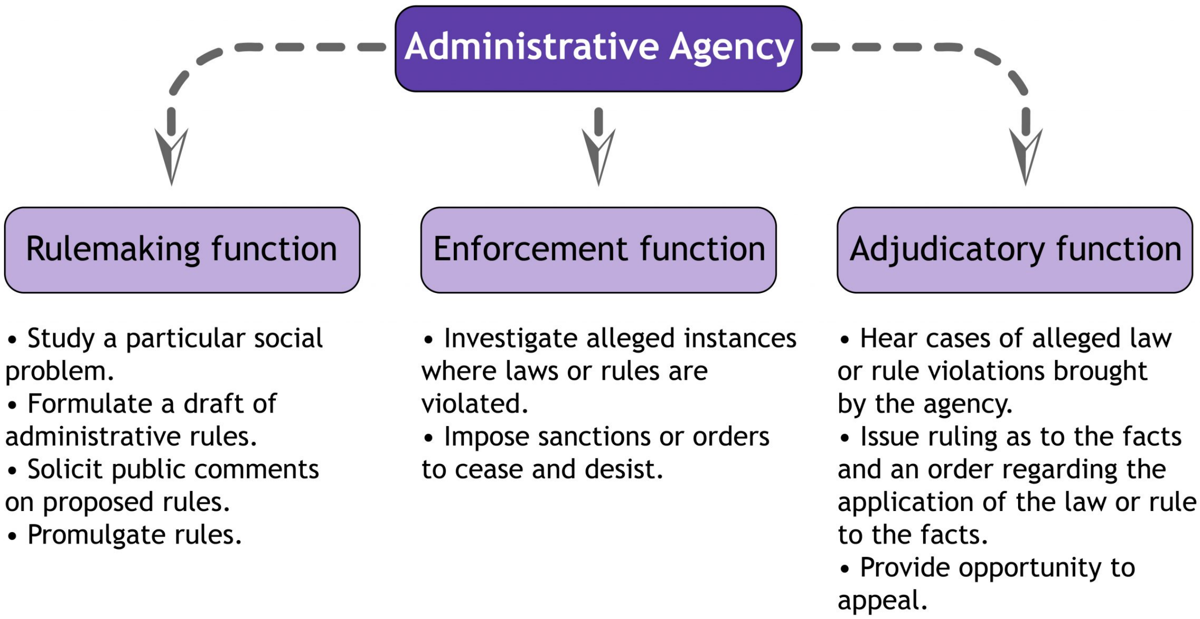


7.3 Agency Functions

Administrative agencies carry out their purpose through the exercise of power in three ways that mirror the three branches of government:

1. Agencies engage in rulemaking, which is a quasi-legislative function;
2. Agencies engage in enforcement, which is a quasi-executive function; and
3. Agencies engage in adjudication, which is a quasi-judicial function.

Figure 7.3 Roles and Responsibilities of Administrative Agencies



Rulemaking

The enabling statute dictates the types of rules an agency can make to implement and enforce the legislation for which it is responsible. Generally, administrative rules are characterized as internal, procedural, interpretive, and legislative.

Types of Rulemaking	Description
Internal	Policies and procedures adopted for in-house operations
Procedural	Policies and procedures related to how the agency functions & interacts with businesses and individuals
Interpretive	Guidelines issued by the agency to businesses and individuals about how to comply with the law
Legislative	Regulations that have the full force of law because they are an extension of the underlying statute

Legislative rulemaking may be formal or informal. **Formal rulemaking** is agency rulemaking that, when required by the enabling statute, must be on the record after an opportunity for an agency hearing, and must comply with certain procedures, such as allowing evidence and the cross-examination of witnesses. Formal rulemaking provides an opportunity to publicly and thoroughly debate the propriety of a suggested rule. However, this process is very expensive and is sometimes subject to political delays.

Informal rulemaking occurs when the agency publishes a proposed regulation and receives public comments on it, after which the regulation can take effect without the necessity of a formal hearing on the record. Informal rulemaking is the most common procedure followed by an agency when issuing substantive rules because it is less expensive and more efficient.

Agencies will sometimes blend the the two types of rulemaking into a **hybrid rulemaking** approach. This type of rulemaking requires notice and a hearing on a proposed rule but the hearing is not as extensive as in formal rulemaking and cross-examination of witnesses is not available.

Enforcement

Agencies are empowered to enforce administrative rules and the underlying legislation identified in the agency's enabling act. Unlike law enforcement investigations, agencies do not need probable cause to initiate an investigation. Generally, agencies are authorized to investigate simply to ensure the rules are being followed. For example, the Internal Revenue Service may audit a business's taxes without any suspicion of wrongdoing.

Agencies are limited in their power to subpoena evidence in the form of testimony from witnesses and in obtaining documents and evidence. To be lawful, an agency's subpoena must:

- Establish that the purpose of the investigation is legitimate;
- Establish that the agency has the power to conduct the investigation;
- Describe the requested information;
- Explain the relationship between the purpose of the investigation and the requested information; and
- Show that the requested information does not create an unreasonable burden on the business or individual in possession of it.

Businesses do not have all the Constitutional protections as individuals do, especially when it comes to agency investigations. In particular, a business cannot assert a Fifth Amendment right against self-incrimination to prevent agencies from obtaining business records. If an agency subpoenas documents, a business is required to turn them over, even if doing so exposes the business and individuals to potential criminal liability.

Adjudication

Adjudication is the legal process of resolving a dispute. In an agency context, this is the trial-like procedure or hearing used by agencies to enforce their actions and determine whether a business or individual has violated the law or regulations.

Adjudication can be either formal or informal. Formal adjudication is like a trial and is usually overseen by an **administrative law judge (ALJ)**. The ALJ will decide what evidence is relevant and admissible, hear testimony, and determine the outcome of the dispute in a written finding. If appropriate, the ALJ also will determine a penalty.

Like the judiciary, agencies have an internal appeal process for adjudication. If a party wants to appeal a hearing officer or ALJ's decision, the case will be reviewed internally by the agency. Often, appeals boards will consist of three to five agency experts who review the determination.

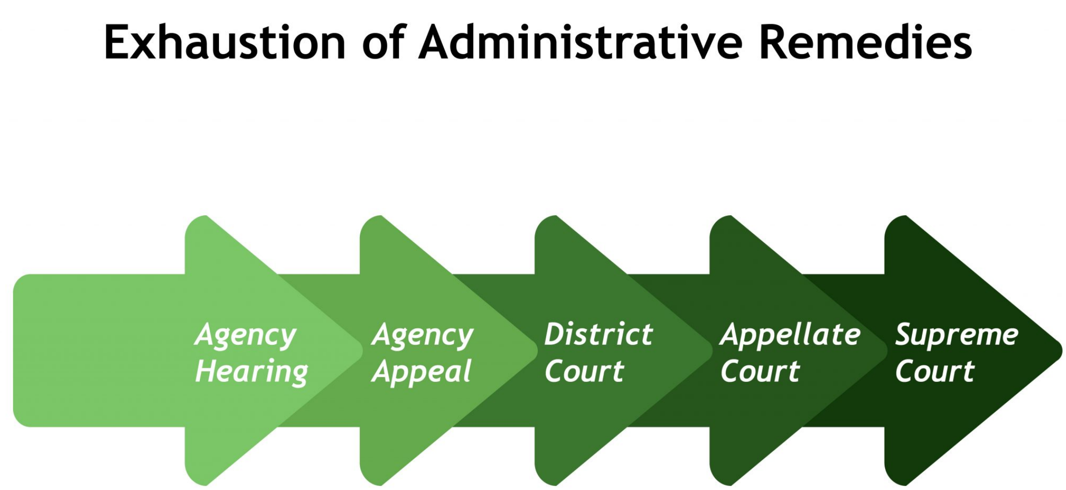
7.4 Judicial Review of Agency Actions

The APA provides for judicial review of almost all agency decisions. However, before going to court, a business or individual must try to get the agency to reconsider its action. To this end, two requirements must be satisfied:

1. Administrative remedies must be exhausted; and
2. The party must have standing.

Exhaustion of administrative remedies is the doctrine that, if an administrative remedy is provided by statute, a party must seek relief first from the agency before judicial relief is available. The purpose of this doctrine is to ensure that courts will not be burdened by cases in which judicial relief is unnecessary. Often courts cite the agency's subject matter expertise as a reason to allow it to reconsider its action and fix errors, especially common ones that may impact more than just the party involved in the hearing.

Figure 7.4 Exhaustion of Administrative Remedies Flowchart



Standing is the requirement that only individuals and entities with a personal stake in the outcome of a controversy may seek judicial review. Standing is discussed more in Chapter 3. With respect to agency actions, this is often a litigated issue when advocacy groups want to challenge an agency's decision but were not a party to the agency's actions.

Because agencies have significant discretion in regulating their areas of expertise, judicial review of agency actions is limited. A court will review an agency's actions in five situations:

Basis for Judicial Review	Description
Agency exceeded its authority	Agency acted beyond the authority given to it in the enabling act
Agency incorrectly interpreted the law	Agency misunderstands or misapplies the law; courts are the legal experts
Agency made a procedural error	Agency failed to follow the APA or its own procedural rules
Agency violated the Constitution	Agency violated the Constitutional rights of businesses or individuals
Agency made arbitrary or capricious decision	Agency's decision is neither based on the facts nor grounded in the law

7.5 Public Access to Agency Information

Accountability and transparency are concerns when governmental entities have a lot of discretion and limited judicial oversight. To ensure that the government remains responsive to the people as required by the Constitution, Congress has passed a series of laws to protect the rights of businesses and individuals.

The **Freedom of Information Act (FOIA)** was passed by Congress in 1966 to give a mechanism for private citizens to request information from the federal government. The central purpose of FOIA is to open up the workings of government to public scrutiny to keep the government accountable to the people and electorate.

The process is simple. A business or individual sends a letter to the head of an agency requesting information regarding a particular subject. The agency then has ten days to respond. If the agency denies the request, the party may either appeal the decision within the agency or sue in federal court for the information.

Not all information is subject to disclosure under FOIA. FOIA has nine exceptions:

- National security and foreign policy;
- Internal personnel rules and practices of an agency;
- Information that Congress prohibits the disclosure of;
- Trade secrets and confidential commercial or financial information;
- Documents protected by the attorney-client privilege;
- Personnel and medical files that would constitute an unwarranted invasion of personal privacy;
- Some law enforcement information;
- Documents related to the regulation of financial institutions; and
- Geological and geophysical information and data, including well maps.

The media makes about ten percent of FOIA requests, which is part of investigative reporting. However, most requests come from businesses, attorneys, and individuals. Unless an exception applies, the government must disclose the requested information. This has become a tool for businesses seeking advantage over their competition.

For example, AT&T received a federal grant to promote communications in school. AT&T self-reported to the Federal Communications Commission (FCC) that it may have overcharged the government for its services. This resulted in an investigation into AT&T's services and billing practices. Several months after AT&T and the FCC reached a settlement in which AT&T reimbursed the FCC $500,000, a trade association representing some of AT&T's competitors made a FOIA request to the FCC for documents related to the investigation and settlement. AT&T tried to block the request, arguing that it was an unwarranted invasion of personal privacy. In a unanimous decision, the US Supreme Court held that corporations do not have a personal privacy right like individuals do. As a result, the FCC disclosed the information to AT&T's competitors.

Over the years, FOIA has been amended and supplemented through complementary legislation. Businesses and individuals have the right to correct information that was submitted to an agency, as well as the right to specific reasons regarding any information that is withheld or redacted under FOIA. In addition, many agency meetings must be open to the public.

Most states have passed legislation similar to FOIA requiring state and local governments to disclose information to the public.

7.6 Concluding Thoughts

The vast majority of governmental work is done through administrative agencies. Given their functions, they are often referred to as the "Fourth Branch" of government. Agencies exist at all levels of government and have a lot of discretion in implementing and enforcing laws. Most businesses and individuals have contact with the government through agencies so it is incredibly important to understand how they work to be successful in business and avoid legal consequences.

7.1: Introduction

7.2: Creation of Administrative Agencies

7.3: Agency Functions

7.4: Judicial Review of Agency Actions

7.5: Public Access to Agency Information

7.6: Concluding Thoughts

8: Criminal Law

8.1 Introduction

LEARNING OBJECTIVES

1. Understand what crime is and learn about common business crimes.
2. Compare and contrast the differences between criminal law and civil law.
3. Understand the constitutional protections given to those accused of committing a crime.
4. Explore the exceptions to the Fourth Amendment's warrant requirement.

A **crime** is a social harm that the law punishes. At the most basic level, criminal statutes reflect the rules that must be followed for a civil society to function. Like individuals, businesses can be both victims and perpetrators of crime.

Crime affects businesses both from outside and inside the organization. Criminal activity "from the outside" may include property damage, theft, shoplifting, corporate espionage, fraud, and arson. Threats "from the inside" may include crimes such as embezzlement, computer crimes, and fraud. Moreover, businesses must also protect themselves from the bad judgment and behavior of their employees. If an employee acting within the scope of employment commits a crime from which the business will benefit, then the business can be convicted of the crime, too. Businesses may actively perpetrate crime, through a bad corporate culture or through organized crime, such as money laundering.

Counselor's Corner Criminal convictions result in more than loss of liberty. Having a conviction on your record can mean inability to obtain certain jobs, to gain admission to college, to vote, and to rent or lease a home. Convictions affect a person's life for much longer than the actual sentence imposed. Make sure you hire an attorney if you are ever faced with a criminal charge. Know your rights and understand the specific laws applicable to your field. When in doubt, consult with an attorney, accountant, or other professional in your field. ~Krista S., attorney

8.2 The Nature of Criminal Law

When crime occurs in the context of business, some people think that no one is "really" injured. 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. Crime undermines confidence in the social order and public safety. No crime is victimless.

In general, a crime requires someone to (1) commit a criminal act, known as **actus reus**, and (2) possess the required criminal state of mind, or **mens rea**. Therefore, intent to commit a crime, without more, is not enough to convict someone. For example, if an accountant thinks about stealing money from her company but does not take any steps to do it, then no crime has been committed. Similarly, if an accountant makes a mistake and transfers money inappropriately between accounts, he has not committed fraud unless he had the required criminal state of mind.

Strict liability crimes are an exception to the mens rea element. **Strict liability crimes** are acts that the legislature defines as social wrongs that do not need proof of the defendant's intent to complete the act. For example, speeding while driving a motor vehicle, possession of child pornography, and sale of tobacco and alcohol to minors all carry criminal liability without the government needing to prove the defendant's intent.

Criminal Law versus Civil Law

Criminal law differs from civil law in several important ways.

Criminal Law	Civil Law
• Because 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, 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**. Our civil tort system allows victims to bring a civil suit against someone for injuries inflicted upon them. Indeed, criminal laws and torts often have parallel causes of action. Sometimes these claims have the same or similar names. For instance, a victim of fraud may	

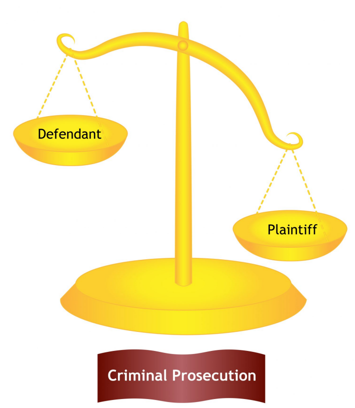
bring a civil action for fraud and may also be a witness for the government during the criminal trial for fraud.

Burden of Proof

In a criminal case, the defendant is presumed to be innocent unless he or she is proven guilty. This **presumption of innocence** means that the government must prove the case against the defendant before it can impose punishment. If the government cannot prove its case, then the person charged with the crime must be **acquitted**. This means that the defendant will be released, and he or she may not be tried for that crime again. This important protection from **double jeopardy** is guaranteed by the Fifth Amendment.

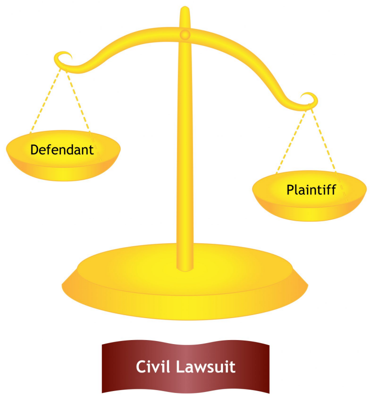
The prosecution has the burden to prove its case **beyond a reasonable doubt**. This means that the evidence must be so compelling that no reasonable doubt exists as to the defendant's guilt. The defendant does not have to prove anything, because the burden is on the government to prove its case. It is useful to think of the criminal standard of proof—beyond a reasonable doubt—as something like 95 percent certainty, with 5 percent doubt. Perhaps there is some doubt about the precise time of day or the victim's exact words to the defendant. However, there is no doubt about the essential elements of the crime, such as the defendant's identity as the perpetrator of the crime, his or her mens rea, and the actus reus.

Figure 8.1 Burden of Proof in Criminal Trials



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**. This means that the evidence to support the plaintiff's civil case is greater than the evidence that does not. Preponderance of the evidence could mean 51 percent in favor of the plaintiff's case, and 49 percent in doubt. Therefore, it is much more difficult to prosecute a criminal defendant than 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. For example, O.J. Simpson was acquitted of murder in a criminal trial because the government did not prove to the jury that he committed the crimes beyond a reasonable doubt. However, a different jury found O.J. Simpson liable for wrongful death in a subsequent civil action.

Figure 8.2 Burden of Proof in Civil Trials



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. Although no one wants to lose assets in a civil case, the loss of liberty through imprisonment is a more significant loss. Therefore, more protections are given to a criminal defendant than are given to defendants in civil proceedings. Because so much is at stake in a criminal case, our Constitutional due process requirements are very high for defendants in criminal proceedings.

Due process procedures 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. For example, a criminal defendant is entitled to confront all witnesses against him or her, and to see the evidence the prosecution intends to introduce at trial. More protections must be in place because a criminal case carries the potential for the most serious penalties.

Classification of Crimes

Felonies versus Misdemeanors

Crimes are generally classified as either felonies or misdemeanors. **Felonies** are serious crimes punishable by a year or more in prison. These type of crimes include fraud, arson, homicide, and most other crimes that are mentioned in news headlines. **Misdemeanors** are less serious crimes that are often punishable by fines, probation or time served in jail pending conviction. Examples of misdemeanors include trespassing, vandalism, and failure to report for jury duty.

White-Collar Crime Versus Blue-Collar Crime

White-collar crime 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. White-collar crimes are not typical street crimes, like burglary or robbery, and they are not personal crimes, like murder or rape. White-collar criminals frequently commit their crimes on the job, in broad daylight, while sitting at a desk. For example, Bernie Madoff was sentenced to 150 years in prison for stealing $20 billion in a Ponzi scheme that had $65 billion in fabricated gains.

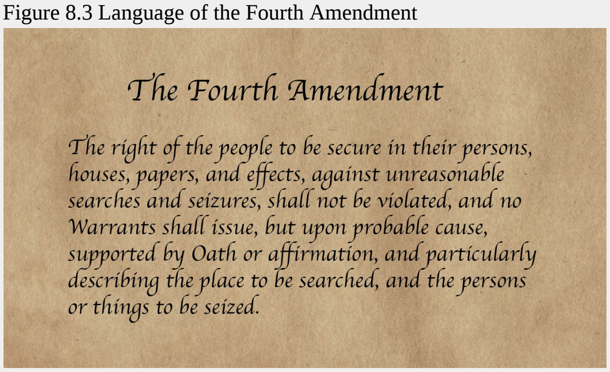
Blue-collar crime is a generic term used to describe crimes that are more traditional street crimes. In business, property crimes (rather than crimes against people) are a primary concern. A property crime is a crime involving damage to property, while a person crime is a crime involving injury to a person's body. Examples of blue-collar crime that often affect businesses include shoplifting, vandalism and destruction of property.

8.3 Constitutional Rights and Defenses

A person accused of a crime has rights guaranteed by the US Constitution to ensure the federal government does not unfairly prosecute them. The Bill of Rights–especially the Fourth, Fifth, Sixth, and Eighth Amendments–list the rights of criminal defendants. The Fourteenth Amendment makes these rights applicable to defendants accused of crimes by state governments. In addition, most states have constitutions that have similar protections.

Fourth Amendment

Figure 8.3 Language of the Fourth Amendment



The Fourth Amendment prohibits illegal searches and seizures. If evidence is obtained in violation of the Fourth Amendment, it cannot be used against the defendant in a court of law. For Fourth Amendment requirements to be met, law enforcement officers (the Executive Branch) must obtain a search warrant from a judge (the Judicial Branch) to search a specific area or person for specific items. A search warrant is issued only when a judge determines that probable cause exists. **Probable cause** exists when the known facts and circumstances would lead a reasonable person to believe that an item sought by the warrant is contraband, is stolen, or is evidence of a crime.

If a valid search warrant is issued, then law enforcement may search the area identified in the warrant for the named item(s) or person. Even if there was no warrant, the items found may still be admissible as evidence. This is because several exceptions to the requirements for a search warrant exist to help law enforcement protect the public and stop crimes as they occur.

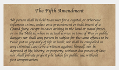
Warrant Exception	Example
◦ Two other common exceptions are the automobile exception and stop and frisk exception. The **automobile exception** means that the passenger compartment of an	

automobile may be searched if the car 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. Similarly, if someone is stopped lawfully, that person may be frisked without a warrant. This is the **stop and frisk exception** to the warrant requirement. Both of these exceptions are based on officer safety, but are often labeled based on the circumstances of the search.

In the business context, it is also important to note that some administrative agencies may conduct warrantless searches of closely regulated businesses, such as junkyards, where stolen cars may be disassembled for parts that can be sold.

Fifth Amendment

Figure 8.4 Language of the Fifth Amendment



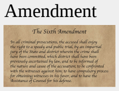
The Fifth Amendment guarantees four important rights:

1. The right to avoid self-incrimination;
2. The right to due process so that all court proceedings are fundamentally fair;
3. The right to be indicted by a grand jury for capital offenses and infamous crimes; and
4. The right to be free from double jeopardy.

The Fifth Amendment guarantees that people can choose to remain silent. No one can be compelled to testify against himself or herself or to make self-incriminating statements. If a person does not want to cooperate with the government's investigation and prosecution of a crime, he or she does not have to. During trial, the prosecution cannot comment on a defendant's silence and it cannot be used as evidence of guilt against the defendant. The prohibition against **double jeopardy** means that a person cannot be tried twice for the same offense by the same governmental body. This prevents the government from harassing individuals with endless prosecutions until they find the "right" jury that is willing to convict. It also requires the government to do its job well the first time it prosecutes a case.

Sixth Amendment

Figure 8.5 Language of the Sixth Amendment


The Sixth Amendment

In all criminal prosecutions, the accused shall enjoy the right to a speedy and public trial, by an impartial jury of the State and district wherein the crime shall have been committed, which district shall have been previously ascertained by law, and to be informed of the nature and cause of the accusation; to be confronted with the witnesses against him; to have compulsory process for obtaining witnesses in his favor, and to have the Assistance of Counsel for his defense.

The Sixth Amendment entitles a criminal defendant to:

1. A speedy trial;
2. A trial by jury;
3. A public trial;
4. An attorney;

and
5. The right to confront witnesses.

The purpose of the Sixth Amendment is to ensure transparency in criminal proceedings so the government cannot selectively prosecute dissidents or employ unfair tactics. 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 government's expense.

Eighth Amendment

Figure 8.6 Language of the Eighth Amendment

The Eighth Amendment prohibits cruel and unusual punishment and excessive fines and bail. Simply put, the Eighth Amendment is an anti-torture amendment. It also prohibits jails from being used against the poor as was commonly practiced in Europe at the time the Constitution was written.

Defenses

Under the **exclusionary rule**, any evidence the government acquires illegally may not be used at trial. This rule prevents governmental misconduct during the investigation of crimes. The theory is simple: if law enforcement and prosecutors know that illegally obtained evidence cannot be used in court, they will not be tempted to make improper searches or engage in other illegal behavior. The exclusionary rule is one of the most powerful limits on the police power of the government. Because the exclusionary rule is intended to prevent law enforcement from intentionally overstepping its authority, an exception exists to the rule for when the police act in good faith. Therefore, the exclusionary rule does not protect individuals and businesses from all governmental errors. Instead, it prevents intentional misconduct. If someone is subject to a custodial interrogation, he or she must first be informed of their **Miranda rights**. These rights are usually stated as:

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 their constitutional rights so they make informed decisions about whether to speak with law enforcement. Entrapment is another defense available to people accused of crimes. **Entrapment** means that the criminal intent originated with the police, and therefore the mens rea of the crime cannot be placed on the defendant. Essentially, the rule against entrapment limits the ability of the police to play the role of criminals during undercover investigations. For example, if the police provide a drug dealer with the opportunity to sell drugs to an undercover agent, there is no defense of entrapment because the dealer had the mens rea to commit a crime regardless of the identity of the buyer. However, if the police knock on someone's door who is not known to be a drug dealer and continues to demand drugs until the person cannot resist and sells the police drugs, then entrapment occurs.

8.4 Common Business Crimes

Each jurisdiction has the power to define what a crime is. Therefore, criminal laws can vary between states and federal governments. However, there are some common crimes that affect businesses across jurisdictions. **Fraud** is the use of deception to acquire money or property. **Securities fraud** is when someone uses deception to circumvent the regulations or statutes interpreted by the US Securities and Exchange Commission (SEC) to acquire money or property. Goldman Sachs was charged with securities fraud when it misrepresented material facts to investors to gain financially. **Financial institution fraud** 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 commit money laundering and those who falsify tax documents, or profit and loss statements, to gain funding from banks.

A **Ponzi scheme** is a fraudulent pyramid scheme, where innocent people pay in to participate. Those at the top of the pyramid may receive something that appears to be a return on their investment (ROI), but those at the bottom do not. Those who operate Ponzi schemes generally solicit investors, and those who invest in such schemes are expecting a legitimate ROI. However, the head of the Ponzi scheme 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 head for his own purposes, including paying investors with fake ROI payments as necessary. Pyramids will eventually collapse under their own unsustainable structure. Bernie Madoff was convicted of running the largest known Ponzi scheme that defrauded investors of approximately $65 billion. **Embezzlement** occurs when someone takes property that was in his or her possession lawfully and then converts it to his or her own use. Embezzlement often happens by people who are in a position of trust over the assets of another person. This includes financial advisors, brokers, accountants, lawyers, and guardians. Embezzlement strategies can involve **forgery**, which is counterfeiting a document or someone else's signature. 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. For example, larceny includes shoplifting and basic theft of personal property.

It is illegal to make false statements or engage in a cover up during dealings with the federal government. **Making False Statements** is a crime that is often easier to prove against a defendant than a more complex crime that is being investigated. For example, Martha Stewart was investigated for insider trading. Although the insider trading charges were dismissed, Martha Stewart was convicted by a jury of making false statements because she lied to officers during the investigation. As a result, she served five months in prison.

RICO

The **Racketeer Influenced and Corrupt Organizations Act (RICO)** is a federal statute that was passed to prevent gangsters from taking money earned illegally and investing it in legitimate businesses. Although RICO was written to target traditional organized crime, less than 10 percent of RICO cases filed have been against the mafia. Instead, 75 percent of RICO cases involve business fraud.

A **racket** is a dishonest or fraudulent scheme, which usually is an organized criminal activity. The two most common rackets are protection rackets and fencing rackets. In a **protection racket**, a criminal offers to protect the victim from violence or destruction of property. If the victim refuses to pay for protection, then the criminal will engage in violence against the victim or destroy his or her property. In a **fencing racket**, a criminal will steal property from a victim then offer to resell it to them. The victim must pay for the return of his or her own property. RICO punishes those engaged in three or more racketeering activities over a ten-year period when funds from those activities were used to maintain, operate, or acquire a legitimate business. **Racketeering activities** include embezzlement, mail fraud, wire fraud, loan-sharking, bookmaking, money laundering, counterfeiting, smuggling, blackmailing, arson, and other similar crimes. RICO is now used against insurance companies, stock brokerages, tobacco companies, banks, and other large commercial enterprises. If convicted, a defendant can be punished with large fines and a prison sentence of up to twenty years. RICO also has a civil provision allowing a competitor to file RICO charges, which come with triple damages if the suit is successful. In other words, a civil plaintiff can recover a judgment for three times the harm actually suffered, as well as attorneys' fees. *Art Cohen vs. Donald J. Trump* was a civil RICO class action lawsuit filed in 2013, accusing Donald Trump of fraudulently misrepresenting the nature of Trump University. Within weeks of winning the presidential election in 2016, Trump settled this case and two others for $25 million in damages to the plaintiffs. Many states also have organized crime statutes. State penalties often are much more severe under the organized crime statutes than they would be if the accused worked alone. For this reason, businesses and individuals need to be careful to protect themselves from another’s wrongful conduct.

8.5 Concluding Thoughts

Crime has an enormous impact on society, including business. Crime is a very important consideration in the business world. Businesses can be both victims and perpetrators of crime. Although jurisdictions may define crimes differently, there are some types of crime that businesses often face, including fraud, embezzlement, and larceny. Successful businesses must be vigilant to protect themselves from those who wish to harm them, both from inside and out. Crime is a public injury. Criminal law can be classified both by the nature of the punishment and the type of offense it is. Criminal law differs from civil law in important ways, including who brings the claim, the burden of proof, due process, and penalties. The most important distinction is the elevated burden of proof in criminal cases. The prosecution must prove that a defendant committed a crime beyond a reasonable doubt. Those who are accused of committing a crime are protected by the US Constitution. Important constitutional protections include the prohibition against illegal searches and seizures, self-incrimination, and cruel and unusual punishment. If the government obtains evidence illegally, it cannot use it against a defendant in a criminal trial. Criminal defendants have the right to a public and speedy trial, an attorney, and to remain silent.

8.1: Introduction

8.2: The Nature of Criminal Law

8.3: Constitutional Rights and Defenses

8.4: Common Business Crimes

8.5: Concluding Thoughts

9: Torts

9.1 Introduction

LEARNING OBJECTIVES

1. Define torts.
2. Understand intentional torts, and how to defend against an accusation of one.
3. Explore negligence.
4. Explain strict liability and how product liability affects manufacturers.

A tort can be understood as a civil wrong to a person or property other than breach of contract. A **tort** is any legally recognizable injury arising from the conduct (or sometimes failure to act) of persons or corporations. There are several key differences between torts and contracts, which are also different than crimes:

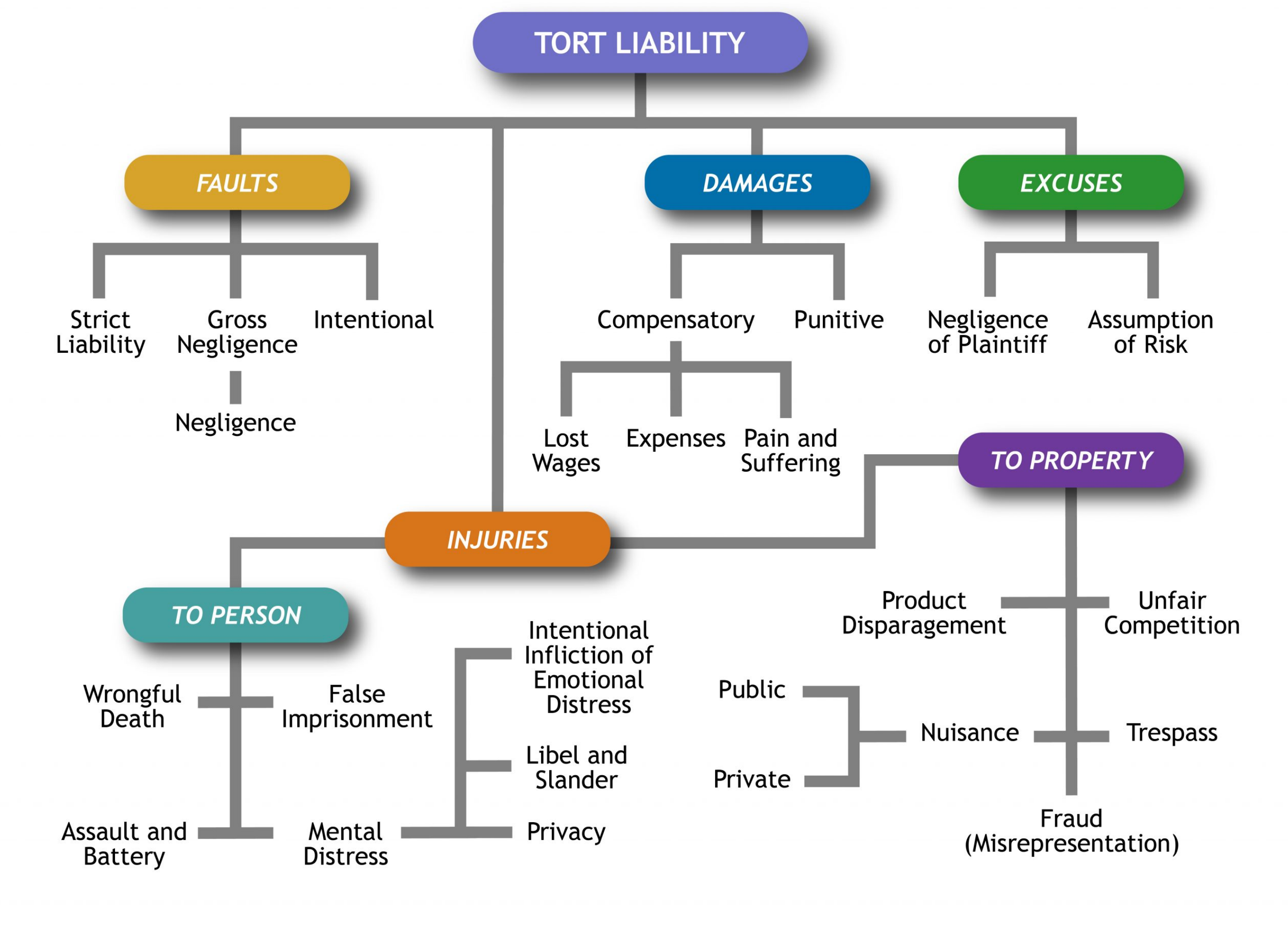
	Contract	**Tort**	**Crime**
Obligation	The parties agree to a contract; which imposes duties on them	Civil law imposes duties	Legislatures pass laws prohibiting certain conduct
Enforcement	Party to contract or beneficiary sues for breach of contract	Injured party sues for tort claims	Government prosecutes
Consequences	Monetary damages	Monetary damages; injunction	Criminal conviction may include fine, imprisonment, & restitution

Some conduct can be both a crime and a tort. If Allie punches Bentley without provocation, then Allie has committed both the tort of battery and the crime of battery. In the tort case, Bentley could sue Allie in civil court for money damages (typically for his medical bills). That case would be tried based on the civil burden of proof—preponderance of the evidence. That same action, however, could result in Allie being charged with criminal battery. If convicted beyond a reasonable doubt, Allie may have to pay a fine or go to jail.

The standard of proof in a criminal case (beyond a reasonable doubt) is far higher than the standard of proof in a civil case (a preponderance of evidence). Therefore, victims of crimes often wait to bring related tort claims against a defendant until after the criminal trial is over. If the defendant is convicted of a crime, it is easier and less expensive to prove liability at a civil trial.

Torts can be broadly categorized into three categories, depending on the level of intent demonstrated by the **tortfeasor** (the person committing the tort). If the tortfeasor acted with intent to cause the damage or harm, then an **intentional tort** has occurred. If the tortfeasor didn't act intentionally but failed to act as a reasonable person, then **negligence** occurs. Finally, **strict liability** occurs where the tortfeasor is held responsible regardless of intent.

Figure 9.1 Tort Liability Diagram



<u>Counselor's Corner</u> Not every injury or harm gives rise to a legal claim. You can't sue someone just because your feelings are hurt or something bad happened. Even though you may have been through something harmful, if the law doesn't recognize the injury as something you can recover for, you don't have a legal claim. Lawsuits are meant to address really bad injuries or really bad behavior. Many things that drive us crazy when dealing with other people are things that we just have to learn to deal with. Or resolve in another forum. ~Heather C., attorney

9.2 Intentional Torts

In an intentional tort, the tortfeasor intends the consequences of his or her act, or knew with substantial certainty that certain consequences would result. This intent can be transferred. For example, if someone swings a baseball bat at someone else but the person ducks and the bat hits a third person, the person hit is the victim of a tort even if the person swinging the bat had no intention of hitting the person actually injured.

It is useful to think of torts based on the type of rights being protected.

Theory of Liability	Description
Interference with Personal Freedom	
Assault	Causing the apprehension or fear of immediate harmful or offensive contact
Battery	Application of force that results in harmful or offensive contact with a person's body

False Imprisonment	Intentional confinement or restrain of a person's movements without justification or consent
Intentional Infliction of Emotional Distress	Intentionally or recklessly causing another person severe emotional distress through extreme or outrageous acts
Interference with Property Rights	
Trespass to Land	Unauthorized entry onto land that is visibly enclosed & owned by another
Trespass to Personal Property	Taking or harming another's personal property without permission
Conversion	Wrongful possession or disposition of property as if it were one's own with the intent to do so permanently
Nuisance	Condition or situation that interferes with the use or enjoyment of property
Interference with Economic Relations	
Disparagement	False & injurious statement that discredits or detracts from the reputation of another's property, product or business
Interference with Contractual Relations	Intentional inducement of a party to break an existing contract
Interference with Prospective Advantage	Intentional interference with a potential business relationship
Misappropriation	Using another's property dishonestly for one's own use
Wrongful Communications	
Defamation	Harming the reputation of another by making a false statement
Slander	Spoken defamation
Libel	Written defamation
Invasion of Privacy	Violating someone's right to be left alone or to restrict public access to confidential information through: • appropriating the person's name or likeness; • invasion of physical solitude; • publicly disclosing private facts; or • false light
Fraud	Intentional misstatement of a material fact that is relied upon by a third party

Interference with Personal Freedom

Assault is the threat of force on another that causes that person to have a reasonable apprehension or fear of immediate harmful or offensive contact. Actual fear or physical injuries are not required for assault. It is also not necessary for the tortfeasor to intend to cause apprehension or fear. If someone points a realistic-looking toy pistol at a stranger and says "give me all your money" as a joke, it is still assault if a reasonable person would have had apprehension or fear in that situation. The intentional element of assault exists here, because the tortfeasor intended to point the realistic-looking toy at the stranger.

Battery is the application of force to another that results in harmful or offensive conduct. It includes any non-consensual touching, even if physical injuries are not present. In battery, the contact or touching does not have to be to the person. Grabbing someone's clothing or possessions they are holding is battery. Notice that assault and battery are not always present together. Assault can occur without physically touching the victim. Similarly, a surgeon who performs unwanted surgery or inappropriately touches a patient who is sedated has committed battery but not assault because the patient did not feel fear or apprehension.

When someone is sued for assault or battery, several defenses are available. The first is consent. Boxers have consented to being battered when competing. Self-defense and defense of others also may be available defenses, as long as the self-defense is proportionate to the initial force.

False imprisonment occurs when someone intentionally confines or restrains another person's movement or activities without justification. The protected interest is the right to travel and move freely without impediment. This tort requires actual and present confinement. False imprisonment is challenging for retailers and other businesses that interact regularly with the public, such as hotels and restaurants. The **shopkeeper's privilege** allows businesses to detain suspected thieves until law enforcement arrives.

The detention must be reasonable, however. Store employees must not use excessive force in detaining the suspect, and the justification, manner, and time of the detention must be reasonable.

Intentional infliction of emotional distress occurs when a tortfeasor intentionally or recklessly causes another person severe emotional distress through extreme and outrageous acts. A plaintiff has to prove the defendant's actions would be outrageous to a reasonable member of the community. The standard is objective. It is not enough for the plaintiff to believe the defendant acted outrageously.

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 intentional infliction of emotional distress. Businesses must be careful when handling sensitive employment situations to avoid potential liability. This is especially true when firing or laying off employees. Such actions must be taken with care and civility. Similarly, bill collectors and foreclosure agencies must be careful not to harass, intimidate, or threaten people.

Interference with Property Rights

Intentional torts can also be committed against property. **Trespass to land** occurs when someone enters onto, above, or below the surface of land that is visibly enclosed without the owner's permission. The trespass can be momentary or fleeting. Soot, smoke, noise, odor, or even a flying arrow or bullet can all become the basis for trespass. These can also be the basis for nuisance claims. **Nuisance** is a condition or situation that interferes with the use or enjoyment of property. Nuisance claims can be public (applying to community areas such as parks or the environment) or private (applying to privately owned property such as houses).

Trespass can be innocent or willful. An innocent trespass occurs when someone enters another's property by mistake or when they believe they have permission but do not. Willful trespass occurs when someone intentionally enters another's property knowing they do not have permission to be there.

There are times when trespass is justified. 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 during an emergency.

Some states do not require the land to be visibly enclosed to be protected from trespass. Therefore, residential homes in urban and suburban areas do not always need a fence around the property to be protected from trespass.

Trespass to personal property is the unlawful taking or harming of another's personal property without the owner's permission. The tort of **conversion** is the wrongful possession or disposition of property as if it were one's own with the intent to do so permanently. It is the civil equivalent to the crime of theft. An employer who refuses to pay an employee for work commits conversion. Similarly, conversion occurs when a business returns personal property to the wrong customer.

Interference with Economic Relations

Torts can also take place against goods or products instead of people. **Disparagement** is a false and injurious statement that discredits or detracts from the reputation of another's property, product, or business. To recover, the injured party must prove that the statement caused a third party to take some action resulting in economic loss to the plaintiff. In other words, the victim of the statement must prove that it lost customers or goodwill as a result of the false statement made about its business or products. These types of false statements are considered unfair competition and, therefore, are unlawful.

Similarly, unfair competition can also be in the form of interfering with a competitor's contracts. **Tortious interference with contractual relations** prohibits the intentional interference with an existing valid and enforceable contract by intentionally inducing one of the parties to break the contract, causing damage to the relationship between the contracting parties. This occurs when a business tries to break up a competitor's contract with vendors, suppliers, or customers in an effort to harm them.

There are four elements to prove intentional interference with contractual relations:

1. A contract exists between the plaintiff and a third party;
2. Defendant knew of the contract;
3. Defendant improperly induced the third party to breach the contract or made performance of the contract impossible; and
4. Plaintiff was injured.

Similarly, **tortious interference with prospective advantage** is an intentional, damaging intrusion on another's potential business relationship, such as the opportunity to obtain customers or employment. Fair competition does not give rise to this tort. However, if a business engages in fraud, intimidation, or threats to drive away potential customers from its competitors, then it is liable. Tortious interference with prospective advantage applies to conduct before a contract exists.

Misappropriation occurs when a person or business uses someone else's property dishonestly for one's own use. Misappropriation is a very broad tort because it covers any likeness or identifying characteristic, as well as property such as patents, copyrights, and trademarks. It also applies to a business's name and goodwill.

Wrongful Communications

Another intentional tort is **defamation**, which is the act of harming the reputation of another by making a false statement to a third party. Spoken defamation is considered **slander**, while written defamation is **libel**. To be liable for defamation, the words must be made to a third party, which may include emails, text messages, and social media. The First Amendment provides strong protection for news organizations, and courts have held that public figures must show actual malice before they can win a defamation lawsuit. This means celebrities and famous individuals must prove the media knew that it was publishing false information, or that it published the information with reckless disregard for the truth. Truth is a complete defense to defamation.

The **invasion of the right of privacy** is essentially the violation of a person's right to be left alone and to restrict public access to personal information, such as tax returns and medical records. There are four forms of this tort:

Form of Invasion of Privacy	Description
1. Appropriating a person's name or likeness	Using someone's name, photograph, or other identifying characteristic for commercial purposes without permission
2. Invasion of physical solitude	Window peeping, eavesdropping, using drones to video private areas, going through garage to find confidential information, etc.
3. Public disclosure of private facts	Disclosure of a private citizen's finances, medical conditions, or personal relationships through a public medium such as social media
4. False light	Using publicity to place a person in false light in the public eye, such as objectionable hobbies or attributing beliefs and opinions to the person that he or she does not hold

Fraud is the intentional misstatement of a material fact that is relied upon by a third party to the detriment of the targeted party. It requires the tortfeasor to misrepresent facts (not opinions) with knowledge that they are false or with reckless disregard for the truth. An "innocent" misrepresentation 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 a résumé to gain employment, lying on a credit application to obtain credit, or in product marketing. Here, there is a fine line between **puffery**, or seller's talk, and an actual lie. If an advertisement claims that a particular car gets a certain gas mileage or meets emissions standards, then fraud occurs if those statements are untrue. Conversely, an advertisement that promises "unparalleled luxury" is only puffery since it is opinion.

9.3 Negligence

Everyone has 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.

The definition of negligence is purposefully broad. **Negligence** is the failure to exercise the standard of care that a reasonably prudent person would have exercised in a similar situation. This legal standard is to protect people against unreasonable risk of harm.

To succeed on a negligence claim, a plaintiff must prove five elements:

1. The defendant owed a duty of care to the plaintiff;
2. The defendant breached that duty;
3. The defendant's conduct was the actual cause of the plaintiff's injuries;
4. The defendant's conduct was the proximate cause of the plaintiff's injuries; and
5. The plaintiff was damaged.

Duty of Care

First, the plaintiff has to demonstrate that the defendant owed it a duty of care. The general rule is that people are free to act any way they want, as long as they do not harm others. This means strangers are generally not responsible for caring for each other unless a special relationship exists. For example, parents owe their children a duty of care and doctors owe their patients a duty of care because of their underlying relationship. In a business context, businesses owe a duty of care to their customers and managers owe a duty of care to their employees. Some business relationships involve a **fiduciary duty**, which is a duty to act with the utmost faith, trust, and candor towards another. Doctors, lawyers, accountants, and corporate officers all have fiduciary duties towards their patients, clients, and shareholders.

It is important to understand that businesses and individuals owe a general duty to the community as a whole. Drivers owe other drivers and pedestrians a duty of care not to cause accidents. However, drivers are not required to report accidents or to stop and help others when they are not involved because they do not owe a duty of care to strangers.

Businesses have a duty to warn and protect customers from crimes committed by other customers. When a business knows about, or should know about, a high likelihood of crime occurring, then the business must warn or take steps to protect its customers. These businesses include bars frequented by biker gangs, hotels where frequent sexual assaults occur, and any business with escalating violence on their premises.

Businesses also 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, including objects falling from shelves, spilled liquids, and icy entryways. If a store knows about a hazardous condition, or should have known about it, then the store must quickly warn customers and remedy the situation.

Breach of Duty of Care

Once a duty has been established, plaintiffs have to prove that the defendant breached that duty. A breach is demonstrated by showing the defendant failed to act reasonably. It is important to keep in mind that the reasonable person is an objective standard. The reasonable person is never sleep-deprived, angry, or intoxicated. He or she is reasonably careful and considers consequences carefully before acting. A jury does not put themselves in the shoes of the defendant to determine what they would have done in that situation. Nor do they take into account the defendant's subjective situation, such as being intoxicated or sleep-deprived at the time.

In practical terms, the presence of injury or harm is usually enough to satisfy the "breach of duty" requirement. Often the harm is the evidence of the breach because it would not have occurred if the defendant had acted as they should.

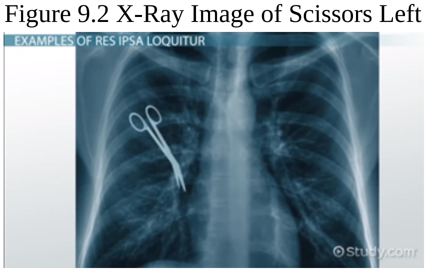
Breach of the duty of care can be both an action (such as causing a car accident) or it can be a failure to act (such as not clearing ice from the sidewalk). These are fact-specific determinations because what a reasonable person would do in a given situation varies.

There are two special doctrines that establish breach of duty of care in limited circumstances. The first, **res ipsa loquitur**, means "the thing speaks for itself" in Latin and holds that a breach of a party's duty of care may be inferred from the events that occurred. It is used in cases where:

1. The injury would not have occurred unless someone was negligent;
2. The defendant had exclusive control over the property causing injury; and
3. The plaintiff had no role in causing the harm.

For example, if a patient discovers surgical equipment inside his or her body after surgery, the patient does not have to prove which person in the operating room negligently left the equipment. Instead, the plaintiff can sue the surgeon under the res ipsa loquitur doctrine because the surgeon is in charge of the surgery room. When res ipsa loquitur is raised, the burden shifts to the defendant to prove that he or she did not cause the harm.

Figure 9.2 X-Ray Image of Scissors Left Inside a Patient



The second doctrine is **negligence per se**. Legislatures sometimes pass laws defining negligence under certain circumstances. If a defendant violates the statute or ordinance, then the defendant is legally negligent. To recover under this theory, a plaintiff has to prove:

1. The defendant broke the law;

2. The plaintiff is in the class of people intended to be protected by the law; and
3. The violation of the law caused plaintiff's injuries.

Negligence per se is often argued in car accidents where the defendant is ticketed for reckless driving by the police, as well as dog bite cases where the victim has physical injuries. When defending against negligence per se claims, defendants may argue:

1. They were unable to comply with the law through reasonable care;
2. It was an emergency situation not caused by them; or
3. Complying with the law would have presented a greater risk of harm.

Actual Cause

The third element of negligence is actual causation, which is 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 a customer slips on ice on a store's property, would the plaintiff been injured but for the store's failure to remove the ice? This is the form of causation that most people describe in their daily interactions. Because the store did not remove the ice, the customer slipped and was injured.

Proximate Cause

The second form of causation asks whether the defendant's actions were the proximate cause of the plaintiff's injury. Sometimes the chain of events results in the injury being too remote from the defendant's conduct to be legally recoverable. In other words, proximate cause means that the act or omission must be related closely enough to the injury to justify imposing legal liability. Proximate cause places a limit on a defendant's responsibility to immediate (or foreseeable) harm. This ensures that no intervening causes of the plaintiff's injuries exist.

A customer slips on ice on a store's property and breaks a leg. On the way to the hospital in an ambulance, there is a car accident and the customer is killed. Although the customer would not have been in the ambulance if she had not fallen on the store's property, the store would not be responsible in a wrongful death claim. The car accident is an intervening event that breaks the causal chain. Put another way, the car accident was not a foreseeable consequence of the store's failure to remove ice on its premises.

Proximate cause prevents actual causation to be taken to a logical but extreme conclusion. At some point, the law has to break the chain of causation to hold parties to a reasonable amount of liability for their actions.

Damages

The final element in negligence is legally recognizable injuries, or damages. If someone walks on a discarded banana peel and does not slip, then no tort occurs. Only when someone has been injured are damages awarded.

There are two types of damages awarded in tort law. The first, **compensatory damages**, seek to compensate the plaintiff for his or her injuries. Compensatory damages can be awarded for medical injuries, economic injuries (such as loss of 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, it is far more difficult to assign a monetary value to pain and suffering. Juries often use the severity and duration of the injury and its impact on the plaintiff's life to calculate damages.

The second type of damages is **punitive damages**, which are intended to deter the defendant from engaging in similar conduct in the future. 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. Punitive damages are available in cases where the defendant acted with willful and wanton negligence, a higher level of negligence than ordinary negligence. There are constitutional limits to the award of punitive damages.

Defenses to Negligence Claims

A defendant being sued for negligence has two main defenses: (1) assumption of risk by the plaintiff; and (2) comparative negligence.

Assumption of Risk

The first defense is assumption of risk. If the plaintiff knowingly and voluntarily assumes the risk of participating in a dangerous activity, then the defendant is not liable for injuries incurred. However, a plaintiff can only assume known risks. A skier assumes the known risks of downhill skiing, including falling, avalanches, and skiing in poor conditions. However, a skier who is injured from a defective chair lift does not assume the risk of injury as a result of a manufacturing defect.

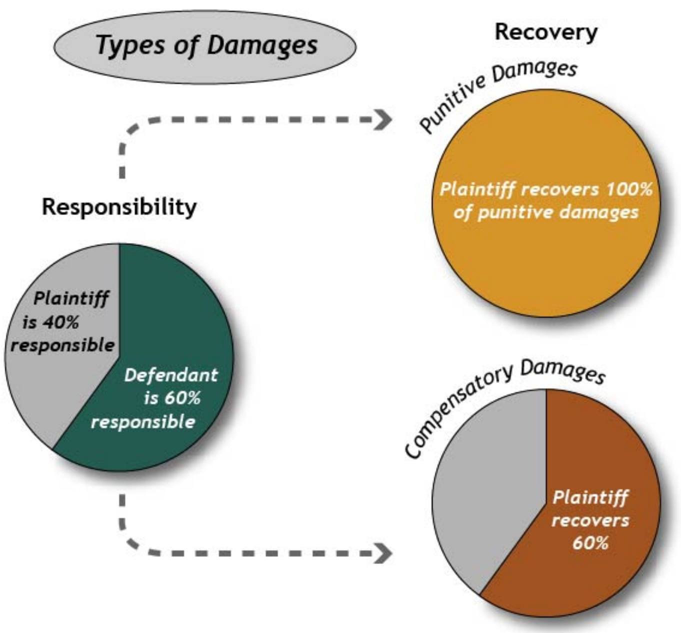
A related doctrine, the **open and obvious doctrine**, is used to defend against lawsuits by persons injured while on someone else's property. For example, if there is a spill on a store's floor and the store owner has put up a sign that says "Caution—Slippery Floor," yet someone decides to run through the spill anyway, then that person would lose a negligence lawsuit because the spill was open and obvious.

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.

Comparative Negligence

The second defense to negligence is when the plaintiff's own negligence contributed to his or her injuries. Most jurisdictions, including Colorado, follow the comparative negligence rule. Under this rule, the jury determines the percentage of fault of all the parties for the plaintiff's injuries. If the jury finds the plaintiff responsible for some of his or her own injuries, then any compensatory damages are reduced by that percentage. For example, if a customer is 40 percent at fault for his injuries, then the compensatory damage award will be reduced by 40 percent. The reasoning for this rule is to hold people and businesses accountable for their own negligence.

Figure 9.3 Recovery of Damages under Comparative Negligence



This rule applies only to compensatory damages, and not punitive damages. Because punitive damages are meant to deter the defendant from committing future bad acts, the purpose would be undercut if the amount of punitive damages was reduced, too.

9.4 Strict Liability

Intentional torts require some level of intent to be committed, such as the intent to batter someone. Negligence torts require carelessness or neglect. Some torts require neither intent nor carelessness. In strict liability, it is irrelevant how carefully the defendant acted. If someone is harmed in a situation where strict liability applies, then the defendant is liable regardless of lack of intent.

Strict liability applies when restaurants and bars serve alcohol to minors or visibly intoxicated persons. This is dangerous because there is a high risk that drunk patrons will injure others if they drive. Sale of tobacco and firearms to minors are also strict liability crimes, as well as possession of child pornography.

Ultrahazardous Activity

An **ultrahazardous activity** is an undertaking that cannot be performed safely even if reasonable care is used while performing it, and it does not ordinarily happen in the community. Ultrahazardous activities include using dynamite, transporting dangerous chemicals, keeping wild animals, and using nuclear and radioactive materials. Some states have passed laws defining offshore drilling for oil and gas as an ultrahazardous activity as well.

Defendants engaged in ultrahazardous activities are almost always liable for resulting harm. Plaintiffs do not have to prove duty of care or breach of duty of care. The “reasonable person” test is also irrelevant, as well as the issue of whether the harm was foreseeable.

Product Liability

Product liability cases address situations in which products, not people, cause injury. Plaintiffs can raise either negligence or strict liability claims for injuries caused by products. There are three main product liability theories: design defect, manufacturing defects, and failure to warn.

Design defects occur when the foreseeable risk of harm can be reduced or avoided by the adoption of a reasonable alternative design. In other words, the manufacturer poorly designed a product that caused injuries which could have been avoided. The law does not require products to be perfect. Litigation in these cases centers on what is a foreseeable risk and whether there was a reasonable alternative. As a result, plaintiffs must show that an alternative design was reasonable.

For example, Takata manufactured airbags that were installed by most major car manufacturers. After many airbags failed to deploy in car accidents, leading to severe injury and death, Takata recalled its airbags. Takata is strictly liable for injuries caused by its defective design.

Manufacturing defects occur when a product fails to conform to the manufacturer’s design for the product. In other words, the product may have been designed adequately but the manufacturer allowed a dangerous product to leave the plant. These claims often involve allegations of failure to adequately inspect products before distribution.

For example, a light bulb factory is strictly liable for manufacturing a batch of faulty bulbs that explode when turned on due to some glitch in the production process.

Failure to warn occurs when the defect is not in the product itself but in the instructions (or lack of them). The plaintiff argues that the manufacturer failed to warn users about the dangers of normal use or a foreseeable misuse. However, there is no duty to warn about obvious dangers.

Defenses to Product Liability

There are several defenses to product liability claims.

First, strict liability applies only to commercial sellers. If an individual sells her car to another person, she would not be strictly liable for selling an unreasonably dangerous product if it had Takata airbags.

Second, plaintiff’s assumption of risk can be a defense. The user must know of the risk of harm and voluntarily assume that risk. Someone cutting carrots with a sharp knife voluntarily assumes the risk of being cut by the knife. However, if the knife blade unexpectedly detaches from the knife handle because of a design or production defect, no assumption of risk occurs.

Third, 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.

A final 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.

9.5 Concluding Thoughts

Tort law significantly impacts businesses, regardless of industry. Businesses must not engage in activities with the intention to harm employees, customers, and the public. They also must act reasonably to avoid injuries caused by their negligence. Similarly, manufacturers can be strictly liable for design defects, manufacturing defects, and failure to warn consumers. Because many businesses are seen to have “deep pockets,” they are often targeted by plaintiffs when injured by their products and services.

Intentional torts occur when the tortfeasor intends the consequences of his or her act or knew with substantial certainty what the consequences would be. Businesses are affected by intentional torts and need to be careful not to commit them against their employees, customers, and members of the public. It is useful to categorize intentional torts based on the types of rights being protected, such as preventing injuries to persons, property or privacy.

Negligence imposes a duty on all persons to act reasonably and to exercise due care in dealing and interacting with others. Negligence has five elements. First, the plaintiff must demonstrate the defendant owed the plaintiff a duty of care. Second, there must be a breach of that duty. A breach occurs when the defendant fails to act like a reasonable person. The plaintiff must also 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 and comparative negligence.

In areas where strict liability applies, the defendant is liable no matter how carefully it tried to prevent 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.

9.1: Introduction

9.2: Intentional Torts

9.3: Negligence

9.4: Strict Liability

9.5: Concluding Thoughts

CHAPTER OVERVIEW

10: Contracts

Learning Objectives

- Explain what constitutes a contract.
- Understand how a contract is formed.
- Know the defenses to performance of a contract.
- Understand breach of contract and its consequences.
- Identify remedies for breach of contract.

10.1: Introduction

Although businesses tend to use the terms “agreement” and “contract” interchangeably, legally the terms have very different meanings. An **agreement** is a mutual understanding between two or more parties about their rights and duties toward each other. A **contract** is a legally enforceable agreement between two or more parties. All contracts are agreements, but not all agreements are contracts.

When contracts are broken, or breached, the injured party can seek damages. In contracts, this usually means an amount that would make that party whole again.

Generally speaking, contracts are a form of **private law**, because the terms of the contract are binding on the parties to the contract but not anyone else. Parties may enter into contracts for whatever they wish and under any terms that they agree on. In other words, parties may assent to agreements even if those agreements represent bad bargains.

Contracts may restrict parties’ future activity. For example, a non-compete clause in an employment contract may be enforceable in the future against an employee after termination of employment.

However, contracts that are illegal or against public policy are not enforceable.

Contract law performs three significant economic functions:

1. It helps individuals and businesses exchange goods and services efficiently.
2. It reduces the costs of economic transactions because parties do not need to negotiate a variety of rules and terms with each separate transaction.
3. It alerts the parties to problems that have arisen in the past, making it easier to avoid potential pitfalls.

Counselor’s Corner We live in a world of contracts, which are the bread and butter of business transactions. However, many consumers, employees, and small businesses are afraid to read and understand contracts. That fear allows others to take advantage of them. Take the time to read contracts provided to you. Ask questions about anything you don’t understand *before* you sign. Have the courage to revise and edit contracts to ensure your interests are protected. Or even write your own. It’s not hard and the more you do it, the more confidence you will have to negotiate business transactions and protect your interests. ~Darnell T., attorney

10.2: Contract Elements

There are three required elements of a contract: offer, acceptance, and consideration. It is important to note that some states and legal scholars expand this list to include whether the subject matter is legal, whether the parties have capacity to enter into a contract, and whether the law requires the contract to be in writing to be enforceable. However, these are best understood as defenses to contract formation, especially in light of the fact that the only elements that all states agree on are offer, acceptance, and consideration.

Offer

All contracts start when an individual or business proposes a deal. It might involve buying or selling goods, performing services, or making an exchange. An **offer** is a conditional promise to do or refrain from doing something now or in the future. In other words, it is willingness to enter into a contract.

Offers can be formal or informal. In some industries, such as retail and restaurants, offers are often posted on menus, signs, and advertisements. For example, a sign hanging above a cash register listing menu items and their prices is the restaurant's offer to sell customers those items at those prices.

There are not a lot of legal requirements about what an offer must contain, but there are some things that cannot be a legal offer:

Type of Invalid Offers	Definition	Example
Illusory Promise	No offer exists because there is no duty to perform	"If I decide to buy a new car, I'll give you my old one."
Pre-existing Duty	A party cannot leverage an existing duty to get more out of someone else	"I agree to teach you business law for $100 even though you have already paid tuition for the course."
Forbearance	An offer cannot be a promise not to pursue a legal claim that is known to be invalid (Note: if the claim is valid, then forbearance may be a valid offer)	"I know the accident was completely my fault but I promise not to sue you."
Past Consideration	An offer cannot be based on past actions	I paint your house. Two months later you say that you will pay me $500 for doing it. If you change your mind and decide not to pay me, I cannot enforce your promise because it was in consideration of a past event.

Once made, offers can be terminated in a number of ways. An offer that has been properly communicated continues to exist until it:

1. Is rejected;
2. Is replaced by a counteroffer;
3. Lapses or expires;
4. Is revoked; or
5. Is terminated by operation of law.

Unless it states a specific time, an offer remains open for a reasonable time. A **lapsed offer** is an offer that is no longer valid because a reasonable time to accept it has expired. An expired coupon is an example of a lapsed offer.

Acceptance

To constitute an agreement, there must be an acceptance of the offer. Legally, **acceptance** is an implied or express act that shows willingness to be bound by the terms of an offer. To be effective, both parties must understand and agree to be bound by the contract.

Acceptance can be both express or implied. Express acceptance occurs when a party states that they accept the offer. Acceptance may be implied based on the parties' conduct. For example, a retailer offers to sell a product to consumers for the price listed on the shelf. A consumer may accept that offer by handing the cashier the item and money to pay for it. The consumer does not need to say anything to complete the transaction. But the consumer must do *something* to accept. Silence, without more (such as handing over payment), is not acceptance. This is because silence may be evidence that the consumer either does not know about the offer or has rejected it.

A common problem in the business community is knowing what constitutes acceptance and what is negotiation. If an acceptance changes, adds, or modifies terms of the offer, it is a **counter-offer** and no contract is formed. The original party may decide to accept, reject, or propose another offer as a result. Although this sounds straightforward, with today's fast-paced communications, parties may respond to part of an offer, negotiate various parts of the contract simultaneously, or agree to terms in installments. As a result, there may be confusion about what the full terms of a contract are.

Offer and acceptance form **mutual assent**, which is also called "meeting of the minds." This is the parties' intention to enter into a binding contract on the terms they agreed upon. If parties do not agree on the essential terms, then there can be no meeting of the minds to enter into a contract. This is the basis for many of the defenses to contract formation.

Consideration

Consideration is the bargained-for exchange of something of value that shows the parties intend to be bound by the contract. There are two elements to consideration:

1. Something of value
2. Is exchanged between the parties.

The "something" that is promised or delivered must be a legal detriment. A **legal detriment** is giving up a legal or property right.

Consideration may be concurrent or a promise to perform in the future. However, it cannot be "past consideration" based on something that has occurred before the formation of the current contract. In other words, an act or promise made before the current contract is not adequate consideration because it was not given in exchange for the current promise.

When bargained-for consideration is not present, a court may validate a promise based on promissory estoppel. **Promissory estoppel** is the principle that a promise made without consideration may nonetheless be enforced to prevent injustice if the promisor should have reasonably expected the promisee to rely on the promise, and the promisee actually relied on the promise to his or her detriment. Promissory estoppel is an equitable doctrine used as a substitute for consideration that allows the imposition of contractual liability to prevent unfairness.

To establish promissory estoppel, a party must show:

1. A definite promise;
2. The party making the promise should have expected that the other party would rely on the promise;
3. A reasonable person would have relied on the promise;
4. The party relied on the promise and it resulted in a substantial detriment; and
5. Basic justice and fairness require that the promise be enforced.

10.3: Types of Contracts

Bilateral and Unilateral Contracts

In a **bilateral contract**, both parties make a promise of performance. These contracts are also called mutual or reciprocal contracts. Bilateral contracts are the most common form of contracts. They include ordering food in a restaurant, buying gas for vehicles, purchasing goods and services, etc.

A **unilateral contract**, on the other hand, is a contract where one party makes a promise that the other party can accept only by doing something. For example, a business offers a reward for information leading to the arrest of a thief. A person cannot collect the reward money by promising to give information–he or she must perform under the contract by providing the information.

Express and Implied Contracts

An **express contract** is a contract in words (orally or in writing) in which the terms are spelled out directly. The parties to an express contract, whether written or oral, clearly intend to make a legally enforceable agreement. For example, an agreement to buy a car for $1,000 and to take title next Monday is an express contract.

An **implied contract** is a contract that is inferred from the parties' actions. Although no discussion of terms took place, an implied contract exists if it is clear from the conduct of the parties that they have an agreement. A delicatessen patron who asks for a "turkey sandwich to go" has made a contract and is obligated to pay when the sandwich is made. By ordering the food, the patron is implicitly agreeing to the price, whether posted or not.

Quasi-contract: Contract Implied in Law

Both express and implied contracts embody an actual agreement of the parties. A **quasi-contract**, by contrast, is an obligation imposed by law to avoid unjust enrichment of one person at the expense of another. In fact, a quasi-contract is not a contract at all. It is a judicial remedy in which the court decides what a contract should look like between the parties to prevent injustice. For example, a carpenter mistakenly believes a homeowner hired him to repair her porch, when it was actually the neighbor who hired him. One morning the carpenter arrives and begins work. Rather than stop him, the homeowner lets him proceed, excited to get her porch fixed for free. Although no contract exists because there was no offer, acceptance or consideration, the law will imply a contract between the carpenter and homeowner for the value of the work.

Enforceability

A contract that is fully enforceable and reflects the parties' intent is **valid**. Conversely, an **unenforceable contract** is a contract where the parties intend to form a valid bargain but the court declares that it cannot be enforced for legal reasons. For example, Ramesh owes Jai money, but Jai has waited too long to collect it and the statute of limitations has run out. The contract for repayment is unenforceable and Jai is out of luck unless Ramesh makes a new promise to pay or actually pays part of the debt.

An agreement that is lacking one of the legal elements of a contract is **void** because it never was a contract. In other words, it is not legally enforceable because it is not a contract at all. An agreement that is illegal is also void. For example, a promise to commit a crime in return for payment is void because neither side can enforce the agreement in court.

By contrast, a **voidable contract** is a contract that can be annulled. It is a contract that is unenforceable by one party but enforceable by the other. For example, a minor may "avoid" a contract with an adult; meaning the adult may not enforce the contract against the minor if the minor refuses to carry out the bargain. The adult must comply if the minor wishes the contract to be performed. A contract may be voidable by both parties if they are both minors. Usually, the parties to a voidable contract are entitled to be restored to their original position.

A voidable contract remains a valid contract until it is voided. Thus, a contract with a minor remains in force unless the minor decides he does not wish to be bound by it. When minors become adults, they have two choices:

1. **Ratify** the contract–that is, agree to be bound by it; or
2. **Disaffirm** the contract–that is, disavow or avoid it.

Ratification may be explicit or implicit. For example, by continuing to make payments or retaining goods for an unreasonable period of time, a party may ratify the contract. If a party has not disaffirmed the contract while still a minor, she may do so within a reasonable time after becoming an adult.

Degree of Completion

An **executory contract** is a contract that has yet to be completed. Most executory contracts are enforceable. If some, but not all, of the terms of the contract have been performed, the contract is called **partially executed**. A contract that has been completed or carried out fully by both parties is called an **executed contract**.

10.4: Performance and Breach of Contract

Performance simply means undertaking the legal duties imposed by the terms of the contract.

But how do we know whether the contract terms have been performed? Sometimes it's easy to determine. For instance, if someone offers to sell his scooter for four hundred dollars, a purchaser agrees, and they exchange the scooter for the money, then the contract has been fully performed. A contract was formed, the parties performed their obligations under it (known as **complete performance**), and they are subsequently discharged from further duties arising under the contract. Complete performance results in an executed contract.

When a party fails to perform under the terms of the contract without a legally justifiable reason, the party is in **breach of contract**. Not all breach of contract situations give rise to litigation. Some breaches are minor and may be overlooked by parties, especially if there is a long-term business relationship between them. Others may be major and give rise to significant issues between the parties.

In a service contract, the standard used to judge performance is **substantial performance**. This means that the performing party acted in good faith and conveyed enough benefit to the other party under the contract that any breach may be remedied by money damages. A **material breach** in a service contract occurs when a party has not substantially performed under the terms of the contract. A **minor breach** occurs when the party has substantially performed but has not strictly performed.

Performance to the standard of **personal satisfaction** can be enforced if the contract expressly requires it. This means that contract performance is evaluated subjectively, either by one party to the contract or by a third-party beneficiary specified in the contract. If the subject of the contract is something for which approval is dependent on someone's subjective opinion, like personal taste, then assessment can be made on a subjective standard providing this standard is clearly specified in the contract. These contracts often occur in the entertainment industry, as well as the building of custom homes.

Conditions

A **condition** is an act or event (other than the lapse of time) that must occur before performance under a contract becomes due. Conditions determine when a party must perform.

Type of Condition	Description
Condition precedent	A condition must occur before a party's performance is required
Concurrent condition	Each party's performance is dependent on the other party's performance
Subsequent condition	A condition follows the duty to perform that completely eliminates or discharges a duty to perform
Constructive condition	Equitable doctrine that serves as an implied-in-law condition to prevent injustice

A **condition precedent** is an act or event that must occur before a duty of immediate performance of a promise arises. For example, an inspection of property is a condition precedent to the sale of a home.

A **concurrent condition** occurs when mutually dependent conditions must be performed at the same time by the parties. For example, delivery of goods and payment in a cash sale are concurrent conditions.

A **subsequent condition** is an event that discharges a duty of performance that becomes absolute. They are rare and tend to occur in the insurance industry. For example, an insurance company may require notice within thirty days of a claim. The insurance company does not have a duty to pay until the insured gives notice. Notice is the subsequent condition that triggers the insurance company's performance.

A **constructive condition** is a condition contained in an essential contractual term that, though omitted by the parties from their agreement, a court has supplied as being reasonable in the circumstances. It is an equitable doctrine that serves to imply conditions to prevent injustice.

10.5: Defenses to Contracts

A party may have a valid reason for **breaching**, or not performing, a contract. These reasons are known as defenses to contract. Many of the defenses to contracts go to the heart of whether an agreement ever existed. In other words, if a party does not voluntarily consent or there was no "meeting of the minds," then a valid contract was never formed.

Illegality

Illegal contracts are unenforceable because they are void. There are two common types of illegalities: (1) statutory violations, and (2) violations of public policy. An example of a statutory violation is where a company in the US wants to avoid import regulations and quotas by purchasing Cuban cigars through an intermediary in Mexico. If the US buyer pays the Mexican intermediary for the cigars but does not receive them, the buyer cannot sue the intermediary for breach of contract. The law will not provide a remedy to someone who intends to violate the law.

Examples of violations of public policy often occur in an employment context. An employer that tries to bind its employees to unreasonable non-compete agreements violates the public policy of freedom to work. Another common example is contracts with professionals who do not maintain a current license in their field. If they are not legally licensed for the work they perform, they are not entitled to payment for their services. Here, the public policy is that the law does not want to encourage a black market for services outside of government regulation.

Incapacity

If someone lacks mental capacity to understand the terms of the agreement, there cannot be a true meeting of the minds to form a contract. **Capacity** is the mental state of mind sufficient to understand that a contract is made and its legal consequences.

Incapacity can be permanent, such as from mental illness, physical illness, or insanity. Incapacity may also be temporary, such as being intoxicated, under the influence of drugs, or underage (i.e. under eighteen years old).

Undue Influence

Undue influence occurs when one party overpowers the free will of another by use of superior power or influence. In other words, it is unfair persuasion. Undue influence is not a normal level of persuasion. Rather, it occurs when a party agrees to a contract that they would not have otherwise consented to without the unreasonable pressure of the other party. For example, an elderly person who is isolated from others due to poor health and living conditions may be lonely and eager for company. If a caretaker exerted influence over the elder to the extent that he or she could no longer exercise free will, then undue influence occurs. Contracts and transactions in which elders transfer most or all of their wealth to others are frequently reviewed for undue influence.

Duress

Duress occurs when there is a threat to a person, family or property. Economic pressure may constitute duress if it is wrongful and oppressive. Cases involving duress often occur in emergency situations. For example, when someone is required to sign legal paperwork in an emergency room before receiving medical treatment for themselves or their children.

If a person enters into a contract under duress, he or she is able to get out of the contract after the emergency situation is over. Duress essentially overcomes a person's free will to voluntarily choose to enter into the contract.

Unconscionability

Unconscionability occurs when the contract contains markedly unfair terms against the party with less bargaining power or sophistication than the party who created the terms and induced the other party to sign it. Common cases involving unconscionability claims occur when one party is an experienced business dealer, while the other party is an average consumer. If the business dealer uses a very small font and inserts terms into the contract in a way that intentionally misleads the consumer into signing on unfair terms, then the contract may be deemed unconscionable.

Statute of Frauds

The **Statute of Frauds** requires certain contracts to be in writing and signed to be enforceable. The Statute of Frauds originated in England in 1677 to prevent fraud when one party tries to claim a contract existed when it did not. The Statute of Frauds requires a written contract for:

1. Real property interests;
2. Marriage;
3. Payment of another’s debt;
4. Contracts that cannot be completely performed within one year;
5. Contracts for the sale of goods of five hundred dollars or more; and
6. Acting as another’s executor/administrator.

Statute of Limitations

The **statute of limitations** is an affirmative defense that can be raised by a defendant to argue that a lawsuit is being brought too late. This means that if a dispute arises under a contract, then the plaintiff must bring a lawsuit concerning that dispute within a certain time period. States have different statutes of limitations. If a contract has a choice of law provision, then that state’s statute of limitations will apply to disputes related to the contract.

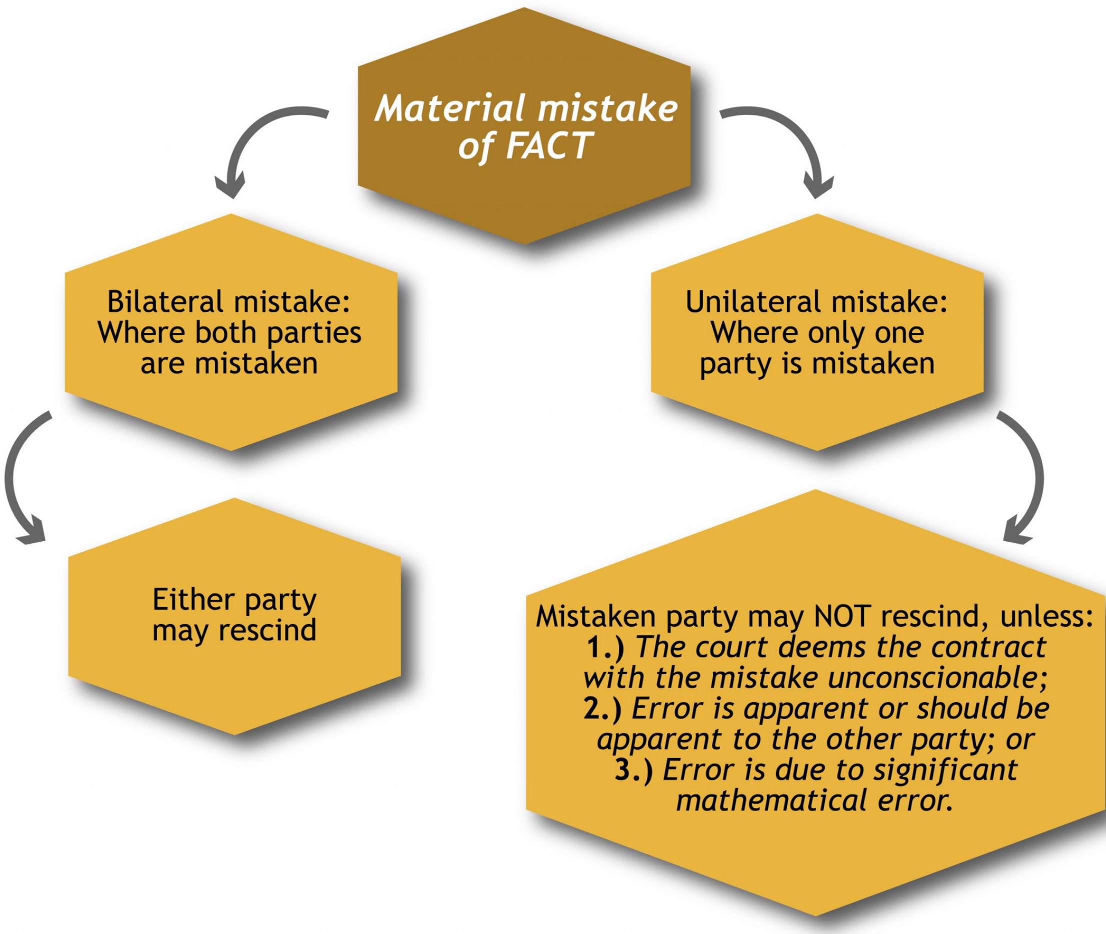
Mistake

In the context of contracts, a **mistake** is the situation in which the parties did not mean the same thing or when one or both parties formed untrue conclusions about the subject matter of the contract. In other words, a mistake is an erroneous belief.

Mutual mistake refers to something that is a mistake by both parties that relates to an essential term of the contract. For example, a contract to buy property that is not actually owned by the seller would be a mutual mistake, if the seller believed in good faith that he owned the property. When mutual mistakes occur, either party may rescind the contract.

Unilateral mistake occurs when only one party is laboring under a mistake. Mistake does not mean bad bargaining. Courts will not step in to save parties from bad bargaining absent evidence of undue influence or unconscionability. In general, parties cannot rescind the contract when unilateral mistakes occur except when the mistake makes the contract unconscionable, the error is apparent to the other party, or when significant mathematical errors occur.

Figure 10.1 Types of Mistakes Affecting Contracts and Their Remedies



Misrepresentation and Fraud

Misrepresentation and fraud are also defenses to contract. **Misrepresentation** is when a party makes a false statement that induces the other party to enter into the contract. **Fraud** is a closely related concept, and it simply means that one party has used deception to acquire money or property. Fraud may also be a basis for criminal charges, depending on the circumstances leading to the contract.

Commercial impracticability

Commercial impracticability is a defense that can be used when fulfilling a contract has become extraordinarily difficult or unfair for one party. For example, a sales contract relating to the sale of goods destroyed by a natural disaster would fall under this defense. It becomes impossible for the seller to deliver goods that no longer exist, and would be unfair to enforce damages against the seller for breach of contract. This is also called **frustration of purpose** or **impossibility** in some jurisdictions.

Bankruptcy

Sometimes a party to a contract files for **bankruptcy** protection. The bankruptcy court will determine which debts the bankrupt party must pay and which are dischargeable. Contract obligations are suspended temporarily through the bankruptcy court's automatic stay. In other words, the debt does not have to be paid during the course of the bankruptcy. At the conclusion of the bankruptcy, if the contract obligation is determined to be a dischargeable debt, then the debt will not have to be paid.

10.6: Assignment, Delegation, and Third Party Beneficiaries

Contracts are by law assignable and delegable. This means that the rights conveyed by the contract may be transferred to another party by **assignment**, unless an express restriction on assignment exists within the contract, or unless an assignment violates public policy. Likewise, the duties imposed on a party may be transferred to another party by **delegation**, unless the contract expressly restricts delegation, there is a substantial interest in personal performance by the original party to the contract, or if delegation would violate public policy.

As a general rule, a party may assign contract rights without the consent of the other party. This is common in the construction industry where a general contractor may assign rights and delegate duties to subcontractors for specific work that needs to be performed under the main contract. For example, the general contractor may delegate the duty to perform electrical work to an electrician, as well as assign the right to be paid for the work performed.

In delegation and assignment, the original contracting party is not "off the hook" if it transfers its duties or rights to another party. For instance, a subtenant assumed the rights and duties imposed on the original tenant in a lease. If the subletting tenant does not pay the rent, the original tenant is still liable.

The way to excuse oneself from legal liability under a contract is through novation. **Novation** is essentially a new contract that transfers all rights and duties to a new party to the contract and releases the previous party from any further obligation. It is the procedure in which one party is dismissed completely from the contract because a third party is substituted. In this situation, the dismissed party no longer has any liability under the original contract. To be effective, all parties must agree to the novation.

Third Party Beneficiaries

Assignment and delegation under a contract should not be confused with rights of third party beneficiaries. A **third party beneficiary** is someone who is not a party to the contract but stands to benefit from it. Life insurance policies are a classic example of contracts with third party beneficiaries. The insurance company and the insured are parties to the contract. But the person who receives payment upon the death of the insured is the third party beneficiary.

Third party beneficiaries can either be intended or incidental. An **intended beneficiary** is someone who the parties intend to receive the benefit of the contract. For example, the named beneficiary of a life insurance policy. The **beneficiary** does not need to know about the contract to have his or her rights vest.

An **incidental beneficiary** is someone who benefits from a contract but was not intended by the parties to benefit. For example, if a business pays for a professional to landscape its property, the neighbors are incidental beneficiaries to the landscaping contract. They benefit from the improved appearance and property values, but the business did not enter the contract with an intent to benefit them. Incidental beneficiaries do not have a legally enforceable interest in the contract.

10.7: Parol Evidence Rule

Courts often must interpret the meaning of a contract. When the contract is written, courts will look within the "four corners" of the document and apply the contract as written. **The Parol Evidence Rule** is the principle that a writing intended by the parties to be a final embodiment of their agreement cannot be modified by evidence that adds to, varies, or contradicts the writing. This rule usually prevents a party from introducing evidence of negotiations that occurred before or while the agreement was being reduced to its final written form.

However, there are several important exceptions that allow oral statements to be admitted:

1. Subsequent modifications;
2. Evidence of intentional misrepresentations by a party;
3. Correcting errors in drafting;
4. Clarifying ambiguities and filling in gaps; and
5. Supplements to a partially integrated contract.

As a result of the parol evidence rule, businesses should do their due diligence to ensure any written contracts fully and adequately include the essential terms of their agreement.

10.8: Remedies

The four main remedies for breach of contract are damages, specific performance, rescission, and restitution. The purpose of contract remedies is to compensate the non-breaching party for the losses suffered. In other words, remedies must put the non-breaching party in the position it would have been if there had been no breach.

Damages

Damages are the money paid by one party to another to discharge a legal liability.

Types of Monetary Damages	Purpose
Compensatory	To make the non-breaching party "whole" as if breach did not occur
Consequential	To cover indirect but foreseeable losses flowing from the breach
Incidental	To cover direct losses flowing from the breach & to avoid further loss
Nominal	To recognize legal breach although no actual damages resulted
Punitive	To punish and deter future wrongful behavior; only available if breach itself is a tort
Liquidated	To allow parties to determine value of contract in case of breach

Compensatory Damages

Compensatory damages are paid to compensate the non-breaching party for the loss suffered as a result of the breach. It is the general category of damages awarded to make the party whole. Compensatory damages include out-of-pocket losses and costs associated with the loss of the bargain. They are the primary damages in contract breach cases and are a direct, foreseeable result of the breach of contract.

Consequential Damages

A basic principle of contract law is that a person injured by breach of contract is not entitled to compensation unless the breaching party, at the time the contract was made, had reason to foresee the loss as a probable result of the breach.

Consequential damages are damages that flow as a foreseeable but indirect result of the breach of contract. For example, a roofer takes longer to fix a leaky roof than specified in a contract. The delay results in a retailer remaining closed for an additional week until the roof is repaired. The loss of sales from that week are consequential damages.

Consequential damages often include:

- Loss of profits due to the interruption of normal business practices;
- Loss of customers due to delays or cancellations; and
- Cost of replacement goods or services.

Incidental Damages

Incidental damages are damages that are paid to the non-breaching party in an attempt to avoid further loss on account of the breach. These damages include additional costs incurred by the non-breaching party after the breach in a reasonable attempt to avoid further loss, even if that attempt was unsuccessful.

For example, an electrician contracts to install light fixtures in a warehouse within seven days. The electrician enters into a purchase agreement with a supplier to buy the fixtures which are to be delivered within three days. On the fifth day, the supplier notifies the electrician that it cannot fill the order, breaching the contract. Because he cannot fulfill his contract with another supplier in time, the electrician breaches his contract with the warehouse and has to refund the warehouse its money. The losses incurred by the electrician to the warehouse are a direct result of the supplier's breach of contract, and are incidental damages.

Incidental costs often include:

- Inspection of items;
- Transportation or care of items;
- Expenses or commissions incurred in connection with incident or delay of items; and
- Storing of defective items until the supplier can retrieve them.

The difference between incidental and consequential damages is the cause of the expense or loss. Incidental damages are the direct result of one party's breach of contract. Consequential damages are more indirect, being incurred not as a result of the breach itself, but due to the end result of the breach.

Nominal Damages

If the breach of contract caused no actual loss, the non-breaching party may be awarded nominal damages. **Nominal damages** are a token amount of money paid when the breach has caused no actual loss. Nominal damages are often awarded symbolically by juries when they find legal liability but believe the breach was minor or could have been accommodated in another way. For example, a buyer could have purchased the same commodity at the same price without spending any extra time or money.

Punitive Damages

Punitive damages are awarded to a non-breaching party in excess of any loss suffered to punish the breaching party. Punitive damages are awarded when the defendant acted willfully and maliciously, and the purpose is to deter similar future bad conduct. Punitive damages are not usually available for breach of contract claims, unless the breach of contract itself constitutes a tort. In other words, punitive damages may be available when the contract breach itself is fraudulent or malicious. Punitive damages have been awarded against insurance companies that have refused to honor disability payments and that have acted in bad faith in denying legitimate claims.

Liquidated Damages

Liquidated damages are damages agreed upon by parties to a contract to be paid in the event of a breach. Because the parties are often in the best position to know the value of their contract, they can negotiate a fixed sum or method to calculate damages in the event of a breach. To be enforceable, liquidated damage provisions must apply equally to all parties, be negotiated fairly at the time the contract is executed, and must bear a reasonable relation to the probable damage in case of a breach.

Equitable Remedies for Breach of Contract

Equitable remedies involve a request for relief that does not include money damages. Equitable remedies are useful for when money does not provide adequate relief to the non-breaching party.

Equitable Remedy	Purpose	Description
Specific Performance	The object of the contract is unique & the loss cannot be easily compensated through money	Party must perform under terms of contract
Rescission	Contract was executed based on mutual mistake or fraud	Parties are put back into position they were in before contract was made
Restitution	Parties must return any benefit received	Benefit or item unjustly obtained is returned

Specific Performance

Specific performance is a judicial order directing a party to deliver the exact property (real or personal) under the terms of a contract. Specific performance is an alternative remedy to damages and may be issued at the discretion of the court. Specific performance is granted when money damages are not an adequate remedy. For example, sale of specific real property (real estate is always unique), artwork, antiques, and heirlooms.

To warrant specific performance, a contract must be clear, definite, complete, and free from fraud and duress.

Specific performance is generally not available for service contracts. This is because ordering someone to perform a contract against their will is a type of involuntary servitude banned by the Thirteenth Amendment of the US Constitution. However, courts have occasionally entered injunctions prohibiting entertainers from performing at alternative venues until they perform at the venue under their original contract. These cases are in response to unethical forum shopping in the entertainment industry, and are very limited in nature.

Rescission

Rescission occurs when one party seeks to undo a contract and return to the position it was in before the contract was made. Rescission often occurs when fraud and mutual mistake occur and enforcing the contract would be unjust. Rescission may also be available when one party materially breaches the contract to such an extent that requiring the other party to perform would be unjust.

A party seeking rescission must notify the other party within a reasonable time after discovery of the facts that are the basis for rescission. The reason is that restoring the parties to their pre-contractual positions is easiest before too much time and performance has passed. Failure to rescind a contract in a timely manner may be held to affirm the contract or waive a breach of contract.

Restitution

Restitution is restoring property to the original owners. In other words, parties must return any benefit received under the contract. Therefore, only to the extent that the injured party conferred a benefit on the other party may the injured party be awarded restitution. Restitution often follows rescission of a contract. The purpose of restitution is to prevent a party from being unjustly enriched when a contract has been legally annulled.

10.9: Concluding Thoughts

Contracts are a fundamental part of business. It is important to understand how contracts are formed, performed, and executed in order to be successful. This understanding also includes understanding what performance is required, what defenses are available when someone breaches a contract, and what remedies are available in the event of a breach.

CHAPTER OVERVIEW

11: Sales Contracts

Learning Objectives

- Explore the differences between the Uniform Commercial Code and common law contract principles.
- Understand important provisions of the Uniform Commercial Code and how they apply to merchants who sell goods.
- Learn when the Uniform Commercial Code applies to mixed contracts.

11.1: Introduction

One of the drawbacks of federalism is that states can implement different laws. This was a serious problem as the US economy grew beyond local and state-based industries to economies of scale during the Twentieth Century because it hampered economic growth. In response, business leaders demanded consistent laws to facilitate trade across the nation, especially for the sale of goods across state lines.

The **Uniform Commercial Code (UCC)** is a proposed set of laws developed by legal experts and business leaders to govern commercial transactions, including sale of goods, secured transactions, and negotiable instruments. The UCC was created in 1952 and its advocates lobbied the states and territories to adopt it. The UCC has been adopted in some form by all fifty states, the District of Columbia, and US territories. Interestingly, it is the only "national" law not enacted by Congress.

This chapter will focus on important provisions that relate to sales contracts that have been adopted by most, if not all, states.

Counselor's Corner When writing something for work, I offer the following advice. First, take time to review and edit your writing. You will be surprised at the number of typos that can be discovered when you give your work fresh eyes. Don't be afraid to reach out to others to review your work as well. Excellence in writing will help to convey your message clearly and credibly. Second, write with honesty. If your reader doubts the sincerity of your work, the message you are trying to convey will be lost. The strongest advocates I have encountered are the most honest ones. Third, be clear and concise. Tell your reader a story but give them the information they need in an organized fashion. ~Tiffany M., attorney

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11.2: Scope of the UCC

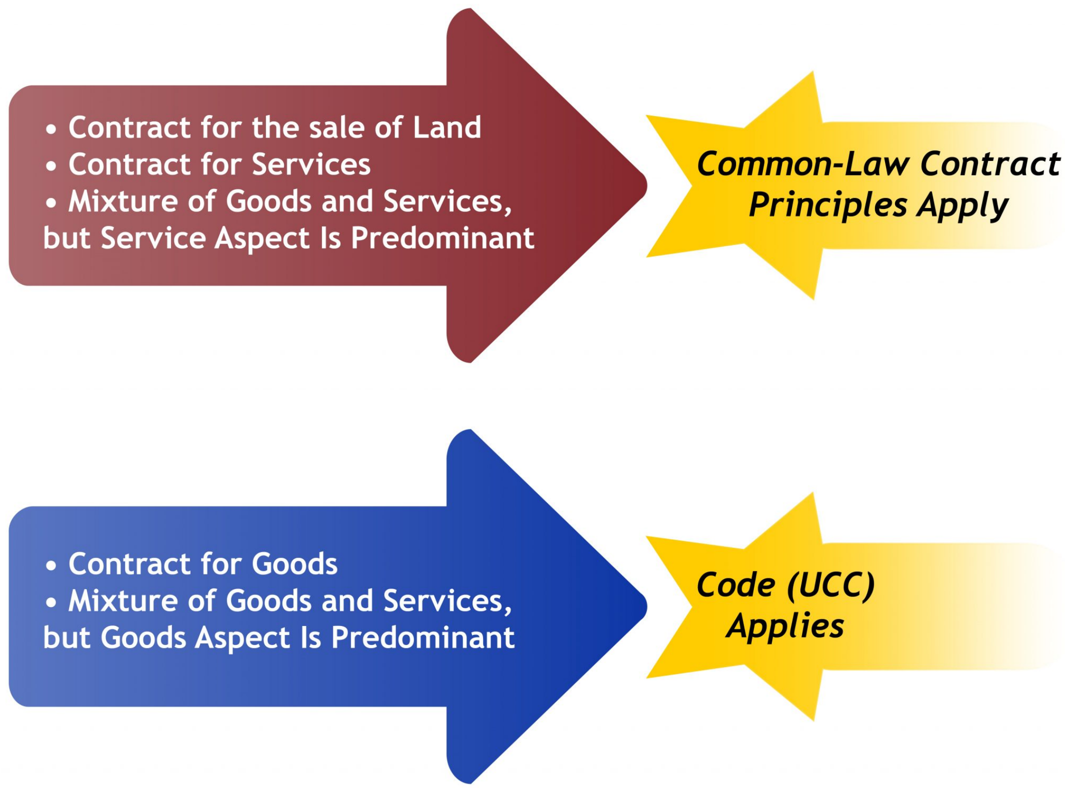
The UCC deals with commercial transactions from start to finish. The power of the UCC is that if the parties do not have a contract with express terms, then the UCC "fills the gaps" with legal requirements. For example, if the parties do not negotiate the terms of delivery, then the UCC states where and when delivery should occur. This is incredibly beneficial to businesses because it provides legal certainty and consistency across jurisdictions. If parties have a dispute, or unforeseen circumstances result in a breach of contract, the parties can resolve the problem without having to litigate the issue in court. This saves businesses a lot of time, money and resources, as well as helps them maintain good working relationships.

The UCC also addresses four important problems that merchants struggled with under the common law:

Problem	Common Law	UCC	Example
Contract Formation	Mirror Image Rule: Offer must be followed by acceptance showing meeting of the minds on all essential terms	Contract can be made in any manner that shows agreement and some terms, including price and time of delivery, may be left open (§2-204 & §2-305)	Jimena writes Ahn that she needs a new computer. Ahn delivers the computer and Jimena starts to use it. Under the common law, there is no contract because price was not discussed. Under the UCC a contract exists for a reasonable price.
Required Writing	All essential terms must be in writing	Any writing that intends to be a contract is enforceable; "merchant" exception can create a contract against party that does not object to writing within ten days (§2-201)	Home Depot sends a purchase order to a wholesaler. The wholesaler receives the order but does not respond. Under the common law, no contract exists. Under the UCC, a contract exists after ten days that Home Depot may enforce against the wholesaler.
Additional Terms	An acceptance with any additional terms is a counteroffer	Additional and different terms are not necessarily counteroffers, may just be part of negotiation process (§2-207)	A florist sends a preprinted order form to buy specific supplies from a manufacturer for a stated price. The manufacturer responds with its own preprinted form accepting the order but adding the term that unpaid balances incur interest. Under the common law, the additional term is a counteroffer and no contract is formed until the florist accepts it. Under the UCC, there is a valid contract that includes the interest term.
Modification	To be valid, a modification must be supported by new consideration	A modification does not need to be supported by new consideration (§2-209)	Fred Farmer agrees to sell produce to Aponi for her restaurant. They agree to all essential terms, including goods, price, and delivery. The next day a hurricane floods the interstate doubling the delivery costs. Fred calls Aponi who agrees to pay half of the increased cost. Under the common law, the modification is void. Under the UCC, the modification is enforceable.

A common problem is determining when the UCC applies. The UCC does not apply to contracts related to the sale of land, intangible personal property, construction, or for services. The UCC applies to the sale of **goods**, which the Code defines as any moveable physical object except for money and securities. In other words, goods are tangible personal property.

Figure 11.1 Determination of when the UCC Applies to Sales Transactions



Mixed contracts are for both the sale of goods and services. For example, a contract for the sale of a dishwasher that includes the service of installation is a mixed contract. The UCC only applies to mixed contracts when the primary purpose of the contract is the sale of goods. In the dishwasher example, the UCC applies because installation would not occur without the sale of the dishwasher.

The UCC also does not apply if none of the parties are a merchant. In other words, the sale of goods between individuals is governed by the common law. If a sales transaction involves a merchant, then the UCC usually applies. A **merchant** is someone who routinely deals in the goods involved in the transaction or who, by his or her occupation, holds himself or herself out as having special knowledge with respect to the goods. Suppliers of services are not merchants.

The UCC provides merchants with rules that facilitate their business needs. For example, contract formation is more informal and flexible than under the common law. However, the UCC often holds merchants to a higher standard of conduct than non-merchants. Merchants are required to act in good faith and to observe reasonable commercial standards of fair dealing.

11.3: Sales Contract Formation

The common law expects parties to form a contract by making an offer, with an acceptance that mirrors the offer and includes all material terms. Modern business transactions, however, frequently do not follow that pattern. As a result, UCC §2-204 provides that a contract may be formed in any manner that shows the parties reached an agreement.

The terms of sales contracts are supplied by three sources:

1. The express agreement of the parties;
2. Course of dealing, usage of trade, and course of performance; and
3. The UCC.

Express Agreement

The general rule is that parties are free to make their own sales contract. When parties agree on terms–especially for quality, quantity, price, delivery and payment–those terms control over UCC provisions. The parties' freedom to contract, however, is not limitless. Parties cannot disclaim their obligation of good faith, diligence, and due care. Similarly, liquidated damages provisions must be based on the value of the contract and cannot be a penalty for breach of contract. Further, limitations on consequential damages cannot be unconscionable.

Course of Dealing, Usage of Trade & Course of Performance

The parties' agreement may be based on their actions. **Course of dealing** is an established pattern of prior conduct between the parties to a particular transaction. If a dispute arises, the parties' course of dealing can be used as evidence of how they intended to carry out the transaction. In other words, the current contract is interpreted based on past contracts.

Course of performance relates to the conduct of the parties under the contract in question after its formation. It occurs when a contract involves repeated performance and looks at how the parties have acted when performing this particular contract, not contracts in the past.

Usage of trade is a practice or custom in a particular trade used so frequently that it justifies the expectation that it will be followed in the current transaction. It is industry standards and customs related to a particular industry.

UCC Provisions

When sales contracts do not have all the necessary terms, the UCC "fills in the gaps" of the contract. The most important UCC gap-filler provisions relate to price, quantity, delivery, and time of performance.

Figure 11.2 UCC Gap-Filler Provisions

Provision	Subject	Description
§2-305	Price	Price can be left open to be fixed at later time
		Reasonable price determined upon delivery “Output” and “Requirement” amounts can be determined at later time
§2-306	Quantity	No quantity that is unreasonably disproportionate to the estimate will be enforced
		Reasonable amount in keeping with normal or prior comparable output or requirements is implied
§2-507	Delivery	Delivery occurs at seller’s place of business unless contract provides otherwise
§2-308/ §2-309	Time	Reasonable time for performance

Provision	Subject	Description
§2-305	Price	Price can be left open to be fixed at later time; Reasonable price determined upon delivery
§2-306	Quantity	“Output” and “Requirement” amounts can be determined at a later time; No quantity that is unreasonably disproportionate to the estimate will be enforced; Reasonable amount in keeping with normal or prior comparable output or requirements is implied
§2-507 & §2-308	Delivery	Delivery occurs at seller’s place of business unless contract provides otherwise
§2-309	Time	Reasonable time for performance

When these sources of contract terms are in conflict, the UCC applies the following hierarchy:

1. Express terms;
2. Course of performance;
3. Course of dealing;
4. Usage of trade; and
5. UCC gap-filler provisions.

The logic is that the parties are free to contract the terms they would like. In absence of an express agreement, the parties’ conduct shows their intent. In practical terms, usage of trade and UCC provisions often go hand-in-hand. For example, what constitutes “reasonable time” for performance is often based on relevant industry standards. Although the UCC identifies a hierarchy, in practice it is not rigidly applied by the courts when determining usage of trade and UCC provisions.

Additional and Different Terms

Under UCC §2-207, an acceptance that adds or alters terms will often create a contract. Unlike the common law that treats modifications as a counter-offer, the UCC has a more flexible concept of acceptance. This is to address the “battle of the forms” that happens when merchants buy and sell goods with pre-printed forms. Frequently buyers use pre-printed forms to place an order that are then acknowledged by the seller on its own pre-printed forms. These forms typically contain language favorable to the party sending it and rarely agree.

Section 2-207 still requires the parties to intend to create a contract. If the differing forms show that the parties never reached an agreement, then no contract exists.

However, if the acceptance contains an additional term, then a contract is usually formed. An **additional term** is a proposed contract term that addresses issues not included in the offer. Additional terms expand the offer to cover more essential terms to ensure a meeting of the minds.

If both parties are merchants, the additional terms usually become part of the contract unless:

1. The offer states that it cannot be accepted with additional or different terms;
2. The additional terms materially alter the offer; or
3. The party making the offer promptly rejects the additional terms.

A **different term** is a proposed contract term that contradicts the term(s) in the offer. Under the UCC, different terms cancel each other out. In most states, different terms are replaced by UCC gap-filler provisions.

11.4: Performance

A seller is expected to deliver what the buyer ordered. **Conforming goods** meet contractual specifications and satisfy performance requirements. **Non-conforming goods** are goods that fail to meet contractual specifications, allowing the buyer to reject the goods or to revoke acceptance.

A buyer has the right to inspect the goods before paying or accepting them. A buyer may also reject non-conforming goods by notifying the seller within a reasonable time.

If a buyer rejects the goods, the seller has the **right to cure**, which is the right to deliver conforming goods before the contract deadline. The UCC also allows the right to cure after the contract deadline in some situations. If the seller delivers conforming goods, then it is entitled to full payment under the contract.

If the seller breaches the contract, the buyer is entitled to cover. **Cover** is obtaining reasonable substitute goods because another party failed to perform under a contract. If the seller obtains reasonable substitute goods, the seller is entitled to the difference between the contract price and its cover price, plus incidental and consequential damages, minus expenses saved.

If the buyer breaches the contract, the seller may refuse to deliver the goods. If a buyer refuses to accept or pay for goods without justification, the seller may resell them to another party. When the resale is commercially reasonable, the seller may recover the difference between the resale price and the contract price, plus incidental damages, minus expenses saved.

If the buyer has accepted the goods and refuses to pay, or if the goods are conforming but resale is impossible, the seller may sue the buyer for the contract price. This is common when the buyer orders goods with unique specifications.

11.5: Warranties

A **warranty** is a contractual assurance that goods will meet a certain standard. An **express warranty** is a guarantee, created by the words or actions of the seller, that goods will meet certain standards. Under the UCC, a seller may create an express warranty in three ways:

1. With an affirmation of a fact or a promise;
2. With a description of the goods; or
3. With a sample or model.

To constitute a warranty, the seller's words or actions must be part of the basis of the bargain. For example, if a salesperson says that a car's timing belt was just replaced and will not need to be replaced for another 100,000 miles, and the buyer relied on that statement when deciding to buy the car, then the salesperson's statement becomes an express warranty.

An **implied warranty** is a guarantee created by the UCC and imposed on the seller of goods. There are two main implied warranties: merchantability and fitness for a particular purpose.

The **implied warranty of merchantability** is a warranty that the goods are fit for the ordinary purposes for which they are used. To disclaim this warranty, a merchant must use the term "merchantability." The novel or unusual use of goods is not protected by this warranty. If a buyer uses goods for something other than their intended purpose, the warranty does not apply.

The **implied warranty of fitness for a particular purpose** is a warranty that the property is suitable for the buyer's special purpose. For the warranty to apply, the seller must know what the buyer's purpose is and the buyer must rely on the seller's judgment that the goods meet the buyer's needs.

11.6: Concluding Thoughts

The UCC is a national law that was proposed by legal experts and business leaders to address the need for consistent laws related to the sale of goods across state lines. The UCC also applies to secured transactions and negotiable instruments, which are areas beyond the scope of this book. For individuals and businesses who buy or sell goods with merchants, it is important to understand how the UCC fills in gaps with terms that are not expressly contained in a contract, as well as to understand applicable warranties. The flexibility of the UCC facilitates business by making commercial transactions more consistent and predictable.

12: Writing Contracts

12.1 Writing Contracts

LEARNING OBJECTIVES

1. Learn how to write valid contracts.
2. Understand strategies for drafting contracts.

Knowing how to write legally enforceable contracts that protect their interests is a vital skill for businesses. In fact, most contracts are not written by attorneys. Individuals and businesses write contracts without legal help because they are trying to save time, money, and tension with others. However, hiring an attorney to write or review a contract to protect personal or business interests is sometimes necessary and worthwhile.

There are no magic words that a contract must have to be enforceable. Some are short and informal, while others are long and formal. No one style, format, or approach will always serve the parties' needs. The only legal requirement that contracts must have are the elements of a contract: offer, acceptance, and consideration. This chapter offers some guidelines for business people to consider when writing their own contracts.

Counselor's Corner It has been said that a poorly drafted contract will work if everyone gets the benefit of their bargain. This may be true, but it does not excuse sloppy drafting. Address all essential matters, clearly, succinctly, and at once. Non-essential terms, inconsistent use of defined terms, and repetition create fertile ground for disputes. You cannot control how the other party will perform. However, you put yourself in the best position possible by ensuring that the intent, obligations and rights of all parties are stated clearly and unambiguously. ~Kathy K., attorney

12.2 Structure of Contracts

Written contracts can be organized in many different ways. However, having a structure can help keep information organized, clear, and easy to find. The best contracts have clear headings that accurately describe what is contained in that section. Using emphasis, such as **bold** and underlining, work better than *italics* alone for capturing the reader's eye.

In general, contracts often contain a structure like this:

1. Title
2. Introduction of Parties and Purpose
3. Definitions of Material Terms
4. Covenants and Promises of Performance
5. Conditions
6. Breach and Its Consequences
7. Representations and Warranties
8. Standard (often called "Boilerplate") Provisions
    - Procedure to Modify Contract
    - Rights of Assignment and Delegation
    - Alternative Dispute Resolution
    - Choice of Law and Forum
    - Integration
    - Severability
    - Exculpatory Clause
    - Force Majeure
    - Attorney Fees
9. Signature Block

Not all contracts will contain all these elements and provisions. The parties' needs and the purpose of the contract drive the structure of the document.

Title

Contracts have a title, often in **bold** or CAPITAL letters, at the top of the page. Titles should be as descriptive as possible. “Contract” or “Agreement” are not useful because they require the reader to read through the contract to know what it is about. The best contracts capture the nature of the document in the title. For example, “Employment Agreement Between Jane Doe and Stanford University.”

Introduction of Parties and Purpose

The introduction should name the parties and describe the nature of the contract. If background information is useful in explaining the parties’ interests and objectives, then it should be included here.

Definitions of Material Terms

Most business contracts contain some definitions, unless the subject matter and parties are clear. Definitions are useful because it is an area readers can reference to ensure compliance with the contract. For example, did the seller provide the specific goods as defined by the contract?

Definitions are not necessary for every term, though. If not defined, legal terms are given their legal meaning. And ordinary words are given their common, ordinary meaning. Therefore, businesses should define the material terms of the transaction: goods, services, quantity, quality, price, etc. Definitions that are specific to the industry are also helpful to include.

Covenants and Promises of Performance

A **covenant** is a formal promise to perform. This is the section of the contract where the parties state exactly how they will perform the contract. Buyer will pay a specific amount for the goods or service. Seller will deliver a specific item at a particular location.

To ensure clarity, the best contracts use active verbs in this section. For example, “Buyer will pay Seller ten dollars.” It is clear who will be paying whom, and how much is owed. Passive voice injects ambiguity, which can be problematic. For example, “Seller shall be paid ten dollars.” Will Buyer pay Seller the money or will someone else tender payment? If payment is not made, is Buyer in breach of contract?

Conditions

As discussed in Chapter 10, **conditions** are things that must occur before performance is due. Usually conditions must be expressly stated in a contract to be legally enforceable. The best contracts identify any conditions and delineate a timeline for when performance is due after the condition is met. For example, if an inspection of a property is a condition precedent of purchasing it, how long after the inspection is completed must the buyer perform?

Breach and Its Consequences

To constitute a violation of the contract, a breach must be material. A **material breach** is a substantial breach of contract that excuses aggrieved parties from further performance and affords them the right to sue for damages.

In contracts that require performance over a period of time, or payments in installments, it is helpful to define what constitutes a material breach. This clarifies when the non-breaching party can seek a remedy. The best contracts anticipate reasons for breach and identify consequences for them.

Acceleration Clause

An **acceleration clause** makes all future payments due immediately under the contract. Acceleration clauses often exists in contracts where periodic payments occur. For example, a contract to purchase a vehicle may require payment of all remaining money owed under the contract if the buyer misses a monthly payment. This allows the business that sold the vehicle or the bank that issued the loan to sue for breach of contract once, rather than filing a new lawsuit for each month.

Liquidated Damages

A **liquidated damages clause** allows parties to determine the amount of damages in the event of a material breach. Agreeing to the value of the contract before any breach occurs often saves time and money should the case be litigated. To be enforceable, the liquidated damages must apply to all parties equally, and be based on the value of the contract rather than act as a penalty.

Representations and Warranties

Representations are statements of fact made to induce someone to enter into a contract. Common representations by businesses include:

- They are properly licensed;
- They are insured;
- Their financial statements are accurate;
- They own all relevant assets;
- They have legal authority to enter into contracts.

Warranties in a contract are express promises that guarantee something in furtherance of the contract by one of the parties. For example, a seller warrants that the object being sold is as represented or promised.

Warranties differ from representations in four ways:

1. A warranty is an essential part of a contract, while a representation is usually only a collateral inducement;
2. A warranty is written in a contract; while a representation may be written or oral;
3. A warranty is conclusively presumed to be material, while a representation must be proven to be material by the party claiming breach; and
4. A warranty must be strictly complied with, while a representation must be substantially true.

Please note that express contract warranties are different from implied warranties under the Uniform Commercial Code (UCC). A party may disavow implied warranties under the UCC through a written contract.

Modification

Often with contracts that require an extended period for performance, modification becomes a concern. What happens if prices or deadlines need to be altered? Does that require a new contract or can the existing contract be modified? Good contracts often include a procedure for how to modify a contract. This may be as informal as writing changes directly on the original contract with the parties' initials and date. Or it could be through a formal addendum procedure.

Regardless of the chosen procedure, it is a best practice for businesses to discuss modification procedures when entering into a contract. If the procedure is clear, less friction occurs when a party seeks modification.

Assignment and Delegation

In general, parties are free to assign and delegate their rights and duties under a contract. Parties can limit those rights or they can request notice if an assignment or delegation occurs. This is a provision that is often not needed unless a party has a concern about assignment, such as in the insurance industry.

Alternative Dispute Resolution

As discussed in Chapter 4, many businesses want to reduce their risk of litigation by participating in alternative dispute resolution (ADR). Mandatory arbitration clauses are common in consumer and employment contracts. Before including an ADR provision in a contract, parties should be fully comfortable with the option that they choose. If a party agrees to mediation or arbitration, a court will enforce that choice even if the parties change their mind.

Choice of Law and Forum

Choice of law provisions determine which state's laws will be used to interpret the contract. **Choice of forum** provisions determine the state in which any litigation will take place.

This provision is often unnecessary for contracts involving individuals and entities in the same state. If the parties do not select that state law or location for litigation, the courts look to:

1. Where the contract was signed;
2. Where the contract is performed;
3. Where the parties are residents; and
4. The court's jurisdictional rules.

Integration

An **integration clause** is a provision stating that the contract represents the parties' complete and final agreement and supersedes all informal understandings and oral agreements relating to the subject matter of the contract. In other words, it is *the* agreement.

The purpose of an integration clause is to prevent the parties from later claiming that they agreed to additional or different terms than what the contract states. This means that any statements made before the parties signed the contract are not part of the contract and they will not be used to interpret the meaning of the contract.

Severability

A **severability clause** is a provision that keeps the remaining provisions of a contract in force if any portion of the contract is declared unenforceable by the court. It is also known as a savings clause because it "saves" the whole contract from being declared unenforceable.

For example, if a non-compete clause in an employment contract is declared unenforceable by a court, then the rest of the employment contract remains in effect.

Exculpatory Clause

An **exculpatory clause** is a provision relieving a party from any liability resulting from a negligent or wrongful act. They are often employed when the risk of injury exists. Exculpatory clauses cannot limit liability when a party acts with gross negligence, commits an intentional tort, or when public policy or state laws prohibit them. Exculpatory clauses have been struck down by courts in some cases where parties to a contract have greatly unequal bargaining power, especially when the party with greater power acts unethically or with gross negligence.

Force Majeure

A **force majeure** clause is a provision allocating risk to a certain party if performance becomes impossible as a result of an event that the parties could not have anticipated or controlled. Force majeure events are big, disruptive events such as natural disasters, war, terrorist attacks, and fires.

For example, if the subject matter of an international sales contract is destroyed by a hurricane, does the buyer or seller lose the money in the sale?

Attorney Fees

Business contracts often have an attorney fees clause that entitles a party successful in litigation over the contract to be reimbursed its attorney fees. This clause often has the effect of limiting frivolous lawsuits because it becomes more expensive for parties to litigate weaker claims. It may also give leverage to a winning party to prevent or end appeals of a court judgment.

Courts will usually enforce an attorney fees provision in a contract. However, courts review attorney fee awards for reasonableness. Therefore, the amount of fees usually must be deemed reasonable by a court or arbitrator before a party can collect under a contract.

12.3 Common Mistakes

Four of the most common mistakes when writing a contract are not understanding the content, vagueness, ambiguity, and typographical errors.

Not Understanding the Content

One common mistake is using free online resources without ensuring that they are appropriate for the circumstances. Just because it sounds official, a document generated by a computer algorithm may not be helpful. Better to read the contract and ensure that it accurately reflects the parties' agreement.

Courts presume that parties have read a contract before signing it. Any mistakes in drafting go against the party who wrote the contract. In other words, if the contract is unclear, the party who did not write it gets the benefit of the doubt. The idea is that the party who wrote it should have done a better job, and the party who read and signed it should not be penalized as a result of someone else's error. When writing a contract, better to keep it simple and clear.

It is also important to exclude provisions that are irrelevant to the contract. Contracts that are too long and contain irrelevant and contradictory terms are hard to understand. The best contracts are used as a reference between the parties during the period of performance. If a contract is too broad, too confusing, or contains too much irrelevant information, it hinders the effectiveness of the document.

Vagueness

In the context of contracts, **vagueness** means the language is imprecise, uncertain, and not clearly expressed. Vagueness is problematic because it could mean that the parties did not have a meeting of the minds because they were not talking about the same things.

Some business people think that keeping the contract "general" will facilitate a business transaction and that the details can be worked out later. However, if the parties are not in agreement up front, it is uncommon that things will work out smoothly later.

Another risk with vagueness is that it is not clear how a court will interpret the contract. If there are two or more reasonable interpretations, it is possible that the court will decide another interpretation is more reasonable. Again, mistakes in drafting are held against the drafter so if a court concludes that the vague term was a mistake, then it is hard to win in litigation.

Ambiguity

In contracts, **ambiguity** means an uncertainty of meaning or intention. Ambiguities can be either patent or latent. A **patent ambiguity** is where the language of the contract itself creates uncertainty because it is contradictory. For example, a contract states two different sale prices.

A **latent ambiguity** exists where the uncertainty arises during the performance of the contract. For example, the contract states that goods will ship via a carrier that has a common name and could be referring to different carriers.

Typographical Errors

Typographical errors are common in contracts. Some are harmless, some are embarrassing, and others are harmful. Although some typos are easy to ignore because they do not carry legal consequences, some can be fatal to the agreement.

Minor errors are called **scrivener's errors**. The scrivener's error doctrine permits typographical errors in a written contract to be corrected when clear and convincing evidence exists that the mistake does not reflect the intent of the parties.

However, errors related to dates, price, quantity, legal names of individuals and entities, and property descriptions (such as addresses and lot numbers) may not qualify as scrivener's errors. Such errors may be fatal to the contract or may be enforced with adverse consequences against one of the parties.

12.4 Tips for Writing a Contract

Regardless of the purpose of the contract, some tips for writing good contracts include:

Naming the Parties

Be sure to use the correct name of the business entity or individual who is a party to the contract. This may seem obvious, but people often write the name of a representative of the entity rather than the legal name of the entity.

For sole proprietorships, it is appropriate to identify the party as Ling Chen doing business as Chen Bookkeeping. If the business is a Limited Liability Company (LLC), identifying an individual in the contract by name may remove any personal liability protection that a LLC provides. Similar issues may arise with a partnership if each individual is identified as a party to the contract.

Except for sole proprietors who do not have a separate business name, use the business entity's name and not a personal name as a party to the contract. Otherwise, parties may lose the benefit of limited liability. There may also be tax consequences.

Define the Scope of the Work

Clearly define the scope of work or service being provided, and the proposed timeline to complete the work. Be specific. For example, instead of a broad "renovate the kitchen," provide details of the cabinet designs, counter tops, and other materials and work to be provided.

If applicable, a time frame for each phase of the project is useful, along with procedures to follow if there are delays. This is especially helpful when delays occur as a result of a supply shortage or a third party. Breach of contract may not always be the fault of the parties. Having procedures in place in the case of delay often saves business relationships when things go wrong.

Specify Time and Amounts of Payments

Entering an hourly rate and projected time for completion, or the total amount of payment for a project, may be insufficient. Depending on the nature of the goods or services, the contract should include:

- Who is paying whom;
- How much is being paid;
- The method of payment (such as check, cashier's check or bank transfer);
- Any portion of fees to be paid upfront;
- Any fees to be paid at project milestones;
- Payment for work completed if contract is canceled;
- Any late fees; and
- Hourly/per diem rate for time due to delays caused by the other party.

Termination Clause

Few contracts go on forever, so including an end date for the agreement or procedures for a party to cancel the contract are helpful. For example, parties often want to end the agreement if the other party fails to pay or misses too many important deadlines.

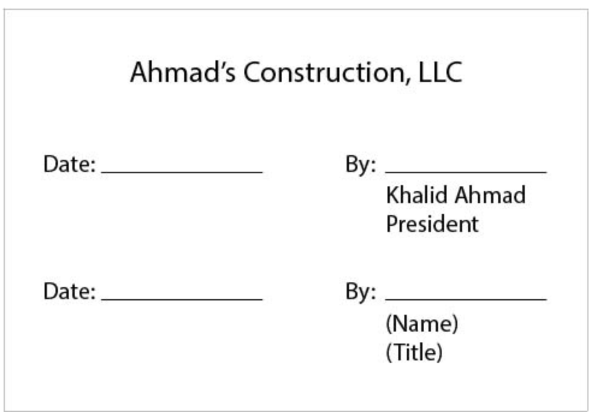
Termination procedures should be as specific as possible and include how much notice needs to be given, the type of notice required, and whether there is a time period where the other party may cure the deficiency.

Termination clauses should anticipate termination by all parties and address the parties' rights based on which party requests termination and why.

Sign and Date the Contract

The signature block should name the business entity, then under the signature, the name and title of the person signing.

Figure 12.1 Signature Block Example


Ahmad's Construction, LLC

Date: ______________ By: ______________
Khalid Ahmad
President

Date: ______________ By: ______________
(Name)
(Title)

For example, Ahmad's Construction, LLC By: ___________ Khalid Ahmad, President

Each person signing the contract should date it next to his or her signature.

For partnerships, only general partners can sign a contract on the partnership's behalf. For corporations, the president or chief executive officer is presumed to have authority to sign. For an organization or association, a board president would have authority, but it may require a vote of the governing board to approve the contract.

Minor Changes

Minor changes can be made directly to the contract. Both parties need to initial and date beside the changes to show that both parties agree to the change.

This is common when people buy property and the amount held in escrow changes (usually based on interest accrued) from the time the contract was prepared to the time it was signed.

Legal Terms

Courts interpret legal terms to have their legal meaning, regardless of the parties' intent. Avoid using legal terminology unless all parties fully understand the legal definition and how it will be applied by the court. Again, simple and clear language is more effective than confusing legal jargon.

Allow for Flexibility

Contracts are usually the result of negotiation and the majority of them never end up in court. Contracts cannot cover every possible future situation but serve as a working document for the parties' business relationship. When writing contracts, it is best to think of them as an agreement between parties that need some flexibility for the transaction(s) to take place. Life is dynamic and the best contracts give structure without being too rigid.

12.5 Concluding Thoughts

Writing valid contracts is an essential skill to be successful in business. Most contracts are not written by attorneys but they are critical to capturing an agreement between parties. Successful business people see contracts not just as a way to protect their interests, but also as a document that governs their business relationships with others. A well-written contract can be used throughout a transaction to guide the parties in their interactions and responsibilities.

12.1: Writing Contracts

12.2: Structure of Contracts

12.3: Common Mistakes

12.4: Tips for Writing a Contract

12.5: Concluding Thoughts

13: Employment Law

13.1 Introduction

LEARNING OBJECTIVES

1. Understand the principle of employment at will and the exceptions to the doctrine.
2. Learn important employment laws that affect businesses across industries.
3. Examine the laws that govern the relationship between employers and employees who belong to a union.

Until the early Twentieth Century, there were not many laws that regulated the employer-employee relationship. The belief was that the free market system would ensure that employers treat employees fairly or else they would not be able to attract and keep good workers. However, the reality of the Industrial Revolution proved that the traditional employment relationship favored the interests of the employers at the expense of workers, including children. As a result, Congress and state legislatures started passing employment and labor laws to protect the interests of employees. Today, employment law is a very robust area of the law that impacts businesses across industries.

Counselor's Corner As working remotely is the norm now for many employees who formerly went in to work each day, debates have arisen regarding where employees are more productive—at home or back at the office? According to data gathered by various sources, most workers are more productive at home, including both those who enjoy and prefer this arrangement, and those who'd rather be in the office. According to data gathered by RescueTime, remote workers had a 4% increase in average daily time spent on their core work and an 18% *decrease* in time spent on communication, compared with employees in the office. Translated, working from home for many means spending more time on meaningful work and less time on communication, all without the commute. The latest Census data indicates that the average commute for Americans is 27 minutes each way, so almost an hour a day roundtrip. These data raise interesting questions about what the workplace will look like when it is safe for most workers to return to the office. ~Denise K., attorney

13.2 Employment At Will

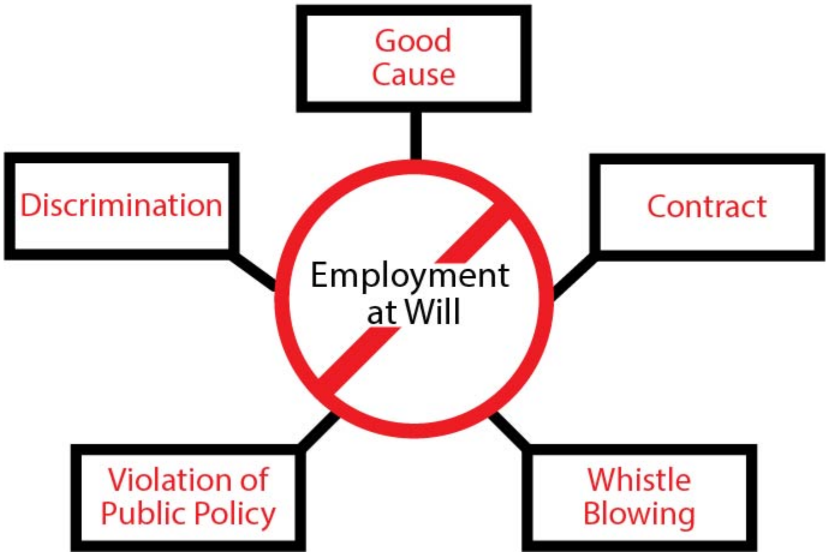
In general, employees are free to quit a job at any time for any reason, with or without notice. Similarly, employers are free to end a worker's employment at any time for any reason, with or without notice. This principle is called **employment at will**. This doctrine is based on the concept that employment is a form of an implied contractual relationship. Therefore, as long as both parties want to continue their contract to work together, the law presumes they will. When one party does not want to continue, then they may end their working relationship.

There are five major exceptions to the employment at will doctrine:

1. Contract;
2. Good cause;
3. Discrimination against an employee based on membership in a protected class;
4. Violation of public policy; and
5. Whistleblowing.

Figure 13.1 Exceptions to the Employment at Will Doctrine

13.2 Exceptions to Employment at Will



Contract

Employers and employees may modify the employment at will doctrine through contract. In addition to formal, written employment contracts, courts have also enforced oral promises made during the hiring process. Promises made to job applicants are generally enforceable, even when the promises are not approved by the employer's executives or upper management. Therefore, it is important when hiring employees that companies do not make promises that can be reasonably interpreted to be guaranteed employment or employment for a certain period of time.

Employee handbooks also may create implied contracts that modify the employment at will doctrine. Often handbooks state that the company follows a progressive discipline policy and that employees may only be fired for "just cause" or after receiving warnings, notice, hearing, or other procedures. Policies such as this create an implied contract that require businesses to follow the progressive discipline policy before terminating a worker's employment, in absence of good cause.

Good Cause

The definition of "good cause" for terminating the employment of a worker varies from state to state. And businesses often define "good cause" in their policies. However, most states recognize the following as good cause to fire an employee without going through progressive discipline first:

- Theft;
- Fraud;
- Damage to company property;
- Being under the influence of illegal drugs or alcohol at work;
- Fighting;
- Threats against other employees or customers;
- Domestic violence;
- Having weapons on premises;
- Unethical behavior; and
- Willful or malicious misbehavior.

Poor performance also constitutes good cause for firing an employee. Employers need to be careful, however, to document the performance issues and to engage in progressive discipline when appropriate. If an employee has not been counseled that their performance is unsatisfactory, then the employee is more likely to bring a charge of wrongful discharge against the employer. Courts are more likely to rule that poor performance constitutes good cause when an employee has notice of the performance issue(s) and has a reasonable opportunity to fix them.

Discrimination Against a Protected Class Member

Anti-discrimination laws make it illegal to take adverse actions against a member of a protected class *based on* their membership in the class. A protected class is a group of people who are protected by laws that prohibit discrimination based on a personal characteristic, such as race, color, religion, gender, national origin, age or disability.

As discussed in Chapter 14, adverse actions include failure to hire, failure to promote, demotion, and termination of employment. That is not to say that someone who is a member of a protected class may never be fired. Rather, it is illegal to fire them *because of* their race, color, religion, gender, national origin, age or disability.

Violation of Public Policy

The public policy exception occurs when an employee is fired for:

- Refusing to perform an action that violates a law or public policy; or
- For exercising a legal right or advancing a public policy.

In other words, an employee can't be fired for refusing to do something illegal or doing something legal that the employer does not want done. For example, an employee cannot be fired for not falsifying reports, for refusing to testify falsely in court, for filing a workers' compensation claim, or for serving on a jury.

Whistleblowing

A **whistleblower** is an employee who reports the employer's illegal behavior to a governmental or law enforcement agency. Many different laws have whistleblower provisions that encourage people who have knowledge of illegal activity to report it without fear of retribution or losing their jobs. Whistleblower protections apply to good faith reports of wrongdoing, even if it turns out that the activity is not illegal. However, whistleblower protection does not usually protect employees who make reports that they either know, or should have known, do not include illegal activity.

13.3 Common Employment Law Torts

Employees may assert various tort claims against their employers. Tort claims are often decided on the basis of generalized duties of care rather than specific types of conduct prohibited by law. Tort claims vary state to state but most states recognize the following claims between employers and employees:

- Negligent hiring, retention, and supervision;
- Negligent investigation;
- Negligent infliction of emotional distress;
- Intentional infliction of emotional distress (also called outrageous conduct);
- Tortious interference with contract and/or prospective business advantage;
- Defamation (libel and slander);
- Invasion of privacy; and
- Fraud.

Torts are discussed in more detail in Chapter 9. However, it is important for businesses to understand that they owe their employees and managers a duty of care. If they violate that duty, then they may be subject to legal liability.

13.4 Wage and Hour Laws

The Fair Labor Standards Act (FLSA) is a federal law that was passed in 1938 that nationalized standards for pay, record keeping and child labor for businesses with two or more employees that engage in interstate commerce. The FLSA prohibits "oppressive child labor," which means that children under fourteen cannot work unless it is a family business, babysitting, newspaper delivery, entertainment, or agriculture. Fourteen and fifteen year olds are permitted to work limited hours after school in nonhazardous jobs, such as retail and restaurants. Sixteen and seventeen year olds may work unlimited hours in nonhazardous jobs.

Figure 13.2 FLSA Facts

The FLSA also provides for a national minimum wage and a standard forty hour work week. Under the FLSA, an employee who works more than forty hours is entitled to overtime pay. However, the Act provides exemptions to the overtime requirement. Employees who earn more than a certain amount and perform specific types of work are not entitled to overtime pay.

Exempt Categories to Overtime Pay under the FLSA

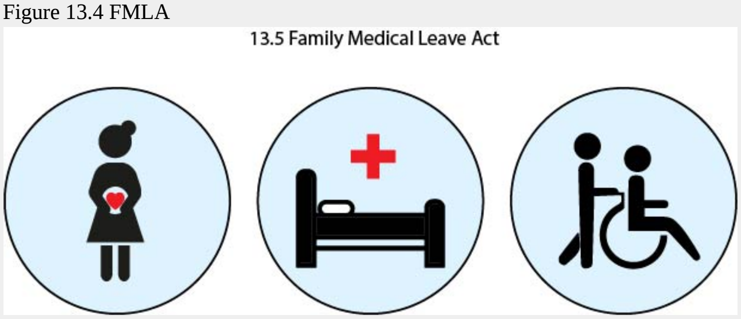
- Figure 13.3 Overtime under the FLSA

The Department of Labor (DOL) is charged with enforcing the FLSA and other federal wage and hour laws. As a general rule, federal wage and hour laws do not preempt state and local laws. Therefore, employers must comply with federal, state, and local laws regarding employees' wages. Many state and local governments have set a higher minimum wage than is required federally. Therefore, businesses must ensure that they comply with all wage and hour laws applicable to them.

13.5 Family Medical Leave Act

The Family Medical Leave Act of 1993 (FMLA) is a federal law that guarantees employees up to twelve weeks of unpaid leave each year for childbirth, adoption, or a serious health condition of their own or their immediate family member. Under the FMLA, a qualifying family member is a spouse, child, or parent. Siblings, grandchildren, and in-laws are not usually qualifying family members. The FMLA applies to businesses with at least fifty workers that engage in interstate commerce.

Figure 13.4 FMLA



An employee must work for the company for at least one year before being eligible to take leave under the FMLA. The Act requires that employees who take leave be allowed to return to the same or equivalent job with the same pay and benefits.

What constitutes a “serious health condition” is a heavily litigated issue. In general, a serious health condition requires continued treatment by a health provider and results in at least three days of incapacitation. Sometimes this aligns with recognized disabilities but it does not always. Also, a condition such as migraines may incapacitate people to varying degrees. To avoid legal liability, businesses should request appropriate documentation from medical providers rather than relying on a subjective determination of what constitutes serious health conditions.

13.6 Occupational Safety and Health Act

In a heavily industrialized society, workplace safety is a major concern. To that end, Congress passed the Occupational Safety and Health Act (OSHA) in 1970. The Act requires employers to provide a workplace that is free from recognized hazards likely to cause death or serious physical harm to employees.

Employers must comply with specific health and safety standards for their industry. For example, standards for restaurants differ from standards for health care providers or those for the mining industry. Employers must also keep records of all workplace injuries and accidents, and under some circumstances must automatically report them to the government. Employees may also report violations.

The Occupational Safety and Health Administration (also known as OSHA) is an agency within the Department of Labor that is responsible for enforcing the Act. The Agency may inspect workplaces to ensure they are safe and impose fines for violations of the Act. The Act also provides for criminal penalties when the violations are willful.

Figure 13.5 Common OSHA Violations

States and local governments also have a variety of health and safety laws and regulations. Therefore, businesses must ensure that they comply with all laws applicable to them.

13.7 Employee Retirement Income Security Act

In 1974, Congress passed the Employee Retirement Income Security Act (ERISA) to regulate employer-sponsored pension plans. ERISA requires employers disclose a large amount of information regarding the funding and vesting of pension plans. This Act was in response to fraudulent handling of pension plans that deprived employees of savings at the time of their retirement.

ERISA also applies to employer-sponsored medical, disability, and welfare benefit programs. Although the Act does not require employers to provide these types of benefits to their employees, if employers choose to do so, ERISA regulates what types of information employees are entitled to, along with their enforcement rights under the plans.

Figure 13.6 ERISA Areas of Regulation

13.8 Workers' Compensation Laws

Workers' compensation laws provide payment to employees for injuries incurred at work. In essence, workers' compensation is a type of no-fault insurance system that every state has. The intent of these laws is to provide quick and efficient delivery of disability and medical benefits to injured workers at a reasonable cost to employers.

Figure 13.7 Workers' Compensation

Workers' compensation is the exclusive remedy for injury claims. In other words, if an employee makes a workers' compensation claim, he or she may not sue the employer for his or her injury. The amounts provided for medical expenses and lost wages are often lower than an employee may receive in a successful lawsuit. However, the employee benefits from receiving payment upfront and does not have to risk the uncertain outcome of a lawsuit or pay attorney fees associated with litigation.

There are two exceptions to the exclusive remedy doctrine:

1. Intentional actions resulting in harm; and
2. Product liability claims against a manufacturer of a defective product.

State law varies with respect to types of workers who are excluded from coverage, as well as types and amount of compensation. All states cover medical costs, rehabilitation costs, and lost wages and benefits as a result of the injury.

In general, an employee may recover workers' compensation benefits when:

1. The employer has complied with the state's legal requirements;
2. The employee was acting in the course of his or her employment when injured;
3. The injury was proximately caused by his or her employment (i.e. the injury was not caused by off work activities); and
4. The employee did not intentionally injure himself or herself.

An employer may not retaliate against an employee who files a workers' compensation claim.

13.9 Unemployment Compensation

Every state provides an unemployment compensation insurance program that is funded by a tax paid by employers. To draw from the program, an employee must:

- Have worked for the employer for a certain amount of time;
- Not have quit without good cause;
- Not have been fired for egregious behavior;
- Be capable of work; and
- Actively look for a new job.

Unemployment compensation is meant to help workers who are subject to lay offs and reductions in force while they look for new employment. It is generally not available to employees who voluntarily leave a job and want to continue receiving income from their former employer.

States have different formulas for calculating unemployment compensation, but in general benefits are a percentage of past earnings and are available for a limited period of time.

13.10 Labor Relations

Labor law affects the working relationship of employees who are represented by a union in their workplace. A **union** is an organization formed to negotiate with employers, on behalf of workers collectively, about job-related issues such as salary, benefits, hours, and working conditions. Labor law essentially creates a framework for employers, employees, and unions to create a contract unique to that business for the purpose of regulating the employment relationship and resolving disputes.

National Labor Relations Act

The first unions in the United States were formed after the Civil War and began to flourish during the Industrial Revolution. In 1935, Congress enacted the National Labor Relations Act (NLRA) to provide workers three important rights:

1. The right to organize;
2. The right to collectively bargain; and
3. The right to strike.

The NLRA also prohibits employers and unions from engaging in **unfair labor practices**. Unfair labor practices by employers include:

- Interfering with protected employee rights, such as the right to self-organize;
- Discriminating against employees for union-related activities;
- Retaliating against employees who invoke their labor rights;
- Refusing to engage in collective bargaining;

- Interfering with the administration of a union; and
- Discouraging employees from forming or joining a union.

Unfair labor practices by unions include:

- Causing an employer to discriminate against an employee who is not a union member;
- Engaging in an illegal strike or boycott;
- Requiring an employer to hire more employees than necessary (called **featherbedding**);
- Coordinating a **secondary boycott** (an action against a third party who deals with the employer but has no direct contact with the union);
- Refusing to engage in collective bargaining; and
- Charging excessive dues.

Most states also have laws that make it illegal for an employer to mandate union membership as a condition of employment.

The NLRA also states that supervisors are not employees and do not have a right to join a union. **Supervisors** are individuals with the authority to make independent decisions on hiring, firing, disciplining, or promoting other employees.

Under the NLRA, a validly recognized union is the exclusive representative of the employees. This means that the union represents all the employees, even if a particular worker is not a member of the union or has not paid dues. The employer may not bargain directly either with employees or with another organization representing the employees.

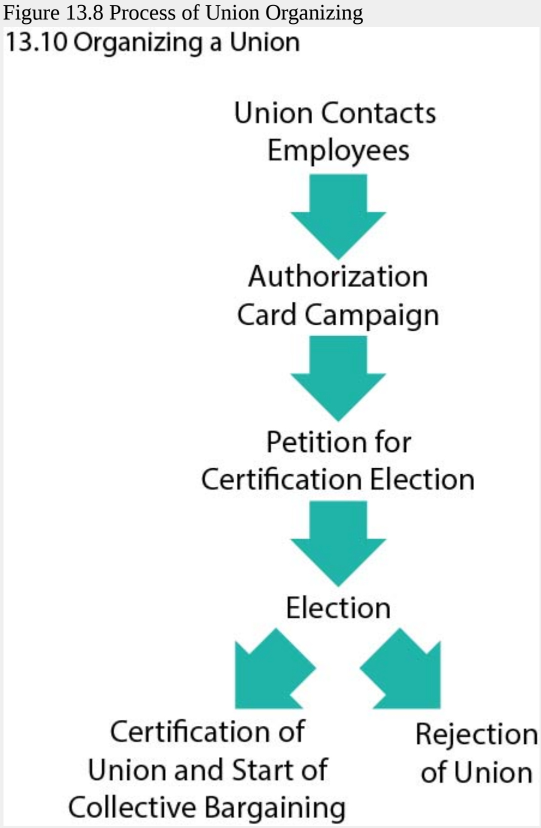
Unions have a **duty of fair representation**, which requires unions to treat all members fairly, impartially, and in good faith. A union may not favor some members over others and may not discriminate against members based on their membership in a protected class, such as race or gender.

Organizing a Union

A union trying to represent employees follows these steps:

1.	Campaign	Union organizers try to persuade employees to form a union. An employer may not restrict organizing discussions unless they interfere with business operations. An employer may present anti-union views but may not use threats or rewards to defeat a union drive.
2.	Authorization Cards	Union organizers ask employees to sign authorization cards stating that they want the union to represent them.
3.	Petition	If a union obtains authorization cards from 30% of the workforce, it may petition the NLRB for an election.
4.	Election	If more than 50% of the employees vote for the union, the NLRB designates it as the exclusive representative of the employees.

Figure 13.8 Process of Union Organizing



Collective Bargaining

Once a union is formed, the employer and union must negotiate to create a new employment contract that regulates employment conditions called a **collective bargaining agreement (CBA)**. The **bargaining unit** is a group of employees authorized to engage in collective bargaining on behalf of all of the employees of a company or an industry sector.

The NLRA allows the parties to bargain almost any subject they wish but it *requires* them to bargain wages, hours, and other terms and conditions of employment. Conditions of employment include:

- Benefits;
- Retirement benefits;
- Order of layoffs and recalls;
- Production quotas;
- Work rules, such as safety practices; and
- Onsite food service and prices.

The parties are not required to reach an agreement but they are required to bargain in good faith. In other words, they must meet with open minds and make a reasonable effort to reach a contract.

Concerted Activity

Concerted activity is an action by employees concerning wages or working conditions. It is action taken by members of a union to gain a bargaining advantage. Concerted activity is protected by the NLRA and cannot be used as a basis for disciplining or discharging an employee.

The most common forms of concerted activity are strikes and picketing. A **strike** is an organized cessation or slowdown of work by employees to compel the employer to meet the employees' demands. The NLRA protects the employees' right to strike when:

- The parties are unable to reach a CBA;
- The employer engages in an unfair labor practice; or
- The employer is considering sending work elsewhere.

However, a strike is illegal when:

- The union does not provide the employer with sixty days notice (when issue is modifying or terminating a CBA);
- The union represents public employees;
- The union engages in a **sit-down strike**, in which employees stop working but physically block replacement workers from taking their places; and
- The union engages in **partial strikes**, in which employees strike intermittently to disrupt operations but prevent the employer from hiring replacement workers.

When unions go on strike, employers have the right to hire replacement workers to keep the business operating. If the union engages in an **economic strike** to obtain increased wages and benefits, the employer may hire permanent replacement workers. When an economic strike ends, the employer is under no obligation to lay off replacement workers to allow strikers to return to work. However, if and when the employer hires additional employees, it may not discriminate against the employees who went on strike. If the union engages in an **unfair labor practices strike** to protest an employer's unfair labor practice, union members are entitled to their jobs after the strike ends.

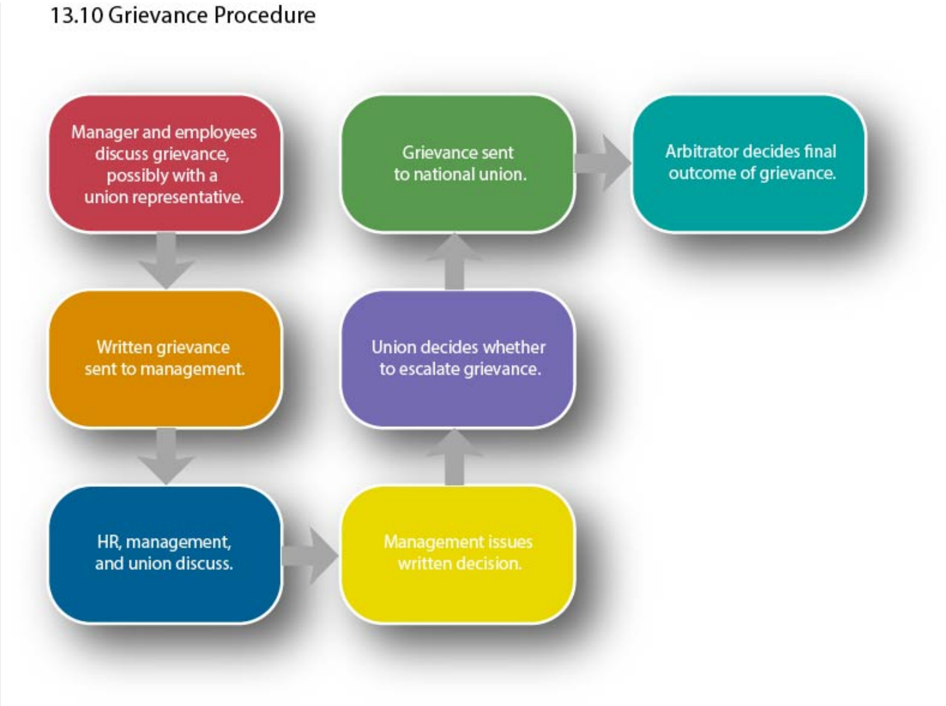
Picketing is the demonstration by one or more employees outside a business to protest its activities or policies and to pressure it to meet the protesters' demands. The power of picketing is to publicize a labor dispute and influence the public to withhold business from the employer. Picketing is usually lawful, as long as the picketers do not prevent other employees, replacement workers, or customers from entering the business.

Employers have their own form of legal pressure on union members called a lockout. A **lockout** occurs when an employer closes a business or prevents workers from entering the premises and earning their paychecks because of a labor dispute. By withholding work and wages, the employer tries to pressure the union to bargain less aggressively. Most lockouts are legal.

Grievance Procedure

One of the main benefits to union members is that they are able to participate in a grievance procedure when issues at work exist. A **grievance** is a formal employee complaint about a violation of a workplace policy or the collective bargaining agreement between the union and employer.

Figure 13.9 Grievance Procedure



The **grievance procedure** defines the rules and process for documenting, presenting, and resolving workplace disputes. The exact steps are usually defined in the collective bargaining agreement. However, most grievance procedures start with a discussion between the employee and his or her manager, often with a union representative present. Issues often are resolved informally at this step.

If the issue is not resolved, then the employee may write a formal grievance, which is then sent to management. After receiving a written grievance, management of the company investigates and discusses how to address the issues contained in the grievance. This process often involves the human resource department, union representatives, and consultation with legal counsel.

Management will then issue a written decision. If the union is not satisfied with the company's response, it may decide to refer the grievance to the national union. If the national union decides to pursue the issue further, then arbitration before the NLRB or a private arbitrator often occurs.

13.11 Concluding Thoughts

Employment and labor laws regulate the employer-employee relationship. Although most laws are written to provide rights to employees, the laws try to balance the need of employers to run a profitable business with the right of employees to fair treatment. While the law does not always strike the right balance, it is helpful to understand that employers retain a lot of control in their day-to-day business operations and in establishing the business culture.

13.1: Introduction

13.2: Employment At Will

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14: Anti-Discrimination Law

14.1 Introduction

LEARNING OBJECTIVES

1. Understand the primary federal anti-discrimination laws.
2. Learn the procedure for bringing and defending against discrimination complaints.
3. Explore how businesses can protect themselves from discrimination claims.

The Civil Rights Movement of the 1960s resulted in several important federal laws that addressed discrimination. The first was the Equal Pay Act of 1963, which requires equal pay for equal work, regardless of the worker’s gender. Title VII of the Civil Rights Act of 1964 is probably the most well-known of the civil rights legislation. Title VII prohibits employment discrimination on the basis of race, color, religion, gender and national origin. Since the 1960s, more laws have been passed to refine what constitutes discriminatory practices and expand coverage to additional groups, such as people with disabilities.

Figure 14.1 Participants in the 1963 March on Washington

It is important for businesses to know and comply with these laws so they are not liable for discriminating against their employees, customers, and members of the public. State and local governments may pass laws that expand or provide protections to additional groups but they cannot reduce protections found in federal law.

Type of Discrimination	Federal Anti-Discrimination Laws
Race	Title VII of the Civil Rights Act of 1964
Color	Title VII of the Civil Rights Act of 1964
Religion	Title VII of the Civil Rights Act of 1964
National Origin	Title VII of the Civil Rights Act of 1964; Immigration Reform and Control Act of 1986
Gender	Equal Pay Act of 1963; Title VII of the Civil Rights Act of 1964; Pregnancy Discrimination Act of 1978

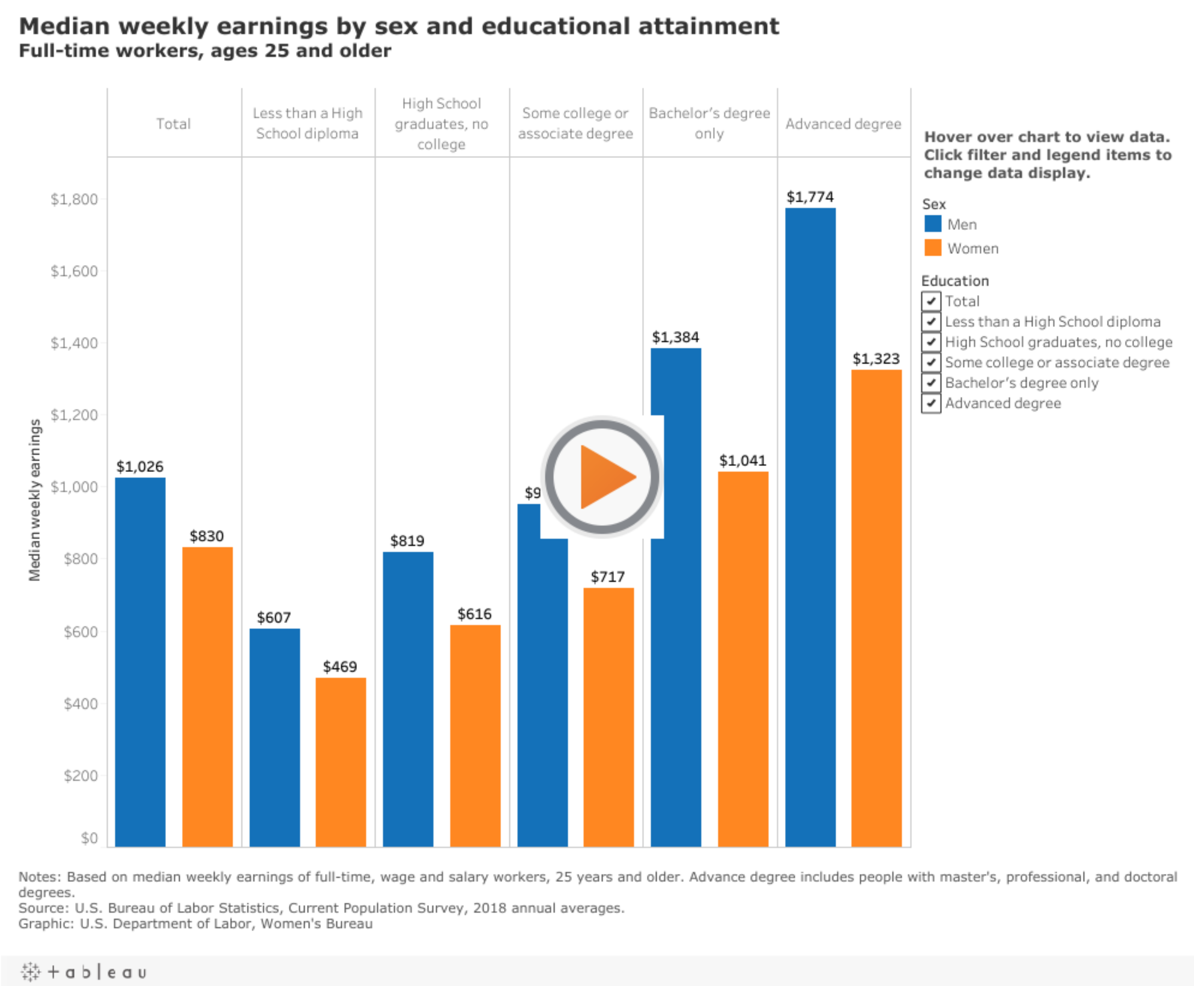
Age	Age Discrimination in Employment Act of 1967
Disability	Americans with Disabilities Act of 1990; Americans with Disabilities Amendments Act of 2008
Genetic Information	Genetic Information Nondiscrimination Act of 2008

Counselor's Corner We live in a multicultural society and our anti-discrimination laws are intended to address inequality in employment. While not perfect, they have addressed the some of the most blatant discriminatory practices. However, *all* employers (even those who see themselves as having "good intentions") need to review their practices to ensure that they are not perpetuating systemic discrimination against protected classes of people. Although this may seem like a backburner issue to some employers, it will help protect them from legal liability (which is costly) and send a positive message to their employees about how they value them (which is invaluable). ~ LaTeesha S., attorney

14.2 The Equal Pay Act of 1963

The Equal Pay Act of 1963 seeks to eliminate the wage gap between men and women. In 1963, women earned roughly fifty-nine cents for every dollar men earned. In 2019, that number increased to seventy-nine cents. The Equal Pay Act requires employers to 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 bonuses.

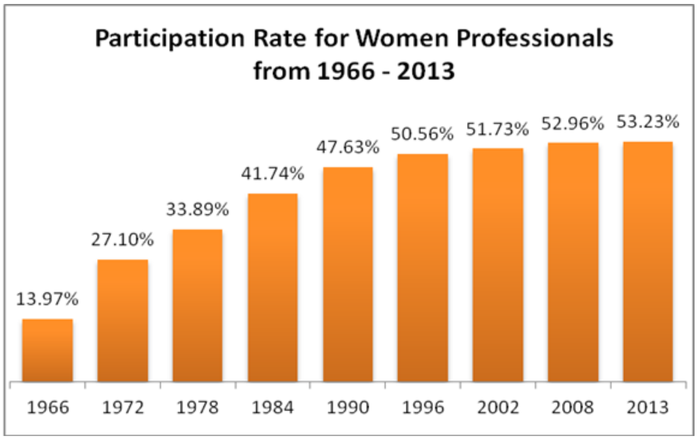
Figure 14.2 Median Weekly Earnings by Gender and Educational Level from US Department of Labor



Victims do not need to file a complaint with the Equal Employment Opportunity Commission (EEOC) but may file an equal pay claim in federal court, as long as they do so within two years after learning of the inequality in pay or benefits. Victims typically also pursue Title VII claims at the same time they pursue Equal Pay Act claims.

The Equal Pay Act is 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 equal pay for substantially equal work. A common problem occurs when women voluntarily leave the workforce to raise children. This can result in a challenging comparison between a woman's experience for pay purposes and her male counterparts, who may not have an interruption in their careers.

Figure 14.3 Participation Rates for Women Professionals from Equal Employment Opportunity Commission



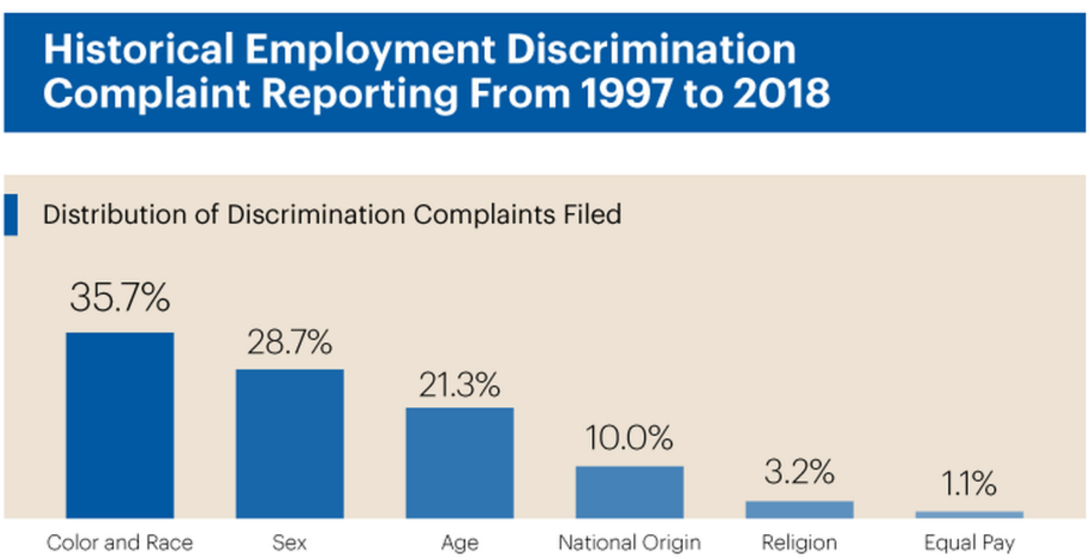
14.3 Title VII of the Civil Rights Act of 1964

The Civil Rights Act of 1964 has broad significance for all racial minorities, religious organizations, and women. The bill has several provisions, but the most important for businesses is known widely as "Title VII." It applies to employers with more than fifteen employees. Its aim is to eliminate discrimination on the basis of:

- Race;
- Color;
- Religion;
- Gender; and
- National origin.

Discrimination on any of these bases is illegal. These acts may be a refusal to hire, a failure to fully compensate, a failure for opportunities for advancement, a demotion, a temporary layoff, a termination of employment, or any other term or condition of employment.

Figure 14.4 Employment Discrimination Claims Made to the Equal Employment Opportunity Commission

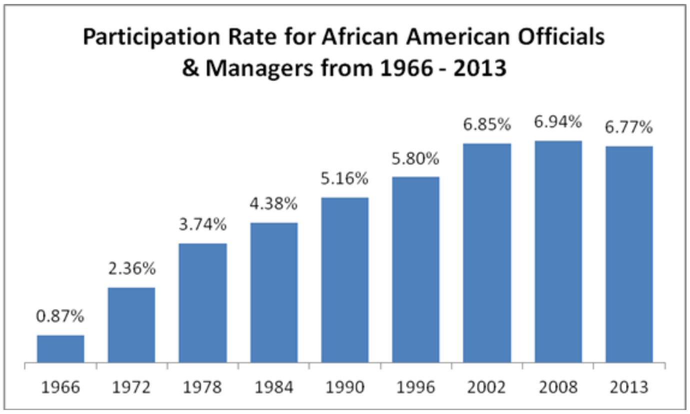


Race and Color

Race discrimination involves treating someone unfavorably because he or she is of a certain race or because of personal characteristics associated with race, such as hair texture, skin color, or certain facial features. Color discrimination involves treating someone unfavorably because of skin color or complexion.

Race and color discrimination also can involve treating someone unfavorably because the person is married to, or associated with, a person of a certain race or color. Race and color discrimination can occur within the same racial group.

Figure 14.5 Participation Rates for African Americans Professionals from Equal Employment Opportunity Commission



Religion

The prohibition against religious discrimination protects anyone who has sincerely held religious or moral beliefs. Therefore, Native American tribes are protected, as well as major religions such as Buddhism, Christianity, Hinduism, Islam, and Judaism. In general, employees cannot be required to participate in religious activities as a condition of employment, unless the place of employment is a church, synagogue, mosque, or temple.

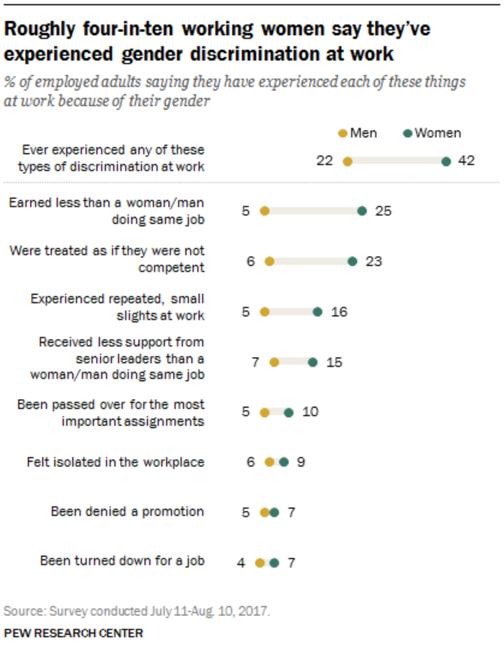
Employers must reasonably accommodate an employee’s religious beliefs or practices as long as it does not cause an undue hardship on the employer’s operation of its business. Typically, this involves being flexible in schedule changes and leaves for sabbath observance or religious holidays. Issues of dress and appearance are often grounds for charges of religious discrimination. For example, if a Muslim woman wears a *hijab*, or traditional headscarf, then she should be permitted to do so unless it places an undue hardship on business operations.

Gender

The prohibition on gender 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. However, an example of a legitimate BFOQ is hiring female security officers to monitor women’s changing areas for loss prevention in retail stores.

Gender discrimination also includes making stereotypical assumptions about women simply because they might be the primary caregiver to children at home. If there are two equally qualified 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.

Figure 14.6 Pew Research Center Results Regarding Gender Discrimination at Work



In 2019, unmarried childless women earned 95 percent of what men did, while married mothers earned 75 percent (averaging to 79 percent as discussed above). This discrepancy has led to an increase in **family responsibility discrimination** claims under Title VII. This includes claims that mothers are given less-appealing assignments than fathers based on misconceptions about being less qualified or lacking commitment to the job.

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

Gender discrimination can also take the form of workplace sexual harassment. Courts have generally recognized two forms of sexual harassment. The first, known as **quid pro quo**, involves asking for sexual favors in return for job opportunities or advancement. Courts reason that if a male worker asks a female worker for sex in return for favorable treatment, it is because that worker is female, and therefore a Title VII violation has occurred. If a supervisor fires a subordinate for breaking up with him or her, then quid pro quo harassment has taken place. The second is **hostile work environment**, which is discussed in more detail below.

National Origin

Discrimination on the basis of national origin involves treating workers unfavorably because of where they are from (specific nation 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.

The protected class of national origin means that it is illegal to discriminate against noncitizens. Therefore, employers should not ask job applicants about their nation of origin. Instead, they are permitted to ask whether the applicant is authorized to work in the US. If they applicant answers “yes,” then the employer cannot ask for evidence of authorization until the applicant is hired and completes the Employment Eligibility Verification (I-9) Form.

Title VII creates only five protected classes. Other characteristics, such as obesity, attractiveness, and political affiliation, are not protected classes. Note too that Title VII does not prohibit all discrimination. Employers are free to consider factors such as experience, business acumen, personality, 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.

Prohibited Activities

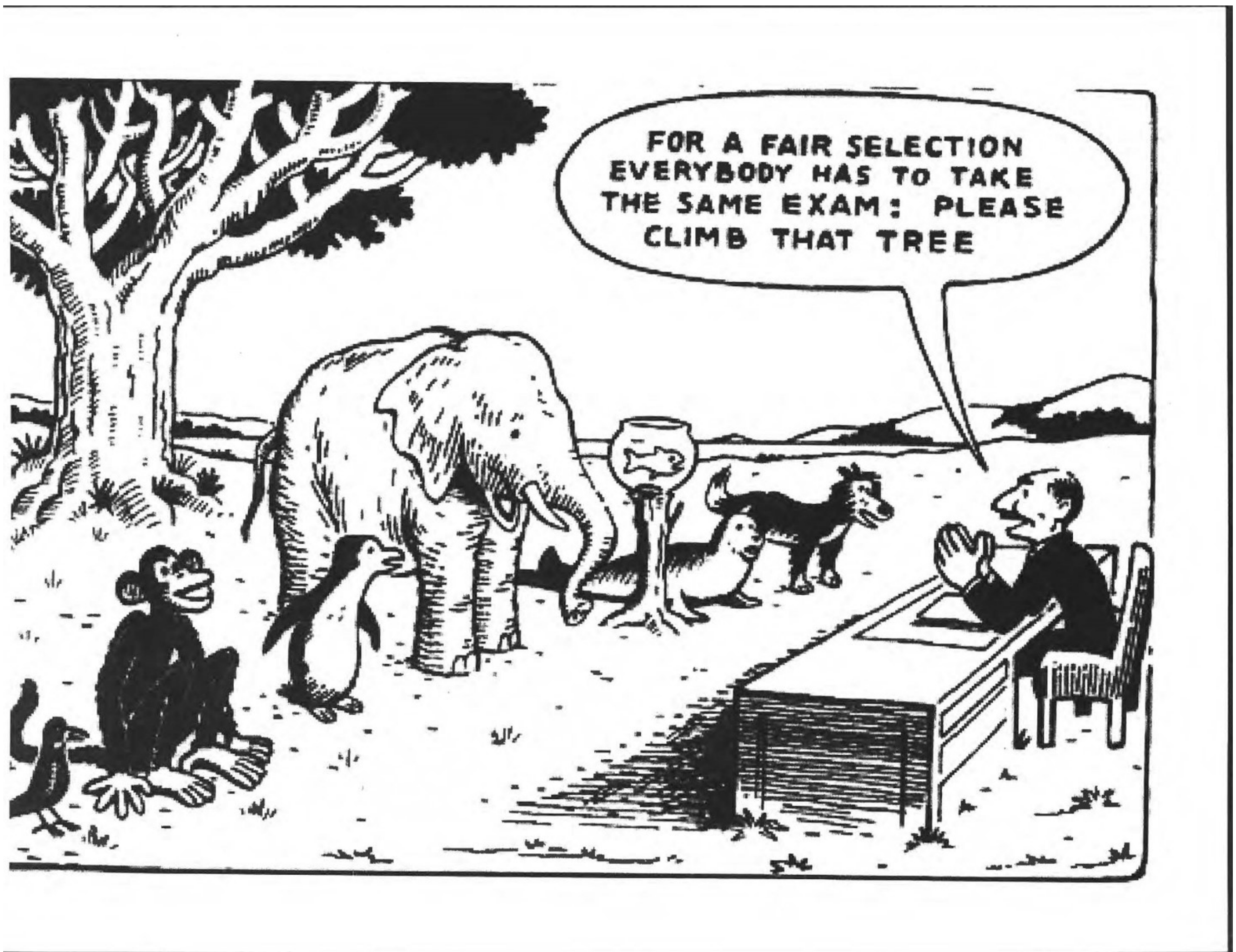
There are four types of illegal activities under Title VII:

1. Disparate Treatment;
2. Disparate Impact;
3. Hostile Work Environment; and
4. Retaliation.

To prove a **disparate treatment** case, a plaintiff must show that he or she was treated differently *because of* his or her race, color, religion, gender or national origin. In other words, disparate treatment is intentional discrimination. Winning a disparate treatment case is hard because it is unusual for a defendant to say explicitly that his or her intention is discriminatory. Evidence of discriminatory intent is often inferred through someone's conduct. For example, a hiring manager refuses to hire women because he does not want to deal with maternity leave requests would be evidence of disparate treatment.

Disparate impact, on the other hand, applies when a rule or policy is not discriminatory on its face but negatively impacts a protected group when it is applied. In other words, disparate impact is unintentional discrimination. Business policies that raise suspicions of disparate impact include educational qualifications, written tests, intelligence or aptitude tests, height and weight requirements, credit checks, 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.

Figure 14.7 Disparate Impact Cartoon



Proving a disparate impact case is not easy for victims of discrimination. It is not enough for the employee to use statistics alone to show a policy or practice has a disparate impact on the victim's protected class. Victims must show that they were harmed from the discriminatory practice.

Employers also violate Title VII if they have a **hostile work environment** towards people in a protected category that affects their ability to work. These cases often involve allegations where a company or employees try to get a member of a protected group to quit through name calling, undesirable work assignments, slurs, and threats. Employers are liable for hostile work environment claims if the victim suffered a "tangible employment action" such as a demotion, undesirable reassignment, or termination of employment. Even if the victim did not suffer a tangible employment action, an employer may be liable unless it can prove (1) it used reasonable care to prevent and correct the inappropriate behavior, and (2) the victim unreasonably failed to take advantage of the company's complaint procedures.

Hostile work environment claims often involve allegations of constructive discharge. **Constructive discharge** occurs when an employer makes the employee's working conditions so intolerable that a reasonable employee would feel compelled to quit. Constructive discharge claims recognize that employees should not be forced to stay in situations that risk their physical, mental, and emotional safety.

Title VII also prohibits acts of **retaliation** against anyone who complains about, or participates in, any employment discrimination complaint. Employers need to be very careful about this provision, because while the employer may be innocent of the first charge of discrimination, taking any subsequent action after an employee has complained can be a separate charge of discrimination. Once an employee has made a complaint of discrimination, it is very important that the employer not alter any condition of his or her employment until the complaint has been resolved. Similarly, if a witness takes part in an investigation or hearing of another employee's complaint, the witness could also bring charges of retaliation.

Bona Fide Occupational Qualification

The law does, however, allow discrimination on the basis of religion, gender, and national origin if a **bona fide occupational qualification (BFOQ)** reasonably necessary for normal business operations exists. 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. Since BFOQ discrimination extends to national origin, a producer casting for a role that specifically calls for a Filipino actor can legally restrict hiring to Filipinos only.

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, airlines cannot refuse to hire men even if surveys show customers prefer female flight attendants.

14.4 Enforcement of Title VII

Equal Employment Opportunity Commission

The Civil Rights Act of 1964 is a federal law, but it does not give victims of discrimination the immediate right to file a federal lawsuit. Instead, the Act created a federal agency, the Equal Employment Opportunity Commission (EEOC) to enforce civil rights in the workplace. The EEOC publishes guidelines to assist businesses in deciding what employment practices are lawful. The EEOC also investigates complaints filed by workers who believe they are victims of unlawful discrimination. If the EEOC believes that unlawful discrimination has taken place, the EEOC can file charges against the employer.

Employees must file a Title VII charge with the EEOC before going to court. If the EEOC investigates and decides not to pursue the case any further, the EEOC will 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. If employees wait beyond 180 days, their claims will be dismissed.

In 2009, the Lilly Ledbetter Fair Pay Act clarified that discriminatory pay decisions occur every time unequal compensation is paid and the statute of limitations begins again on the date of each unequal paycheck. Therefore, plaintiffs have 180 days from the time they receive a discriminatory paycheck to file a complaint with the EEOC.

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 continuing any 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. In cases of severe or reckless discrimination, punitive damages are also available.

EEOC Procedure

After receiving the charge, the EEOC will investigate the allegations. If there is sufficient proof of discrimination, the EEOC may (1) help the parties reach a settlement; (2) impose sanctions; or (3) prosecute the case in federal court. The EEOC's investigative and enforcement powers are broad.

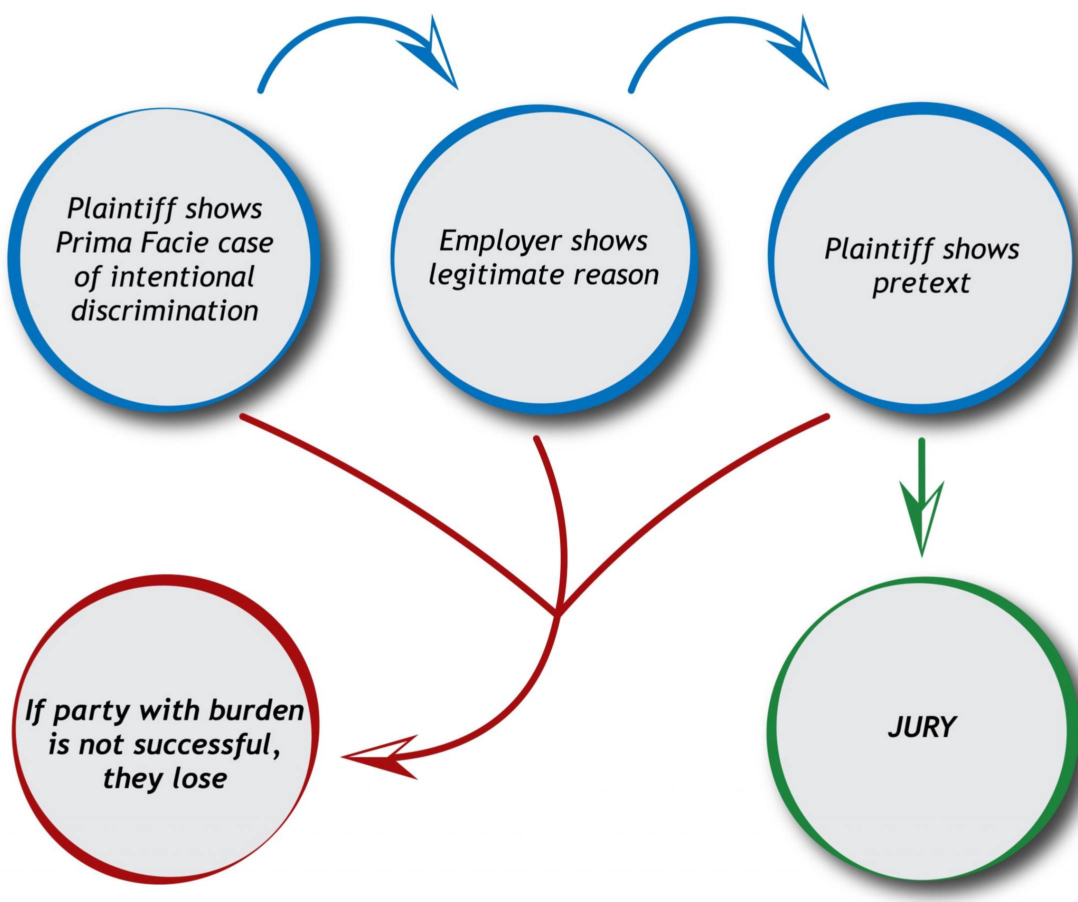
When filing a complaint, the plaintiff must show a *prima facie* case of discrimination. This means that "on first look," the plaintiff has evidence that the defendant discriminated against him or her based on membership in a protected class. The plaintiff is not required to prove discrimination at this stage. Instead, the plaintiff must show only a presumption that discrimination occurred.

The defendant then files a response and may present evidence that its decision was based on a legitimate, non-discriminatory reason or business necessity. For example, an employee was fired for poor performance rather than membership in a protected class.

After the defendant presents its case, the plaintiff must show that the defendant's reason is pretext. In other words, the reason the defendant gave was a "cover" for discrimination. In disparate impact cases, the plaintiff may show that less discriminatory rules would achieve the same result.

The case is investigated and decided by the EEOC hearing officer. The officer will issue either a finding on the charge or a notice of the right to sue, after which an employee has 180 days to file a discrimination complaint in federal court.

Figure 14.8 Burden of Proof in Equal Employment Opportunity Commission Charges



Affirmative Action

To correct past mistakes in treatment of women and minorities, many businesses go beyond being equal opportunity employers by adopting affirmative action programs. Businesses are not legally required to undertake affirmative action programs, but many do. Businesses 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 non-beneficiaries.

Affirmative action plans can be tricky to administer because Caucasian Americans can also be the victims of race discrimination, which is often called **reverse discrimination**. The provisions of Title VII are meant to protect all individuals from race discrimination.

The EEOC will take into consideration if a defendant’s actions are part of an affirmative action program. However, businesses may still be liable for discrimination even if they adopt an affirmative action program. Therefore, businesses should be careful that they are not adopting a program that results in disparate impact claims from other protected groups.

14.5 The Age Discrimination in Employment Act of 1967

The Age Discrimination in Employment Act of 1967 (ADEA) makes it illegal to discriminate against workers over the age of forty. It does not protect younger workers so an employer may favor an older worker over a younger worker. The ADEA applies to any employer with over twenty workers, including state governments. 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 under the same conditions. 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 may discriminate against older workers if there is a bona fide occupational qualification 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.

In 2005, the Supreme Court held that the disparate impact theory can apply to age discrimination cases. 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.

14.6 The Americans with Disabilities Act of 1990

The Americans with Disabilities Act of 1990 (ADA) and the Americans with Disabilities Amendments Act of 2008 (ADAA) expand the promise of equal opportunity in the workplace to cover persons with disabilities. It is illegal for employers with fifteen or more employees to discriminate against “qualified individuals with disabilities.”

The ADA only applies to the qualified disabled. To be qualified, the individual must meet the legitimate skill, experience, education, or other requirements for the position he or she is seeking and be able to perform the “essential functions” of the job without reasonable accommodation. In other words, the first step an employer must take is to define what the essential functions of the job are, and then see if a disabled individual who has applied for the job meets the requirements for the job and can perform those essential functions. Obviously, someone who is legally blind will not be permitted to be a bus driver or airline pilot under this test.

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.

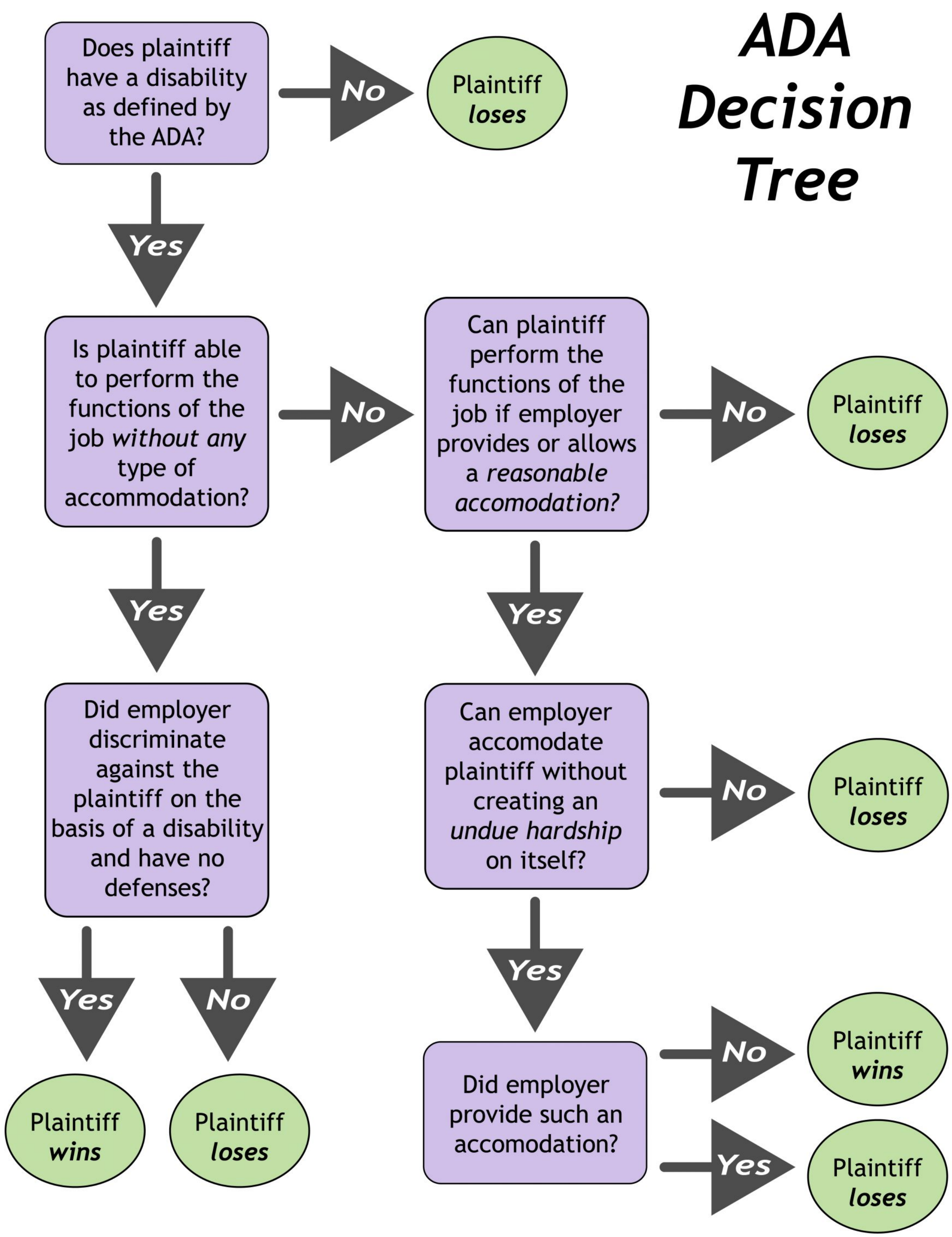
The ADA makes it illegal for an employer to require a job applicant take a medical exam before an employment offer is made. However, after a job offer has been made, applicants can be asked to take medical and drug exams. Tests for illegal use of drugs, any time during employment, are permitted under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

One of the hardest challenges is 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.

Consider a person being actively treated for cancer. During the treatment, many major life activities may be substantially limited, so the person is disabled. However, if a major life activity is not limited but the person loses his or her hair as a result of chemotherapy, he or she may be “regarded” as having an impairment, which makes him or her disabled under the ADA. An employer who purposefully refuses to hire a qualified job applicant with no hair because the employer believes the applicant has cancer (regardless of whether the cancer is active or in remission) is therefore violating the ADA. Finally, if the cancer patient recovers fully and has no physical sign of cancer, that patient is still considered protected by the ADA because he has a “record” of a qualifying disability.

Employers must provide reasonable accommodations to any disabled worker who asks for it. A **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; reassigning the worker to a vacant position; purchasing special equipment or software; providing e-readers; or making an exception to an employment policy. Employers do not have to undertake reasonable accommodation if doing so would cause them undue hardship, meaning it would require significant difficulty or expense, or significantly alter the nature or operation of the business. Among factors to be considered in whether an accommodation would pose an undue hardship are the cost of the accommodation as well as the employer’s size and financial resources.

Figure 14.9 Americans with Disability Act Decision Tree



14.7 Genetic Information Nondiscrimination Act of 2008

In 2008, Congress passed the Genetic Information Nondiscrimination Act (GINA) to protect individuals from adverse decisions based on their genetics. Under GINA, employers may not require genetic testing, or use information about genetics (including family medical history) as a factor in hiring, promoting, demoting, or firing employees. This includes if an employee is a caretaker for someone with a genetic disorder. Health insurers cannot use genetic information when making coverage and premium decisions. Finally, an employer wellness program cannot require participants to answer questions about their family medical history.

14.8 Concluding Thoughts

Anti-discrimination laws are important for businesses to understand and follow. State and local laws may expand protections and identify more protected classes. Therefore, it is important for businesses to research all levels of anti-discrimination laws that apply to them to ensure they are not liable for discrimination against their employees, customers, and members of the public.

The 1964 Civil Rights Act is an important law that affects most 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, gender, and national origin. Some forms of discrimination on the basis of religion, gender, or national origin are permitted if a bona fide occupational qualification exists. The Equal Employment Opportunity Commission (EEOC) investigates charges of illegal workplace discrimination. These charges must be filed by workers within 180 days of the alleged discriminatory act occuring.

The EEOC's investigation and enforcement powers are broad. Both parties have an opportunity to present evidence and argue their case to the EEOC. Filing a charge with the EEOC is required before filing a lawsuit alleging violations of Title VII in federal court.

The Americans with Disabilities Act prohibits employment discrimination against the qualified disabled and prohibits pre-employment 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.

14.1: Introduction

14.2: The Equal Pay Act of 1963

14.3: Title VII of the Civil Rights Act of 1964

14.4: Enforcement of Title VII

14.5: The Age Discrimination in Employment Act of 1967

14.6: The Americans with Disabilities Act of 1990

14.7: Genetic Information Nondiscrimination Act of 2008

14.8: Concluding Thoughts

CHAPTER OVERVIEW

15: Agency

Learning Objectives

- Know the basic principles of an agency relationship.
- Identify the different duties principals and agents owe each other.
- Understand the consequences of legal liability for principals regarding an agent's actions.

15.1: Introduction

Fundamentally, the principles of agency hold individuals and businesses liable for the acts of others. For example, if an employee uses a racial slur against a customer, the business is liable for that employee's discriminatory act. Likewise, if an agent signs a contract in the name of a business, that business may be bound by the terms of the contract.

Agents cannot give themselves power without the express or implied authority of the principal. Once an agency relationship is formed, agents and principals owe each other certain duties. This ensures fair dealings between them and gives third parties some assurance regarding their rights.

Counselor's Corner Agency is not a sexy area of the law. Most people don't give much thought about it. But I often see cases in my courtroom where people and businesses are liable for the acts of their agents. It doesn't matter if you didn't know the person was legally your agent. You are still responsible for their actions under the law. While there is no way to prevent all mistakes and bad behavior of others, the best way you can insulate yourself from liability of an agent is to surround yourself with people who have integrity. If your grandmother wouldn't approve of them, then you shouldn't work with them. ~Christopher W., judge

15.2: The Agency Relationship

An agency relationship is created when one person or entity agrees to perform a task for, and under the direction of, another individual or entity. An **agent** is the person who is authorized to act for or in place of another. A **principal** is the person who authorizes another to act on his, her, or its behalf as an agent.

Agency is a fiduciary relationship created by express contract or implied actions, in which the agent has the authority to act on behalf of the principal and legally bind the principal to third parties.

A **fiduciary relationship** is a relationship in which one person is under a duty to act for the benefit of the other on matters within the scope of the relationship. Fiduciary relationships require trust, good faith, and acting in the best interest of the other. In fiduciary relationships, the law requires the fiduciary to act with the highest duty of care. This means that the fiduciary must put the interests of the other party before their own. Examples of fiduciary relationships include doctor-patient, attorney-client, accountant-client, trustee-beneficiary, and guardian-child. An agent is also a fiduciary of a principal.

Types of Principals

There are three types of principals, which are described from the perspective of a third party: disclosed, partially disclosed, and undisclosed.

A **disclosed principal** is a principal whose identity is revealed by the agent to a third party. These are the most common types of principals. For example, employees work for a disclosed principal when they are on the employer's premise, wear a name badge or uniform identifying the employer, or answer the phone by identifying the employer's name.

A **partially disclosed principal** is a principal whose existence, but not actual identity, is revealed by the agent to a third party. In other words, a third party knows that the agent represents a principal but does not know the identity of the principal. For example, a realtor in Aspen may represent celebrities and wealthy individuals who want to purchase property but do not want the paparazzi to publicize the information.

An **undisclosed principal** is a principal whose identity is kept secret by the agent. Often third parties do not realize that an agency relationship exists and believe that the agent is working on his or her own behalf. Undisclosed principals occur when the identity of the principal can lead to increased purchase prices, unwanted publicity, and security concerns.

Types of Agents

An agent is someone who is authorized to act on behalf of a principal. Because there is a variety of authority that a principal can grant an agent, there are many different types of agents. In general, agents are described as either general or special. **General agents** have the authority to transact all the principal's business of a particular kind or in a particular place. General agents often include partners, managers, factors and brokers. **Special agents**, in contrast, only have the authority to conduct a particular transaction or to perform a specific act. Special agents often include realtors, athlete's agents, and employment recruiters.

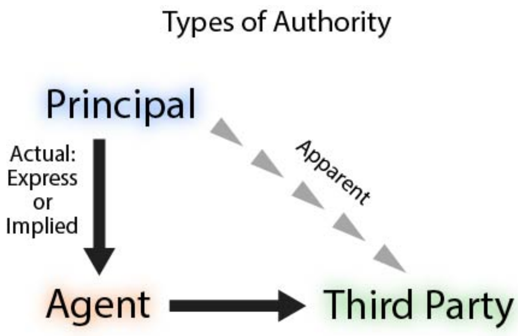
Some of the most common business agents include:

Agent	Description
Broker	Receives a commission to make contracts with third parties on behalf of a principal
Business agent	Has general power involving the exercise of judgment and discretion, such as a manager or officer
Factor	Receives and sells goods or property for a commission
Forwarding agent	Receives and ships goods for a principal
Independent contractor	Exercises independent judgment on the means used to accomplish the result demanded by principal
Local agent	Acts as a representative to transact business within a specified area
Ordinary agent	Acts under the direction and control of the principal, such as an employee
Process agent	Authorized to accept legal service of process on behalf of the principal
Registered agent	Authorized to accept legal service of process for a corporation in a particular jurisdiction

Types of Authority

Authority is the right or permission to act legally on another's behalf. In general, authority can be either actual or apparent. **Actual authority**, sometimes called real authority, occurs when a principal intentionally confers authority on an agent. Actual authority can be either express or implied. **Express authority** is authority given by an express agreement, either orally or in writing. **Implied authority** is authority granted to the agent as a result of the principal's conduct.

Figure 15.1 Types of Authority



Apparent authority is authority that a third party reasonably believes an agent has, based on the third party's dealings with the principal. If a principal's words or actions lead others to believe that he or she gave authority to someone else, then the principal is held accountable even if no authority was actually given to the agent. For example, if a principal fails to give notice that an agent is no longer working for the principal, the agent may still bind the principal through apparent authority when dealing with third parties.

To constitute apparent authority, three elements must be met:

1. The principal's words or actions lead others to believe the agent has authority;
2. A third party reasonably relies on the principal's words or actions; and
3. The third party is injured.

Sometimes an agent acts without authority. If a disclosed principal likes what an agent does, even if done without authority at the time, the principal can still benefit from the agent's actions. **Ratification** occurs when a disclosed principal adopts or confirms a contract entered into on his or her behalf by an agent who did not have authority to act. Unlike apparent authority, the third party does not have to be injured. Rather, ratification allows principals to enter into contracts for their benefit. Ratification is an "all or nothing" doctrine that prevents principals from ratifying only part of the contract or renegotiating its terms.

15.3: Duties of Agents and Principals

Because they are in a fiduciary relationship, agents and principals owe each other specific duties. While the duties are similar in nature, there are differences based on their roles.

Duties of Agents

Figure 15.2 Duties of Agents

Agents are fiduciaries of principals and so they are required to act with the highest duty of care. In particular, agents owe principals the following duties:

Duty	Description
Account	Agent must keep proper records to account for all principal's money and property given to agent
Care	Agent must act reasonably, in good faith, and avoid negligence at all times
Inform	Agent must inform principal of all material facts that affect principal's interests
Loyalty	Agent cannot engage in any dealings that compete or interfere with the principal's business or interests
Obedience	Agent must obey all principal's instructions within scope of agency unless they are illegal or unethical
Protect confidential information	Agent cannot use or disclose principal's confidential information

If an agent breaches a duty owed to the principal, the principal has three available remedies:

1. The principal may recover damages the breach has caused;
2. The principal may receive any profit the agent received as a result of a breach of the duty of loyalty; and
3. The principal may rescind a transaction when the duty of loyalty is violated.

Duties of Principals

Principals also owe duties to agents as part of the fiduciary relationship. These duties are:

Duty	Description
Compensation	Principal must pay agent for work performed
Honesty	Principals cannot deceive agents about the nature and scope of the work they are to perform
Indemnification	Principal must hold agent harmless and free from legal liability for actions properly taken on principal's behalf
Loyalty	Principal cannot engage in any dealings that prevent agent from performing agency tasks
Reimbursement	Principal must reimburse agent for money reasonably expended on behalf of principal

Figure 15.3 Duties of Principals

If a principal breaches a duty owed to the agent, the agent has two available remedies:

1. The agent may recover damages the breach has caused; and
2. The agent may terminate the agency relationship.

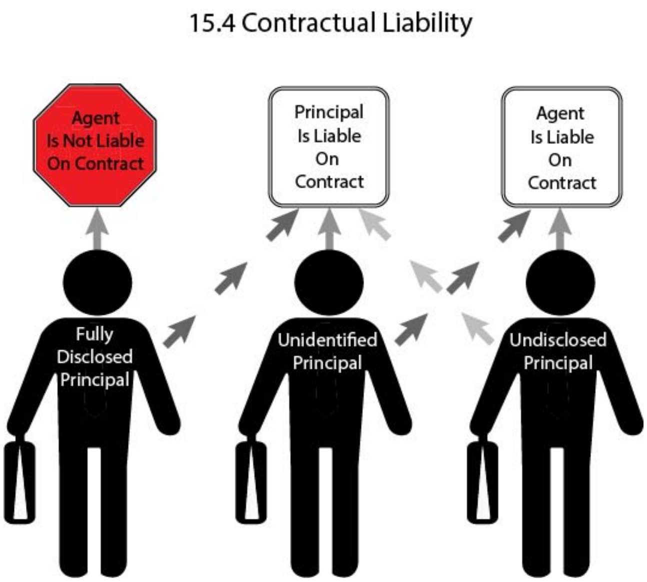
15.4: Liability to Third Parties

An agency relationship affects liability to third parties. The scope of liability depends on the type of principal involved, the type of authority involved, and the nature of the dispute.

Contractual Liability

A principal is always liable on a contract if the the agent had authority. However, the agent's liability on a contract depends on how much the third party knows about the principal. Disclosure, when allowed by the principal, is the agent's best protection against legal liability.

Figure 15.4 When Agents are Liable on Contracts



An agent is not liable for any contracts he or she makes with authority on behalf of a fully disclosed principal. Therefore, if a third party knows the existence and identity of the principal, then all legal liability lies with the principal. The only exception to this is when an agent exceeds his or her authority. In that case, the agent has not acted with authority and becomes personally responsible to the third party. If the agent did not have authority, but the principal later ratifies the contract, then the principal will be liable for the contract.

If a principal is partially disclosed, then the third party may recover from either the principal or agent. In this situation, the principal and agent are jointly and severally liable, and the third party may sue either or both of them to recover the full amount of damages owed. However, the third party cannot seek "double damages" and recover more than the total amount owed for the contractual breach.

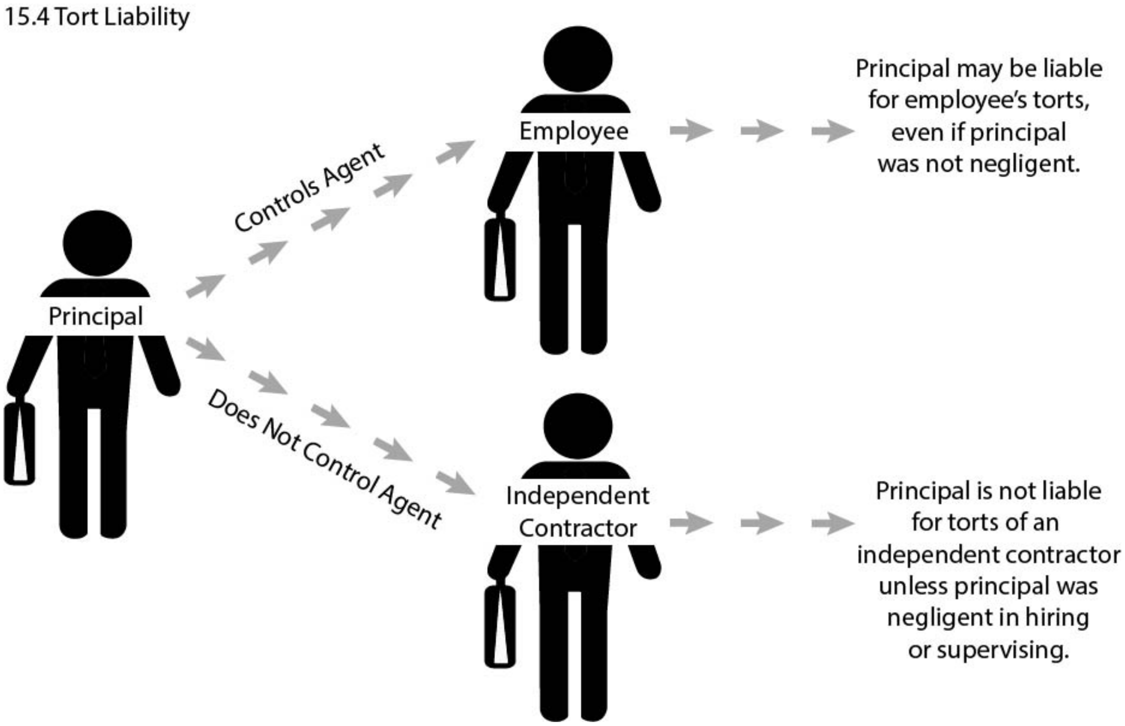
In the event of an undisclosed principal, a third party may recover from either the agent or the principal. The fact that a principal's existence or identity is hidden from third parties does not change the nature of the agent-principal relationship. Therefore, undisclosed principals may become liable for contracts entered into by agents acting with actual authority. An undisclosed principal has no liability to an agent or third party when the agent exceeds the actual authority granted by the principal. In addition, the type of contract must be the type that can be assigned to the undisclosed principal. If the contract is for personal services, then liability cannot be assigned to the principal in case of a breach.

Tort Liability

Agents, employees, and independent contractors are personally liable for their own torts. This concept is rooted in the notion that every individual who commits a tort is personally liable to the party who is damaged by the tortious act. The law holds wrongdoers personally accountable.

However, the reverse is not true. Agents, employees, and independent contractors are not liable for the torts of the principal or employer. If a principal or employer is engaged in tortious behavior, its liability cannot be passed down to its agents and employees.

Figure 15.5 When Principals Have Tort Liability for Employees and Independent Contractors



An employer is liable for the torts of an employee if the employee is acting within the scope of employment. This doctrine is called **respondeat superior** and imposes vicarious liability on employers as a matter of public policy. Even if the employer does not direct its employees to act negligently or intentionally, the employer is responsible because employers are usually in a better position to pay for damages than employees. There is also a strong public policy consideration to not allow employers to turn a blind eye to an employee's bad behavior. By making an employer responsible for an employee's actions, it incentivizes the employer to address situations promptly that could lead to potential liability.

Conversely, a principal is not usually liable for the torts of an independent contractor. Independent contractors have the power to control the details of the work they perform and generally are only responsible to a principal for the results of their work. Therefore, independent contractors are not directed and controlled by a principal as employees are by their employers. As a result, the doctrine of respondeat superior does not apply to independent contractors.

Two exceptions exist that may impose liability on a principal for the work of an independent contractor. The first exception is where the work is inherently dangerous. Public policy prevents principals from insulating themselves from the risks of liability by selecting an independent contractor rather than an employee to perform the dangerous work. The second exception is where the work is illegal. Public policy also prevents principals from hiring independent contractors to perform a task that is illegal.

15.5: Termination of Agency Relationship

Agents and principals may end their agency relationship in various ways. The most common way is through mutual agreement. As a matter of contract, principals and agents may decide to end their relationship. For example, an employee may decide to quit his or her job, or the agency agreement may only be for a set period of time or for a specific transaction.

In addition, there are some events that will terminate an agency relationship as a matter of law. Death of a principal or agent automatically terminates the agency agreement, even if the other party is unaware of the death. Once the time of death is established, any transactions afterward are deemed void.

Similar to death, mental incapacity of a principal or agent terminates an agency relationship. It is often hard to determine the precise time someone loses mental capacity. Therefore, courts often hold that an agent's contract with a third party is binding on the principal unless the third party was aware of the principal's incapacity.

Bankruptcy terminates an agency relationship when the bankruptcy affects the subject matter of the agency agreement. For example, if a principal declares bankruptcy and the real property that an agent is authorized to sell is part of the bankruptcy estate, then the bankruptcy will automatically terminate the agency relationship.

Finally, the destruction or illegality of the subject matter will terminate the agency relationship. For example, if Congress passes a law making it illegal for private parties to sell specific types of weapons, the agency relationship between a gun dealer and its factor for selling those weapons will automatically end.

15.6: Concluding Thoughts

Agency relationships are flexible and varied depending on the needs and interest of the principals and agents. Because the agency relationship is fiduciary in nature, agents and principals owe each other certain duties. Third parties may hold principals legally liable for the actions of their agents. Therefore, it is important for businesses to select their agents carefully to minimize their risk of liability.

CHAPTER OVERVIEW

16: Business Organizations

Learning Objectives

- Know the available entity choices when forming a business.
- Identify the factors that determine entity selection.
- Understand common business entities and their advantages and disadvantages.

16.1: Introduction

At its most fundamental level, a business exists to make a profit for its owners. Some businesses make things in factories (manufacturers), other businesses sell things that other businesses make (retailers), and still other businesses exist to help both the makers and sellers make and sell better (business consultants). Some businesses don't make things at all, and instead profit by selling their services or by lending money.

With this diversity, it's not surprising that there is no "one size fits all" approach to choosing a business organization. When choosing what form of entity is best, several factors are important to consider:

1. How much it costs to create the entity and how hard it is to create.
2. How easy it is for the business to continue if the founder dies or retires.
3. How difficult it is to raise money to grow or expand the business.
4. What type of managerial control they wish to keep on the business, and whether they are willing to cede control to outsiders.
5. If expanding ownership to members of the public is desired.
6. How to minimize the taxes paid on earnings and income.
7. How to protect personal assets from claims, a feature known as limited liability.

Depending on the type of business and its goals, different business entities may be appropriate.

Counselor's Corner Selection of business entities is often the first step when going into business. Many entrepreneurs and small businesses do not spend enough time thinking about the legal and tax consequences of the entity they choose. Ironically, an important discussion to have at the beginning is an exit strategy. What happens if one of the business owners becomes ill, dies, or wants to leave the business? What if the economic situation changes and the business no longer is profitable? Discussing exit strategies up front helps people make the best decisions when crises happen. Don't avoid hard conversations up front. It may be uncomfortable but will save a lot of problems down the road. ~Allison W., attorney

16.2: Sole Proprietorship

A **sole proprietorship** is an unincorporated business owned by one person or married couple. The legal name for a sole proprietorship is usually the owner's name.

There are many advantages to doing business as a sole proprietor. First, it's easy to create a sole proprietorship. In effect, no creation costs or time is required because there is nothing to create. The entrepreneur in charge of the business simply starts doing business, charging money, and providing goods or services.

Another key advantage to sole proprietorship is autonomy. The owner can decide how he or she wants to run the business. The owner can set her own hours, grow as quickly or slowly as she wants, and expand into new lines of businesses. That autonomy also comes with total ownership of the business's finances. All the money that the owner takes in, even if it is in a separate bank account, belongs to her, and she can do with that money whatever she wants.

A sole proprietorship is a **flow-through tax entity**, which means the business does not pay tax on its profits and does not file a separate tax return. Instead, the owner pays personal income tax on all business profits.

These advantages must be weighed against some disadvantages. First, because a sole proprietorship can have only one owner, it is impossible to bring in others to the business. In addition, the business and the owner are identical so it is impossible to pass on the business.

Raising working capital can be a problem for sole proprietors, especially those early in their business ventures. Many entrepreneurial ventures are built on great ideas but need capital to flourish and develop. If the entrepreneur lacks individual wealth, then he or she must seek those funds from other sources. Outsiders can make a loan to the owner, or enter into a profit-sharing contract with her, but there is no way for him to own any part of the owner's business. Traditionally, most sole proprietors seek funding from banks. Banks approach these loans just like any other personal loan to an individual, such as a car loan or mortgage. Down payment requirements may be high, and typically the banks require some form of personal collateral to guarantee the loan, even though the loan is to be used to grow the business.

Sole proprietors are personally liable for all the business's debts and obligations. Unlimited liability puts all the personal assets of the sole proprietor at risk. Personal homes, automobiles, bank accounts and retirement accounts—all are within reach of creditors.

Advantages of Sole Proprietorship	Disadvantages of Sole Proprietorship
• Easy to create • No formal documents or governmental filings required to start business • No formation start up costs • Autonomy • Total control over finances and management decisions	• Flow-through tax entity (owner pays personal income tax on all business profits) • Cannot bring someone else into business • Impossible to pass on the business • Hard to raise capital • Unlimited liability

16.3: Partnerships

A **partnership** is an unincorporated association of two or more co-owners who operate a business for profit. Each owner is called a **general partner**.

General Partnerships

A **general partnership** is when all partners participate fully in running the business and share equally in profits and losses, even if the partners' monetary contributions vary. No legal documents are required to file with the government to form a partnership. If two or more people do business together, sharing management of the business, profits and losses, they have a partnership.

If a partnership is formed formally, then the written agreement is called the **articles of partnership**. The articles can set forth anything the partners wish to include about how the partnership will be run. Normally, all general partners have an equal voice in management, but as a creation of contract, the partners can modify this if they wish.

A general partnership is taxed just like a sole proprietorship. A partnership is a **flow-through tax entity**, where the partnership's income "flows through" the business to the partners, who then pay individual tax on the business income. The partnership may file an information return, reporting total income and losses for the partnership, and how those profits and losses are allocated among the general partners. However, an information return is usually not required.

General partnerships are also similar to sole proprietorships in unlimited liability. Every partner in the partnership is jointly and severally liable for the partnership's debts and obligations. This is a very unattractive feature of general partnerships. One partner may be completely innocent of any wrongdoing and still be liable for another partner's malpractice or bad acts.

General partnerships are dissolved as easily as they are formed. Since the central feature of a general partnership is an agreement to share profits and losses, once that agreement ends, the general partnership ends with it. In a general partnership with more than two persons, the remaining partners can reconstitute the partnership if they wish, without the old partner. A common issue that arises in this situation is how to value the withdrawing partner's share of the business. Articles of partnership therefore typically include a buy/sell agreement, setting forth the agreement of the partners on how to account for a withdrawing partner's share, which the remaining partners then agree to pay to the withdrawing partner.

Management Duties

Partners have a **fiduciary duty** to the partnership. This means that partners have a duty to act for the benefit of the partnership. In particular:

- Partners have an obligation of good faith and fair dealing with each other and the partnership.
- Partners are liable to the partnership for gross negligence or intentional misconduct. Partners are not liable for ordinary negligence.
- Partners cannot compete with the partnership.
- Partners cannot take opportunities away from the partnership unless the other partners consent.
- Partners cannot engage in conflicts of interest.

Limited Partnerships

In most states, owners can form a limited partnership. A **limited partnership** has both general partners and limited partners. As a limited partner, the most he or she can lose is the amount of his investment into the business, nothing more. Limited partnerships have to be formed in compliance with state law, and limited partners are generally prohibited from participating in day-to-day management of the business. This often occurs when someone invests money in the partnership but is not interested in running the business.

Advantages of Partnerships	**Disadvantages of Partnerships**
• Easy to create • No formal documents or governmental filings required to start business • Flexibility in sharing management decisions • Allows for investment by limited partners to raise capital • Easy to dissolve	• Flow-through tax entity (owner pays personal income tax on all business profits) • Unlimited liability • May be hard to value individual partner's share of business • Dissolution occurs any time a new partner is added or old partner leaves

16.4: Franchises

A **franchise** is when a business grants to another the sole right of engaging in a certain business or in a business using a particular trademark in a certain area. Franchises are not a separate form of business organization. Rather, they are a form of contract between businesses. Most franchises involve corporations or limited liability corporations, but they may include sole proprietorships and partnerships.

The advantage of a franchise is that under a **franchise agreement**, an entrepreneur can open and run a business under a proven business model. The local owner, the **franchisee**, uses the **franchisor's** trademark, intellectual property, and business model under a license agreement. The franchisee offers goods or services to the public and keeps any income earned. In exchange for the right to sell goods or services developed by the franchisor, the franchisee pays a fee to the franchisor.

Franchises are common in some industries such as fast food restaurants, hotels, and tax preparation services. Franchise agreements are very detailed and often require the franchisee to use specific vendors, ingredients, store layouts, colors, etc.

Franchises are also very popular with US businesses interested in conducting business abroad. US businesses collect franchise fees from owners in other nations who are responsible for running the business abroad. This allows US companies to have a presence in nations that may restrict business ownership by foreigners because the businesses themselves are owned and operated by locals.

16.5: Joint Venture

A **joint venture** is when two or more individuals or businesses combine their efforts in a particular business enterprise and agree to share the profits and losses jointly or in proportion to their contributions. Unlike a partnership, which operates as a general business for as long as the partners desire, a joint venture is for a single transaction or a limited activity. The businesses remain separate entities and they do not share financial or confidential information unless they decide to. Joint ventures automatically terminate at the conclusion of an event or project.

Joint ventures are often formed to address a common need or to reach a mutual goal. For example, Google and National Aeronautics and Space Administration (NASA) developed Google Earth as a joint venture. To do so, they shared resources and information necessary to develop Google Earth but Google did not become part of the government, nor did NASA share any confidential information or intellectual property more than necessary.

Joint ventures are also common to share the costs of major research or infrastructure projects within an industry. This occurs frequently when industries are impacted by advances in technology. For example, BMW and Toyota created a joint venture to research hydrogen fuel cells, electric vehicles, and ultra-lightweight materials needed in next generation vehicles. By sharing the cost of research and development, the companies are able to be on the forefront of technological advancements in their industry.

Franchises	Joint Ventures
• The right to use a trademark by paying a fee to the franchisor • Contract isn’t separate from the business • Franchise either offers a good or a service • Mainly used in conducting business abroad	• Share a mutual goal/cost/losses • Combines efforts in a single transaction or a limited activity • Agreement becomes terminated at the end of the event or project • Financial and confidential information is not shared

16.6: Corporations

Unlike a sole proprietorship or general partnership, a corporation is a legal entity separate and distinct from its owners. It can be created for a limited duration, or it can have a perpetual existence. Since it is a separate legal entity, a corporation has continuity regardless of its owners. Similarly, in a publicly traded company, the identity of shareholders can change, but the corporation continues its business operations without being affected.

Corporations must be formed in compliance with the law of the state law where they are incorporated. Most corporations incorporate where their principal place of business is located, but not all do. Many companies choose to incorporate in Delaware. Delaware chancery courts have developed a reputation for fairly and quickly applying a very well-developed body of corporate law in Delaware. The courts also operate without a jury, meaning that disputes heard in Delaware courts are usually predictable and transparent, with well-written opinions explaining how the judges decided the cases.

To start a corporation, the corporate founders must file **articles of incorporation** with the Secretary of State where they are incorporated. Articles of incorporation typically include:

- The name of the company;
- Whether the company is for-profit or nonprofit;
- The founders' names;
- The company's purpose;
- How many shares the corporation will issue initially; and
- The par value of any shares issued.

Unlike sole proprietorships, corporations can be quite complicated to manage and often require attorneys and accountants to maintain corporate books in good order. In addition to the foundation requirements, corporate law requires ongoing annual maintenance of corporations. In addition to filing fees due at the time of incorporation, there are typically annual license fees, franchise fees and taxes, and fees related to maintaining minute books, corporate seals, stock certificates and registries, as well as out-of-state registration. A domestic corporation is entitled to operate in its state of incorporation but must register as a foreign corporation to do business in other states.

Corporate Legal Structure

Owners of corporations are called **shareholders**. Corporations can have as few as one shareholder or as many as millions of shareholders, and those shareholders can hold as few as one share or as many as millions of shares. In a **closely held corporation**, the number of shareholders tends to be small, while in a **publicly traded corporation**, the body of shareholders tends to be large.

In a publicly traded corporation, the value of a share is determined by the laws of supply and demand, with various markets or exchanges providing trading space for buyers and sellers of certain shares to be traded. Shareholders own shares in the company but have no legal right to the company's assets. As a separate legal entity, the corporation owns any property in its name.

Shareholders of a corporation enjoy limited liability. The most they can lose is the amount of their investment. Shareholders' personal assets are not available to the corporation's creditors.

Shareholders can be individuals or other business entities, such as partnerships or corporations. If one corporation owns all the stock of another corporation, the owner is said to be a **parent company**, while the company being owned is a **wholly owned subsidiary**. Often large corporations form subsidiaries for specific purposes so that the parent company has limited liability or advantageous tax treatment. For example, large companies may form subsidiaries to hold real property so that premises liability is limited to that real estate subsidiary only, shielding the parent company and its assets from lawsuits. Companies that deal in a lot of intellectual property may form subsidiaries to hold their intellectual property, which is then licensed back to the parent company so that the parent company can deduct royalty payments for those licenses from its taxes. This type of sophisticated liability and tax planning makes the corporate form very attractive for larger businesses in the United States.

An exception to the rule of limited liability arises in certain cases involving closely held corporations. Many sole proprietors incorporate their businesses to gain limited liability but fail to realize when they do so that they are creating a separate legal entity that must be respected as such. If sole proprietors fail to respect the legal corporation with an arm's length transaction, then creditors can ask a court to pierce the corporate veil. If a court agrees, then limited liability disappears and those creditors can reach the shareholder's personal assets.

Rights of Shareholders

Not all shareholders in a corporation are necessarily equal. US corporate law allows for the creation of different types, or classes, of shareholders. Shareholders in different classes may be given preferential treatment when it comes to corporate actions such as paying dividends or voting at shareholder meetings.

Shareholder rights are generally outlined in a company's articles of incorporation or bylaws. Some of these rights may include the right to obtain a dividend, but only if the board of directors approves one. They also include the right to attend shareholder meetings, the right to examine the company's financial records, and the right to a portion of liquidated company assets.

Under most state laws, shareholders are also given a unique right to sue a third party on behalf of the corporation. This is called a **shareholder derivative lawsuit**. In essence, a shareholder alleges that the people who are ordinarily charged with acting in the corporation's best interests (the officers and directors) are failing to do so, and therefore the shareholder must step in to protect the corporation.

One of the most important functions for shareholders is to elect the board of directors of a corporation. Only shareholders elect a director. The board is responsible for making major decisions that affect a corporation, such as declaring and paying a corporate dividend to shareholders; authorizing major decisions; appointing and removing corporate officers; determining employee compensation, especially bonus and incentive plans; and issuing new shares and corporate bonds.

One critical function for boards of directors is to appoint corporate officers. These officers often hold titles such as chief executive officer, chief operating officer, chief marketing officer, and so on. Officers are involved in everyday decision making for the company and implement the board's decisions. As officers of the company, they have legal authority to sign contracts on behalf of the corporation, binding the corporation to legal obligations. Officers are employees of the company and work full-time for the company, but can be removed by the board.

Corporate Taxation

Corporations are subject to double taxation. Because corporations are separate legal entities, they must pay federal, state, and local tax on net income. Then, if the board of directors declares a dividend, shareholders are taxed on the dividend that they receive in the form of a dividend tax.

One way for closely held corporations (such as small family-run businesses) to avoid double taxation is to form an S corporation. An S corporation (the name comes from the applicable subsection of the tax law) can choose to be taxed like a partnership or sole proprietorship. In other words, taxes are only collected when a dividend is declared and not on corporate net income. An S corporation is formed and treated just like any other corporation; the only difference is in tax treatment.

S corporations provide the limited liability feature of corporations but the single-level taxation benefits of sole proprietorships. There are some important restrictions on S corporations, however. They cannot have more than one hundred shareholders, all of whom must be US citizens or resident aliens and cannot include partnerships and corporations. S corporations can have only one class of stock and there are restrictions on how shares may be transferred. Finally, all shareholders must agree that the company should be an S corporation. These restrictions ensure that "S" tax treatment is reserved only for small businesses.

Advantages of Corporations	Disadvantages of Corporations
• Separate legal entity from owners • Corporation unaffected by change of ownership/shareholders • Limited liability for shareholders • Not subject to some laws • Considered as an "individual" with Constitutional rights	• Formal documents required to filed in state of incorporation • Can be complicated to manage • High formation and maintenance costs • Subject to double taxation • Heavily regulated by government

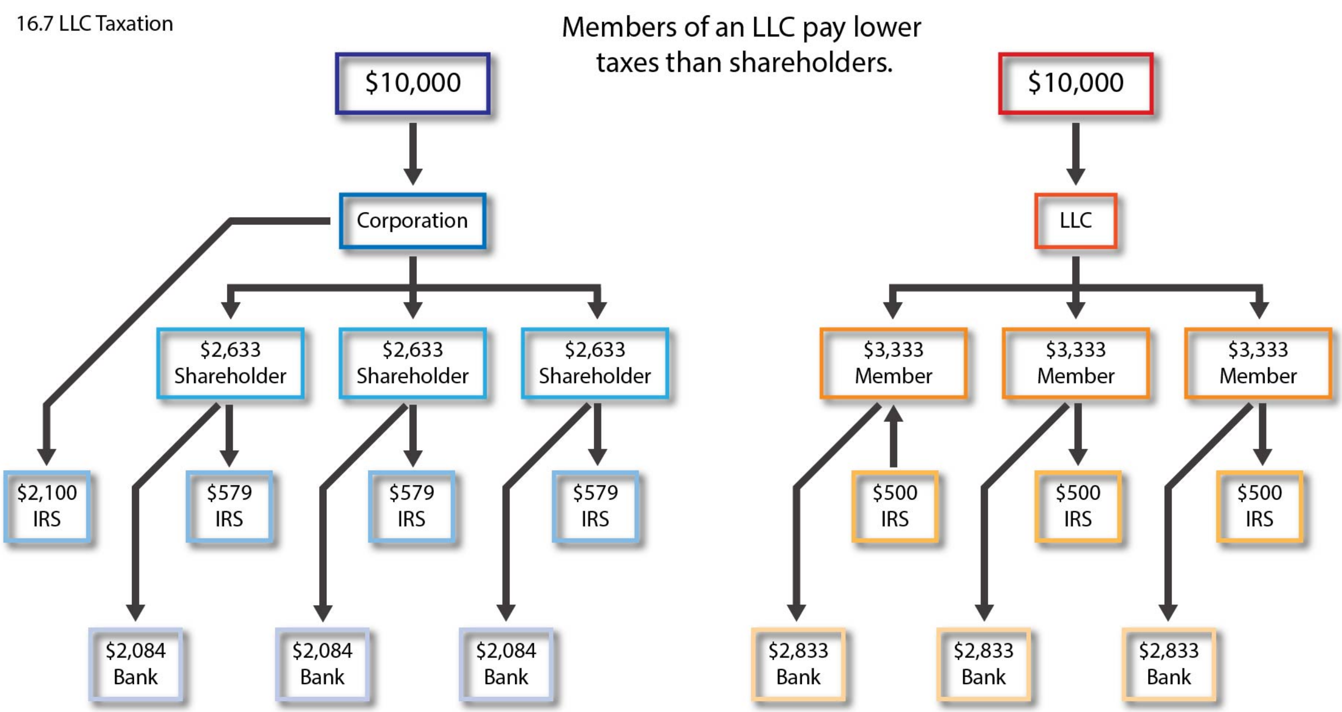
16.7: Limited Liability Entities

A **limited liability company (LLC)** is a "hybrid" form of business organization that offer the limited liability feature of corporations but the tax benefits of partnerships. Owners of LLCs are called **members**. Just like a sole proprietorship, it is possible to create an LLC with only one member. LLC members can be individuals or other LLCs, corporations, or partnerships. LLC members can participate in day-to-day management of the business.

Members are not personally liable for the debts of the business. Like shareholders of a corporation, members of an LLC risk only their financial investment in the company.

Taxation of LLCs is very flexible. Every year the LLC can choose how it will be taxed. It may want to be taxed as a corporation, for example, and pay corporate income tax on net income. Or it may choose instead to have income "flow through" the corporate form to the member-shareholders, who then pay personal income tax just as in a partnership. Sophisticated tax planning becomes possible with LLCs because tax treatment can vary by year.

Figure 16.1 LLC Taxation



LLCs are formed by filing the articles of organization with the state agency charged with chartering business entities, typically the Secretary of State. Starting an LLC is often easier than starting a corporation. Typical LLC statutes require only the name of the LLC and the contact information for the LLC's legal agent. Unlike corporations, there is no requirement for an LLC to issue stock certificates, maintain annual filings, elect a board of directors, hold shareholder meetings, appoint officers, or engage in any regular maintenance of the entity. Most states require LLCs to have the letters "LLC" or words "Limited Liability Company" in the official business name.

Although the articles of organization are all that is necessary to start an LLC, it is advisable for the LLC members to enter into a written LLC operating agreement. The operating agreement typically sets forth how the business will be managed and operated. It may also contain a buy/sell agreement just like a partnership agreement. The operating agreement allows members to run their LLCs any way they wish.

Since LLCs are a separate legal entity from their members, members must take care to interact with LLCs at arm's length, because the risk of piercing the veil exists with LLCs as much as it does with corporations. Fundraising for an LLC can be as difficult as it is for a sole proprietorship, especially in the early stages of an LLC's business operations. Most lenders require LLC members to personally guarantee any loans the LLC may take out. Finally, LLCs are not the right form for taking a company public and selling stock. Fortunately, it is not difficult to convert an LLC into a corporation, so many start-up business begin as LLCs and eventually convert into corporations prior to their initial public offering (IPO).

Advantages of LLCs	Disadvantages of LLCs
• Limited liability for owners • Flow-through tax entity so not subject to double taxation • Easier to form and operate than corporation or S corporation • Owners can deduct losses for personal taxes	• Subject to state laws so lacks consistency in enforcement • Laws not as developed as corporate law & partnership law

Limited Liability Partnerships

A related entity to the LLC is the limited liability partnership, or LLP. Be careful not to confuse limited liability partnerships with limited partnerships. LLPs are just like LLCs but are designed for professionals who do business as partners. They allow the partnership to pass through income for tax purposes, but retain limited liability for all partners. LLPs are especially popular with doctors, architects, accountants, and lawyers. Most of the major accounting firms have now converted their corporate forms into LLPs.

Professional Corporations

Professional Corporations (PCs) are mostly a legacy form of organization. In other words, before LLCs and LLPs were an option, PCs were the only option available to professionals who wanted limited liability. Some states still require doctors, lawyers, and accountants to organize as a PC.

If a member of a PC commits malpractice, the PC's assets are at risk along with the personal assets of the member who committed malpractice. However, the personal assets of the non-involved members are not at risk. PCs do not shield individuals from their own malpractice but they offer limited liability to innocent members.

PCs are a separate taxable entity but they are not flow-through entities like partnerships. As a result, taxation of PCs is complicated and a major drawback of this form of business entity.

Type of Business Organization	Ease of Formation	Funding	Personal Liability for Owners	Taxes	Ease of Transferring Ownership	Perpetual Existence	Dissolution
Sole Proprietorship	Very easy	Same as owner	Yes	Flow-through	Must sell entire business	No	When & how owner decides
General Partnership	Easy	Partners contribute capital	Yes	Flow-through	Hard	No	Upon death, bankruptcy, agreement, or termination of partnership
Limited Partnership	Easy	Partners contribute capital	General partner is personally liable; limited liability for limited partners	Flow-through	Hard	No	Upon death, bankruptcy, agreement, or termination of partnership
Corporations	Difficult	Sell stock to raise capital	No	Subject to double taxation	Easy	Yes	By resolution of board of directors, bankruptcy, or court order
S Corporations	Difficult	Sell stock to raise capital	No	Taxed only on dividends	Transfer restrictions	Yes	By resolution of board of directors, bankruptcy, or court order

Limited Liability Companies (LLCs)	Medium	Members make capital contributions	No	Flow-through	Depends on operating agreement	Varies by state; yes in most states	Upon death, bankruptcy, agreement, or court order
Limited Liability Partnerships (LLPs)	Difficult	Members make capital contributions	Non-acting partners have limited liability; state law varies regarding liability of acting partners vs. partnership	Flow-through	Depends on the partnership agreement	Depends on partnership agreement	Upon death, bankruptcy, agreement, or termination of partnership
Professional Corporations	Difficult	Members make capital contributions	No	Complex tax issues	Transfer restricted to members of the same profession	Yes, as long as it has shareholders	Upon death, bankruptcy, agreement, or court order

16.8: Concluding Thoughts

Depending on a business's type and goals, different business entities may fit the needs of owners better than others. It is important when starting a business to decide how to minimize tax and liability exposure and to maximize profits. Because there is no perfect "fit" for every business need, understanding the advantages and disadvantages of the various business entities is important.

17: Partnerships

17.1 Introduction

LEARNING OBJECTIVES

1. Learn when a partnership exists.
2. Understand the rights and duties of partners.
3. Comprehend how a partnership is terminated and the priority of distributing assets.

Partnerships are the most common business form in the United States. Partnerships may be express or implied, and they are the default business organization when two or more people work together who are not legally married. People do not need to call themselves partners for a partnership to exist, so it is important for business professionals to understand what constitutes a partnership so they do not inadvertently form a business entity that they do not intend. And, if they do intend to form a partnership, partners should understand their rights and duties towards each other.

17.2 Types of Partnerships

A **partnership** is a voluntary association of two or more people who jointly own and carry on a business for profit. Under the Uniform Partnership Act, a partnership is presumed to exist if the parties agree to share proportionally the business's profits or losses.

There are only two required elements to form a partnership:

1. A common interest to conduct business together; and
2. An understanding to share profits and losses.

A **general partnership** is a partnership in which all partners participate fully in running the business and share equally in profits and losses, even if the partners' monetary contributions vary.

A **limited partnership** is composed of one or more people who control the business and are personally liable for the partnership's debts. These partners are called **general partners** and they have the power to make all types of business decisions and manage all aspects of the partnership. A limited partnership also has one or more people who contribute capital and share profits but who cannot manage the business and are liable only for the amount of their contribution. These partners are called **limited partners**. The main purpose of a limited partnership is to allow people to invest in a business without having to manage the business, and without risking more than the invested sum.

Partnerships may also have silent and secret partners. A **silent partner** is a partner who shares in the profits, has no active voice in management of the business, and whose existence is not publicly disclosed. A **secret partner** is a partner whose connection to the business is concealed from the public but may participate in the management of the business. The difference between a silent and secret partner relates to whether the partner may make management decisions.

A **partnership by estoppel** is an equitable doctrine in which a partnership is implied when one or more people represent themselves as partners to a third party who relies on that representation. A person who is deemed a partner by estoppel becomes liable for any credit extended to the partnership by the third party.

Counselor's Corner When a business is seeking to innovate their operations, become more efficient, introduce new products or seek competitive advantages, corporate or business attorneys are most effective if they are business partners from the outset. Consulting with legal counsel early and often allows the business to avoid legal pitfalls without wasting valuable time and other resources by making legal counsel a true business partner. So often in business, the legal consulting occurs at the end of the process but by forming the consulting relationship early and often, it avoids being blindsided by possible legal restrictions or impediments and more importantly allows the business to adjust and adapt to any legal implications during the process. ~Rick T., attorney

17.3 Partnership Agreements

A written partnership agreement is not required to form a partnership, but it is a best business practice. Given the variety of different types of partnerships, it is understandable that no formal requirements for a partnership agreement exist. However, the following provisions are ones that should be considered when writing a partnership agreement.

- **Name of partnership**. Partnerships may choose almost any name they would like. However, partnerships may not use the word "company" or any other word that would imply the business is a corporation. If partners choose a name that does not include their names, the **fictitious name statement** requires that they must give public notice as to the identities of the partners.

- **Purpose and duration**. Is the partnership for a limited time or for a specific purpose? Is it a joint venture between businesses that grants partners only limited authority and property rights? Is it a general partnership with the flexibility to grow the business as the market allows?
- **Capital contributions**. Partners may contribute cash, intellectual property rights, real and personal property, and goodwill to the partnership. Capital contributions do not include the partners' business experience. An individual may also become a partner without making a capital contribution as long as the other partners agree to it.
- **Methods of sharing profits and losses**. Without this provision, the default rule is that each partner shares equally in the profits and losses of the partnership. These provisions often include any credit for capital contributions partners may receive in the event of dissolution.
- **Effects of advances**. If the partnership is short of cash and a partner agrees to advance money to the partnership, that cash advance could be considered either a personal loan or a capital contribution to the partnership. Determining in advance how that money will be spent, repaid, and/or credited within the partnership helps facilitate these types of transactions.
- **Compensation**. If general partners receive any salary or additional compensation for their management of the business, the terms of compensation should be clearly defined. In addition, the procedure for setting the amount and type of compensation should also be addressed.
- **Fiscal year and accounting methods**. How a partnership will handle accounting and tax liabilities are important to clearly define, especially because partnerships are flow-through tax entities.
- **Property**. Partnerships often use personal property of partners as well as property of the business. The default rule is that all property brought into the partnership or acquired by it becomes partnership property. If a partner does not want to lose property rights to the partnership or its creditors, he or she should specify that it remains personal property.
- **Dispute resolution**. If partners are unable to agree on how to manage the business, how will the deadlock be resolved? These provisions are especially helpful when there are an even number of partners to avoid dissolution when deadlock occurs.
- **Modification**. How may the partners modify the partnership agreement? Is unanimous consent required to add new partners or add new terms to the contract?
- **Rights and obligations at dissolution**. Partners should think about what will happen if a partner chooses to leave the partnership or dies. Can the remaining partner(s) buy out that partner's share of the business? If so, under what terms or process?

It is important to remember that partnership agreements exist between partners in a business, not between the partners and third parties. Partnership agreements are contracts between individuals who want to work together. Therefore, provisions that help facilitate that business relationship within the particular industry may be appropriate.

17.4 Rights and Duties of Partners

Rights of Partners

Figure 17.1 Rights of Partners

All general partners have an equal right to manage the partnership’s business. This does not mean that partners cannot divide up responsibility for the day-to-day management of the business. Rather, partners have the right to enter into contracts on behalf of the partnership, hire employees, and engage in business transactions.

Partners also have a right to compensation for services on behalf of the partnership if they have an agreement for compensation beyond profit sharing. Compensation provisions are particularly common in limited partnerships where some partners are active in the management of business and others are not.

Partners also have the right to receive interest on cash advances made to the partnership. Similar to a loan, an advance is not automatically considered a capital contribution unless determined to be so under the partnership agreement.

Every partner is entitled to full and complete access to inspect the business records of the partnership. Each partner has the right to receive notices and information from all other partners regarding the business. Therefore, partners must notify other partners about material information related to the business and business interests.

Similarly, partners are entitled to an accounting when another partner has withheld profits from the partnership, when there are legal proceedings against the partnership, or upon dissolution.

Partners also have the right to indemnification from the partnership for actions of other partners. For example, if the partnership is sued because a partner commits a tort, the other partners may lose their monetary investment in the partnership but their personal assets are not at risk.

Partners are co-owners of partnership property. Unless altered by a partnership agreement, partners have an equal right to possess partnership property for business purposes.

Duties of Partners

Figure 17.2 Duties of Partners

A partnership is a fiduciary relationship. Therefore, partners owe each other duties as a result of their relationship of trust and confidence.

Partners owe each other a duty of care. In a partnership, this generally means refraining from intentional and reckless misconduct. A partner is not liable to the other partners for simple negligence. Thus, the duty of care for partnerships is not particularly burdensome.

Partners also owe each other the duty of loyalty, which requires the partner to put the interests of the partnership before his or her own personal interests. Self-dealing and taking business opportunities away from the partnership are examples of breaches of the duty of loyalty.

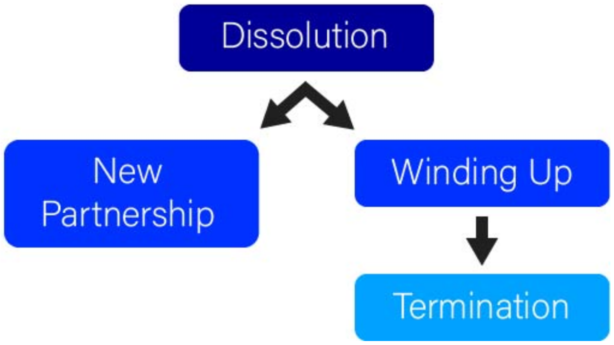
From the duty of loyalty rise the remaining duties that partners owe each other: the duty of service, obedience, accounting, and to inform other partners of material information. When loyal to the partnership, a partner will work in service of the partnership, follow reasonable directions of other partners, provide an accounting of business assets, and inform the other partners of material information that affects the business.

17.5 Termination of a Partnership

The legal end of a partnership is called **dissolution**. Dissolution may occur when partners mutually agree to stop working together, a partner dies or withdraws from the partnership, or a new partner is added. A new partnership is formed when there is a change in partners, whether an existing partner leaves or a new partner is added. Often, these types of changes do not impact the day-to-day operations of the business significantly. However, a new partnership agreement, and sometimes a new partnership name, is necessary.

If the partnership ceases to operate, then winding up occurs. **Winding up** is the process in which a partnership is liquidated. Partnership assets are reduced to cash, creditors are paid off, and any remaining profit and assets are distributed to the partners. **Partial winding up** occurs when the partnership has insufficient cash to operate its business and needs to sell its assets to pay off debts. **Complete winding up** occurs when the partnership is no longer viable or the partners decide not to work together any more. **Termination** is when the process of winding up is finished and the partnership no longer exists.

Figure 17.3 Dissolution of Partnership



Many factors can determine whether there is partial or complete winding up. For example, bankruptcy of a partner or the partnership, change in laws that make the subject matter of the business illegal, the death or incapacity of a partner, change in economic circumstances, or litigation.

During winding up, there is a priority of distributing the partnership assets. In general, all creditors other than partners are entitled to be paid before the partners divide up the partnership's assets.

The priority of distributing the partnership assets is:

1. Third party creditors;
2. Partnership advances;
3. Partnership capital; then
4. Remaining profits to partners.

If the partnership does not have enough assets to cover its debts, then the priority of paying creditors is governed by the state law where the partnership exists. State laws vary regarding the priority of distributing assets, but most states follow a process called marshaling of assets. **Marshaling of assets** is an equitable doctrine for a fair distribution of a debtor's assets among multiple creditors.

17.6 Concluding Thoughts

Partnerships are the most common business form in the United States, in large part because of their flexibility and ease of creation. However, if individuals want to create a partnership, a best practice would be to create a partnership agreement that identifies the rights and obligations of the partners. Partnerships are fiduciary relationships in which the law creates certain rights and obligations even if there is not a partnership agreement.

17.1: Introduction

17.2: Types of Partnerships

17.3: Partnership Agreements

17.4: Rights and Duties of Partners

17.5: Termination of a Partnership

17.6: Concluding Thoughts

18: Corporations

18.1 Introduction

LEARNING OBJECTIVES

1. Understand how corporations are structured and managed.
2. Learn about shareholder rights and the powers and liabilities of corporate officers and directors.
3. Learn the legal theories under which limited liability is taken away from corporations.
4. Comprehend how corporations merge, consolidate, and dissolve.

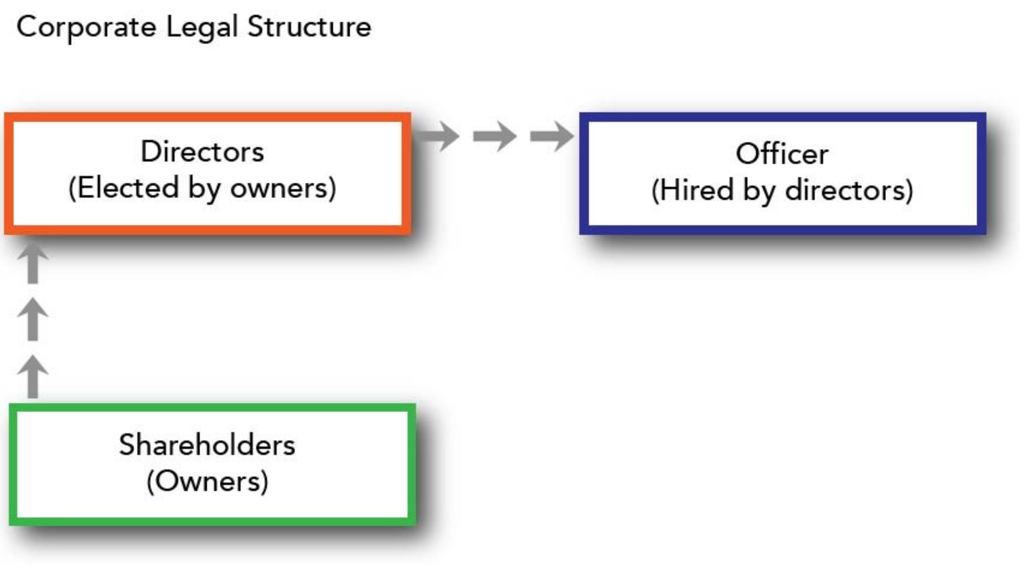
Corporations are incredibly important to the stability and growth of the US economy. Without corporations, industries such as pharmaceuticals and technology would not be able to raise the capital needed to fund their research and development of new drugs and products. As discussed in Chapter 16, corporations are incorporated under state law and are subject to double taxation. Corporations are separate legal entities from the shareholders who own them.

Counselor's Corner“Corporations are [often] people too!” Although the word “corporation” is not found in the Constitution, US corporations are increasingly considered US persons for legal purposes. The Supreme Court has ruled that corporations are entitled to equal protection, to make political contributions, and to refuse certain employee health plans on religious grounds. Congress now generally defines “person” as including “corporations,” which allows them to enter contracts, own property, sue and be sued, and pay taxes. The president has issued Executive Orders giving corporations certain privacy protections regarding the government's authority to collect and use information about them. Corporations do not, however, have all the legal protections that people have, such as the right to avoid self-incrimination. Nevertheless, generally thinking of US corporations as US persons will often help you better understand their legal rights, responsibilities, and protections, and make you a more educated business person, lawyer, or citizen. ~Tom M., attorney

18.2 Corporate Structure

Under most state laws, corporations are required to have at least one director. A **director** is a person appointed or elected to sit on a board that manages the business of a corporation and supervises its officers. Directors are elected by shareholders and collectively are called the **Board of Directors**. Directors elect **officers**, who are responsible for the daily operations of the corporation. Officers often have titles such as president, chief operating officer, chief financial officer, or controller.

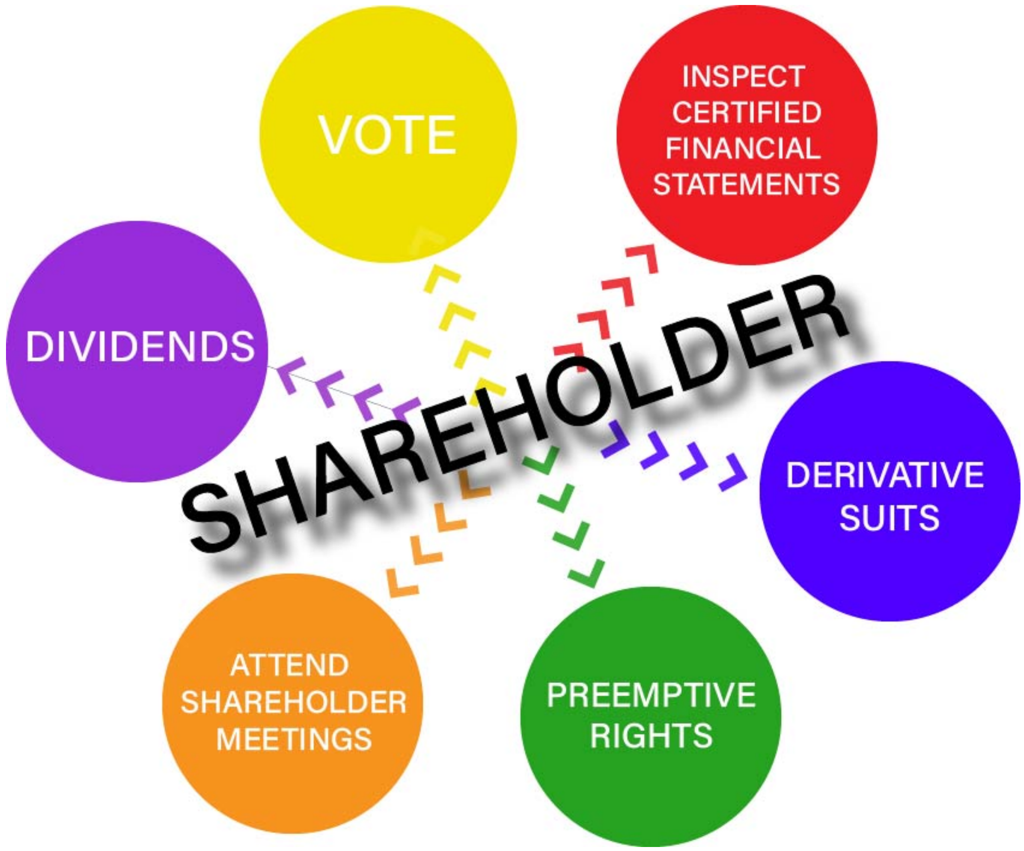
Figure 18.1 Corporate Legal Structure



18.3 Shareholder Rights

As owners of the corporation, shareholders have specific rights to help them assess their investment decisions. Shareholders are not entitled to manage the day-to-day operations of the business, but they enjoy the following rights.

Figure 18.2 Corporate Shareholder Rights



Inspection

Shareholders have the right to inspect the certified financial records of a corporation. This right also extends to other information related to exercising their voting privilege and making investment decisions.

The right, however, is limited to good-faith inspections for proper purposes at an appropriate time and place. A proper purpose is one that seeks to protect the interests of both the corporation and the shareholder seeking the information. In other words, the inspection cannot be against the best interest of the corporation.

Courts have held that proper purposes include:

- Reasons for lack of dividend payments or low dividend amounts;
- Suspicion of mismanagement of assets or dividends; and
- Holding management accountable.

Corporations have a legitimate interest in keeping their financial and managerial documents private. Therefore, inspection of documents usually occurs at the corporation's headquarters during regular business hours. Documents made available for inspection do not have to be allowed off premise if the corporation does not want them to be removed.

Shareholder Meetings

Shareholders have the right to notice and to attend shareholder meetings. Shareholder meetings must occur at least annually, and special meetings may be called to discuss important issues such as mergers, consolidations, change in bylaws, and sale of significant assets. Failure to give proper notice invalidates the action taken at the meeting.

A quorum of shareholders must be present at the meeting to conduct business. A **quorum** is the minimum number of shareholders (usually a majority) who must be present to take a vote. The corporation's bylaws define what constitutes a quorum, if not set by state law.

If a shareholder is not able to be physically present during a meeting, he or she may vote by proxy. A **proxy** is a person authorized to vote on another's stock shares.

Vote

Depending on the type of share owned, shareholders may have the right to vote. In general, shareholders of common stock are entitled to a vote for each share of stock owned. Owners of preferred stock often do not have a voting right in exchange for a higher dividend amount or preference in receiving dividends.

Common issues that shareholders vote on include:

- Election of directors;
- Mergers, consolidations, and dissolutions;
- Change of bylaws;
- Change in major corporate policies; and
- Sale of major assets.

Preemptive Rights

The **Preemptive right** is a shareholder's privilege to buy newly issued stock in the corporation before the shares are offered to the public. Shareholders are allowed to buy shares in an amount proportionate to their current holdings to prevent dilution of the existing ownership interests.

Preemptive rights usually must be exercised within thirty to sixty days of being offered. This allows the corporation to complete the sale to shareholders before offering any remaining shares to the public.

Derivative Suit

A **derivative suit** is a lawsuit brought by a shareholder on the corporation's behalf against a third party because of the corporation's failure to take action on its own. Derivative actions are usually brought by shareholders against officers or directors for not acting in the best interest of the corporation.

To be eligible to bring a derivative action, a shareholder must own shares in the corporation at the time of the alleged injury. An individual or business cannot buy shares in a corporation to file a derivative suit for actions that occurred before becoming a shareholder.

Before bringing a derivative suit, shareholders must show that they attempted to get the officers and directors to act on behalf of the corporation first. Only after the officers and directors refuse to act may a derivative suit be filed.

Dissatisfaction with the corporation's management is insufficient to justify a derivative suit. Derivative suits have been successful when misconduct or fraud of a director or officer is involved. If successful, any damages are awarded to the corporation, not the shareholders who brought the lawsuit.

Dividends

A **dividend** is a portion of a corporation's profits distributed to its shareholders on a pro rata basis. Dividends are usually paid in the form of cash or additional shares in the corporation.

Although shareholders have a right to a dividend when declared, the board of directors has the discretion to decide whether to declare a dividend. The board may decide to reinvest profits into the corporation, pay for a capital expense, purchase additional assets, or to expand the business. As long as the board of directors acts reasonably and in good faith, its decision regarding whether to declare a dividend is usually upheld by the courts.

18.4 Corporate Officer and Directors

Although shareholders own the corporation, the officers and directors are empowered to manage the day-to-day business of the corporation. The officers and directors owe a fiduciary duty to both the corporation and its shareholders. This means that the officers and directors must act in the best interest of the corporation and shareholders.

Duty of Loyalty

As part of their fiduciary duty, officers and directors have a duty of loyalty to the corporation and its shareholders. The duty of loyalty requires them to act:

- In good faith;
- For a lawful purpose;

- Without a conflict of interest; and
- To advance the best interests of the corporation.

Duty of loyalty issues frequently arise in the context of a director entering into a contract with the corporation or loaning it money. Other situations may involve a director taking a business opportunity away from the corporation for his or her own personal gain. The **corporate opportunity doctrine** prevents officers and directors from taking personal advantage of a business opportunity that properly belongs to the corporation.

Duty of Care

The duty of care requires officers and directors to act with the care that an ordinary prudent person would take in a similar situation. In other words, they have a duty not to be negligent.

The extent of this duty depends on the nature of the corporation and the type of role the director or officer fills. For example, the duty of care imposed on the board of directors of a federally-insured bank will be higher than the duty imposed on a small nonprofit organization.

In general, though, directors should understand the nature and scope of the corporation's business and industry, as well as have any particular skills necessary to be successful in their role. Officers and directors also should stay informed about the corporation's activities and hire experts when they lack the expertise necessary to make the best decisions for the corporation. The duty of care requires officers and directors to make informed decisions.

Compensation

Officers and directors are usually entitled to compensation for their work on behalf of the corporation. Some states restrict whether directors may receive compensation and, if so, how much. The issue of executive compensation has been a hot button issue in recent decades.

Business Judgment Rule

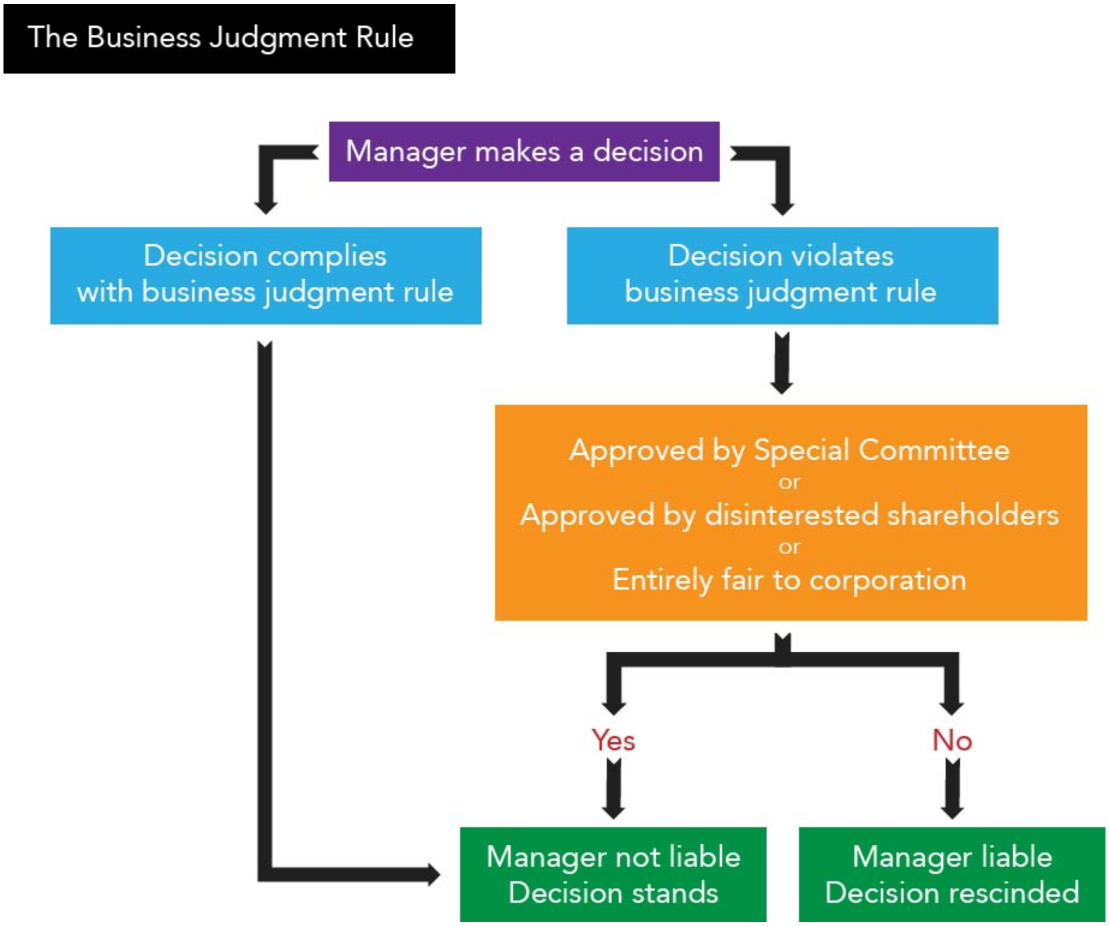
The **business judgment rule** is the presumption that corporate directors act in good faith, are well-informed, and honestly believe their actions are in the corporation's best interest. The rule shields directors and officers from liability for unsuccessful or unprofitable decisions, as long as they were made in good faith, with due care, and within their authority.

It is important to understand that courts do not focus on the result of the business decision. Instead, courts look at the process that the decision makers went through. If the process is careless or not in the best interest of the corporation and shareholders, the business judgment rule will not protect them.

The business judgment rule does not protect officers and directors from decisions made in their own self-interest or self-dealing. In those situations, the action must be approved by disinterested members of the board of directors or shareholders. If the decision is subject to a derivative suit, the court may determine that the decision was fair to the corporation. If the decision is approved by the court or disinterested board members or shareholders, then the decision may be valid.

The business judgment rule does not protect officers and directors from decisions made in bad faith, as a result of fraud, through gross negligence, or as an abuse of discretion. In those situations, the officers and directors may be personally liable for their actions.

Figure 18.3 Business Judgment Rule Flowchart



18.5 Legal Theories

One of the main benefits of corporations is limiting shareholders' liability to the amount of their investment in the corporation. In general, a shareholder may lose his or her investment in the corporation if it is not a successful business or if it is sued. Because corporations are a separate legal entity than their shareholders, shareholders are generally shielded from corporate liability. However, three exceptions to this rule allow shareholders to be held liable for the corporation's actions.

Piercing the Corporate Veil

Piercing the Corporate Veil is a legal theory under which shareholders or the parent company are held liable for the corporation's actions or debts. Under this theory, plaintiffs ask the court to look beyond the corporate structure and allow them to sue the shareholders or parent company as if no corporation existed. In essence, the court strips the "veil" of limited liability that incorporation provides and hold a corporation's shareholders or directors personally liable.

This theory applies most often in closely held corporations. While legal requirements vary by state, courts are usually reluctant to pierce the corporate veil. However, courts will do so in cases involving serious misconduct, fraud, commingling of personal and corporate funds, and deliberate undercapitalization during incorporation.

Alter Ego Theory

The **Alter Ego Theory** is the doctrine that shareholders will be treated as the owners of a corporation's property or as the real parties in interest when necessary to prevent fraud or to do justice. In other words, the court finds a corporation lacks a separate identity from an individual or corporate shareholder.

This theory applies most often when a corporation is a wholly-owned subsidiary of another company. Courts allow the alter ego theory when evidence exists that the parent company is controlling the actions of the subsidiary, and the corporate form is disregarded by the shareholders themselves. The rationale is that shareholders cannot benefit from limited liability when there is such unity of ownership and interest that a separate entity does not actually exist. To allow shareholders to "have it both ways" would result in injustice to the corporation's debtors and those hurt by its actions.

Promotion of Justice Theory

The **Promotion of Justice Theory** is used when the corporate form is used to defraud shareholders or to avoid compliance with the law. Courts use this theory to prevent shareholders from using a corporation to achieve what they could not do directly themselves. For example, if a state limits the number of liquor licenses an individual may obtain at one time, a person cannot form multiple corporations to obtain more licenses.

18.6 Mergers, Consolidations, and Dissolutions

Once incorporated, corporations may last forever. However, they also may be merged or consolidated into other business entities or dissolved.

Often businesses will buy the assets of another business. When this happens, the seller remains in existence and retains its liabilities. The buyer does not become legally responsible for the seller's actions through a mere purchase of assets.

Mergers and consolidations, however, involve the termination of the seller.

Merger

A **merger** occurs when one corporation absorbs another. The acquiring corporation continues to exist but the target corporation ceases to exist. The acquiring corporation acquires all the assets and liabilities of the target corporation.

Corporate mergers must conform to state laws and usually must be approved by the majority of shareholders of both corporations. Many states require approval by two-thirds of the shareholders. If approved, articles of merger must be filed in the state(s) where the corporations exist.

Figure 18.4 Merger

Consolidation

Consolidation occurs when two or more corporations are dissolved and a new corporation is created. The new corporation owns all the assets and liabilities of the former corporations.

Like mergers, consolidations must be approved by the majority or two-thirds of shareholders of all corporations involved. If approved, articles of consolidation must be filed in the state(s) where the corporations existed.

Mergers and consolidations are often scrutinized under antitrust laws to ensure that the resulting corporation is not a monopoly in the relevant market. Antitrust laws are discussed in Chapter 19.

Figure 18.5 Consolidation

Voluntary Dissolution

A corporation that has obtained its charter but has not begun its business may be dissolved voluntarily by its incorporators. They simply need to file articles of dissolution in the state of incorporation.

If a corporation has been in business, voluntary dissolution is possible when either (1) all shareholders give written consent or (2) the board of directors vote for dissolution and two-thirds of the shareholders approve.

To dissolve a corporation voluntarily, the corporation must file a statement of intent to dissolve. At that point, the corporation must cease all business operations except those necessary to wind up its business affairs. The corporation must give notice to all known creditors of its dissolution. If the corporation fails to give notice, then the directors become personally responsible for any debt and legal liability. The corporation is required to pay off all debts before distributing any remaining assets to shareholders.

Until the state issues the articles of dissolution, the statement of intent may be revoked if shareholders change their mind.

Involuntary Dissolution

States have the power to create corporations through granting corporate charters. Similarly, states have the right to revoke corporate charters. Actions brought by the state to cancel a corporate charter are called **quo warranto proceedings**.

Corporate charters may be canceled when a corporation:

- Did not file its annual report;
- Failed to pay its taxes and licensing fees;
- Obtained its charter through fraud;
- Abused or misused its authority;
- Failed to appoint or maintain a registered agent; or
- Ceased to do business for a certain period of time.

Shareholders may also request dissolution when:

- The shareholders are deadlocked and cannot elect a board of directors;
- When there is illegal, fraudulent or oppressive conduct by the directors or officers;
- When majority shareholders breach their fiduciary duty to the minority shareholders;
- Corporate assets are being wasted or looted; or
- The corporation is unable to carry out its purpose.

Finally, dissolution may occur as a result of bankruptcy or when the corporation is unable to cover its debts to creditors.

18.7 Concluding Thoughts

Corporations are owned by shareholders but are run by directors and officers. As a legal entity separate from its shareholders, corporations provide limited liability to shareholders who invest in them. However, personal liability may be imposed when fraud or other serious misconduct occurs. As long as their decisions are made in good faith, with due care, and within their authority, officers and directors are protected by the business judgment rule. Finally, corporations have a perpetual existence unless they are dissolved through their own action, by the state, or initiated by shareholders or creditors.

18.1: Introduction

18.2: Corporate Structure

18.3: Shareholder Rights

18.4: Corporate Officer and Directors

18.5: Legal Theories

18.6: Mergers, Consolidations, and Dissolutions

18.7: Concluding Thoughts

19: Antitrust Law

19.1 Introduction

LEARNING OBJECTIVES

1. Understand the important federal antitrust laws, along with their exemptions.
2. Learn the factors used to determine whether a monopoly exists.
3. Comprehend the common types of unreasonable restraints on trade.

Antitrust laws are designed to protect trade and commerce from unreasonable restraints, monopolies, price fixing, and price discrimination. Antitrust laws regulate the market just enough to foster economic growth and competition while preventing stagnation and unethical practices by monopolies that prevent the free market from operating as it should.

The main federal antitrust laws are the Sherman Act, the Clayton Act, and the Federal Trade Commission Act. The legislative declarations of these Acts make it clear that Congress wants to promote fair competition within the market economy.

Counselor's Corner It is difficult at first blush to determine if a business's strong market presence is the result of a superior product or service that the public demands or unfair business practices. In the technology industry, the big players have invested so much into research and development to bring cutting edge products to market. But if their products are not user friendly and do not meet customer needs, they will not get a return on their investment. As a result, we see an uptick in antitrust complaints from competitors to bring down businesses when they can't do so on the open market. Antitrust laws are not a sword of competitors to be used for unjust means. Thus, antitrust allegations require examining the entire relevant market, including the complaining party. ~Robert S., judge

19.2 Historical Development

The United States economy was founded on the capitalist principle of free enterprise. **Free enterprise** is a private and consensual system of production and distribution, usually conducted for profit in a competitive environment, that is relatively free of governmental interference. The theory is that, given the freedom, businesses will operate efficiently and be responsive to consumer needs and demands.

The weakness of the free enterprise system is that it assumes that businesses will be ethical and compete with each other fairly. During the Industrial Revolution, powerful businessmen took advantage of the free enterprise system to increase their wealth at the expense of their workers, competitors, and consumers.

These Industrialists bought shares in competing companies then transferred the shares to a trust. The trust then set prices for goods within the industry, determined which companies could operate in a given geographic area, and micromanaged the business operations of companies within an industry. As a result, companies that were not part of the trust went bankrupt, new competitors were prevented from entering the market, and consumer prices rose beyond market requirements.

States tried to stop the abuses of the Industrialists through the trusts. State attempts failed because the US economy was growing beyond state industries to national ones. As a result, national legislation was needed to restore balance to the market. The resulting legislation is called "antitrust law" because its purpose was to break up the power of the Industrialists' trusts.

In 1890, Congress passed the Sherman Antitrust Act under its power to regulate interstate commerce. The **Sherman Antitrust Act** (also known as the Sherman Act) prohibits direct or indirect interference with the freely competitive interstate production and distribution of goods. The Act addresses two main concerns:

1. Unreasonable restraints on trade between two or more parties; and
2. Monopolies.

In 1914, Congress passed the Clayton Act. The **Clayton Act** amended the Sherman Act and expanded antitrust regulations to prohibit:

1. Price discrimination;
2. Tying arrangements;
3. Exclusive-dealing contracts; and
4. Mergers resulting in monopolies or substantially lessening competition.

Congress also passed the Federal Trade Commission Act in 1914. The **Federal Trade Commission Act** established the Federal Trade Commission (FTC) to protect consumers against deceptive practices and enforce antitrust laws. The Act prohibits false, deceptive, and unfair advertising and trade practices. Some of these practices are discussed in more detail in Chapter 20.

Figure 19.1 The Federal Trade Commission Act

The last major antitrust law is the Robinson-Patman Act, which was passed by Congress in 1936. The **Robinson-Patman Act** amended the Clayton Act and prohibits price discrimination that hinders competition or that tends to create a monopoly.

19.3 Monopoly

A **monopoly** is the control or advantage obtained by one supplier or producer over the commercial market within a given region. Not all monopolies are illegal. In fact, some industries are exempted from antitrust laws:

- Highly regulated industries;
  - Utilities;
  - Railroads;
  - Airlines;
  - Insurance companies;
  - Securities; and
  - Banks
- Labor unions;
- Agricultural and fishing cooperatives (farmers not distributors);
- Exporters;
- Lobbyists;
- States (unclear if includes US territories); and
- Professional baseball.

To be an illegal monopoly, a business must have (1) monopoly power (2) in the relevant market and (3) the intent to acquire and use such power.

Monopoly Power

Monopoly power is the power of a business to fix prices unilaterally or to exclude competition. The size of a business's market share is a primary factor of whether monopoly power exists.

Courts have found monopoly power when a business controls seventy percent or more of a market.

If a business controls 51-69 percent of a market, then it is possible that monopoly power exists. Courts examine other factors such as number of competitors, market concentration, degree of difficulty for new businesses to enter the industry, and the nature of the industry. If the entry costs and barriers are high and there are few other competitors, a business may have monopoly power when it controls slightly more than half the market.

If a business controls fifty percent or less of a market, then no monopoly power exists.

Relevant Market

To determine whether a business has monopoly power, it must be determined whether it has monopoly power within the relevant market. However, defining the relevant market can be challenging. The relevant market includes both the product or service market and the geographic area.

Product or Service Market

The first element in determining the relevant market is to determine what goods or services are interchangeable in consumers' minds. This is sometimes called **substitutability** or **functional interchangeability**. Defining the exact product or service market is usually heavily litigated because it may result in market concentration or dilution, and ultimately whether a business has enough market share to be deemed a monopoly.

For example, Ford shares the passenger truck market with manufacturers such as Chevrolet, GMC, Dodge, Toyota, Nissan, and Honda. However, Ford shares the commercial truck market with manufacturers such as Peterbilt, Volvo, Daimler, and Volkswagen. If sued for violation of antitrust law, Ford would want a broad definition of the product market, such as "trucks," to include a greater number of competitors and lessen its own market share. Plaintiffs would want to define the product narrowly, such as "three-quarter ton passenger trucks," to lessen the number of competitors and heighten Ford's market share.

As large companies expand their products and services across industries, this inquiry becomes more complex and expensive to litigate.

Geographic Area

Determining a business's market power also requires determining the geographic area in which the business operates. As globalization and e-commerce increase the geographic reach of businesses, this inquiry is also becoming more difficult.

For example, should the market for Ford passenger trucks be determined by city, state, nation, continent, hemisphere, or globally? Ford trucks may have higher sales in Detroit, Michigan than in Tokyo, Japan. Determining the geographic area of the relevant market may include areas of higher or lesser concentrations of sales. Therefore, parties also heavily litigate what is the appropriate geographic area for the relevant market.

Intent

The third factor is the business's intent to acquire and use its monopoly power.

Not all monopolies are the result of a business's predatory actions. Some "boom and bust" industries, such as mining and oil and gas, are difficult to maintain long-term success. If an industry goes through a difficult time and competitors go out of business, the remaining company may end up as a monopoly without engaging in anticompetitive behavior.

To determine intent, courts look at the conduct of the business. Purchasing smaller competitors to increase its market share and engaging in predatory pricing is often evidence of a company's intent to become a monopoly.

Specifically, an intent to monopolize requires:

1. Predatory or anticompetitive conduct;
2. Specific intent to control prices or destroy competition; and
3. A dangerous probability of success.

A business's intent is evaluated in the context of the current industry and economic conditions. For example, are there significant changes to the law that affect the profitability of the industry or an economic downturn that impacts competition? Just because a company is large enough to successfully survive a challenging time, it may not have the necessary intent to become an illegal monopoly.

19.4 Unreasonable Restraints on Trade

Antitrust laws prohibit unreasonable restraints on trade. A **restraint on trade** is an agreement between two or more businesses intended to eliminate competition, create a monopoly, artificially raise prices, or adversely affect the free market. A restraint on trade that produces a significant anticompetitive effect and, therefore, violates antitrust laws is an **unreasonable restraint on trade**.

Concerted Action

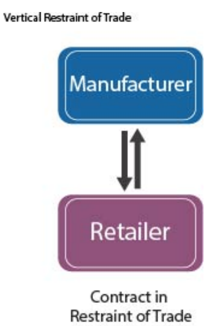
Concerted action is an action that has been planned, arranged, and agreed on by parties acting together to further some scheme or cause. Concerted action can be either horizontal or vertical. **Horizontal agreements** occur between direct competitors. For example, cell phone providers decide to lock customers into two-year contracts. Customers are required to agree to terms that benefit the companies, regardless of which provider they choose.

Figure 19.2 Horizontal Restraints on Trade

Horizontal agreements are almost always struck down as per se violations of antitrust laws. Because competitors appear to make decisions based on their own self-interest rather than letting the market forces decide price and conditions, courts conclude that such agreements are not in the interest of consumers and the free market.

Vertical agreements occur between businesses at different places along the distribution chain of a given product. For example, a manufacturer suggests a sale price to a wholesaler of its product (i.e. “manufacturer’s suggested retail price”).

Figure 19.3 Vertical Restraints on Trade



Vertical agreements are usually subject to a “rule of reason” test to determine if they are illegal. The rule of reason test is a case-by-case analysis of the agreement, industry, effects, and intent of the businesses. Although it is possible to show that a vertical agreement is legal, it usually costs businesses a lot to litigate these types of cases.

Price Fixing

Price fixing is the artificial setting or maintaining of prices at a certain level, contrary to the workings of the free market. **Horizontal price fixing** is price fixing among competitors at the same level, such as retailers throughout an industry. **Vertical price fixing** is price fixing among businesses in the same chain of distribution, such as manufacturers and retailers attempting to control a product’s resale price.

One form of price fixing is predatory pricing. **Predatory pricing** occurs when a company lowers its prices below cost to drive competitors out of business. Once a predator rids the market of competition, it raises prices to make up lost profits. The goal of predatory pricing is to win control of a market or to maintain it.

Predatory pricing has three elements:

1. The alleged predator is selling products below cost;
2. The alleged predator intends that its competition goes out of business; and
3. If the competitors go out of business, the alleged predator will be able to earn sufficient profits to recover its prior losses.

Predatory pricing cases are often hard to win because it is difficult to prove the alleged predator’s intent.

Division of the Market

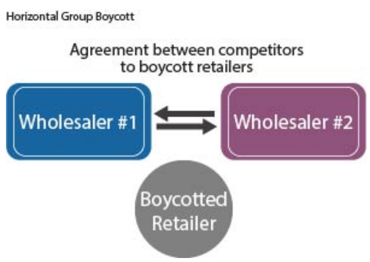
Division of the market occurs when businesses agree to exclusively sell products or services in specific geographic territories. A **horizontal division of the market** is when competitors enter into an agreement to not compete for customers by dividing a geographic area into separate sales territories. A **vertical division of the market** is when a manufacturer and its wholesalers agree to exclusive distributorships in a given territory.

Exclusive distributorships are usually legal unless the manufacturer has dominant power in the overall market. For example, Wendy's grants exclusive distributorships to its franchisees to avoid oversaturation in a given geographic area. As long as Wendy's is not the only fast food restaurant within a particular market, the exclusive distributorships will be upheld. This is because Wendy's has a legitimate business interest in not diluting the value of its franchises, which does not restrict consumers' choice of fast food restaurants in the overall market.

Group boycotts

A **boycott** is an action designed to socially or economically isolate an adversary. A **group boycott** is an agreement between two competitors who refuse to do business with a third party unless it refrains from doing business with an actual or potential competitor of the boycotters. Group boycotts may be either horizontal or vertical.

Figure 19.4 Horizontal Group Boycott



Exclusionary Contracts

Exclusionary contracts require businesses to buy or lease products on the condition that they do not use the goods of a competitor of the seller. The most common types of exclusionary contracts are tying arrangements and exclusive dealing arrangements.

A **tying arrangement** occurs when a buyer is not permitted to purchase one item without purchasing another. These are often called "bundling packages." These arrangements benefit a seller because it allows the seller to wed a popular item with one that is less desirable and would not get as many sales independently.

Under the rule of reason test, a tying arrangement is illegal when:

1. The agreement involves two distinct products not closely related to each other;
2. Commerce is impacted significantly; and
3. The seller has sufficient economic power in the tying product to enforce the tie-in.

An **exclusive dealing arrangement** exists when a buyer agrees to purchase all of its requirements from a single seller or a seller agrees to sell all of its output to a single buyer. Exclusive dealing arrangements are illegal when they substantially lessen competition or tend to create a monopoly.

Mergers and Acquisitions

Regardless of a business's intention when merging or acquiring another business, a merger or acquisition is prohibited when it may substantially lessen competition or may create a monopoly. When analyzing a potential merger, the court considers:

1. The relevant market;
2. The pre-merger profile of the business; and
3. The post-merger profile of the business.

As discussed above, the relevant market is determined by examining the relevant product or service market, as well as the geographic area of the business's operations.

The pre-merger profile is determined by analyzing the type of merger, the size of the companies involved, and the concentration of the industry. Mergers may be horizontal, vertical, or conglomerate. Horizontal mergers are between competitors. Vertical mergers are between businesses within a supply chain. And conglomerate mergers are between companies in different industries. An example of a conglomerate merger is Amazon's acquisition of Whole Foods in 2107.

The post-merger profile uses the same factors as the pre-merger profile but looks at the anticipated business after the merger.

19.5 Price Discrimination

Price discrimination is the practice of offering identical or similar goods to different buyers at different prices when the costs of producing the goods are the same. Price discrimination may violate antitrust laws if it reduces competition.

Price discrimination may be either direct or indirect. **Direct price discrimination** occurs when a seller charges different prices to different buyers. **Indirect price discrimination** occurs when a seller offers special concessions (such as favorable credit terms) to some, but not all, buyers.

The Robinson-Patman Act defines discrimination in terms of first, second and third lines. **First line price discrimination** is when the seller directly offers different prices to different buyers. For example, coffee sold to individual customers is priced differently. First line price discrimination is legal when the lower price is offered to customers who buy large quantities, use coupons, or are part of a loyalty program. It is also legal if the price difference is the result of manufacturing, sales or delivery costs. For example, coffee prices may be lower for Hawaiian coffee in Hawaii because there are less transportation costs involved than shipping coffee to the Continental United States.

Figure 19.5 First Line Discrimination

Second line price discrimination occurs when a manufacturer demands lower prices from suppliers. For example, large retailers often demand discount prices from manufacturers because they buy goods in large quantities. Second line price discrimination is legal as long as the negotiations for the lower price are done fairly and there is not a substantial anticompetitive impact in the market. When second line price discrimination results in larger businesses freezing out smaller competitors, it violates antitrust laws.

Figure 19.6 Second Line Price Discrimination

Third line price discrimination occurs when a customer of a customer of the seller is benefited by the seller's actions. For example, a clothing manufacturer gives a price discount to a clothing wholesaler, who then passes the savings on to the retailer, who then reduces prices for consumers. The consumers ultimately benefit from the price discount given to the wholesaler by the manufacturer.

Figure 19.7 Third Line Price Discrimination

Price discrimination, at any line, is legal when a seller lowers prices in good faith to meet an equally low price offered by a competitor. If lower prices are a result of good faith, courts determine that the prices reflect market forces at work. In other words, the businesses are honestly competing for consumers. However, if the lowered prices are not done in good faith but are an attempt to undercut competition, then the business commits predatory pricing.

19.6 Enforcement

Antitrust laws impose both civil and criminal penalties. A private business that has been injured by anticompetitive practices may sue for damages. To encourage private enforcement, the Sherman and Clayton Acts award successful litigants treble (i.e. triple) damages and attorneys' fees. To be successful, a plaintiff must show that an anticompetitive act directly resulted in a tangible injury.

However, most antitrust actions involve governmental enforcement. This makes sense because the government has the power to investigate and subpoena that private businesses do not. It also saves businesses a lot of money for the government to enforce the laws rather than through private litigation.

Both the Department of Justice and the Federal Trade Commission enforce antitrust laws. Both agencies may pursue civil and criminal remedies for violations of the law.

Civil remedies include:

- **Injunctions** (court orders prohibiting the business from committing further violations);
- **Consent decrees** (court-approved agreements in which a party does not admit wrongdoing but agrees to change its behavior); and
- **Divesture orders** (court orders requiring a company to sell its interest in an acquired company).

The Department of Justice may also pursue criminal charges for violations of antitrust laws. If convicted of a felony, individuals may be fined up to $1 million per violation and may be sentenced up to ten years in prison. A business may be fined as much as $100 million per violation.

19.7 Concluding Thoughts

The underlying tension of antitrust laws is the appropriate amount of regulation in a free enterprise system. By definition, a free enterprise market-oriented system should be free from governmental regulation. However, it is clear that some regulation and oversight is necessary to protect individuals and businesses from unethical and anticompetitive business practices. Even absent unethical practices, some businesses may be so successful that over time they gain enough market share to freeze out competition, and have less incentive to deliver quality products and services. As a result, the market may become stagnant, which is not in the best interest of the national economy or consumers. Antitrust laws attempt to protect consumers and the economy while allowing free enterprise to operate.

history is available upon request.

19.1: Introduction

19.2: Historical Development

19.3: Monopoly

19.4: Unreasonable Restraints on Trade

19.5: Price Discrimination

19.6: Enforcement

19.7: Concluding Thoughts

20: Consumer Law

20.1 Introduction

LEARNING OBJECTIVES

1. Learn the primary consumer laws that protect purchasers and debtors.
2. Understand the enforcement role of the Consumer Financial Protection Bureau.

Consumer law is the area of law dealing with consumer transactions, including an individual's ability to obtain credit, goods, real property, or services for personal, family, or household purposes. Business to business transactions are usually governed by contract law and are not considered part of consumer law.

Consumer protection laws are laws designed to protect consumers against unfair trade and credit practices involving consumer goods, as well as to protect consumers against faulty and dangerous goods. The focus of these laws is to ensure that businesses do not take advantage of individual consumers.

Counselor's Corner Approximately 80 percent of Americans are in debt. Consequently, consumer protection laws, especially those that protect debtors, are incredibly important to the majority of Americans, even if they don't realize it. Debt collection agencies can be aggressive and unethical. Know your rights so that you are not bullied or taken advantage of. ~Maria M., attorney

20.2 Protecting the Purchaser

Consumer protection laws that protect purchasers of goods and services generally fall into four categories:

- Labeling and packaging;
- Sales;
- Deceptive advertising; and
- Hazardous materials.

Labeling and Packaging

How goods are labeled and packaged influences whether consumers will buy them. As a result, regulations require that labels must be truthful and allow consumers to understand what the product is, what it contains, and any potential hazards.

Labeling and packaging regulations fall into four categories:

Type	Example
Product comparison	Nutrition labels on food and beverages
Preventing injury	Warning not to use lawn mower to trim hedges
Preventing access	Childproof caps on medications; tobacco secured in retail stores
Informing of potential hazards	Potential side effects of hazardous items and drugs

Sales

The general principle in sales regulations is that advertising must be honest. Consumers should be able to make informed decisions based on what products and services really are and not based on false claims or empty promises. These regulations apply to all sales materials regardless of medium: print, electronic, social media, or radio.

One important regulation involves door-to-door sales. Consumers who buy goods or services from door-to-door salespeople have three days to cancel purchases without penalty. This is called a **cooling off period** and is intended to protect consumers from high pressure sales tactics. The exception to the cooling off period is when services are immediately rendered. For example, someone who aerates a lawn or removes snow as soon as a consumer consents to pay for the service is entitled to payment without being subject to a cooling off period.

Another important regulation involves delivery of goods ordered online, through catalogs, or by door-to-door sales. Goods must be shipped within the promised time period or notice must be given to the consumer. If the goods are not shipped and proper notice is not given, then the consumer has the right to cancel the order for a full refund. Similarly, if a consumer receives goods that he or she did not order through the mail, the consumer can treat it as a gift and does not have to pay for it.

Sellers are allowed to promote their goods and services and make them appealing to consumers. **Puffery** is a broad promotional statement made by a business about goods or services that is not intended to be taken literally. In other words, puffery is an exaggerated opinion, such as “the best,” “most popular,” and “nobody can beat it!” As long as puffery remains an opinion and does not contain false factual statements, puffery is legal. However, if puffery contains false statements, then the statements are deceptive advertising and illegal.

Deceptive Advertising

Deceptive advertising is a material misrepresentation or omission likely to mislead a potential customer and would mislead a reasonable customer. In other words, deceptive advertising is a lie.

For example, if a car manufacturer advertises a vehicle as “the best in its class” or “the most popular” sedan, such statements are legal puffery. If the manufacturer advertises that the vehicle gets 35 miles per gallon when it only gets 30 miles per gallon, then that statement is deceptive advertising.

Another form of deceptive advertising is called bait and switch or bait advertising. **Bait and switch** is a sales practice where a seller advertises a low-priced product to lure consumers into a store only to induce them to buy a higher-priced product. Often the advertised product is not actually available as advertised or the seller refuses to sell it on the advertised terms. The low-priced product is the “bait” that brings consumers in but then the seller “switches” the higher-priced product as the subject of the transaction. Bait and switch advertising can also apply to sales of services.

Hazardous Materials

In the context of consumer protection law, **hazardous materials** are products deemed dangerous to the consuming public. Hazardous materials include drugs that may be consumed safely in small amounts under supervision of a medical provider, as well as toxic chemicals that are banned for certain public uses such as lead and asbestos.

Hazardous materials regulations are extensive to ensure that products reaching consumers are safe for their intended use and other reasonable, foreseeable uses. These regulations also control product recalls.

Regulations vary depending on the business’s industry. To help consumers understand their rights and report harmful products, the Consumer Product Safety Commission established the www.SaferProducts.gov website.

20.3 Protecting the Debtor

A **debtor** is someone who owes an obligation to another individual or business, especially the obligation to pay money. Consumers become debtors when they owe a business money for the purchase price of goods and services. If consumers pay the purchase price at the time of the transaction or shortly afterward, then the transaction is completed. If, however, the consumer does not immediately pay but receives the goods or services, then the consumer becomes a debtor under consumer protection laws.

Consumer protection laws that protect debtors generally fall into five categories:

- Obtaining credit;
- Reporting credit information;
- Electronic fund transfers;
- Identity theft; and
- Debt collection.

Obtaining Credit

The process of obtaining credit is regulated by two federal laws. The **Truth in Lending Act** regulates what information must be provided by creditors who wish to extend credit to consumers. The **Equal Credit Opportunity Act** prohibit creditors from discriminating against consumers based on their membership in certain protected classes.

Truth in Lending Act

Congress passed the Truth in Lending Act (TILA) in 1968 to help consumers understand and compare various credit options available to them. TILA only applies to consumer credit transactions and leasing. The law does not apply to commercial credit transactions.

TILA applies to all real estate transactions and consumer credit transactions of $25,000 or less. The law also applies to credit transactions involving finance charges or when the loan repayment involves four or more installments.

TILA also regulates credit cards. The law prohibits credit card companies from issuing credit cards unless they were requested by the consumer. Any changes to interest rates or policies to existing credit card accounts must be provided in writing to consumers, who must be allowed to cancel their credit cards without penalty. Consumers are required to pay any outstanding balance accrued to that point, but they cannot be forced to accept altered terms.

TILA requires certain disclosures be made to applicants for credit. These disclosures include:

- Minimum rate of repayment;
- Billing period;
- Interest rate in the form of the annual percentage rate;
- Type of interest (simple or compound);
- Service charges and fees; and
- Prepayment penalties.

All disclosures must be in ordinary language that makes sense to the ordinary customer. Disclosures must also be clear and conspicuous, meaning that the terms cannot be buried in a contract to hide them from consumers.

Equal Credit Opportunity Act

Congress passed the Equal Credit Opportunity Act (ECOA) in 1975 to protect consumers from discrimination when applying for credit. ECOA prohibits creditors from discriminating against creditors based on their:

- Race;
- Color;
- National origin;
- Religion;
- Gender;
- Age;
- Marital status; and
- Welfare status.

The purpose of ECOA is to require creditors to consider only those characteristics of an applicant related to creditworthiness rather than social status or stereotypes. Therefore, creditors may consider an applicant's marital or welfare status only to the extent that it relates to the applicant's creditworthiness. For example, an applicant's marital assets and debts are relevant factors when determining how much credit, if any, should be extended to the applicant. However, denying or granting credit solely on the basis of marital and welfare status is illegal.

ECOA also requires creditors to provide specific reasons for denying credit to applicants. This allows applicants to determine whether the denial was for discriminatory reasons or as pretext to hide the discriminatory reason, in violation of the law.

Reporting Credit Information

Congress passed the **Fair Credit Reporting Act (FCRA)** in 1970 to regulate the gathering, storage, and reporting of credit-related information. FCRA applies to individual consumer information only. FCRA does not apply to business entities' credit reports.

A **credit bureau** is an organization that maintains and distributes information regarding a person's credit worthiness to potential creditors, insurance companies, and employers. The three main credit bureaus in the United States are Equifax, Experian, and Transunion.

Before releasing consumer information, a credit bureau must confirm the identity of the party making the request and verify the reason for its use. The credit bureau then provides information about a consumer's credit in the form of a **credit report**.

In general, consumers do not have to consent to the release of their information. FCRA requires notice to consumers in three specific circumstances:

- A credit report is provided to an employer and includes negative information that could prevent the consumer from being hired;
- When the consumer is denied credit, insurance, or employment based on information contained in the report;
- An investigative report is requested about the consumer's character, personal attributes, and living arrangements.

Credit bureaus must delete general information that is more than seven years old, and bankruptcies that are more than ten years old. If debts were incurred over seven years ago, or bankruptcies filed more than ten years ago, but are still "open" because the debt has not been paid off, then that information may be reported.

FCRA gives consumers some specific rights regarding their consumer reports. First, consumers are entitled to one free report per year from each of the credit bureaus. Consumers may pay for additional copies of their credit reports.

Second, consumers are entitled to dispute information included in a credit report. If the credit bureau determines that the report contained an error, the erroneous information must be removed. If the credit bureau confirms the information or cannot determine that it was erroneous, then the consumer has the right to add an objection to the information in the report.

Finally, consumers are entitled to place a credit freeze on their credit reports. A **credit freeze** is when the consumer restricts or prohibits creditors from requesting credit reports about them. In essence, a credit freeze prevents third parties from requesting a consumer's credit report without the consumer's permission. If the consumer wants to apply for credit or a new job, then the consumer may lift the credit freeze for a limited period of time or give authority to specific entities to request a credit report.

Electronic Fund Transfers

The **Electronic Fund Transfer Act (EFTA)** was passed by Congress in 1978 to protect consumers from unauthorized electronic fund transfers from their accounts. EFTA applies to electronic direct deposits and withdrawals, automatic teller machines (ATMs), and point-of-sale transactions with merchants.

EFTA requires banks to investigate errors and reported fraud promptly and to correct any errors within one business day. A consumer's liability for unauthorized transfers is limited to $50 or the amount of the transfer (whichever is less) for transfers made before the consumer notified the bank of the unauthorized use. After the consumer notifies the bank, the consumer is not liable for any additional unauthorized transfers. However, if the consumer fails to notify the bank within two business days of the unauthorized transfer, then the consumer's liability rises to $500.

A **preauthorized transfer** is an electronic fund transfer authorized in advance to recur at regular intervals. For example, a consumer authorizes her monthly mortgage payment to be automatically withdrawn from her banking account on the first of every month. Preauthorized transfers require banks to:

- Receive written instructions from the consumer about the timing, amount, and duration of the transfers; and
- Allow the consumer to stop payment up to three business days before the scheduled transfer date.

Identity Theft

Identity theft is an increasing concern for businesses and consumers. The Federal Trade Commission estimates that at least ten million consumers are victims of identity theft each year.

While consumers cannot completely prevent identity theft, there are some steps that they can take to minimize their risk. First, consumers should monitor their bank accounts and charges on their credit and debit cards. If they notify their banks of unauthorized transactions as soon as possible, then they will minimize their personal liability. Second, consumers should request their credit report at least annually. Parents are entitled to request credit reports for their minor children. Third, consumers can place a credit freeze on their credit report to prevent third parties from accessing their financial and personal information and from obtaining credit under their name.

If a consumer is a victim of identity theft, he or she can post a fraud alert with the credit bureaus to be included in his or her credit report. A **fraud alert** requires businesses to verify the identity of an applicant for credit before extending any credit to him or her.

Debt Collection

Businesses that are owed money from debtors may seek a court judgment to collect the debt. However, the judicial process is often expensive and time consuming. As a result, many businesses prefer to collect debts outside of the court system.

To prevent abusive practices by debt collectors, Congress passed the **Fair Debt Collection Practices Act (FDCPA)** in 1978. Under FDCPA, a debt collector must, within five days of contacting a debtor, send a written notice containing:

- The amount of the debt;
- The name of the creditor to whom the debt is owed; and
- A statement that if the debtor disputes the debt in writing, all collection efforts must stop until the creditor receives evidence of the debt.

FDCPA also prohibits certain debt collection practices. Debt collectors cannot:

- Contact a debtor who has notified the collector in writing that he or she wants no further contact;
- Contact a debtor who is represented by an attorney;

- Call a debtor before 8:00 a.m. or after 9:00 p.m.;
- Threaten a debtor or use obscene or abusive language;
- Contact a debtor at work if the employer prohibits such contact;
- Imply or say that they are attorneys or government officials when they are not;
- Use a false name;
- Make any false, deceptive, or misleading statements;
- Contact family and acquaintances of the debtor more than once or for any reason other than to locate the debtor;
- Tell family and acquaintances of the debtor that he or she is in debt;
- Publish the debtor's name and address on a "bad debt" list on the internet or in the newspaper; or
- Collect charges in addition to the debt unless permitted by state law or contract signed by the debtor.

Filing a collection action in court does not violate any of these rules.

20.4 Enforcement

Congress empowered both the Federal Trade Commission and the Consumer Financial Protection Bureau to enforce the primary federal consumer protection laws. However, numerous federal and state laws contain provisions to protect consumers. As a result, there are many federal and state agencies that have regulations related to consumer protection.

The **Consumer Financial Protection Bureau (CFPB)** was created by Congress in 2010 to be a single point of contact for consumers who seek financial consumer protection. The CFPB is intended to consolidate enforcement efforts and to make them more consistent than when they were shared among agencies. The CFPB is authorized to enforce the federal consumer protection laws discussed in this chapter, as well as others.

20.5 Concluding Thoughts

Consumer protection laws are intended to protect consumers from unethical and unfair business practices. These laws are broad in range, from advertising and marketing to recalling delivered products that are hazardous. With the continued evolution of electronic transactions and banking, consumer law will continue to evolve to address areas of concern as they develop.

20.1: Introduction

20.2: Protecting the Purchaser

20.3: Protecting the Debtor

20.4: Enforcement

20.5: Concluding Thoughts

CHAPTER OVERVIEW

21: Workplace Privacy and Information Security

Learning Objectives

- Identify some of the most important privacy laws impacting businesses today.
- Understand the Constitutional basis for privacy rights.
- Explore the legal issues involved with modern technology and information security.

21.1: Introduction

Privacy is a fundamental right of individuals that is often compromised by government and businesses. Sometimes individuals and businesses voluntarily give up their privacy rights, without considering the consequences of doing so. Workplace privacy and information security is a fast growing area of the law that has important implications across industries.

Counselor's Corner Privacy and cybersecurity are two of the most dynamic areas of the law. As our society becomes more and more dependent on technology, and as the Internet of Things continues to expand, we are seeing privacy issues explode in personal and professional contexts. Businesses would do well to consult with cybersecurity and privacy experts to ensure that they are complying with the law and protecting their networks and confidential information as much as possible. Bringing in experts after you have a security breach or lawsuit filed is way too late. Be proactive. It just may save your business. ~Katie D., attorney

21.2: Right to Privacy

Privacy is the right of a person or person's property to be free from unwarranted public scrutiny or exposure. In other words, it is the right to personal autonomy and to express oneself selectively. Privacy includes both bodily integrity and the protection of confidential information, including medical and financial records.

Implied Constitutional Right

Privacy is an **implied Constitutional right**, meaning it is a right based on the "zones of privacy" created by the US Constitution. However, the word "privacy" is not in the Constitution itself.

The right to privacy was first mentioned in a Harvard Law Review article in 1890 by Samuel Warren and Louis Brandeis, who later served on the US Supreme Court from 1916 until 1939. Warren and Brandeis argued the right to privacy is an important civil liberty which should not be violated by sensational journalists and developments in technology. The technology in the late 1890s they were the most concerned with was photography and telephones. In particular, they were concerned about people losing their right to privacy when others take photographs of them or listen to their conversations.

Privacy was discussed in the legal community for 75 years before the US Supreme Court expressly held individuals have a Constitutional right to privacy in the 1965 *Griswold v. Connecticut* decision.

Privacy cases involve different circumstances, such as the right to choose whether to marry and to whom, the right to choose whether to have children, and the right to protect confidential information such as medical and financial records.

The Framers of the Constitution did not include the word "privacy" in the Constitution but it is a fundamental right underlying the core tenets of the document. The Bill of Rights begins by recognizing fundamental rights that are essential to an individual's identity: speech, religion, press, assembly, and petition for redress from the government. From there, the Bill of Rights expands protection of individuals to include their homes and possessions. For example, the Fourth Amendment prohibits unreasonable searches and seizures by the government. As reflected in the Bill of Rights, privacy is an essential right the Constitution intends to protect.

When analyzing privacy cases, courts ask whether an individual has a reasonable expectation of privacy. To establish a "reasonable expectation of privacy," a person must meet two requirements:

1. **The individual has an actual, subjective expectation of privacy**. In other words, did that particular person think he or she was doing something in private that others could not observe?
2. **Society accepts the individual's expectation of privacy as reasonable**. In other words, as a community do we expect those circumstances to be private?

This legal test has both a subjective and objective standard. If an individual does not expect their actions to be private, then no right to privacy exists under the circumstances. Similarly, if society as a whole does not expect to have privacy under the circumstances, it does not matter what the individual may personally believe, no right of privacy exists.

For example, if a person calls her doctor to discuss medical test results, then she has a subjective expectation of privacy. If she calls her doctor from her home, then she has an objective expectation of privacy because society recognizes the right of people to have private conversations in their own homes. However, if she has the conversation on her cell phone while riding the bus, then she does not have a right to privacy because it is not objectively reasonable to expect privacy on public transportation.

Privacy cases also focus on whether a person has given either express or implied consent to disclose or use personal information. **Express consent** is often given in the form of contracts, including end user agreements. Implied consent is usually based on the person's actions, such as a history of business transactions. In essence, **implied consent** means that a business has reason to believe that a person would give consent if the business asked for it. For example, customers who sign up for a loyalty program may give implied consent to receive marketing emails from that particular business.

While consent and the expectation of privacy are interrelated concepts, they are legally different concepts.

Statutes

Congress and state legislatures have also passed various laws to protect the privacy of individuals and their property. Some of the most important federal laws related to workplace privacy are discussed below.

There is a growing trend among states to require internet service providers to obtain consent from consumers before sharing any of their personal information, including websites visited and consumer habits.

Businesses engaged in e-commerce with residents of California must post their privacy policy conspicuously on their websites and abide by their policies. California law also requires disclosure of consumer software tracking policies.

International Law

The right to privacy is contained in Article 12 of the Universal Declaration of Human Rights, which was adopted in 1948 in response to the horrors of World War II. The Universal Declaration of Human Rights states:

No one shall be subjected to arbitrary interference with his privacy, family, home or correspondence, nor to attacks upon his honor and reputation.

The Universal Declaration of Human Rights has been adopted by the majority of nations, including the United States.

Many other bilateral treaties and conventions recognize the right to privacy in various circumstances. Currently, about 150 nations recognize privacy as part of their international legal obligations. However, enforcement of the right to privacy is inconsistent across nations.

It is important for US businesses operating in Europe or conducting business transactions with Europeans to understand that the European Union (EU) has a comprehensive set of laws to protect the privacy of European individuals and businesses. The **EU General Data Protection Regulation (GDPR)** applies to all businesses, even located outside of Europe, that collect, store, or process data about any European. Under GDPR, individuals have the right to know how their personal data is being collected and used, to remove information from the internet, and to stop companies from processing their data. GDPR has significant penalties. For example, businesses mishandling customer information may be fined up to four percent of their annual worldwide revenue.

Under GDPR, businesses must comply with six data processing principles. Personal information must be:

1. Processed lawfully, fairly and transparently;
2. Collected only for specific legitimate purposes;
3. Adequate, relevant and limited to what is necessary;
4. Accurate and, where necessary, kept up to date;
5. Stored only as long as is necessary; and
6. Processed in a manner that ensures appropriate security.

21.3: Workplace Privacy

Employees generally do not have a reasonable expectation of privacy in the workplace, especially when using company equipment or when the employer has a policy stating employees may be monitored. However, some areas such as employee restrooms and locker rooms may not be monitored. Courts have held employees do not give up all expectations of privacy by the nature of their employment. Therefore, employers should ensure that they limit monitoring activities to reasonable places where the employer has a legitimate business interest for doing so.

Hiring Process

Employers often run background checks on prospective employees as part of their hiring process. Depending on what type of background check is done and the information used, a range of privacy issues are involved. Some states regulate the type of documents that a prospective employer may consider when making hiring decisions. Businesses need to ensure they comply with all state laws where they hire employees.

The use of artificial intelligence (AI) is a growing trend in recruiting and hiring. AI is often used to review resumes, applications, and publicly available social media. AI-powered video-interview platforms apply algorithms to video-recorded interviews to facilitate an employer's assessment of applicants.

Illinois was the first state to pass an AI Interview Act, which requires prospective employers to notify applicants of their use of AI and to obtain their consent before using AI tools on their application materials. Although limited to its state, the Illinois law has been cited by many legal experts as a template for other federal and state laws.

Based on the Illinois law, employers who use AI during their hiring process should adopt the following best practices:

- Give notice to applicants of the use of AI-powered video-interview platforms;
- Explain what the AI is and how it works in ordinary language to applicants;
- Obtain consent of applicants to use and record their video interviews;
- Offer an alternative interview method for interviews; and
- Have a procedure in place for the destruction of recordings.

Drug and Alcohol Testing

Employers with drug and alcohol testing policies are highly regulated by the states where they operate. State requirements vary about required notice of testing, the nature and location of testing, and when testing may occur. All states protect employee privacy regarding who receives the test result and how those results are to be collected, stored, and destroyed. Employers who engage in drug and alcohol testing need to be informed about the legal consequences of enforcing their policies.

Employees frequently challenge drug and alcohol testing as a violation of their right to privacy. Employers generally win these lawsuits when:

- The employer complies with all state requirements for drug and alcohol testing;
- Conducts the test with the employee's consent;
- Conducts the test in a manner that was not offensive; and
- The test results do not reveal information unrelated to the purpose of the test.

Employers must be careful to limit disclosure of test results to only those with a need to know. Businesses may lawfully conduct a drug or alcohol test but still be liable for privacy violations based on how they handled the results.

Health Insurance Portability and Accountability Act

The Health Insurance Portability and Accountability Act of 1996 (HIPAA) seeks to protect confidential health information and mandates standards for handling such information.

HIPAA has a Privacy Rule regulating the use and disclosure of individually identifiable health information. The Privacy Rule protects **Protected Health Information (PHI)** , which includes all information related to the past, present or future health status of an identified individual, of treatment received, or of payment for treatment. PHI also includes billing records, information about premium payments, and enrollment information. As a result, PHI includes medical information required by employers to carry out their obligations under the Americans with Disabilities Act, the Family Medical Leave Act, workers' compensation, drug testing, and employer-sponsored health care plans.

HIPAA also has a Security Rule to ensure the confidentiality, integrity and availability of electronic PHI. Under the Security Rule,

- **Confidentiality** means PHI is not made available or disclosed to unauthorized individuals or processes;
- **Integrity** means PHI is not altered or destroyed in an unauthorized manner; and
- **Availability** means PHI is accessible and usable upon demand by an authorized individual.

The Security Rule also requires businesses to protect electronic PHI against reasonably anticipated threats and reasonably anticipated violations of the Privacy Rule.

Figure 21.1 HIPAA Security Rule

C.I.A.

Technology Safeguard

- *Access Control*
- *Audit Control*
- *Integrity*
- *Person or Entity Authentication*

Physical Safeguard

- *Facility access controls*
- *Workstation use*
- *Workstation security*

Administrative Safeguard

- *Security management, security officer*
- *Workforce security, information, access management*
- *Training security incident*

Privacy Rule "Reasonable" Safeguard for all

HIPAA requires businesses to designate a single person who is ultimately responsible for the security of electronic PHI. This person is also responsible for ensuring the business engages in the mandatory security management process under HIPAA. This process starts with a risk analysis of the potential vulnerabilities in the business's system and management of PHI. The security management process is extensively regulated.

Importantly, HIPAA applies to "covered entities" rather than specific types of information. Personal fitness trackers such as Fitbit, gather what is essentially healthcare data of its consumers. However, Fitbit data can be sold as consumer information because Fitbit is not a covered entity under HIPAA with regard to its consumers. However, if Fitbit gathers PHI of its employees who request medical leaves of absence, then Fitbit is a covered entity as an employer.

Electronic Monitoring

Federal law and most state laws allow employers to monitor their employees' electronic communications occurring over the employer's hardware, software, and servers. If the employer provides the computer system, the employer has the right to monitor electronic communications on the system, even if those communications are not work related.

Employers may also monitor communications when employees consent to the monitoring. Therefore, many employers require employees to sign a waiver consenting to private communications sent via the employer's equipment to be monitored. This helps defend against invasion of privacy claims better than having a policy in the employee handbook alone.

Businesses may also monitor conversations with customers in the ordinary course of business as long as they give notice. As a result, many customer service lines use a recorded message that "this call may be monitored for training purposes" before customers are connected to a customer service agent.

The most important federal law regarding monitoring of electronic communications is the **Electronic Communications Privacy Act (ECPA)**, which was passed by Congress in 1986. ECPA has two parts. The first part is known as the Wiretap Act and the second as the Stored Communications Act. ECPA prohibits the acquisition of the the content of a wire, oral or electronic communication using an electronic, mechanical or other device. ECPA also prohibits the use or disclosure of an unlawfully intercepted communication.

ECPA exposes businesses to multiple levels of liability within a business. For example, personnel in the IT department may be liable for unlawfully intercepting an employee's email, and human resource personnel who use and disclose the email may be liable as well. Each unlawfully intercepted communication may give rise to liability. Therefore, a handful of communications may result in multiple individuals throughout a business repeatedly violating ECPA.

Workplace Recordings

Although recordings may be useful to capture the content of a conversation, recordings pose legal and business risks to employers. Both employers and employees may violate federal and state wiretapping laws by recording conversations without consent of the other parties. Even with consent, businesses that engage in recording employees and customers damage employee morale and risk losing customers.

Twelve states prohibit recording a conversation unless all parties consent. The majority of states allow customers and employees to hold a business liable for wiretapping violations under the respondeat superior doctrine. As a result, businesses may be liable for their employees' unlawful recordings if done in the course and scope of employment or done to help the business.

State and federal wiretapping laws carry both civil and criminal penalties. Many state laws provide for treble damages or a statutory damage amount. Federal wiretapping laws impose fines up to one hundred dollars per day or ten thousand dollars, whichever is greater.

Another potential problem for businesses is putting confidential business information at risk. For example, employees may capture trade secrets, proprietary information, or business strategies that the business wants to protect. Recorded information can be compromised or shared against the business's interests.

Social Media

An employer's right to monitor electronic communications generally does not include social media. As a result, employers are not entitled to monitor social media accounts through coercion or deceit. For example, an employer cannot require employees to provide passwords to their social media accounts. Employers also cannot log onto the social media accounts of others (including employees) and pose as them to see private accounts.

However, if social media accounts are public, then employers are entitled to review them to the same extent as other members of the public.

Videotaping and Surveillance Cameras

ECPA only protects electronic communications. As a result, ECPA does not apply to video or camera surveillance without an audio component. To avoid violating ECPA, businesses should ensure their security and surveillance cameras do not capture human voices.

Security cameras cannot be used in areas in which employees and customers have a reasonable expectation of privacy. For example, retailers cannot use cameras in changing rooms, restrooms, and locker rooms. Businesses need to place cameras so that private activity cannot, and is not, monitored and recorded.

Businesses engaged in surveillance must use the most limited means available to conduct the surveillance. Companies should have a legitimate business reason to use security cameras, and they need to ensure the surveillance is targeted and limited in duration and scope.

Retailers who use cameras to prevent theft at entryways and cash registers should place cameras in positions that are open and obvious to act as notice to customers. Signs giving express notice are also a best practice to avoid legal liability.

Biometrics and Wearable Technology

Biometrics is the automated identification of people using their physical characteristics. While many metrics can be used, fingerprints and facial recognition are the most common. It is helpful to think of biometrics as measurements of some aspect of a person.

There is a growing trend among businesses to move from traditional time clocks to biometric time clocks that scan fingerprints, retinas, or irises to verify an employee's identity and clock the employee in and out of work. Biometric time clocks prevent time clock fraud, increase timekeeping efficiency, and increase accuracy of wages.

The type of biometric technology used impacts the privacy rights involved. Technology storing biometric data directly impacts privacy rights more than technology creating a "template" through an algorithm to create a representation of a fingerprint. Whether the technology captures and uses existing personal information or creates a replica has legal consequences.

There have been a series of class action lawsuits against employers that have not notified employees when their biometric identifiers and data were being shared with third party timekeeping vendors. Consent is only a defense for employers if they give notice and obtain consent for all uses of the information.

Another technology trend is the use of wearable technology. **Wearable technology** is a category of electronic devices that can be worn as accessories, embedded in clothing, implanted in the user's body, or even tattooed on skin. The devices are intended to be hands-free, are powered by microprocessors and connect with the Internet. Wearable technology includes smartwatches, fitness trackers, and medical devices. It is helpful to think of wearable technology as something that an employee has.

Wearable technology is often used to track employee locations and grant access to areas. Concerned about private companies coercing employees to be microchipped, states are passing laws prohibiting employers to require, coerce, or compel an individual to receive a microchip implant or use wearable technology as a condition of employment.

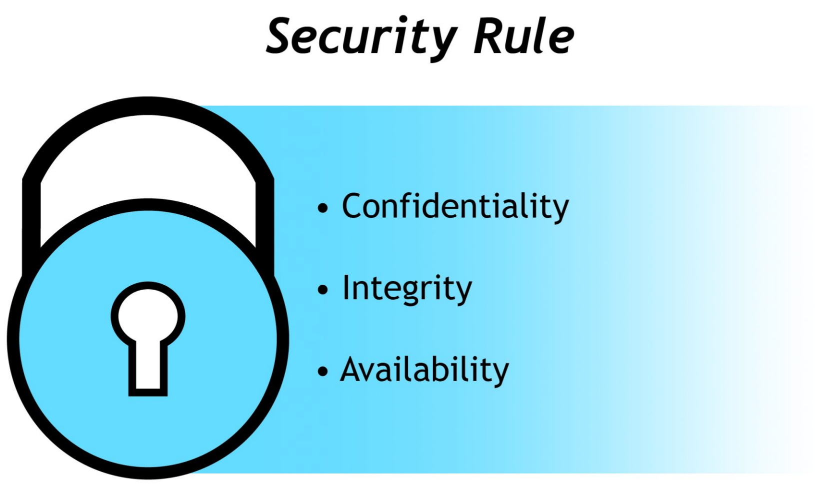
21.4: Information Security Issues

Information security is one of the fastest growing areas of the law affecting businesses today. Any business that collects, uses, and stores personal information about employees and customers is subject to these laws. Businesses are also increasingly targeted by hackers who seek to steal private information on a large scale.

Security Analysis

A simple but widely-used security model is the **CIA Principle** or **CIA Security Rule**, which stands for Confidentiality, Integrity and Availability. The principle is applicable across points of contact from access to a user's internet history to security of encrypted data across the Internet.

Figure 21.2 CIA Principle



Confidentiality is the ability to hide information from those without authorization to view it. While perhaps the most obvious principle, it is usually the one that is attacked most often. Cryptography and Encryption are methods used to protect confidentiality of data transferred across the Internet.

Integrity is the ability to ensure that data is an accurate and unchanged representation of the original information. One common security attack is to intercept some important data and make changes to it before sending it on to the intended receiver.

Availability is the ability to make information readily accessible to authorized users at all times. Some security attacks attempt to deny access to appropriate users, either to inconvenience them or to achieve another goal such as redirecting business to a competitor.

As discussed in Section 21.3 above, HIPAA's Security Rule requires covered entities to implement the CIA principle to protect PHI.

Data Breaches

According to the Pew Research Center, almost eighty-five percent of individuals in the US shop online. And most retailers collect customer's personal and financial data. If a customer uses a form of payment other than cash, then the customer's personal and financial information will be shared with the business.

Rather than pickpocket an individual consumer, thieves today are targeting businesses to collect personal and financial information of entire consumer sets. Data breaches affect all industries, such as retail, credit bureaus, hospitals, and government agencies. In the first half of 2019, there were over 4.1 billion compromised documents reported as part of only 3,800 disclosed data breaches.

Cybersecurity experts advise that cyber criminals run automated online scripts looking for unsecured databases. While some larger businesses are particularly targeted, cyber criminals are the most successful when targeting small to medium-sized businesses that are unaware of the threat or do not want to spend adequate resources on cybersecurity.

Businesses should be aware, though, that approximately sixty percent of data breaches are the result of human error rather than outdated or insufficient technology. Therefore, by adequately training employees, many data breaches may be avoided. For example, breaches often result from sending emails to the wrong person, responding to phishing attacks, sharing passwords, and leaving computer screens open.

Another big risk is when people use the same password for multiple accounts, such as email accounts, bank accounts, and social media. If the password is obtained by cyber criminals and added to the database of passwords, all the accounts will be at risk.

Big Data

In addition to financial data, businesses collect personal information about consumers and their habits. This is called **big data**. Consumer information is very valuable because businesses can search the data to identify spending habits to target marketing to likely customers. This reduces costs and increases profit for businesses, especially as e-commerce increases the number of competitors across industries.

Another benefit to mining the data available about consumers is businesses can make more profitable decisions. For example, health insurance companies are heavily invested in big data because they want information about the lifestyle habits of the people they insure and potentially insure. If they know someone is a smoker, eats a lot of sugary foods, or has a sedentary lifestyle, then they can adjust premiums accordingly to minimize their risk. Insurance companies look for trends not just for individuals but also regions, types of occupations (including those with the highest risk of addiction or obesity), and socio-economic status.

Big data is also connected to the Internet of Things. The **Internet of Things (IoT)** is a system of interrelated computing devices, mechanical and digital machines, objects, animals or people that are provided with unique identifiers and the ability to transfer data over a network without requiring human-to-human or human-to-computer interaction. In other words, the IoT includes everyday devices connected to the internet, including medical devices, appliances, vehicles, and buildings.

As more businesses seek big data about consumers and sell IoT items to consumers, privacy rights are impacted. Data collection in public spaces, such as billboards tracking who stops to read them, may be lawful. However, the location and manner of data collection involves different expectations of privacy. For example, businesses argue that by purchasing and installing "smart home" appliances and products, consumers have consented to surveillance and data collection. Consumer advocacy groups argue that purchasing goods for a particular use does not give consent to businesses to invade consumer privacy in their homes. These issues will be heavily litigated in the years to come.

Transborder Data Transfers

As discussed previously, the EU has a comprehensive set of privacy laws and regulations. The EU has strict limits on the export of all human resources data and consumer information to the US, even when the data export occurs within the same business. To help US businesses comply with the EU laws, the US Department of Commerce negotiated a "safe harbor" of data protection practices that the EU approved. If a US business can certify its compliance with the Safe Harbor Principles, then the EU will approve data transfers to that business.

Security Incident Preparation and Response

Businesses are not able to prevent all data security breaches. However, businesses need to take steps to protect against known and reasonably anticipated threats to confidential information. For businesses without sufficient in-house cybersecurity staff or expertise, **Managed Security Service Providers (MSSPs)** offer a wide range of security services, including setting up security infrastructure and incident response.

Although federal and state laws vary regarding legal requirements, a business should have a written cybersecurity program that conforms to their industry's recognized cybersecurity framework.

In general, a cybersecurity program should:

- Protect the security and confidentiality of all electronically stored records containing an employee or customer's social security number, driver's license number, state identification card number, credit and debit card information, dates of birth, passwords, and personal information;
- Protect against any anticipated threats or hazards to the security or integrity of the confidential information;
- Provide for reliable and accurate backups of data; and
- Protect against unauthorized access to and acquisition of information likely to result in an employee or customer being exposed to a material risk of identity theft or fraud.

Many laws, including HIPAA, have cybersecurity regulations with which businesses must comply. Certain industries have also issued their own security standards. For example, the Payment Card Industry (PCI) Security Standards Council has issued standards for the safety of credit and debit cardholder data across the globe.

Businesses wanting information about implementing cybersecurity programs that are appropriate for their industry should consider the National Institute of Standards and Technology's (NIST) Framework for Improving Critical Infrastructure Cybersecurity. The mission of NIST is to help organizations understand and improve their management of cybersecurity risks. It is an excellent place to start when analyzing cybersecurity issues.

21.5: Concluding Thoughts

The internet and technology are changing the world at an incredibly fast pace. With those changes come the challenges to individuals and businesses to maintain privacy and protect personal information. Privacy is an implied Constitutional right deeply impacted by the use of technology. Regardless of type of industry, businesses need to have adequate cybersecurity policies and practices in place to protect confidential business, employee, and customers information.

CHAPTER OVERVIEW

22: Property

Learning Objectives

- Distinguish between personal property and real property.
- Understand classifications of property.
- Examine methods of acquisition of real and personal property.
- Examine the landlord-tenant relationship.
- Understand how property is transferred through wills and trusts.
- Explore common land use regulations and environmental laws that businesses face.

22.1: Introduction

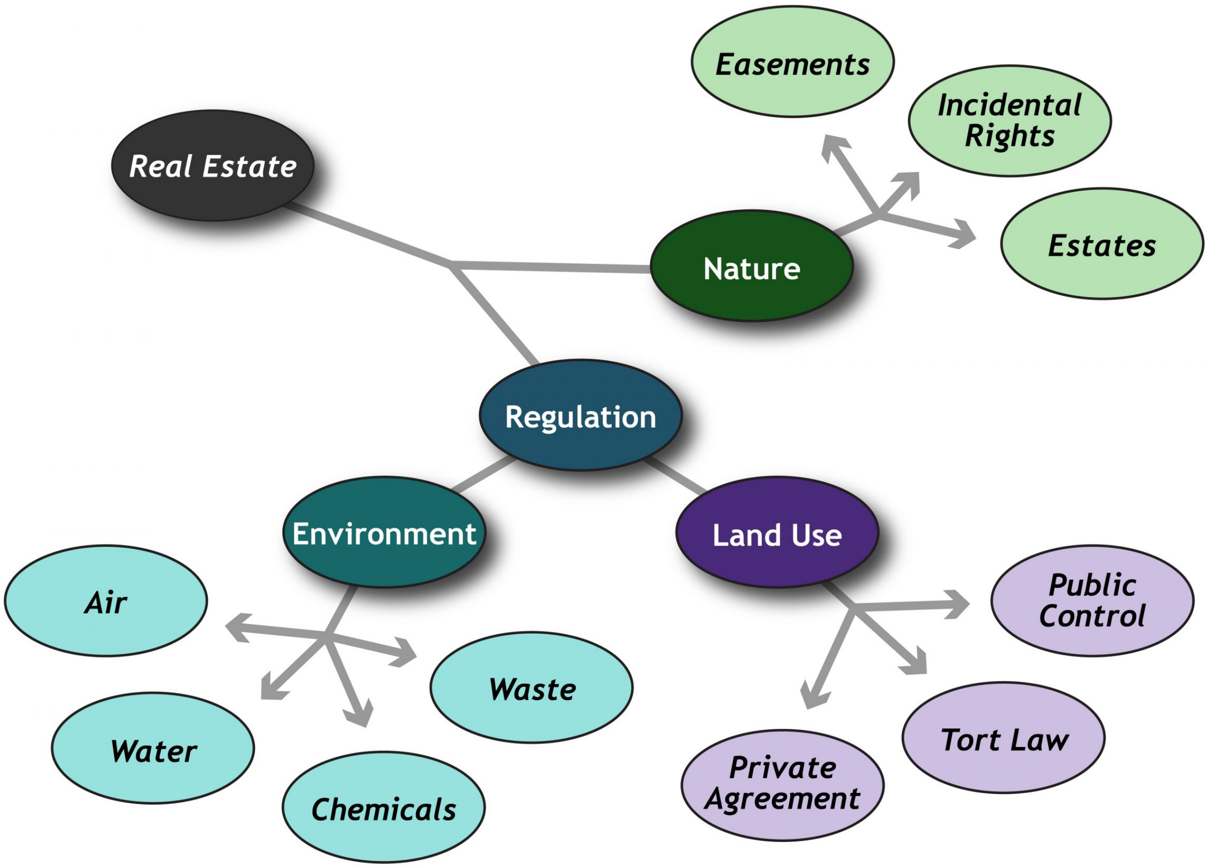
Property refers to tangible and intangible items that can be owned. **Ownership** is a concept that means the right to exclude others. Legal systems create a peaceful means to acquire, retain, and divest property, and to settle property disputes. Businesses need to understand the legal system regarding both personal and real property because they often own or lease both. In addition, the government regulates how real property can be used as well as any environmental impact a business has.

Counselor's Corner Property is regulated by state laws. Because of the variation of laws from state to state, it is imperative that businesses understand all legal requirements where they have property interests. Property can be a great seducer–it seems like owning or possessing property is an asset. However, the liability that comes with it may not be in the business's best interest. Take the time to assess the financial and legal risks and rewards before acquiring property interests to ensure that you are not overextending yourself. ~Elizabeth H., judge

22.2: Personal Property

Property can be classified as real or personal. **Real property** 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 or an office. Additionally, things associated with land, like mineral rights, are also real property. People often talk about real property by using the term **real estate**, which includes both real property and its related ownership interest.

Figure 22.1 Types of Real Estate Legal Issues



Personal property is property that is not real property. **Tangible property** is something that can be touched. Moveable, tangible personal property is called **chattel**. Many businesses exist to sell personal property. For example, the primary purpose of retailers is to sell personal property. Some property can also be described as fungible property. Property that can easily be substituted with identical property is said to be **fungible**. Types of fungible goods include juices, oil, metals such as steel or aluminum, and physical monetary currency.

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.

Personal property can become attached to the land as a fixture. 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 so when real property is transferred, fixtures are transferred as a part of the real property. A ceiling fan for sale at a store is personal property. However, once the fan is installed in a house, it becomes a fixture and is part of the real property.

Some things that are attached to the land are not fixtures but are part of the real property itself. Imagine a farm with planted corn. The corn crop is an example of real property that can become personal property. While the corn is growing and still attached to the land, the corn is real property. Once it is picked from the stalk, the ear of corn becomes personal property.

Property also can be classified by ownership. Personal and real property can be private or public. **Private property** is owned by someone or some entity that is not the government, such as individuals, corporations, and partnerships. Private property can include real property like land or buildings, and personal property, such as vehicles, furniture, and computers. Property that is owned by the government is **public property**. Rocky Mountain National Park is an example of public property that is real property. Public property can also include personal property, such as vehicles and computers owned by state or local governments.

Methods of Acquisition of Personal Property

Personal property may be acquired in several different ways. For example, **ownership by production** occurs when one produces something. However, if an employee produces a good as part of his or her job, then the employer will own the property, not the employee. **Ownership by purchase** is the most common method of acquiring property. For example, if a customer buys a good, then the customer owns it through purchase from the manufacturer.

Property may also be gifted. A **gift** is a voluntary transfer of property. Generally, the donor 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. A **conditional gift** is a gift that requires a condition to be met before the gift will transfer, such as a wedding or graduation.

Property that someone finds can be classified in several ways. If property is **abandoned**, a person who finds it may claim ownership. However, the original owners of abandoned property must intend to relinquish ownership in it. For example, if someone takes a chair to the landfill, he or she has abandoned the chair. Someone may come along and take legal possession of it. However, if the property is simply **lost or mislaid**, then the finder must relinquish it once the rightful owner demands its return. Another classification of personal property applicable to found property is treasure trove. A **treasure trove** is money or precious metals, like gold, which is hidden in the ground or other private place by an unknown owner. Whoever finds a treasure trove becomes the owner unless the true owner (i.e. the person who hid it) comes forward.

Type of Property	Description	Rights of Finder	Rights of Owner
Abandoned	Owner intentionally parted with property with intent to relinquish ownership rights	Finder acquires rights to the property	None
Lost	Owner unintentionally parted with possession of the property	Finder has rights to the property against everyone except the owner	Owner has right to have property returned because owner never lost ownership interest
Mislaid	Owner intentionally placed property in a specific place but has forgotten where	Finder has no rights and cannot keep property	Owner has right to have property returned because owner never lost ownership interest
Treasure Trove	Owner intentionally hid property	Finder acquires rights to the property unless the owner comes forward	Owner must come forward to maintain right to property; if not, finder becomes new owner

Bailment

Sometimes it is necessary to intentionally leave personal property with someone else. A **bailor** is someone in the rightful possession of personal property who gives the property to someone else to hold, who is called a **bailee**. A **bailment** is the arrangement in which the personal property is exchanged. The bailee agrees to accept the property and has the duty to return it. For example, a customer gives clothes to a dry cleaner. The dry cleaner is a bailee and has a duty to return the clothes (personal property) upon demand by the customer, who is the bailor.

Bailments may be voluntary or involuntary. A **voluntary bailment** is created when intention exists to create the bailment, as described in the dry cleaner example above. 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.

Bailment is common in business, including placing packages with common carriers for delivery, warehousing goods with a third party, or taking clients' or customers' automobiles in a valet service.

The duty of care that the bailee owes to a bailor depends on the nature and value of the property involved, as well as who benefits from the bailment. In general, a higher standard of care is required for more valuable property. Damages in a bailment case are based on the retail replacement value of the property.

22.3: Real Property

Real property is land, and certain things that are attached to or associated with it. Real property includes undeveloped land, like a field, and it includes buildings, such as houses, and office buildings. Real property also includes things associated with the land, like subsurface rights (rights to minerals and things found beneath the surface).

Methods of Acquisition

Real property may be acquired by purchase, inheritance, gift, or through adverse possession. Ownership rights are transferred by **title**. 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 the use and enjoyment of real property, the owner may bring a nuisance claim. Similarly, the owner may bring a trespass claim against those who enter the land without consent or permission.

Purchase

Land owners may convey or sell part or all of their land interests. 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. That means if the grantor has no interests in the real property, a conveyance by quitclaim will not grant any interests in the property. By comparison, a **warranty deed** conveys title and the seller gives a warranty against defects in title as well as encumbrances. Buyers typically demand a warranty deed when they purchase property because the seller assumes the risk of the title not being clear.

After title is transferred by the deed, the deed is recorded in the county where the property is located. Recording a deed is important because it places others on notice about who owns the property. States have different rules about who is considered the legitimate owner when a conflict in ownership claim exists. A **bona fide purchaser** is a purchaser who takes title in good faith, with no knowledge of competing claims to title. Many states recognize a bona fide purchaser's rights to ownership over those who did not properly record a deed.

Inheritance

Another common way in which real property may be obtained is through inheritance. Real property may be bequeathed through a will or may be transferred by state law when someone dies without a will. 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. If someone dies without living relatives, the government becomes the owner of the property.

Gift

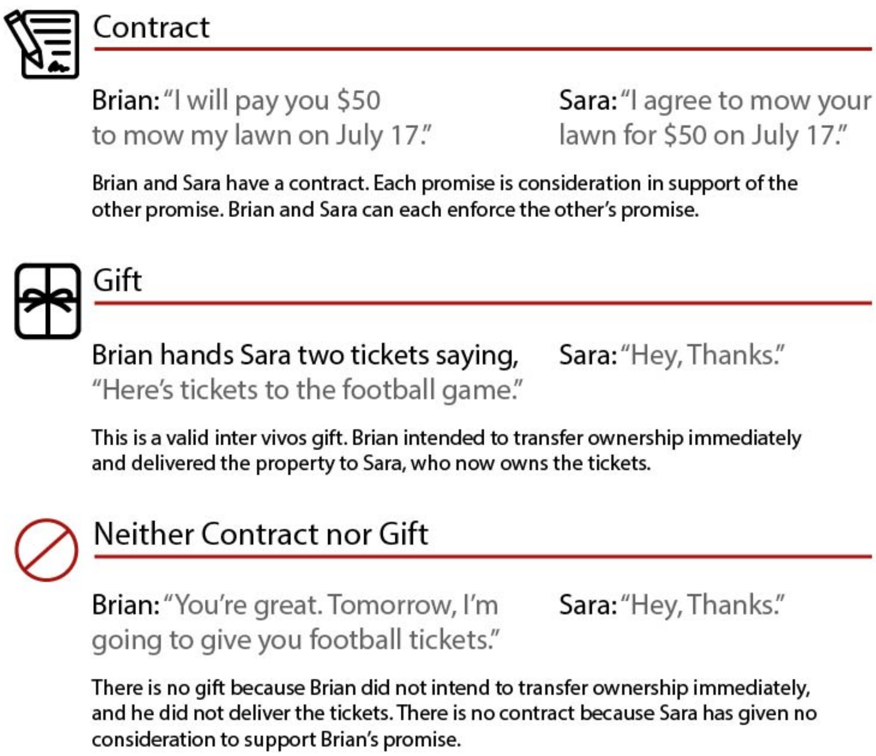
Real property may also be acquired through a gift. A gift is valid when:

1. The person giving property intends to make the gift;
2. The person delivers the deed to the recipient; and
3. The recipient accepts the gift.

If one of these elements is not met, then title will not be conveyed.

Figure 22.2 Comparison of Contract and Gift

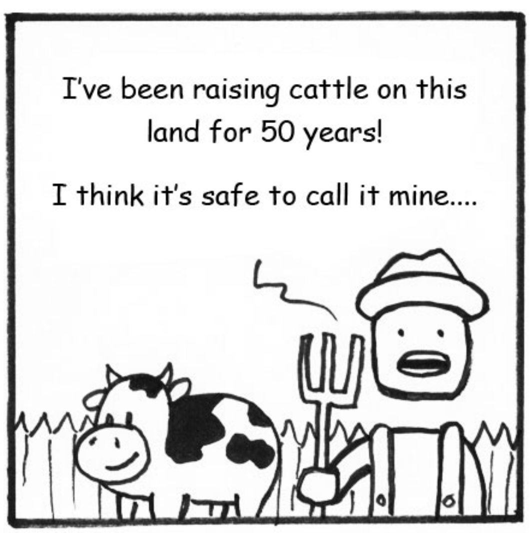
22.3 Contract & Gift Comparison



Adverse Possession

A less common way to acquire real property is through the doctrine of adverse possession. **Adverse possession** is when someone who is not the owner of real property has claimed the real property for his own. This is referred to as "squatter's rights." If land sits idle at the owner's hands but someone else puts it to use, then the law may favor the user's claim to the land over that of the actual owner. Adverse possession claims often occur around property lines, where one party has routinely used another's property because a fence has been misplaced.

Figure 22.3 Adverse Possession Cartoon



Interests and Scope

Owning real property carries many responsibilities, as well as the potential for great profit and great liability. It is important to learn how to protect against potential liability of property ownership. For instance, if a toxic waste site is discovered on real property, the owner may be liable for its cleanup, even if he or she did not realize that such a site was there when purchasing the land. Each buyer of real property has a duty to exercise due diligence when purchasing land. A purchaser should never agree to buy land "sight unseen" or without a professional inspector.

It is important to know the duties of landowners, how to limit liability associated with the ownership of land, and when severance of liability occurs.

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** is a person who intentionally enters the land of another without permission. A landowner has a duty to not intentionally injure a trespasser. For instance, booby traps and pitfalls are illegal. Trespassers injured from such traps have valid claims against the landowner. However, if trespassers are injured from unknown or unforeseeable dangers, the owner is not usually liable.

A **licensee** is someone who has permission to be on the land. Landowners have a higher duty of care to such a person. Licensees include delivery people, meter readers, and utility workers. A landowner must not intentionally injure a licensee and must 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 that those steps are icy. Failure to do so may result in liability for the landowner.

An **invitee** is someone who has entered real property by invitation. Businesses and public places that want members of the community to visit have issued invitations to the public. Landowners must inspect their property for defects, correct those defects when found, and warn invitees about such defects. For example, a grocery store must clean up spills as quickly as possible and put up a "caution" sign in that area.

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. Sometimes 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 recognized by law is called **fee simple absolute**. This ownership allows the owner complete control over the land and lasts until the owner dies or conveys the property to someone else. Generally, if someone wants to buy real property, he or she is looking to buy property in fee simple absolute.

Compare that with a defeasible fee. A **fee simple defeasible** is subject to a condition of ownership or to some future event. For instance, if an owner donates land to a city "so long as it is used as a public greenway," then the land would be owned in defeasible fee by the city as long as it maintains 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**, which is a future interest in real property.

Another ownership interest is a **life estate**. This interest is measured by the life of the owner. For example, a person could grant ownership rights in real property to a parent for the length of his or her life, but then the property would be returned upon the parent's death. A common investment, known as a reverse mortgage, 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. These arrangements essentially gamble on life expectancies of the sellers of real property by granting life estates to them in the property.

Property can be owned by more than one owner. 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** describes an ownership interest in which all owners have an equal right to possess the whole property. Compare this to **joint tenancy**, in which the surviving owner has the right of survivorship. If one of the owners dies, his or her property interests automatically transfers to the remaining owner(s).

These different interests are created by specific wording in the instrument of conveyance. An owner in tenancy in common may sell or transfer his or her rights without seeking permission from the other owners. This is because owners in a tenancy in common have the unilateral right to transfer their interests in property. Conversely, to transfer one's interests in a joint tenancy, the consent and approval of the other owners is required.

Scope of Interests in Real Property

Scope of ownership determines what can (or cannot) be done with the land. The surface of the land and the buildings that are attached to the land are what most people think of about ownership of real property. However, land interests also include subsurface or mineral rights, and right to light or 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** (the right to cross or otherwise use someone's land for a specified purpose) and **covenants** (guides or restraints on how one may build on their land) grant certain rights to non-possessors of land.

Subsurface Rights

Subsurface or mineral rights are rights to the substances beneath the actual surface of the land. Purchasing mineral rights allows the owner to extract and sell whatever exists under the surface of the land, such as oil, natural gas, and gold.

Water Rights

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, 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. However, most western states use the prior appropriation doctrine, which grants rights to those who used those rights "first in time." Under this concept, the use must be beneficial, but the owner of the right need not be an adjacent landowner. This policy has resulted in claims by "downstream" users having priority over landowners where water runs through the land. For example, casinos in Las Vegas, Nevada may have priority of water rights over ranchers in Colorado where a tributary runs through the ranch. Prior appropriation is a "use it or lose it" doctrine.

Easements and Covenants

Easements and covenants are nonpossessory interests in real property. An **easement** can be express or implied and it gives people the right to use another's land for a particular purpose. For example, a common easement is for utility companies to enter private property to maintain poles and power lines. Other examples include sidewalks and a landlocked property having an easement across another piece of property for the purpose of a driveway or walkway.

A **covenant** 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 approved colors, or they might contain prohibitions against building swimming pools.

Some covenants and easements "run with the land," which means that the restrictions will apply to subsequent owners of the property. Whether a covenant or easement runs with the land depends on the type of interest granted.

Landlord-Tenant Relationships

A **leasehold interest** also may be created in real property. 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. The landlord 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 a legal remedy for breach of contract. Most state laws also impose duties on landlords to maintain safe and habitable conditions on the property. Tenants also have a duty to use the premises properly and not to damage the property beyond normal wear and tear.

Different types of tenancies may be created:

Type of Tenancy	Description
Tenancy for years	• Lease lasts for a specified period of time; • Called tenancy for years regardless of how long the tenancy is for; • Once the time expires, so does the tenancy

Periodic tenancy	• Lease states when rent is due but does not have a set duration; • E.g. a month-to-month lease
Tenancy at will	• Lease may be terminated at any time by landlord or tenant; • Tenancy often created through actions of parties rather than written lease
Tenancy at Sufferance	• Tenant remains on the property after the right of possession has ended and without the landlord’s consent; • Law views tenant as trespasser who is responsible for paying rent during holdover period; • Most states require landlord to evict tenant through formal eviction or unlawful detainer proceedings

Tenancies may be created for residential or commercial purposes. Commercial leases typically last for longer periods of time than residential leases. 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.

Lease interests are assignable unless those rights are expressly restricted by agreement. This means that the rights conveyed by the lease may be transferred to another party by assignment, unless expressly prohibited by the lease. Common restrictions on assignment in residential leases is a no-subletting clause. 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.

22.4: Wills and Trusts

Both real and personal property may be transferred to another owner through wills and trusts. Although most people think of wills and trusts as a tool for conveying property owned by individuals, businesses property often needs to be transferred when the business owner dies. This is especially true for sole proprietorships and partnerships.

A **will** is a document by which an individual directs his or her estate to be distributed upon death. Wills must be in writing and signed by the individual(s) making them. Although state laws regarding wills vary slightly, most states require:

Requirement	Description
Legal age	• The individual must be 18 (16 in Louisiana, 14 in Georgia, under 18 in the military)
Testamentary intent	• Must make clear that document is a will through words such as "last will and testament"
Testamentary capacity	• The individual must be "of sound mind" and understand that he or she is creating a will, what property is being transferred & to whom it is being given
Signature	• The individual must sign the document
Witnesses	• There must be 2 adult witnesses to the individual signing the will; • Most states do not require the will to be notarized but this step is recognized as a best legal practice

A **trust** is a property interest held by one person or entity at the request of another for the benefit of a third party. For a trust to be valid, it must involve specific property, reflect the person's or entity's intent, and be created for a lawful purpose. Trusts are very popular for leaving property to benefit children who are under 18 years old, elderly, and people with disabilities.

When planning how to distribute property upon death, it is important to understand the difference between probate and non-probate assets. **Probate** is the process through which a court determines how to distribute property after someone dies. Some assets are distributed to heirs by the court (**probate assets**) and some assets bypass the court process and go directly to beneficiaries (**non-probate assets**). Probate assets generally are subject to inheritance taxes and distribution can be delayed until the court orders the distribution of the assets. Because of these drawbacks, many individuals prefer non-probate assets.

Probate Assets	Non-Probate Assets
• Real property titled solely in the decedent's name or held in tenancy in common • Personal property, such as jewelry, furniture & vehicles • Bank accounts solely in the decedent's name • Interest in a partnership, corporation or limited liability company • Life insurance policies or brokerage accounts identifying the decedent or his or her estate as a beneficiary	• Real property held in joint tenancy or tenancy by the entirety • Bank or brokerage accounts held in joint tenancy or with payable on death (POD) or transfer on death (TOD) beneficiaries • Real property, personal property, and money held in a trust • Life insurance or brokerage accounts identifying someone other than the decedent as a beneficiary • Retirement accounts

Death of a property owner impacts the ability to transfer property. The ownership interest dictates how the property may be transferred.

Type of Ownership	Death of Owner	Transfer	Where Available
Tenancy in Common	Owner's interest passes to heirs	Owner may transfer interest without agreement of co-owners	All states
Joint Tenancy	Owner's interest passes to the remaining joint tenants as non-probate asset	Owner may not transfer interest without agreement of co-owners	All states
Tenancy by Entirety	Owner's interest passes to the surviving spouse	Owner may not transfer interest without agreement of spouse	Approximately half of the states
Community Property	Half of owner's interest passes to the surviving spouse & other half passes to other heirs	Owner may not transfer interest without agreement of spouse	Only 9 states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas & Washington

If someone dies without a will or trust, the probate court will determine:

1. The nature and value of the decedent's estate;
2. The nature and value of any outstanding debts and tax obligations;
3. Whether the decedent has any heirs;
4. The identity of the heirs and their relationship to the decedent; and
5. What, if anything, the heirs are entitled to receive from the decedent's estate.

The essential role of the probate court is to ensure that the deceased person's creditors are paid and that any remaining assets are distributed to the proper beneficiaries. However, this process takes time and costs money from the deceased person's estate. And there is no guarantee that the deceased person intended his or her property to be distributed based on the state's rules on who qualifies as an heir and what they are entitled to receive. Business assets owned by the deceased person may complicate the probate process even more.

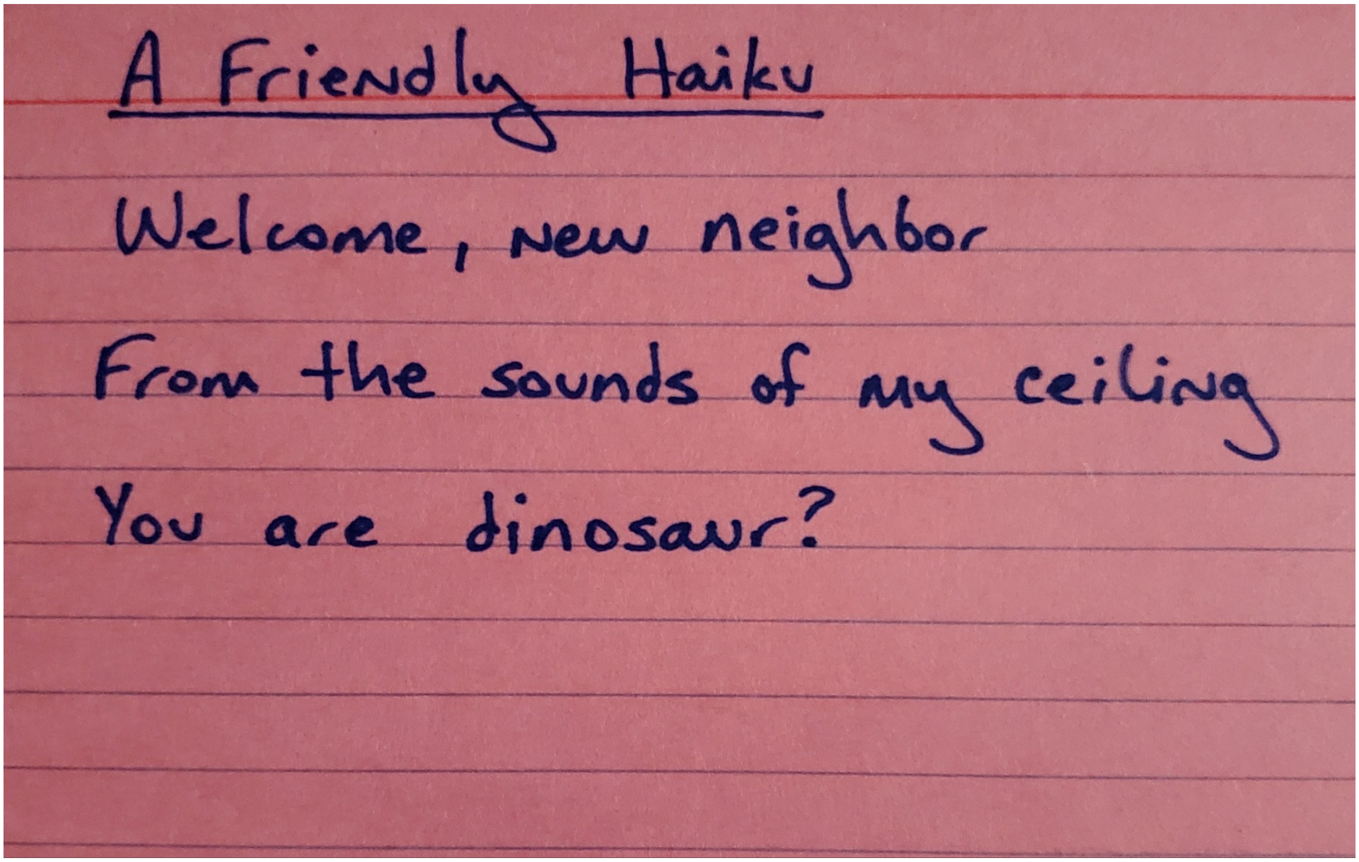
22.5: Land Use Regulation

A **nuisance** is a condition or situation, such as a loud noise or foul odor, that interferes with the use or enjoyment of property. Courts balance the utility of the act that is causing the problem against the harm done to neighboring property owners. For example, restrictions exist on when manufacturing plants may operate to not interfere with sleeping patterns of neighbors.

Nuisance can be both intentional and unintentional, as well as public or private. A **public nuisance** is an unreasonable interference with a right common to the general public, such as a condition dangerous to the public's health or a restriction on the public's access to public property. Many jurisdictions also include conduct that is offensive to the community's moral standard to regulate the placement of adult industries in residential neighborhoods. Public nuisance claims often include manufacturing noises, smoke and smells. A **private nuisance** is a condition that interferes with a person's enjoyment of their property that does not involve a trespass. For example, cigarette smoke entering a neighbor's house from a smoker on an adjacent property is a private nuisance.

Figure 22.4 Public Nuisance Street Sign

Figure 22.5 Private Nuisance Example



Most states have passed laws that allow local governments to regulate zoning. **Zoning ordinances** are laws passed by counties, cities, and municipalities that regulate land development. These ordinances determine whether commercial or residential buildings can be built in an area, how tall buildings may be, and how much green space must be maintained. They also apply to existing buildings and regulate whether a building may be converted from residential property to commercial, as well as what type of commercial property it may be. For example, many zoning ordinances regulate the types of businesses that may be located next to schools and hospitals.

Eminent domain is the power of the government to take private property for public use. A governmental entity may need to build or expand highways, public transport systems, or public housing. To address the public's need, the government can take private property and use it for the good of the community. All levels of government–federal, state, and local–have the power of eminent domain. The Fifth Amendment of the US Constitution requires that any owners of private property taken for public use must be given "just compensation." Just compensation means fair market value for the land.

22.6: Environmental Law

Federal and state governments have passed environmental laws to limit pollution and protect the health and welfare of the public. Although most people are supportive of these laws in theory, the practical implementation of them has been controversial. Underlying the political debate is the question, how should the law balance the costs and benefits of environmental decisions?

Clean Air Act

In 1963, Congress passed the Clean Air Act to regulate air pollution. Under the Clean Air Act, the Environmental Protection Agency (EPA) has the authority to regulate both the total amount of existing air pollution and its ongoing production. The Clean Air Act was passed to address concerns of global warming and acid rain.

Figure 22.6 EPA Seal

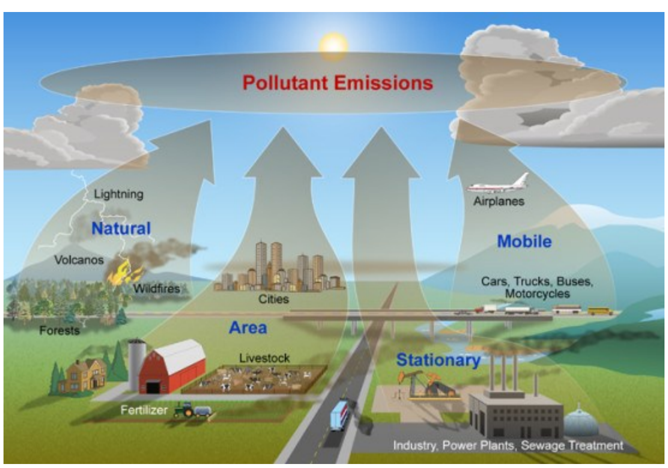
The Clean Air Act requires the EPA to set national air quality standards that protect public health and provide an adequate margin of safety without regard to cost and to implement them if appropriate and necessary. This “without regard to cost” directive has been heavily litigated. In 2015, the US Supreme Court ruled that the EPA must consider costs as part of its analysis of whether the standards are “appropriate” and necessary. In other words, a regulation is not “appropriate” if it does more harm than good.

The Clean Air Act is a federal law that is implemented through the states. After the EPA sets air quality standards, states must enforce them. States may implement more stringent air quality standards than the EPA requires, but they cannot do less. Therefore, businesses must comply with both state and federal agencies to ensure their compliance with the Clean Air Act.

A controversial aspect of the Clean Air Act is that it allows for trading of credits. For example, a manufacturer who removes more carbon monoxide than necessary from its emissions is given a “credit” from the EPA. These credits can then be sold to another manufacturer that does not remove enough to be compliant with the law. The rationale is that credits make it profitable for manufacturers to invest in technology that pollutes less than is legally required. By giving a market incentive to industries to protect the environment, there will be less need for governmental enforcement.

The Clean Air Act imposes daily fines for emission violations, as well as punitive damages and criminal liability for corporate officers who knowingly and willfully violate the law. As a result, the Clean Air Act is a law that manufacturers must take seriously.

Figure 22.7 Common Air Pollutants



Clean Water Act

Congress passed the Clean Water Act in 1972 to regulate water quality of navigable waters. Similar to the Clean Air Act, the EPA sets standards that are enforced by the states. The intent of the Clean Water Act is to keep water clean for recreational use and to protect fish and wildlife. It requires a discharge permit to release waste into navigable water.

Figure 22.8 Photo of discharge of industrial waste into river

The EPA sets limits, by industry, on the amount of each type of pollution that can be discharged in a given area, as well as the type of technology that can be used to treat water. As a result, the two biggest issues when enforcing the Clean Water Act are (1) is the waterway navigable? and (2) what is the best available technology that each industry can use to reduce pollution. Both issues are heavily litigated.

The Clean Water Act also requires the EPA to set national standards for water quality in general. It is worth noting that water quality standards vary depending on the use of the water. Water quality for drinking is the highest, with wildlife and recreation higher than irrigation and industry. As a result, even businesses that are not discharging waste into navigable waterways are subject to EPA standards of water quality on their premises. For example, a retailer must comply with water quality requirements in its drinking fountains and bathrooms.

Like the Clean Air Act, the Clean Water Act imposes daily fines for emission violations, as well as punitive damages and criminal liability for corporate officers who knowingly and willfully violate the law.

Waste Disposal

Waste disposal, especially of chemicals, has been an area of increased regulation over the past decades. The disposal of ordinary garbage is primarily regulated by the states. However, the federal government sets minimum standards for landfills and regulates how states manage garbage. Most of these regulations are “invisible” to businesses and individuals.

Figure 22.9 Improper Toxic Waste Disposal

Toxic waste, on the other hand, directly impacts manufacturers. In 1976 Congress passed several laws to address the problem of industrial waste and toxic waste. **Toxic waste** is hazardous or poisonous substances that cause an increase in the death rate or serious irreversible illnesses. Toxic waste includes arsenic, asbestos, clinical waste (i.e. syringes), cyanide, lead, and mercury. Many of these chemicals are found in batteries, electronics, and household cleaners. Manufacturers have a “cradle to grave” responsibility for all hazardous and toxic waste. This means that hazardous waste must be (1) tracked from creation to final disposal and (2) disposed of at a certified facility.

To clean up hazardous waste that was illegally dumped in the past, Congress passed the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), which is popularly known as “Superfund.” The philosophy of Superfund is that the polluter pays. Therefore, former and current owners of a site on which hazardous waste is found or who transported waste to the site are strictly liable for remediation of the land. The law has an exception for innocent landowners who unknowingly purchased the land. However, that exception is narrowly applied.

Environmental Impact Statements

The National Environmental Policy Act (NEPA) requires all federal agencies to prepare an **environmental impact statement (EIS)** for every major federal action that significantly affects the quality of the human environment. An EIS is required not only for actions by the federal government, but also activities regulated or approved by the government. Therefore, private businesses that need federal approval to open or expand their operations are subject to this requirement. For example, an EIS was needed before expanding the Snowmass ski area in Aspen because the US Forest Service was required to approve the expansion.

An EIS must include:

- A description of the environmental impact of the proposed action;
- An estimate of the energy requirements for the project;

- A description of potential adverse effects on the urban quality, including historic and cultural resources;
- Identification of the short-term and long-term impact on the environment;
- A description of any irreversible impact on the environment;
- A plan of how to mitigate any adverse environmental impact; and
- A discussion of possible alternatives.

The process of preparing an EIS can be long and expensive. After an EIS is written, the federal agency must allow for public comments and hold a hearing. Therefore, a private business may have its EIS scrutinized and commented on by interest groups and competitors before receiving federal approval. There is also a risk to the business that the government agency denies the business's request based on public comments and concerns.

22.7: Concluding Thoughts

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.

When thinking about acquiring property, it is important to understand the rights and duties associated with acquiring it, the protections afforded to the owner, and how to transfer it to another party at the time of sale, lease, or licensing the right to use it. Real property includes land and the buildings attached to it, as well as the minerals below it. Personal property is everything else. Because property ownership includes exposure to liability, businesses need to take steps to protect people on their real property from hazards. Businesses are also subject to land use regulations and environmental laws for the use of their real property.

Real and personal property may be transferred to another owner through wills and trusts upon the death of the original owner. Businesses property often needs to be transferred when the business owner dies, and not having a will or trust in place to convey the property can complicate the probate process. Non-probate assets are popular to avoid inheritance taxes and delays in distributing assets.

Environmental laws have a big impact on businesses, especially manufacturers. The Clean Air Act and the Clean Water Act are federal laws that are implemented through the states, so businesses must work with both state and federal governments to ensure they are legally compliant. Businesses that want to open or expand their operations are required to prepare an environmental impact statement if they need federal approval.

CHAPTER OVERVIEW

23: Intellectual Property

Learning Objectives

- Understand what intellectual property is.
- Define the four types of intellectual property.
- Explore the Constitutional roots for providing legal protection to intellectual property.

23.1: Introduction

Regardless of size and industry, a business's Intellectual Property (IP) is often more valuable than its physical assets. In fact, Fortune 500 companies have 45-75% of their assets tied to IP. Companies invest tremendous resources in developing innovative new products and services. Intellectual property law prevents competitors from immediately profiting from another's invention and provides incentives for continued innovation.

Counselor's Corner Intellectual property is one of a business's most important assets. But it can also be hard to define and, thus, hard to protect. A good IP attorney will understand the nuances of your invention and help you identify ways to get the most protection for your intellectual property. You may find that working with her contributes to your inventive process! ~ Jenny C., attorney

23.2: Intellectual Property

Intellectual Property is a form of intangible property representing the commercially valuable product of the human mind. IP can be in either an abstract or concrete form. For example, a composer may have IP interests to both the abstract sound of the music he or she composed, as well as the concrete sheet music that instructs musicians how to play the musical composition.

Protection of IP rights generally fall into one of four categories: patents, trade secrets, copyrights, and trademarks.

	Patent	**Trade Secret**	**Copyright**	**Trademark**
Protects	Inventions & methods	Valuable secrets that give a business a competitive advantage	Tangible expression of an idea; but not the idea itself	Words & symbols used to identify products or services
Elements	Novel & non-obvious	Distinctiveness	Original expression	Reasonable measures in place to protect secrecy
Filing Requirements	Application must be approved by USPTO	Information must be kept secret but no formal process is necessary	Protection is automatic once creative expression takes tangible form; does not have to be filed with the CO but receives greater protection if it is	Mark is used in commerce; does not have to be filed with USPTO but receives greater protection if it is
Duration	20 years (14 years for a design patent)	Forever, as long as information is kept secret	70 years after death of author, 95 years from publication, or 120 years from creation (whichever is shorter)	10 years but can be renewed an unlimited number of times as long as mark is still being used
Type of Law	Federal only	State (Economic Espionage Act may provide some federal protection depending on facts of case)	Federal only	Federal and state
Type of Enforcement Action	Infringement	Misappropriation	Infringement	Infringement & dilution
Criminal Liability	No	Yes	Yes	Yes
Expensive	Yes	No	No	Maybe (depends on policing costs)
Search Required for Existing IP Holders	Yes	No	No	Yes

Different types of IP may attach to aspects of the same product or service. For example, Coca-Cola has trademarks for its name and logo, a patent for the shape of its original glass bottle, a copyright for its commercial jingle, and a trade secret for its cola recipe.

Figure 23.1 Examples of Coca-Cola trademarks

23.3: Constitutional Roots

The US Patent and Trademark Office (USPTO) was established to protect patents as enumerated in Article I, Section 8 of the Constitution. That clause, known as the **Copyright Clause**, says that Congress may "promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries." The USPTO website has a searchable database for trademarks and patents.

The Copyright Clause directs the federal government to protect certain products of the mind, just as much as it protects personal land or money. The Copyright Clause essentially allows the government to create a special kind of monopoly around IP. For example, a pharmaceutical company invents a drug and applies for a patent. If the patent is granted, then the company can charge as much as it needs to recover its research and development costs because competitors are shut out of that drug market by virtue of the patent. Violations of patent law carry severe penalties.

How can Congress outlaw most monopolies when the Constitution grants monopolies for 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 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," which is a very specific purpose. Note that making an inventor rich is not the purpose. Rather, the purpose is progress. Granting temporary monopolies encourages progress by providing a financial incentive to producers. Singers, songwriters, inventors, drug companies, and manufacturers invent and create in the hope of making money. If they were not protected, they would either not invent at all or would simply do it for themselves, 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." Congress makes the decision on how long a monopoly can last based on how best to promote progress. When the monopoly ends, science is advanced again because others can freely copy and improve upon the producer's products. Society benefits greatly from the expiration of 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. Similarly, 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 royalties because copyrights last for only seventy years after the death of the author or creator. These inventions and works are now in the **public domain** to be enjoyed by all.

23.4: Patents

A **patent** is the exclusive right to make, use or sell an invention for a specified period of time (usually seventeen years), granted by the federal government to the inventor. A **patent holder** owns a patent. Patents may be legally sold to others. Therefore, an inventor may sell a patent to others, which ends his or her property interest in the invention.

Many inventors and designers work for employers in creative and inventive capacities. If an employee invents something as part of his or her employment, then the employer is the patent holder. This arrangement allows innovative ideas to be adequately funded and to prevent employees working against the best interests of their employers. However, if an employee invents something outside of work on his or her own time, and the invention is not related to his or her employment, then the employee is the patent holder.

To apply for a patent, an inventor must meet two requirements: the invention must be (1) novel and (2) non-obvious. To be **novel**, the invention must not have been previously invented and must not come from a trivial improvement to an existing invention. In other words, it must not have been previously known or used. To be **non-obvious**, the invention must not be obvious to a reasonable person in an appropriate field with ordinary skill. In other words, patents reward creativity that results in something new and is not considered common knowledge by someone in the industry.

Patent Requirement	Description
Novel	New; cannot be something that was already invented or in use
Non-obvious	Not common knowledge to a reasonable person with ordinary skills in the industry

Not all things can be patented. An idea alone (without a definite description) cannot be patented. Similarly, the laws of nature (such as gravity) and things that occur naturally (such as DNA) cannot be patented. This is because some items found in nature are not the result of the human mind or creativity. If not the product of human invention, then a patent cannot apply. This distinction can be narrow in some industries. For example, DNA cannot be patented but the scientific process of synthetically reproducing DNA can be patented. Likewise, oil cannot be patented but the process for extracting it from the ground can be.

Types of Patents

Three types of patents exist. The most common type of patent is the utility patent. **Utility patents** are granted for a useful innovative machine, process, manufacture, composition of matter (such as a new chemical) or an improvement to an existing item or process. These patents usually are granted for twenty years.

A **design patent** may be granted for new, original, and ornamental designs for an article of manufacture. This type of patent protects a product's appearance or nonfunctional aspects. These patents last for only fourteen years.

A **plant patent** covers inventions or discoveries of asexually reproduced plants (e.g., plants produced through methods such as grafting, root cuttings, and budding). In other words, the plant is able to multiply without using seeds. For example, one company patented a unique rose whose color combination did not exist in nature.

Type of Patent	Description
Utility	• Protects the way an invention is used and operates • Useful innovative machine (e.g. table saw), process (e.g. software program), manufacture (e.g. thumb drive that fits into USB port), composition of matter (e.g. new chemical) or an improvement to an existing item or process • Must be useful and functional • Inventor does not have to show invention has monetary value • Lasts 20 years (unless patent granted before June 8, 1995)
Design	• Protects appearance of product (e.g. Jeep's grill design) • Lasts 14 years
Plant	• Protects any distinct and new variety of plant • Plant cannot have been sold or released in US for more than 1 year • Involves many controversial patents involving genetically modified plants used for food • Lasts 20 years

Patent Enforcement

The USPTO grants property rights to patent holders within the United States. Patent law is complicated, and attorneys who wish to practice patent law must have an engineering or science background and pass a separate patent bar exam. When an application is filed, the USPTO assigns a patent examiner to decide whether the patent application should be approved. While the application is pending, the applicant is permitted to use the term "patent pending" in marketing the product to warn others that a patent claim has been filed. Even after a patent has been issued by the USPTO, however, the patent is only presumed to be valid. If someone challenges a patent in a lawsuit, final validity rests with the US federal courts.

In the last decade there has been more than a 400 percent increase in the number of patents filed, resulting in a multiyear delay in processing applications. An increase in the number of business method patents contributed to this dramatic increase in patent applications. A business method patent seeks to monopolize a new way of conducting a business process. For example, "Patent Filing for One-Click Web Ordering" 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 button. This one-click patent was granted to Amazon.com. Amazon licensed the patent to Apple so that it could feature one-click on its website. This in turn allowed Amazon to recover some of its development costs from Apple, which also wanted to use the technology.

IP protection sometimes involves controversial issues. For example, pharmaceutical companies rely on patent law to protect their massive investment in research and development of new drugs. For the few drugs that eventually get governmental approval and commercial success, manufacturers seek to extract the highest possible price during the period of patent monopoly. For example, 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 nations, individuals cannot afford US prices. Therefore, some governments have declared national health emergencies, a procedure under international treaties called compulsory licensing, that forces drug companies to license the formula to generic drugmakers. As a result, Cipla, a generic drug manufacturer in India, manufactures the same antiretrovirals for about $350 a year.

Outside the United States, a patent granted by the USPTO does not automatically protect the inventor's interest in that property. Instead, IP is protected by a series of international conventions. Because international law is only binding on nations who agree to be bound by it, IP is not protected internationally in nations that have not signed the conventions.

Patent Infringement

If someone uses a patented invention without permission from the patent holder, then the user violates the patent holder's rights. **Patent infringement** is the act of making, using, selling, or offering to sell a patented invention without the permission of the patent holder. Patent infringement can be either direct or indirect. **Direct infringement** occurs when someone copies and uses an invention, or uses an invention with a slight variation or addition. **Indirect infringement** occurs when someone "designs around" a patent by creating a product that is substantially the same and performs a similar function.

If patent holders successfully sue for patent infringement, they may be entitled to an injunction forcing their competitors to stop using the invention, treble damages, costs, and attorney's fees. The most common defense to patent infringement claims is to challenge the validity of the patent. Given the scientific and technical nature of patent cases, litigating these cases is expensive.

As a result of the cost of litigation, patent trolls exist in certain industries such as technology and pharmaceuticals. **Patent trolls** are individuals or companies who obtain the rights to one or more patents to profit by means of licensing or litigation, rather than by producing their own goods or services. The main source of revenue for patent trolls comes from suing companies for infringement and hoping the companies settle. For a relatively minor cost of applying for a patent and attorneys' fees, patent trolls look for a big payout. For example, NTP, a patent troll, sued the maker of BlackBerry, claiming patent infringement for the technology used to deliver the BlackBerry's push email feature. Faced with a potential shutdown of service, BlackBerry settled the case for more than six hundred million dollars.

Over the past decade, there have been some legal developments to help protect companies from patent trolls. For example, the US Supreme Court unanimously ruled that patent infringement cases must be filed in the federal court where the defending company is based rather than a court of the plaintiff's choice. This reduces the exposure and cost to the company of defending against cases filed across the nation, and for the patent trolls to "forum shop" for districts they believe will be more beneficial to their claims.

More companies are choosing to fight patent trolls in court rather than payout. For example, Apple has been defending itself in court against patent troll VirnetX over patents that VirnetX obtained in FaceTime and iMessage delivery systems. Although Apple has a large enough budget to engage in protracted litigation, not every company does. Therefore, patent trolls often target start-up companies hoping that the economic threat of a lawsuit encourages quick settlements.

23.5: Trade Secrets

A **Trade secret** is a formula, process, device, or other business information that is kept confidential to maintain an advantage over competitors. The scope of trade secret protection goes well beyond patent law. Unlike patent law, protection under trade secret law is not tied to the information's novelty. Instead, the essence of a trade secret is its relative secrecy.

Elements of a Trade Secret	Information that: 1. Is not generally known or ascertainable; 2. Provides a competitive advantage; 3. Has been developed at the owner's expense & is used continuously in the owner's business; and 4. The owner intends to keep it confidential.

A trade secret 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, 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, Google's algorithm for conducting web searches is a trade secret.

Trade secrets are unlike patents in that with a patent, the inventor must specifically disclose in the application the details of the invention. Thus, 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. Even if others discover how the invention works (which often is not difficult because patent applications are public record), they are prohibited from making, using, or selling it without the patent holder's permission. After the patent expires, the patent holder no longer has a property right to exclude others.

Trade secrets can last forever if the owner of the secret keeps it a secret. If someone uses lawful means to uncover the secret, then the secret is no longer protected. Therefore, some companies would rather not make their confidential information public knowledge through a patent application in return for a temporary monopoly. Instead, they choose to protect the confidentiality of the information or product internally with the hope of a longer period of protection. For example, Google protects its search algorithm as a trade secret to maintain a competitive advantage in the market for as long as possible.

A claim for misappropriation may be brought when a trade secret has been wrongfully obtained, such as through corporate espionage or bribery. Generally, 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.

23.6: Trademarks

A **trademark** is any word, name, logo, motto, device, sound, color, or graphic symbol used by a manufacturer or seller to distinguish its products. The main purpose of a trademark is to guarantee a product's genuineness. In effect, the trademark is the commercial substitute for one's signature. To receive federal protection, a trademark must be (1) distinctive rather than merely descriptive, (2) affixed to a product that is actually sold in the marketplace, and (3) registered with the USPTO.

Symbol Associated with Trademarks	Meaning
®	The mark is officially registered with the USPTO
™	The mark is not registered with the USPTO & is used with goods
SM	The mark is not registered with the USPTO & is used with services

The Lanham Act protects trademarks. Unlike copyrights and patents, trademarks can last forever and are not subject to the Constitution's limited time restriction. Since the objective of trademark law is to prevent consumer confusion, the public good is best served by allowing companies to maintain their trademarks as long as consumers associate a trademark with a specific origin. The moment they no longer make that association, however, the trademark ceases to exist.

When it comes to trademarks, distinctiveness is good. Therefore, an invented word is the easiest type of trademark. In 1997, Larry Page and Sergey Brin were brainstorming names for their new Internet search engine, and invented the word "Google," which is a play on "googol" that means 1 followed by 100 zeroes. They felt the name reflected their goal to organize the staggering amount of information available on the Internet. Common words can also become trademarks as long as consumers identify them with a particular source. For example, Amazon is the name of the world's longest river, but it is also the name of an online retailer. Since consumers now identify Amazon.com as an online retailer, the name can be trademarked.

People's names may also be trademarked as long as they have a business presence. Over time, if consumers begin to identify a person's name with their business, then the 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 motor vehicles.

Figure 23.1 Photo of Samuel Adams Beer Bottle

Figure 23.2 Photo of Ben & Jerry's Justice ReMix'd Ice Cream

In addition to names and logos, slogans may also be trademarked. For example, "Built Ford Tough" and the "Quicker Picker Upper" are both trademarked slogans. Trademarks can also apply to a combination of distinctive words, logos, and slogans. McDonald's has a trademark for its name, a trademark for its "golden arches," and a trademark for its slogan "i'm lovin' it." McDonald's could also trademark the combination of how those three items are displayed together in its advertising materials.

Trademarks are usually granted for a specific category of goods. The same name can sometimes be used for multiple categories of goods. The name Delta is a trademark for both an airline and a brand of faucets. Since there is little chance that consumers will confuse an airline with a faucet brand, trademark law allows these dual registrations.

On the other hand, some brands are so strong that they may 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 and is instantly recognizable. In 1988, hotel chain Quality Inns launched 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 a company's name or its logo. A color can be trademarked if it is 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. Distinctive colors, materials, textures, and signage of a Starbucks or T.G.I. Friday's are considered trade dress and cannot be copied. A unique bottle shape also can be trade dress. **Trade dress** is the overall appearance and image in the marketplace of a product or commercial enterprise, including any packaging, labeling, design and decor. 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.

Companies providing services may receive trademark protection called a **service mark**. Instagram, 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. The International Organization for Standardization (ISO) and its various standards for quality management (ISO 9000) or environmental quality (ISO 14000). The Forest Stewardship Council (FSC) allows its logo to be used on paper products that come from sustainable forests, while certain foods can be labeled "Organic" or "Fair Trade" if they meet certain standards as established by governmental or nongovernmental organizations. Each of these marks is an example of a **certification mark**.

Finally, a mark can represent membership in an organization, such as the National Football League, Girl Scouts of America, Chartered Financial Analyst, or Realtor. Each of these is known as a **collective mark**. The rules that apply to trademarks apply equally to service marks, collective marks, and certification marks.

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. When starting a new company, businesses need to make sure that their business name is not already trademarked by someone else. Trademarks also cannot contain the US flag, any government symbol (such as the White House or Capitol buildings), or anything immoral. Trademarks cannot be merely descriptive. Therefore, every restaurant is allowed to offer a "Kid's Meal," but only McDonald's can offer a "Happy Meal."

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 no longer exists. This process is called **genericide**. Many words today once started as trademarks: furnace, aspirin, escalator, thermos, asphalt, zipper, 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 actively police their use. If trademarks become generic, the owners 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.

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. When Apple first released the iPhone, it found out that "iPhone" was already a registered trademark belonging to Cisco for a phone used for calling over the Internet. To avoid trademark infringement liability, Apple purchased the trademark from Cisco.

The elements of trademark infringement are:

- Distinctiveness (strength) of plaintiff's mark;
- Similarity of the two marks;
- Similarity of goods or services associated with marks;
- Similarity of the parties' facilities/operations;
- Similarity of the parties' advertising;
- Defendant's intent; and
- Proof of actual confusion.

Even if a trademark owner does not believe a similar use of its mark would lead to any consumer confusion, it can protect its trademark through a concept called dilution. **Trademark dilution** occurs when a trademark's strength or effectiveness is impaired by the use of the mark by an unrelated product, often blurring the trademark's distinctive character or tarnishing it with an unsavory association. For example, when an adult novelty store in Kentucky opened as "Victor's Secret," Victoria's Secret filed a dilution suit in response. Under dilution concepts, the trademark owner only needs to show a likelihood that its mark will be diluted or tarnished in some way.

Companies or persons accused of trademark infringement can rely on several defenses:

- Marks are sufficiently different;
- Fair use;
- Parody;
- Comedy and satire; and
- Consumer advocacy.

The most obvious is arguing that no infringement has occurred because the two marks are sufficiently different enough that consumers will not 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.

Figure 23.3 Photos of Hummer H2 and Jeep Grills

Another defense is fair use. The Lanham Act prohibits the use of someone else's trademark when selling goods. However, when a company mentions a competitor's product to draw a comparison, this is called **comparative advertising** and is **fair use** of the competitor's trademark. Honda, therefore, is free to claim that the "Honda Accord is better than the Toyota Camry" in its advertising even though Toyota and Camry are both trademarks.

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. The First Amendment is also a defense for websites run by consumer activists who seek to criticize or parody companies, such as "www.fordreallysucks.com" or "www.peopleofwalmart.com."

23.7: Copyright

The final form of intellectual property protection is copyright. A **copyright** is a property interest in an original work of authorship (such as literary, musical, artistic, photographic, or film work) fixed in any durable medium of expression. The owner of a copyright has the exclusive right to reproduce, adapt, distribute, perform, and display the work. The durable medium requirement exists because otherwise it would be impossible to prove who is the original author of a work. Ideas, by themselves, cannot be copyrighted.

Like patents and trademarks, federal law protects copyrights. Copyright is designed to protect creativity. It is one of the two types of IP specifically mentioned in the Copyright Clause of the US Constitution. Copyright extends to any form of creative expression, including digital forms.

Because computer software is a compilation of binary code expressed in 1 and 0, software can be copyrighted. Similarly, if a group of students were given a camera and asked to photograph the same subject, each student would frame the subject differently, which is an expression of their creativity.

A copyrighted work is automatically protected upon its creation. Unlike patents and trademarks, which must go through an expensive and rigorous application process, authors do not need to send their work to the government for approval. In 1989, the United States signed the Berne Convention, which is an international copyright treaty. This treaty eliminated the need to write "Copyright" or place a © symbol on the work itself to receive legal protection. Copyrights may be registered with the US Copyright Office, if the author chooses.

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 the copyright expires, the work falls into the public domain. The works of Shakespeare and Beethoven are in the public domain, and may be freely recorded or modified without permission.

The copyright owner may allow the public to view or use a copyrighted work for free or for a fee. This use is contained in a copyright license. A license is essentially permission from the copyright holder to use the copyrighted material, within the terms of the license. When purchasing a book, MP3 or DVD, for example, the copyright license allows the purchaser to read the book, listen to the music, and view the movie in private. The license does not allow the purchaser to show the movie to a broad audience, to modify the music, or to photocopy the book to give away or sell. These rights of reproduction, exhibition, and sale are not part of a license. The purchaser does have the right of first sale. This means that the owner of the physical work can do with it as he or she pleases, including resell the original work.

There are common licenses that authors can easily refer to if they wish to distribute their work easily. The General Public License (GPL) for software and Creative Commons (CC) license for text and media are well-known examples.

Licenses in the digital arena can be very restrictive. Copyright holders may use schemes such as Digital Rights Management (DRM) to limit 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.

Copyright infringement occurs when someone uses a copyrighted work without permission or violates the terms of a license. Copyright infringement is common when someone takes someone else's work and simply repackages it as their own. For example, J. K. Rowling's Harry Potter series created an international following, and many fans gather online to discuss her books. One website, called the Harry Potter Lexicon, served as an encyclopedia to the Harry Potter world, with reference notes on characters, places, spells, and other details. When the site announced plans to publish the contents of the Lexicon in a book format, J. K. Rowling successfully sued, claiming copyright infringement.

Copyright infringement also may be indirect, such as helping others violate a copyright. Websites such as Napster and Grokster, which existed solely for the purpose of facilitating illegal downloading of music, were copyright infringers even though the websites themselves did not directly violate any copyrights. The music recording industry pursues these cases aggressively.

Copyright law makes a distinction between "fair" and "infringing" use. **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.

Factors to determine Fair Use of Copyrighted Materials:

1. The purpose and character of the use • Is it for educational purposes or to make a profit?
2. The nature of the copyrighted work • Is the work part of the “core” of the intended protection that copyright provides?
3. The amount and substance of the portion used • Is the amount used a small portion or the entire work?
4. The effect of the use on the potential market for the copyrighted work • Does the use of the copyrighted work unfairly impact the owner’s business?

In an attempt to tackle the problem of copyright infringement on the Internet, Congress passed the Digital Millennium Copyright Act (DCMA) in 1998. One portion of the law helps Internet service providers by expressly stating that those providers cannot be sued for copyright infringement if others use their networks for infringing uses. Another portion of the law helps websites by stating that if a user uploads infringing material and the website complies with a copyright holder’s request to remove the material, the website is not liable for infringement. For example, if an individual uploads a portion of a copyrighted song, movie, or television show to YouTube, YouTube may remove the clip at the request of the copyright holder. Finally, the DMCA makes it illegal to attempt to disable a copy protection device, such as DVD and Blu-ray Discs. Anyone who writes software that disables a copy protection device violates the DMCA.

23.8: Concluding Thoughts

The framers of the Constitution recognized the value of intellectual property by including the Copyright Clause into Article I, Section 8. As IP law evolved, laws that govern trade secrets, patents, trademarks, and copyright have emerged. These legal protections provide a foundation for businesses, entrepreneurs, and artists to create useful and innovative works. Without the financial incentives provided by IP law, innovation would grind to a halt.

The Constitution states the primary purpose of providing temporary IP monopolies is to advance science and the 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.

CHAPTER OVERVIEW

24: Bankruptcy

Learning Objectives

- Examine the three primary chapters of the federal bankruptcy code affecting businesses.
- Compare and contrast the different types of bankruptcies.
- Explore the priority of payment of debts in a bankruptcy estate.

24.1: Introduction

Bankruptcy occurs when an individual or business is financially unable to pay off debts and meet financial obligations. Bankruptcy is a proceeding under federal law in which an individual or business is relieved of most debts and undergoes a court-supervised reorganization or liquidation for the benefit of the creditors. Bankruptcies may be either voluntary or involuntary. A **voluntary bankruptcy** is a proceeding initiated by the debtor. An **involuntary bankruptcy** is a proceeding initiated by creditors to force the debtor to be legally declared bankrupt so the creditors may recover their assets.

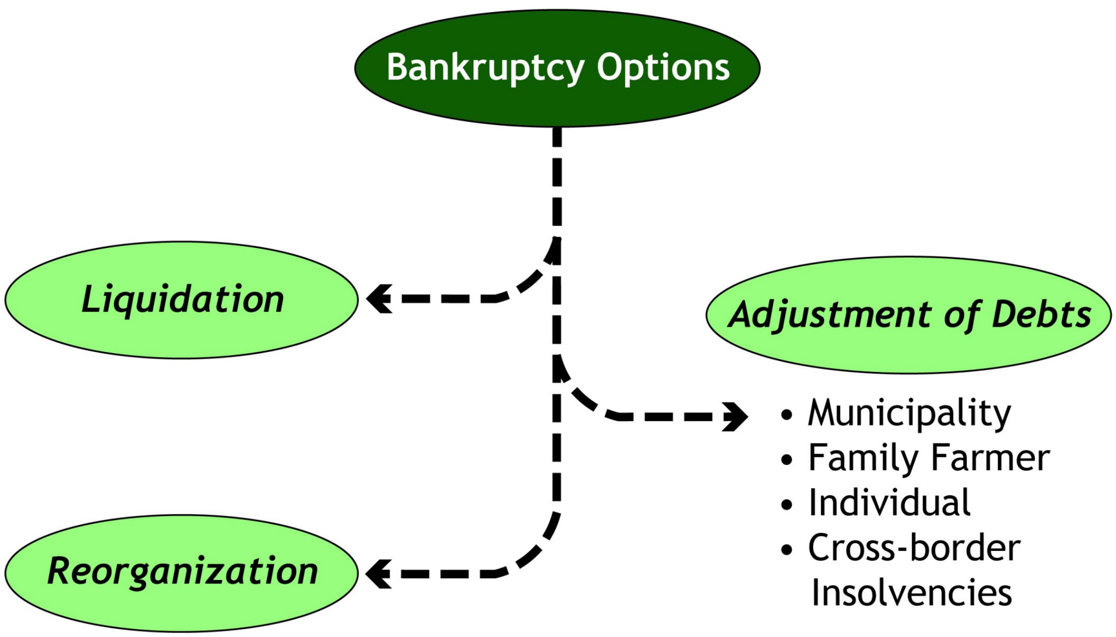
The purpose of bankruptcy is to preserve as much of the debtor's property as possible and to divide it as fairly as possible between the debtor and creditors. Bankruptcy encourages businesses to take risks and engage in entrepreneurial activities. It ultimately allows debtors in difficult financial situations to have a fresh start financially. However, critics allege that it allows some businesses to avoid the consequences of their mistakes and mismanagement. The United States has the highest bankruptcy rate in the world, with individuals filing for bankruptcies more frequently than businesses.

Counselor's Corner Bankruptcy is a vehicle for individuals and businesses to get out of crushing debt. But it comes at a cost: bankruptcy upends a person's life and may end a business. Before filing for bankruptcy, people and businesses should see if they can negotiate a settlement to some of their debt. Often creditors will accept partial payment that is guaranteed over a claim for a larger debt that they will never receive. Cash in hand has value to unsecured creditors. So pick up the phone and put your negotiation skills to work. It just may save your business and prevent needing to file for bankruptcy. ~M. Mo, attorney

24.2: Types of Bankruptcy

There are three main types of bankruptcy under the federal bankruptcy laws that impact businesses the most. They are identified by the chapter number in the bankruptcy code. Regardless of the type of bankruptcy, there are some important terms under bankruptcy law. A **debtor** is the individual or business entity who owes money to others. Debtors either file a bankruptcy petition (in a voluntary bankruptcy) or a petition is filed against them (in an involuntary bankruptcy). A **claim** is the right of payment from the debtor. A **creditor** is an individual, business or governmental entity to whom money is owed by the debtor. Therefore, a creditor has a claim against the debtor.

Figure 24.1 Types of Bankruptcy



Chapter 7 of the bankruptcy code involves the liquidation of an individual's or business's assets to satisfy creditor claims. The debtor loses most, if not all, of current assets but keeps all future earnings free of claims by current creditors. Chapter 7 bankruptcy results in the end of the current business entity.

Chapters 11 and 13, on the other hand, aim to reorganize and rehabilitate the debtor. Chapter 11 may apply to either an individual or business entity, while Chapter 13 only applies to individuals. Under Chapter 11, businesses continue to operate and their creditors are entitled to a portion of both current and future assets and earnings.

	Chapter 7	**Chapter 11**	**Chapter 13**
Objective	Liquidation	Reorganization	Reorganization
Type of Debtor	Individual & business	Individual & business	Individual

Voluntariness	Voluntary or involuntary	Voluntary or involuntary	Voluntary
Who Distributes Assets	Trustee	Debtor	Trustee
Who Selects Trustee	Creditors or US Trustee Program	——	US Trustee Program
Who Proposes Plan	——	Debtor & creditors	Debtor
Creditor Approval Needed?	No	Creditors can vote but court retains power to approve plan without creditor approval	No
Future Income	Debtor keeps all future income	Debtor must pay debts under court approved plan	Debtor must pay debts under court approved plan

To prevent individuals and businesses from using bankruptcy as a tool to avoid all negative financial situations, the law requires waiting periods between bankruptcy filings. In other words, a debtor must wait a certain amount of time before being able to file for bankruptcy again.

First Bankruptcy Case	To File under Chapter 7, must wait:	To File under Chapter 13, must wait:
Chapter 7	8 years	4 years
Chapter 11	8 years	4 years
Chapter 13	6 years	2 years

Chapter 7 Liquidation

Under Chapter 7 of the bankruptcy code, most or all of a debtor's assets are liquidated and used to satisfy creditor claims. **Liquidation** is the process of converting assets into cash to settle debts. Under Chapter 7, liquidation includes winding up the affairs of a business entity because it will no longer exist after the bankruptcy is complete. As a result, discharge of debts under Chapter 7 applies to all debts incurred before bankruptcy was filed.

Before filing for Chapter 7 bankruptcy, individual debtors must meet two requirements:

1. The individual must receive credit counseling from an approved agency within 180 days before filing for bankruptcy; and
2. The individual must financially qualify under the Department of Justice's means test.

The means test for individuals is complex and dependent on the median income in the state where the individual debtor resides.

Chapter 7 has some advantages for debtors. The first is that it immediately protects them from collection efforts and wage garnishments from creditors. The exception to this is child support. Regardless of the status of other creditors, the law prioritizes the right of children to receive financial support from their parents. A second advantage is that most income received after the bankruptcy filing date is not part of the bankruptcy estate. The main exception to this rule is that inheritance is added to the bankruptcy estate and may be used to satisfy creditors. A third advantage is that no minimum amount of debt is required and bankruptcy may be filed if the debtor owns assets but faces cash flow problems. The final advantage is that it is a relatively quick proceeding, with most bankruptcies discharged within three to six months.

Chapter 7 has some disadvantages to debtors, too. The first is that the debtor is not in charge of distributing the bankruptcy estate. Instead, a trustee is appointed by the United States Trustee Program, which is a part of the Department of Justice responsible for overseeing the administration of bankruptcy cases. Trustees in Chapter 7 cases usually sell all non-exempt property, including homes and vehicles. Therefore, individual debtors risk losing a significant amount of their personal property without being able to retain any control of the process. A second disadvantage is that co-signors of any affected loans may be responsible for the full amount of the debt under the loan. Sometimes trustees will prioritize payment of debts without co-signors, which may result in co-signors filing for bankruptcy as well.

Chapter 11 Reorganization

The goal of reorganization under Chapter 11 is to restructure the debtor's finances and pay creditors' claims over an extended period of time. Ultimately, the goal of Chapter 11 is to help debtors remain in business.

One advantage of Chapter 11 bankruptcies is that a trustee is not always required. If the debtor is cooperative and able to distribute assets according to the court-approved plan, then a trustee will not be appointed. However, if the debtor is uncooperative or lacks the skills necessary to successfully implement the bankruptcy plan, a trustee may be appointed.

Another advantage is that the debtor and creditors are allowed to propose payment plans to the bankruptcy court. Although the court is not required to adopt the plans, creditors are given an opportunity to vote on a proposed plan before the court decides whether to adopt it. This gives the interested parties an opportunity to create a reasonable solution that addresses the needs of both the debtor and creditors.

A final advantage of Chapter 11 is that it provides an expedited process for small business bankruptcies. The process allows small businesses to resolve their bankruptcies quickly so that they can move forward with their reorganization plans.

Chapters 7 and 11 have an interesting relationship. Businesses may file for bankruptcy under Chapter 11 with an intent to reorganize their debt and stay in business. However, if creditors do not believe that reorganization is viable for a business, they may request the court to convert the bankruptcy to Chapter 7. For example, in March 2016, Sports Authority filed for Chapter 11 bankruptcy. When creditors discovered the extent and nature of Sports Authority's debt, they successfully requested the court convert the bankruptcy to Chapter 7. When the court granted the creditors' request, Sports Authority was forced to liquidate its assets and wind up its affairs.

Chapter 13 Reorganization

Chapter 13 bankruptcy is only available to individual debtors. The purpose of Chapter 13 is to adjust the debts of individuals whose debts are small enough and income is large enough that a substantial repayment plan is feasible. In other words, the proceedings help individuals keep most of their existing assets but must use most, if not all, future income to pay off debts.

A primary advantage of Chapter 13 is that it allows individual debtors to stop the cycle of compound interest on debts from spiraling to a point where they are forced to file for bankruptcy under Chapter 7. Chapter 13 provides for an automatic injunction against collection efforts and wage garnishments, except for child support. And debtors are allowed to keep their property as long as they make the required payments under the bankruptcy plan.

One characteristic of Chapter 13 is that it provides for long periods to pay off debts. The average payment plan under Chapter 13 lasts between 3 to 5 years. This can be either an advantage or disadvantage to a debtor. On one hand, it allows for reasonable payment plans that balance the interests of the debtor and creditors. On the other hand, it ties up future income for a long time to pay off existing debt.

24.3: Bankruptcy Proceedings

Although there are some differences among Chapter 7, 11, and 13, bankruptcy proceedings have some common characteristics.

Bankruptcy Estate

The **bankruptcy estate** is the debtor's legal and equitable interests in property at the time a bankruptcy petition is filed. Under the bankruptcy code, the bankruptcy estate includes real and personal property, bank and investment accounts, life insurance benefits, and inheritances. Debtors are allowed to claim some property as exemptions. In other words, certain property is returned to the debtor from the bankruptcy estate.

Common exemptions include:

- Equity interest in a residence, vehicle, and personal property (up to a certain value);
- Prescribed health aids, such as walkers and wheelchairs;
- Benefits, such as social security, unemployment compensation, public assistance, disability benefits, and child support;
- Retirement funds and pension (up to a certain value); and
- Education savings accounts.

Debts that Cannot be Discharged

Bankruptcy does not discharge all debts. There are some types of debts that a debtor remains legally liable for, regardless of being bankrupt.

Common debts that are not discharged through bankruptcy include:

- Child support and maintenance to a former spouse;
- Taxes and fines payable to a governmental agency;
- Debt incurred by fraud;
- Liability for intentional torts;
- Liability for accidents caused while driving while intoxicated;
- Student loans less than 5 years old; and
- Debts owed under a prior bankruptcy plan.

Grounds for Denying Bankruptcy Relief

Discharge of debts through bankruptcy is a privilege, not a legal right. Therefore, Congress specified certain situations in which a debtor is not eligible for bankruptcy relief. These grounds include:

- Fraudulent transfers;
- Keeping inadequate records;
- Committing a "bankruptcy crime," such as perjury, making a false claim, bribery, and withholding or destroying records;
- Failure to explain a loss or deficiency of assets;
- Refusing to testify in the proceedings or to obey a court order; and
- Failure to complete the required consumer credit education course.

The grounds for denying a discharge in bankruptcy usually exist when wrongful conduct occurs by the debtor, the debtor does not fully cooperate in the proceedings, or the debtor does not maintain sufficient records to allow the proceedings to move forward.

Procedural Steps

Bankruptcy proceedings begin when a debtor or creditor files a **petition for bankruptcy** with the bankruptcy court. Married couples may file a joint petition. The petition lists the identity of the debtor(s), the identity of all secured and unsecured creditors, the property in the bankruptcy estate, any claimed exemptions, and a statement of affairs of the debtor.

Filing a bankruptcy petition results in an **automatic stay**, which prevents creditors from beginning or continuing collection efforts against the debtor. The stay is designed to protect both the debtor and creditors. Debtors are protected from collection efforts while they focus on creating plans for reorganization and repaying debts. Creditors are protected from assets being transferred to prevent payment of debts and the inequitable distribution of assets among creditors.

The bankruptcy court has decision-making power in bankruptcy cases. The court decides matter connected with a bankruptcy case, from the filing of the petition through final discharge of the bankruptcy. The court determines whether a debtor is eligible for bankruptcy, approves the bankruptcy plan, and oversees the bankruptcy proceedings.

If a trustee is required or needed, a trustee will be appointed by the U.S. Trustee and approved by the bankruptcy court. The trustee takes charge of and administers the debtor's estate during bankruptcy proceedings. A **trustee** is the representative of the estate and is responsible for prioritizing and satisfying creditors' claims. To achieve this goal, trustees may hire professionals such as accountants, attorneys, and appraisers.

The main job of the trustee is to execute the bankruptcy plan. The **bankruptcy plan** is a detailed plan of action for the liquidation or reorganization of the debtor's assets and to satisfy creditors' claims.

Bankruptcy plans identify and prioritize debts. The first debts to be paid off are to **secured creditors** who have interest is a particular property to "secure" the debt. Mortgages, car loans, and liens are common examples of secured debts. If the individual or business defaults on the loan payments, a secured creditor may force the debtor to sell or forfeit the property to satisfy the debt. The second category of debts are to **unsecured creditors**, who do not have an interest in any particular property.

The bankruptcy code prioritizes claims from unsecured creditors as follows:

1. Child support and maintenance to a former spouse;
2. Administrative expenses of the bankruptcy estate, including the trustees' and accountants' fees;
3. Creditors who loan money to the debtor during the bankruptcy;
4. Wages, salaries and commissions;
5. Contributions to employee benefit plans;
6. Consumer deposits;
7. Specific taxes and governmental fees;
8. Wrongful death and personal injury claims; and
9. General creditors.

Once the bankruptcy plan is completely implemented, a discharge occurs. A **bankruptcy discharge** releases the debtor from monetary obligations that existed at the time the petition was filed and ends the bankruptcy case.

24.4: Concluding Thoughts

A fundamental goal of bankruptcy is to give debtors a financial “fresh start” from overwhelming debts. This goal is accomplished through discharging debts, which releases the debtor from liability from specific debts and prohibits creditors from undertaking collection actions against the debtor. However, bankruptcy does have a cost to it. It negatively impacts a debtor’s credit history and impacts an individual or business’s ability to get a loan or build up assets again. Businesses also run the risk of liquidation and the business terminating, even if intending only to reorganize. Before filing for bankruptcy a business should consider if there are better alternatives available to manage and pay off their debt.

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