



# **Legal Aspects of Commercial Transactions**

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**v. 1.0**

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# Table of Contents

<b>About the Authors</b> .....	1
<b>Acknowledgments</b> .....	4
<b>Preface</b> .....	5
<b>Chapter 1: Introduction to Law and Legal Systems</b> .....	7
What Is Law? .....	8
Schools of Legal Thought .....	10
Basic Concepts and Categories of US Positive Law .....	16
Sources of Law and Their Priority .....	22
Legal and Political Systems of the World .....	31
A Sample Case.....	33
Summary and Exercises .....	39
<b>Chapter 2: Corporate Social Responsibility and Business Ethics</b> .....	43
What Is Ethics? .....	45
Major Ethical Perspectives .....	51
An Ethical Decision Model.....	62
Corporations and Corporate Governance.....	65
Summary and Exercises .....	77
<b>Chapter 3: Courts and the Legal Process</b> .....	82
The Relationship between State and Federal Court Systems in the United States .....	84
The Problem of Jurisdiction.....	91
Motions and Discovery .....	110
The Pretrial and Trial Phase .....	113
Judgment, Appeal, and Execution .....	119
When Can Someone Bring a Lawsuit? .....	123
Relations with Lawyers.....	126
Alternative Means of Resolving Disputes .....	129
Cases .....	132

<b>Chapter 4: Constitutional Law and US Commerce .....</b>	<b>140</b>
Basic Aspects of the US Constitution .....	141
The Commerce Clause .....	146
Dormant Commerce Clause.....	153
Preemption: The Supremacy Clause .....	158
Business and the Bill of Rights.....	162
Cases .....	172
Summary and Exercises .....	194
<b>Chapter 5: Administrative Law .....</b>	<b>199</b>
Administrative Agencies: Their Structure and Powers .....	200
Controlling Administrative Agencies.....	208
The Administrative Procedure Act .....	211
Administrative Burdens on Business Operations .....	214
The Scope of Judicial Review .....	218
Cases .....	223
Summary and Exercises .....	230
<b>Chapter 6: Criminal Law .....</b>	<b>235</b>
The Nature of Criminal Law .....	236
Types of Crimes .....	239
The Nature of a Criminal Act .....	249
Responsibility .....	253
Procedure .....	256
Constitutional Rights of the Accused.....	259
Cases .....	263
Summary and Exercises .....	270
<b>Chapter 7: Introduction to Tort Law.....</b>	<b>275</b>
Purpose of Tort Laws .....	276
Intentional Torts .....	282
Negligence .....	291
Strict Liability .....	299
Cases .....	303
Summary and Exercises .....	315
<b>Chapter 8: Introduction to Contract Law.....</b>	<b>319</b>
General Perspectives on Contracts .....	320
Sources of Contract Law .....	324
Basic Taxonomy of Contracts .....	329
Cases .....	335
Summary and Exercises .....	344



<b>Chapter 9: The Agreement</b> .....	350
The Agreement in General .....	351
The Offer .....	354
The Acceptance .....	365
Cases .....	371
Summary and Exercises .....	379
<b>Chapter 10: Real Assent</b> .....	385
Duress and Undue Influence .....	386
Misrepresentation.....	390
Mistake .....	399
Capacity.....	402
Cases .....	408
Summary and Exercises .....	419
<b>Chapter 11: Consideration</b> .....	425
General Perspectives on Consideration .....	426
Legal Sufficiency .....	429
Promises Enforceable without Consideration.....	438
Cases .....	444
Summary and Exercises .....	452
<b>Chapter 12: Legality</b> .....	458
General Perspectives on Illegality .....	459
Agreements in Violation of Statute .....	462
Bargains Made Illegal by Common Law .....	467
Effect of Illegality and Exceptions .....	473
Cases .....	476
Summary and Exercises .....	485
<b>Chapter 13: Form and Meaning</b> .....	491
The Statute of Frauds .....	492
The Parol Evidence Rule.....	504
Interpretation of Agreements: Practicalities versus Legalities .....	509
Cases .....	513
Summary and Exercises .....	521

<b>Chapter 14: Third-Party Rights .....</b>	<b>526</b>
Assignment of Contract Rights .....	527
Delegation of Duties .....	535
Third-Party Beneficiaries .....	539
Cases .....	543
Summary and Exercises .....	552
<b>Chapter 15: Discharge of Obligations .....</b>	<b>558</b>
Discharge of Contract Duties .....	559
Cases .....	576
Summary and Exercises .....	585
<b>Chapter 16: Remedies .....</b>	<b>591</b>
Theory of Contract Remedies .....	592
Promisee’s Interests Protected by Contract .....	594
Legal Remedies: Damages .....	596
Equitable Remedies .....	601
Limitations on Contract Remedies .....	606
Cases .....	615
Summary and Exercises .....	627
<b>Chapter 17: Introduction to Sales and Leases .....</b>	<b>633</b>
Commercial Transactions: the Uniform Commercial Code .....	634
Introduction to Sales and Lease Law, and the Convention on Contracts for the International Sale of Goods .....	638
Sales Law Compared with Common-Law Contracts and the CISG .....	644
General Obligations under UCC Article 2 .....	649
Cases .....	654
Summary and Exercises .....	667
<b>Chapter 18: Title and Risk of Loss .....</b>	<b>672</b>
Transfer of Title .....	673
Title from Nonowners .....	680
Risk of Loss .....	686
Cases .....	693
Summary and Exercises .....	702

<b>Chapter 19: Performance and Remedies</b> .....	708
Performance by the Seller .....	709
Performance by Buyer .....	715
Remedies .....	721
Excuses for Nonperformance.....	736
Cases .....	740
Summary and Exercises .....	753
<b>Chapter 20: Products Liability</b> .....	762
Introduction: Why Products-Liability Law Is Important .....	763
Warranties .....	768
Negligence .....	781
Strict Liability in Tort.....	785
Tort Reform .....	794
Cases .....	798
Summary and Exercises .....	809
<b>Chapter 21: Bailments and the Storage, Shipment, and Leasing of Goods</b> .....	817
Introduction to Bailment Law .....	818
Liability of the Parties to a Bailment .....	824
The Storage and Shipping of Goods .....	831
Negotiation and Transfer of Documents of Title (or Commodity Paper).....	844
Cases .....	849
Summary and Exercises .....	863
<b>Chapter 22: Nature and Form of Commercial Paper</b> .....	872
Introduction to Commercial Paper .....	873
Scope of Article 3 and Types of Commercial Paper and Parties .....	880
Requirements for Negotiability .....	887
Cases .....	893
Summary and Exercises .....	902
<b>Chapter 23: Negotiation of Commercial Paper</b> .....	908
Transfer and Negotiation of Commercial Paper .....	909
Indorsements.....	914
Problems and Issues in Negotiation.....	921
Cases .....	927
Summary and Exercises .....	943

<b>Chapter 24: Holder in Due Course and Defenses</b> .....	948
Holder in Due Course .....	949
Defenses and Role in Consumer Transactions .....	957
Cases .....	964
Summary and Exercises .....	978
<b>Chapter 25: Liability and Discharge</b> .....	983
Liability Imposed by Signature: Agents, Authorized and Unauthorized .....	984
Contract Liability of Parties .....	988
Warranty Liability of Parties .....	995
Discharge .....	1000
Cases .....	1005
Summary and Exercises .....	1022
<b>Chapter 26: Legal Aspects of Banking</b> .....	1028
Banks and Their Customers .....	1029
Electronic Funds Transfers .....	1040
Wholesale Transactions and Letters of Credit .....	1046
Cases .....	1053
Summary and Exercises .....	1067
<b>Chapter 27: Consumer Credit Transactions</b> .....	1072
Entering into a Credit Transaction .....	1074
Consumer Protection Laws and Debt Collection Practices .....	1083
Cases .....	1089
Summary and Exercises .....	1099
<b>Chapter 28: Secured Transactions and Suretyship</b> .....	1104
Introduction to Secured Transactions .....	1105
Priorities .....	1124
Rights of Creditor on Default and Disposition after Repossession .....	1132
Suretyship .....	1137
Cases .....	1145
Summary and Exercises .....	1155
<b>Chapter 29: Mortgages and Nonconsensual Liens</b> .....	1162
Uses, History, and Creation of Mortgages .....	1163
Priority, Termination of the Mortgage, and Other Methods of Using Real Estate as Security .....	1170
Nonconsensual Lien .....	1178
Cases .....	1182
Summary and Exercises .....	1199

<b>Chapter 30: Bankruptcy</b> .....	1204
Introduction to Bankruptcy and Overview of the 2005 Bankruptcy Act .....	1205
Case Administration; Creditors' Claims; Debtors' Exemptions and Dischargeable Debts; Debtor's Estate .....	1211
Chapter 7 Liquidation .....	1224
Chapter 11 and Chapter 13 Bankruptcies .....	1230
Alternatives to Bankruptcy .....	1236
Cases .....	1239
Summary and Exercises .....	1250

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# Preface

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

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

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

The Unnamed Publisher model eliminates the need for “families” of books (such as the ten Miller texts mentioned below) and greatly simplifies text selection. Instructors have only to select between our *Law of Commercial Transactions* volumes of the text and then click on the features they want (as opposed to trying to compare the large number of texts and packages offered by other publishers). In addition to the features inherent in any Flat World publication, this book offers these unique features:

- Cases are available in excerpted and summarized format, thus enabling instructors to easily “mix and match” excerpted cases with case summaries.
- Links to forms and uniform laws are embedded in the text. For example, the chapters on contract law incorporate discussion of

various sections of the Uniform Commercial Code, which is available at <http://www.law.cornell.edu/ucc/ucc.table.html>.

- Likewise, many sample legal forms are readily available online. For example, the chapter on employment law refers to the type of terms commonly found in a standard employment agreement, examples of which can be found at [http://www.rocketlawyer.com/popular-legal-forms.rl?utm\\_source=103&campaign=Alpha+Search&keyword=online%2520legal%2520forms&mtype=e&ad=12516463025&docCategoryId=none&gclid=CI3Wgeiz7q8CFSozQgodIjdn2g](http://www.rocketlawyer.com/popular-legal-forms.rl?utm_source=103&campaign=Alpha+Search&keyword=online%2520legal%2520forms&mtype=e&ad=12516463025&docCategoryId=none&gclid=CI3Wgeiz7q8CFSozQgodIjdn2g).
- Every chapter contains overviews that include the organization and coverage, a list of key terms, chapter summaries, and self-test questions in multiple-choice format (along with answers) that are followed by additional problems with answers available in the Instructors' Manual.
- In addition to standard supplementary materials offered by other texts, students have access to electronic flash cards, proactive quizzes, and audio study guides.

# Chapter 1

## Introduction to Law and Legal Systems

### LEARNING OBJECTIVES

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

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

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

## 1.1 What Is Law?

*Law* is a word that means different things at different times. *Black's Law Dictionary* says that law is “a body of rules of action or conduct prescribed by controlling authority, and having binding legal force. That which must be obeyed and followed by citizens subject to sanctions or legal consequence is a law.” *Black's Law Dictionary*, 6th ed., s.v. “law.”

### Functions of the Law

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

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

### Law and Politics

In the United States, legislators, judges, administrative agencies, governors, and presidents make law, with substantial input from corporations, lobbyists, and a

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

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

In most **nation-states**<sup>1</sup> (as countries are called in international law), knowing who has power to make and enforce the laws is a matter of knowing who has political power; in many places, the people or groups that have military power can also command political power to make and enforce the laws. Revolutions are difficult and contentious, but each year there are revolts against existing political-legal authority; an aspiration for democratic rule, or greater “rights” for citizens, is a recurring theme in politics and law.

### KEY TAKEAWAY

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

### EXERCISES

1. Consider Burma (named Myanmar by its military rulers). What political rights do you have that the average Burmese citizen does not?
2. What is a nongovernment organization, and what does it have to do with government? Do you contribute to (or are you active in) a nongovernment organization? What kind of rights do they espouse, what kind of laws do they support, and what kind of laws do they oppose?

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

## 1.2 Schools of Legal Thought

### LEARNING OBJECTIVES

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

There are different schools (or philosophies) concerning what law is all about. Philosophy of law is also called **jurisprudence**<sup>2</sup>, and the two main schools are **legal positivism**<sup>3</sup> and **natural law**<sup>4</sup>. Although there are others (see [Section 1.2.3 "Other Schools of Legal Thought"](#)), these two are the most influential in how people think about the law.

### Legal Positivism: Law as Sovereign Command

As legal philosopher John Austin concisely put it, “Law is the command of a sovereign.” Law is only law, in other words, if it comes from a recognized authority and can be enforced by that authority, or **sovereign**<sup>5</sup>—such as a king, a president, or a dictator—who has power within a defined area or territory. Positivism is a philosophical movement that claims that science provides the only knowledge precise enough to be worthwhile. But what are we to make of the social phenomena of laws?

We could examine existing **statutes**<sup>6</sup>—executive orders, regulations, or judicial decisions—in a fairly precise way to find out what the law says. For example, we could look at the posted speed limits on most US highways and conclude that the “correct” or “right” speed is no more than fifty-five miles per hour. Or we could look a little deeper and find out how the written law is usually applied. Doing so, we might conclude that sixty-one miles per hour is generally allowed by most state troopers, but that occasionally someone gets ticketed for doing fifty-seven miles per hour in a fifty-five miles per hour zone. Either approach is empirical, even if not rigorously scientific. The first approach, examining in a precise way what the rule itself says, is sometimes known as the “positivist” school of legal thought. The second approach—which relies on social context and the actual behavior of the

2. The philosophy of law. There are many philosophies of law and thus many different jurisprudential views.
3. A jurisprudence that focuses on the law as it is—the command of the sovereign.
4. A jurisprudence that emphasizes a law that transcends positive laws (human laws) and points to a set of principles that are universal in application.
5. The authority within any nation-state. Sovereignty is what sovereigns exercise. This usually means the power to make and enforce laws within the nation-state.
6. Legislative directives, having the form of general rules that are to be followed in the nation-state or its subdivisions. Statutes are controlling over judicial decisions or common law, but are inferior to (and controlled by) constitutional law.

principal actors who enforce the law—is akin to the “legal realist” school of thought (see [Section 1.2.3 "Other Schools of Legal Thought"](#)).

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

The positive-law school of legal thought would recognize the lawmaker’s command as legitimate; questions about the law’s morality or immorality would not be important. In contrast, the natural-law school of legal thought would refuse to recognize the legitimacy of laws that did not conform to natural, universal, or divine law. If a lawmaker issued a command that was in violation of natural law, a citizen would be morally justified in demonstrating civil disobedience. For example, in refusing to give up her seat to a white person, Rosa Parks believed that she was refusing to obey an unjust law.

## Natural Law

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

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



## **The Unanimous Declaration of the Thirteen United States of America**

July 4, 1776

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

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

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

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

Legal positivists, on the other hand, would say that we cannot know with real confidence what “natural” law or “universal” law is. In studying law, we can most

effectively learn by just looking at what the written law says, or by examining how it has been applied. In response, natural-law thinkers would argue that if we care about justice, every law and every legal system must be held accountable to some higher standard, however hard that may be to define.

It is easier to know what the law “is” than what the law “should be.” Equal employment laws, for example, have specific statutes, rules, and decisions about racial discrimination. There are always difficult issues of interpretation and decision, which is why courts will resolve differing views. But how can we know the more fundamental “ought” or “should” of human equality? For example, how do we *know* that “all men are created equal” (from the Declaration of Independence)? Setting aside for the moment questions about the equality of women, or that of slaves, who were not counted as men with equal rights at the time of the declaration—can the statement be empirically proven, or is it simply a matter of a priori knowledge? (*A priori* means “existing in the mind prior to and independent of experience.”) Or is the statement about equality a matter of faith or belief, not really provable either scientifically or rationally? The dialogue between natural-law theorists and more empirically oriented theories of “what law is” will raise similar questions. In this book, we will focus mostly on the law as it is, but not without also raising questions about what it could or should be.

### Other Schools of Legal Thought

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

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

The legal realist view influenced the emergence of the critical legal studies (CLS) school of thought. The “Crits” believe that the social order (and the law) is dominated by those with power, wealth, and influence. Some Crits are clearly influenced by the economist Karl Marx and also by distributive justice theory (see [Chapter 2 "Corporate Social Responsibility and Business Ethics"](#)). The CLS school

believes the wealthy have historically oppressed or exploited those with less wealth and have maintained social control through law. In so doing, the wealthy have perpetuated an unjust distribution of both rights and goods in society. Law is politics and is thus not neutral or value-free. The CLS movement would use the law to overturn the hierarchical structures of domination in the modern society.

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

#### KEY TAKEAWAY

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

## EXERCISES

1. Vandana Shiva draws a picture of a stream in a forest. She says that in our society the stream is seen as unproductive if it is simply there, fulfilling the need for water of women's families and communities, until engineers come along and tinker with it, perhaps damming it and using it for generating hydropower. The same is true of a forest, unless it is replaced with a monoculture plantation of a commercial species. A forest may very well be productive—protecting groundwater; creating oxygen; providing fruit, fuel, and craft materials for nearby inhabitants; and creating a habitat for animals that are also a valuable resource. She criticizes the view that if there is no monetary amount that can contribute to gross domestic product, neither the forest nor the river can be seen as a productive resource. Which school of legal thought does her criticism reflect?
2. Anatole France said, "The law, in its majesty, forbids rich and poor alike from sleeping under bridges." Which school of legal thought is represented by this quote?
3. Adolf Eichmann was a loyal member of the National Socialist Party in the Third Reich and worked hard under Hitler's government during World War II to round up Jewish people for incarceration—and eventual extermination—at labor camps like Auschwitz and Buchenwald. After an Israeli "extraction team" took him from Argentina to Israel, he was put on trial for "crimes against humanity." His defense was that he was "just following orders." Explain why Eichmann was not an adherent of the natural-law school of legal thought.

## 1.3 Basic Concepts and Categories of US Positive Law

### LEARNING OBJECTIVES

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

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

### **Law: The Moral Minimums in a Democratic Society**

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

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

property may be limited by law; I can't, without the public's permission, operate an incinerator on my property and burn heavy metals, as toxic ash may be deposited throughout the neighborhood.

## The Common Law: Property, Torts, and Contracts

Even before legislatures met to make rules for society, disputes happened and judges decided them. In England, judges began writing down the facts of a case and the reasons for their decision. They often resorted to deciding cases on the basis of prior written decisions. In relying on those prior decisions, the judge would reason that since a current case was pretty much like a prior case, it ought to be decided the same way. This is essentially reasoning by analogy. Thus the use of **precedent**<sup>7</sup> in common-law cases came into being, and a doctrine of **stare decisis**<sup>8</sup> (pronounced STAR-ay-de-SIGH-sus) became accepted in English courts. *Stare decisis* means, in Latin, "let the decision stand."

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

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

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

7. A prior judicial decision that is either binding or persuasive, and as such, provides a rule useful in making a decision in the case at hand.

8. Latin, for "let the decision stand." By keeping within the rule of a prior judicial decision, a court follows "precedent" by letting the prior decision govern the result in the case at hand.

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

### **State Courts and the Domain of State Law**

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

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

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

### **Civil versus Criminal Cases**

Most of the cases we will look at in this textbook are civil cases. Criminal cases are certainly of interest to business, especially as companies may break criminal laws. A criminal case involves a governmental decision—whether state or federal—to prosecute someone (named as a defendant) for violating society’s laws. The law establishes a moral minimum and does so especially in the area of criminal laws; if you break a criminal law, you can lose your freedom (in jail) or your life (if you are convicted of a capital offense). In a civil action, you would not be sent to prison; in the worst case, you can lose property (usually money or other assets), such as when Ford Motor Company lost a personal injury case and the judge awarded \$295 million

to the plaintiffs or when Pennzoil won a \$10.54 billion verdict against Texaco (see [Chapter 7 "Introduction to Tort Law"](#)).

Some of the basic differences between **civil law**<sup>9</sup> and **criminal law**<sup>10</sup> cases are illustrated in [Table 1.1 "Differences between Civil and Criminal Cases"](#).

Table 1.1 Differences between Civil and Criminal Cases

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

Regarding plaintiffs and prosecutors, you can often tell a civil case from a criminal case by looking at the caption of a case going to trial. If the government appears first in the caption of the case (e.g., *U.S. v. Lieberman*, it is likely that the United States is prosecuting on behalf of the people. The same is true of cases prosecuted by state district attorneys (e.g., *State v. Seidel*). But this is not a foolproof formula. Governments will also bring civil actions to collect debts from or settle disputes with individuals, corporations, or other governments. Thus *U.S. v. Mayer* might be a collection action for unpaid taxes, or *U.S. v. Canada* might be a boundary dispute in the International Court of Justice. Governments can be sued, as well; people occasionally sue their state or federal government, but they can only get a trial if the government waives its sovereign immunity and allows such suits. *Warner v. U.S.*, for example, could be a claim for a tax refund wrongfully withheld or for damage caused to the Warner residence by a sonic boom from a US Air Force jet flying overhead.

9. In contrast to criminal law, the law that governs noncriminal disputes, such as in lawsuits (as opposed to prosecutions) over contract disputes and tort claims. In contrast to common law, civil law is part of the continental European tradition dating back to Roman law.

10. That body of law in any nation-state that defines offenses against society as a whole, punishable by fines, forfeitures, or imprisonment.



## Substance versus Procedure

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

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

In contrast, procedural laws are the rules of courts and administrative agencies. They tell us how to proceed if there is a substantive-law problem. For example, if you drive fifty-three miles per hour in a forty-mile-per-hour zone on Main Street on a Saturday night and get a ticket, you have broken a substantive rule of law (the posted speed limit). Just how and what gets decided in court is a matter of procedural law. Is the police officer's word final, or do you get your say before a judge? If so, who goes first, you or the officer? Do you have the right to be represented by legal counsel? Does the hearing or trial have to take place within a certain time period? A week? A month? How long can the state take to bring its case? What kinds of evidence will be relevant? Radar? (Does it matter what kind of training the officer has had on the radar device? Whether the radar device had been tested adequately?) The officer's personal observation? (What kind of training has he had, how is he qualified to judge the speed of a car, and other questions arise.) What if you unwisely bragged to a friend at a party recently that you went a hundred miles an hour on Main Street five years ago at half past three on a Tuesday morning? (If the prosecutor knows of this and the "friend" is willing to testify, is it relevant to the charge of fifty-three in a forty-mile-per-hour zone?)

In the United States, all state procedural laws must be fair, since the due process clause of the Fourteenth Amendment directs that no state shall deprive any citizen of "life, liberty, or property," without due process of law. (The \$200 fine plus court costs is designed to deprive you of property, that is, money, if you violate the speed

limit.) Federal laws must also be fair, because the Fifth Amendment to the US Constitution has the exact same due process language as the Fourteenth Amendment. This suggests that some laws are more powerful or important than others, which is true. The next section looks at various types of positive law and their relative importance.

### KEY TAKEAWAY

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

### EXERCISES

1. Jenna gets a ticket for careless driving after the police come to investigate a car accident she had with you on Hanover Boulevard. Your car is badly damaged through no fault of your own. Is Jenna likely to face criminal charges, civil charges, or both?
2. Jenna's ticket says that she has thirty days in which to respond to the charges against her. The thirty days conforms to a state law that sets this time limit. Is the thirty-day limit procedural law or substantive law?

## 1.4 Sources of Law and Their Priority

### LEARNING OBJECTIVES

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

### Sources of Law

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

In international legal systems, sources of law include **treaties**<sup>11</sup> (agreements between states or countries) and what is known as customary international law (usually consisting of judicial decisions from national court systems where parties from two or more nations are in a dispute).

As you might expect, these laws sometimes conflict: a state law may conflict with a federal law, or a federal law might be contrary to an international obligation. One nation’s law may provide one substantive rule, while another nation’s law may provide a different, somewhat contrary rule to apply. Not all laws, in other words, are created equal. To understand which laws have priority, it is essential to understand the relationships between the various kinds of law.

### Constitutions

**Constitutions**<sup>12</sup> are the foundation for a state or nation’s other laws, providing the country’s legislative, executive, and judicial framework. Among the nations of the world, the United States has the oldest constitution still in use. It is difficult to amend, which is why there have only been seventeen amendments following the

11. Formal agreements concluded between nation-states.

12. The founding documents of any nation-state’s legal system.

first ten in 1789; two-thirds of the House and Senate must pass amendments, and three-fourths of the states must approve them.

The nation's states also have constitutions. Along with providing for legislative, executive, and judicial functions, state constitutions prescribe various rights of citizens. These rights may be different from, and in addition to, rights granted by the US Constitution. Like statutes and judicial decisions, a constitution's specific provisions can provide people with a "cause of action" on which to base a lawsuit (see [Section 1.4.3 "Causes of Action, Precedent, and "](#) on "causes of action"). For example, California's constitution provides that the citizens of that state have a right of privacy. This has been used to assert claims against businesses that invade an employee's right of privacy. In the case of Virginia Rulon-Miller, her employer, International Business Machines (IBM), told her to stop dating a former colleague who went to work for a competitor. When she refused, IBM terminated her, and a jury fined the company for \$300,000 in damages. As the California court noted, "While an employee sacrifices some privacy rights when he enters the workplace, the employee's privacy expectations must be balanced against the employer's interests....[T]he point here is that privacy, like the other unalienable rights listed first in our Constitution...is unquestionably a fundamental interest of our society." *Rulon-Miller v. International Business Machines Corp.*, 162 Cal. App.3d 241, 255 (1984).

### **Statutes and Treaties in Congress**

In Washington, DC, the federal legislature is known as Congress and has both a House of Representatives and a Senate. The House is composed of representatives elected every two years from various districts in each state. These districts are established by Congress according to population as determined every ten years by the census, a process required by the Constitution. Each state has at least one district; the most populous state (California) has fifty-two districts. In the Senate, there are two senators from each state, regardless of the state's population. Thus Delaware has two senators and California has two senators, even though California has far more people. Effectively, less than 20 percent of the nation's population can send fifty senators to Washington.

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

Each Congressional legislative body has committees for various purposes. In these committees, proposed bills are discussed, hearings are sometimes held, and bills are either reported out (brought to the floor for a vote) or killed in committee. If a bill

is reported out, it may be passed by majority vote. Because of the procedural differences between the House and the Senate, bills that have the same language when proposed in both houses are apt to be different after approval by each body. A conference committee will then be held to try to match the two versions. If the two versions differ widely enough, reconciliation of the two differing versions into one acceptable to both chambers (House and Senate) is more difficult.

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

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

### **Delegating Legislative Powers: Rules by Administrative Agencies**

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

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

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

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

### State Statutes and Agencies: Other Codified Law

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

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

### Judicial Decisions: The Common Law

**Common law**<sup>13</sup> consists of decisions by courts (judicial decisions) that do not involve interpretation of statutes, regulations, treaties, or the Constitution. Courts make such interpretations, but many cases are decided where there is no statutory or other codified law or regulation to be interpreted. For example, a state court deciding what kinds of witnesses are required for a valid will in the absence of a rule (from a statute) is making common law.

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

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

In England and in the laws of the original thirteen states, common-law decisions defined crimes such as arson, burglary, homicide, and robbery. As time went on, US state legislatures either adopted or modified common-law definitions of most

crimes by putting them in the form of codes or statutes. This legislative ability—to modify or change common law into judicial law—points to an important phenomenon: the priority of statutory law over common law. As we will see in the next section, constitutional law will have priority over statutory law.

## **Priority of Laws**

### **The Constitution as Preemptive Force in US Law**

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

### **Statutes and Cases**

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

### **Treaties as Statutes: The “Last in Time” Rule**

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

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

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

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

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

### **Causes of Action, Precedent, and *Stare Decisis***

No matter how wrong someone’s actions may seem to you, the only wrongs you can right in a court are those that can be tied to one or more **causes of action**<sup>14</sup>. Positive law is full of cases, treaties, statutes, regulations, and constitutional provisions that can be made into a cause of action. If you have an agreement with Harold Hill that he will purchase seventy-six trombones from you and he fails to pay for them after you deliver, you will probably feel wronged, but a court will only act favorably on your complaint if you can show that his behavior gives you a cause of action based on some part of your state’s contract law. This case would give you a cause of action under the law of most states; unless Harold Hill had some legal excuse recognized by the applicable state’s contract law—such as his legal incompetence, his being less than eighteen years of age, his being drunk at the time the agreement was made, or his claim that the instruments were trumpets rather than trombones or that they were delivered too late to be of use to him—you could expect to recover some compensation for his breaching of your agreement with him.

14. In a complaint, a legal basis on which a claim is predicated. The legal basis can be a Constitutional law, a statute, a regulation, or a prior judicial decision that creates a precedent to be followed.



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

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

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

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

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

But suppose that an employer fired an employee for not committing perjury (lying on the witness stand in a court proceeding); the employer wanted the employee to

cover up the company's criminal or unethical act. Suppose that, as in earlier cases, there were no applicable statutes and no contract of employment. Courts relying on a holding or precedent that “employers may fire employees for any reason or no reason” might rule against an employee seeking compensation for being fired for telling the truth on the witness stand. Or it might make an exception to the general rule, such as, “Employers may generally discharge employees for any reason or for no reason without incurring legal liability; however, employers will incur legal liability for firing an employee who refuses to lie on behalf of the employer in a court proceeding.”

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

Written judicial opinions are thus a good playing field for developing critical thinking skills by identifying the issue in a case and examining the reasons for the court’s previous decision(s), or holding. What *has* the court actually decided, and why? Remember that a court, especially the US Supreme Court, is not only deciding one particular case but also setting down guidelines (in its holdings) for federal and state courts that encounter similar issues. Note that court cases often raise a variety of issues or questions to be resolved, and judges (and attorneys) will differ as to what the real issue in a case is. A holding is the court’s complete answer to an issue that is critical to deciding the case and thus gives guidance to the meaning of the case as a precedent for future cases.

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

### KEY TAKEAWAY

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

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

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

### EXERCISES

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

## 1.5 Legal and Political Systems of the World

### LEARNING OBJECTIVE

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

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

### Comparing Common-Law Systems with Other Legal Systems

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

### Civil-Law Systems

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

Civil-law systems are used throughout Europe as well as in Central and South America. Some nations in Asia and Africa have also adopted codes based on

European civil law. Germany, Holland, Spain, France, and Portugal all had colonies outside of Europe, and many of these colonies adopted the legal practices that were imposed on them by colonial rule, much like the original thirteen states of the United States, which adopted English common-law practices.

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

There are also legal systems that differ significantly from the common-law and civil-law systems. The communist and socialist legal systems that remain (e.g., in Cuba and North Korea) operate on very different assumptions than those of either English common law or European civil law. Islamic and other religion-based systems of law bring different values and assumptions to social and commercial relations.

### KEY TAKEAWAY

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

### EXERCISE

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

## 1.6 A Sample Case

### *Preliminary Note to Students*

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

(a) it shall be an unlawful employment practice for an employer—

(1) to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or natural origin.

At common law—where judges decide cases without reference to statutory guidance—employers were generally free to hire and fire on any basis they might choose, and employees were generally free to work for an employer or quit an employer on any basis they might choose (unless the employer and the employee had a contract). This rule has been called “employment at will.” State and federal statutes that prohibit discrimination on any basis (such as the prohibitions on discrimination because of race, color, religion, sex, or national origin in Title VII) are essentially legislative exceptions to the common-law employment-at-will rule.

In the 1970s, many female employees began to claim a certain kind of sex discrimination: sexual harassment. Some women were being asked to give sexual favors in exchange for continued employment or promotion (quid pro quo sexual harassment) or found themselves in a working environment that put their chances for continued employment or promotion at risk. This form of sexual discrimination came to be called “hostile working environment” sexual harassment.

Notice that the statute itself says nothing about sexual harassment but speaks only in broad terms about discrimination “because of” sex (and four other factors). Having set the broad policy, Congress left it to employees, employers, and the courts to fashion more specific rules through the process of civil litigation.

This is a case from our federal court system, which has a trial or hearing in the federal district court, an appeal to the Sixth Circuit Court of Appeals, and a final appeal to the US Supreme Court. Teresa Harris, having lost at both the district court and the Sixth Circuit Court of Appeals, here has petitioned for a writ of certiorari

(asking the court to issue an order to bring the case to the Supreme Court), a petition that is granted less than one out of every fifty times. The Supreme Court, in other words, chooses its cases carefully. Here, the court wanted to resolve a difference of opinion among the various circuit courts of appeal as to whether or not a plaintiff in a hostile-working-environment claim could recover damages without showing “severe psychological injury.”

Harris v. Forklift Systems

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

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

JUSTICE O’CONNOR delivered the opinion of the Court.

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

I

Teresa Harris worked as a manager at Forklift Systems, Inc., an equipment rental company, from April 1985 until October 1987. Charles Hardy was Forklift’s president.

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

In mid-August 1987, Harris complained to Hardy about his conduct. Hardy said he was surprised that Harris was offended, claimed he was only joking, and apologized.

He also promised he would stop, and based on this assurance Harris stayed on the job. But in early September, Hardy began anew: While Harris was arranging a deal with one of Forklift's customers, he asked her, again in front of other employees, "What did you do, promise the guy...some [sex] Saturday night?" On October 1, Harris collected her paycheck and quit.

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

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

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

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

## II

Title VII of the Civil Rights Act of 1964 makes it "an unlawful employment practice for an employer...to discriminate against any individual with respect to his



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

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

But Title VII comes into play before the harassing conduct leads to a nervous breakdown. A discriminatorily abusive work environment, even one that does not seriously affect employees' psychological well-being, can and often will detract from employees' job performance, discourage employees from remaining on the job, or keep them from advancing in their careers. Moreover, even without regard to these tangible effects, the very fact that the discriminatory conduct was so severe or pervasive that it created a work environment abusive to employees because of their race, gender, religion, or national origin offends Title VII's broad rule of workplace equality. The appalling conduct alleged in *Meritor*, and the reference in that case to environments "so heavily polluted with discrimination as to destroy completely the emotional and psychological stability of minority group workers," *Id.*, at 66, quoting *Rogers v. EEOC*, 454 F.2d 234, 238 (CA5 1971), cert. denied, 406 U.S. 957, 32 L. Ed. 2d 343, 92 S. Ct. 2058 (1972), merely present some especially egregious examples of harassment. They do not mark the boundary of what is actionable.

We therefore believe the District Court erred in relying on whether the conduct "seriously affected plaintiff's psychological well-being" or led her to "suffer injury."

Such an inquiry may needlessly focus the fact finder's attention on concrete psychological harm, an element Title VII does not require. Certainly Title VII bars conduct that would seriously affect a reasonable person's psychological well-being, but the statute is not limited to such conduct. So long as the environment would reasonably be perceived, and is perceived, as hostile or abusive, *Meritor*, supra, at 67, there is no need for it also to be psychologically injurious.

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

### III

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

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

So ordered.

*Note to Students*

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

### CASE QUESTIONS

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

## 1.7 Summary and Exercises

### Summary

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

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

## EXERCISES

1. What is the common law? Where do the courts get the authority to interpret it and to change it?
2. After World War II ended in 1945, there was an international tribunal at Nuremberg that prosecuted various officials in Germany's Third Reich who had committed "crimes against humanity." Many of them claim that they were simply "following orders" of Adolf Hitler and his chief lieutenants. What law, if any, have they violated?
3. What does *stare decisis* mean, and why is it so basic to common-law legal tradition?
4. In the following situations, which source of law takes priority, and why?
  - a. The state statute conflicts with the common law of that state.
  - b. A federal statute conflicts with the US Constitution.
  - c. A common-law decision in one state conflicts with the US Constitution.
  - d. A federal statute conflicts with a state constitution.

## SELF-TEST QUESTIONS

1. The source of law that is foundational in the US legal system is
  - a. the common law
  - b. statutory law
  - c. constitutional law
  - d. administrative law
  
2. “Law is the command of a sovereign” represents what school of legal thought?
  - a. civil law
  - b. constitutional law
  - c. natural law
  - d. ecofeminist law
  - e. positive law
  
3. Which of the following kinds of law are most often found in state law rather than federal law?
  - a. torts and contracts
  - b. bankruptcy
  - c. maritime law
  - d. international law
  
4. Where was natural law discovered?
  - a. in nature
  - b. in constitutions and statutes
  - c. in the exercise of human reason
  - d. in the *Wall Street Journal*
  
5. Wolfe is a state court judge in California. In the case of *Riddick v. Clouse*, which involves a contract dispute, Wolfe must follow precedent. She establishes a logical relationship between the Riddick case and a case decided by the California Supreme Court, *Zhu v. Patel Enterprises, Inc.* She compares the facts of Riddick to the facts in Zhu and to the extent the facts are similar, applies the same rule to reach her decision. This is

- a. deductive reasoning
  - b. faulty reasoning
  - c. linear reasoning
  - d. reasoning by analogy
6. Moore is a state court judge in Colorado. In the case of *Cassidy v. Seawell*, also a contract dispute, there is no Colorado Supreme Court or court of appeals decision that sets forth a rule that could be applied. However, the California case of *Zhu v. Patel Enterprises, Inc.* is “very close” on the facts and sets forth a rule of law that could be applied to the Cassidy case. What process must Moore follow in considering whether to use the Zhu case as precedent?
- a. Moore is free to decide the case any way he wants, but he may not look at decisions and reasons in similar cases from other states.
  - b. Moore must wait for the Colorado legislature and the governor to pass a law that addresses the issues raised in the Cassidy case.
  - c. Moore must follow the California case if that is the best precedent.
  - d. Moore may follow the California case if he believes that it offers the best reasoning for a similar case.

#### SELF-TEST ANSWERS

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

## Chapter 2

# Corporate Social Responsibility and Business Ethics

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

- Alfred North Whitehead

### LEARNING OBJECTIVES

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

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

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

This chapter has a fairly modest aim: to introduce potential businesspeople to the differences between legal compliance and ethical excellence by reviewing some of



the philosophical perspectives that apply to business, businesspeople, and the role of business organizations in society.

## 2.1 What Is Ethics?

### LEARNING OBJECTIVES

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

Most of those who write about ethics do not make a clear distinction between ethics and morality. The question of what is “right” or “morally correct” or “ethically correct” or “morally desirable” in any situation is variously phrased, but all of the words and phrases are after the same thing: what act is “better” in a moral or ethical sense than some other act? People sometimes speak of morality as something personal but view ethics as having wider social implications. Others see morality as the subject of a field of study, that field being ethics. Ethics would be morality as applied to any number of subjects, including journalistic ethics, business ethics, or the ethics of professionals such as doctors, attorneys, and accountants. We will venture a definition of *ethics*, but for our purposes, *ethics* and *morality* will be used as equivalent terms.

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

In talking about morality, we often use the word *good*; but that word can be confusing. If we say that Microsoft is a “good company,” we may be making a statement about the investment potential of Microsoft stock, or their preeminence in the market, or their ability to win lawsuits or appeals or to influence administrative agencies. Less likely, though possibly, we may be making a statement about the civic virtue and corporate social responsibility of Microsoft. In

the first set of judgments, we use the word *good* but mean something other than ethical or moral; only in the second instance are we using the word *good* in its ethical or moral sense.

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

There are three key points here:

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

Here is a cautionary note: for individuals, it is far from easy to recognize an ethical problem, have a clear and usable decision-making process to deal it, and then have the moral courage to do what’s right. All of that is even more difficult within a business organization, where corporate employees vary in their motivations, loyalties, commitments, and character. There is no universally accepted way for developing an organization where employees feel valued, respected, and free to openly disagree; where the actions of top management are crystal clear; and where all the employees feel loyal and accountable to one another.

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

## How Do Law and Ethics Differ?

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

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

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

- Individuals and organizations have reputations. (For an individual, moral reputation is most often tied to others’ perceptions of his or her character: is the individual honest, diligent, reliable, fair, and caring? The reputation of an organization is built on the goodwill that suppliers, customers, the community, and employees feel toward it. Although an organization is not a person in the usual sense, the goodwill that people feel about the organization is based on their perception of its better qualities by a variety of stakeholders: customers or clients, suppliers, investors, employees, government officials).
- The goodwill of an organization is to a great extent based on the actions it takes and on whether the actions are favorably viewed. (This goodwill is usually specifically counted in the sale of a business as an asset that the buyer pays for. While it is difficult to place a monetary value on goodwill, a firm’s good reputation will generally call for a higher evaluation in the final accounting before the sale. Legal troubles or a reputation for having legal troubles will only lessen the price for a business and will even lessen the value of the company’s stock as bad legal news comes to the public’s attention.)

Another reason to think about ethics in connection with law is that the laws themselves are meant to express some moral view. If there are legal prohibitions against cheating the Medicare program, it is because people (legislators or their agents) have collectively decided that cheating Medicare is wrong. If there are legal prohibitions against assisting someone to commit suicide, it is because there has

been a group decision that doing so is immoral. Thus the law provides some important cues as to what society regards as right or wrong.

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

### **Why Should an Individual or a Business Entity Be Ethical?**

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

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

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

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

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

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

### KEY TAKEAWAY

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

## EXERCISES

1. Think of a person who did something morally wrong, at least to your way of thinking. What was it? Explain to a friend of yours—or a classmate—why you think it was wrong. Does your friend agree? Why or why not? What is the basic principle that forms the basis for your judgment that it was wrong?
2. Think of a person who did something morally right, at least to your way of thinking. (This is not a matter of finding something they did well, like efficiently changing a tire, but something good.) What was it? Explain to a friend of yours—or a classmate—why you think it was right. Does your friend agree? Why or why not? What is the basic principle that forms the basis for your judgment that it was right?
3. Think of an action by a business organization (sole proprietor, partnership, or corporation) that was legal but still strikes you as wrong. What was it? Why do you think it was wrong?
4. Think of an act by an individual or a corporation that is ethical but not legal. Compare your answer with those of your classmates: were you more likely to find an example from individual action or corporate action? Do you have any thoughts as to why?

## 2.2 Major Ethical Perspectives

### LEARNING OBJECTIVES

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

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

### Utilitarianism

**Utilitarianism**<sup>1</sup> is a prominent perspective on ethics, one that is well aligned with economics and the free-market outlook that has come to dominate much current thinking about business, management, and economics. Jeremy Bentham is often considered the founder of utilitarianism, though John Stuart Mill (who wrote *On Liberty* and *Utilitarianism*) and others promoted it as a guide to what is good. Utilitarianism emphasizes not rules but results. An action (or set of actions) is generally deemed good or right if it maximizes happiness or pleasure throughout society. Originally intended as a guide for legislators charged with seeking the greatest good for society, the utilitarian outlook may also be practiced individually and by corporations.

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

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



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

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

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

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

1. Failing to come up with lots of options that seem reasonable and then choosing the one that has the greatest benefit for the greatest number. Often, a decision maker seizes on one or two alternatives without thinking carefully about other courses of action. If the alternative does more good than harm, the decision maker assumes it’s ethically okay.
2. Assuming that the greatest good for you or your company is in fact the greatest good for all—that is, looking at situations subjectively or with your own interests primarily in mind.
3. Underestimating the costs of a certain decision to you or your company. The now-classic Ford Pinto case demonstrates how Ford Motor Company executives drastically underestimated the legal costs of not correcting a feature on their Pinto models that they knew could

cause death or injury. General Motors was often taken to task by juries that came to understand that the company would not recall or repair known and dangerous defects because it seemed more profitable not to. In 2010, Toyota learned the same lesson.

4. Underestimating the cost or harm of a certain decision to someone else or some other group of people.
5. Favoring short-term benefits, even though the long-term costs are greater.
6. Assuming that all values can be reduced to money. In comparing the risks to human health or safety against, say, the risks of job or profit losses, cost-benefit analyses will often try to compare apples to oranges and put arbitrary numerical values on human health and safety.

## Rules and Duty: Deontology

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

For Kantian thinkers, this basic principle of equality means that we should be able to universalize any particular law or action to determine whether it is ethical. For example, if you were to consider misrepresenting yourself on a resume for a particular job you really wanted and you were convinced that doing so would get you that job, you might be very tempted to do so. (What harm would it be? you might ask yourself. When I have the job, I can prove that I was perfect for it, and no one is hurt, while both the employer and I are clearly better off as a result!) Kantian ethicists would answer that your chosen course of action should be a universal one—a course of action that would be good for all persons at all times. There are two requirements for a rule of action to be universal: consistency and reversibility. Consider reversibility: if you make a decision as though you didn't know what role or position you would have after the decision, you would more likely make an impartial one—you would more likely choose a course of action that would be most fair to all concerned, not just you. Again, **deontology**<sup>2</sup> requires that we put duty first, act rationally, and give moral weight to the inherent equality of all human beings.

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

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

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

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

### **Social Justice Theory and Social Contract Theory**

Social justice theorists worry about “distributive justice”—that is, what is the fair way to distribute goods among a group of people? Marxist thought emphasizes that members of society should be given goods according to their needs. But this redistribution would require a governing power to decide who gets what and when. Capitalist thought takes a different approach, rejecting any giving that is not voluntary. Certain economists, such as the late Milton Friedman (see the sidebar in [Section 2.4 "Corporations and Corporate Governance"](#)) also reject the notion that a corporation has a duty to give to unmet needs in society, believing that the government should play that role. Even the most dedicated free-market capitalist will often admit the need for some government and some forms of welfare—Social Security, Medicare, assistance to flood-stricken areas, help for AIDS patients—along with some public goods (such as defense, education, highways, parks, and support of key industries affecting national security).

People who do not see the need for **public goods**<sup>3</sup> (including laws, court systems, and the government goods and services just cited) often question why there needs to be a government at all. One response might be, “Without government, there would be no corporations.” Thomas Hobbes believed that people in a “state of nature” would rationally choose to have some form of government. He called this the **social contract**<sup>4</sup>, where people give up certain rights to government in exchange for security and common benefits. In your own lives and in this course, you will see an ongoing balancing act between human desires for freedom and human desires for order; it is an ancient tension. Some commentators also see a kind of social contract between corporations and society; in exchange for perpetual duration and limited liability, the corporation has some corresponding duties toward society. Also, if a corporation is legally a “person,” as the Supreme Court reaffirmed in 2010, then some would argue that if this corporate person commits three felonies, it should be locked up for life and its corporate charter revoked!

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

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

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

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

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

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

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

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

1. If you have a right of free expression, the government has a duty to respect that right but can put reasonable limits on it. For example, you can legally say whatever you want about the US president, but you can't get away with threatening the president's life. Even if your criticisms are strong and insistent, you have the right (and our government has the duty to protect your right) to speak freely. In Singapore during the 1990s, even indirect criticisms—mere hints—of the political leadership were enough to land you in jail or at least silence you with a libel suit.
2. Rights and duties exist not only between people and their governments but also between individuals. Your right to be free from physical assault is protected by the law in most states, and when someone walks up to you and punches you in the nose, your rights—as set forth in the positive law of your state—have been violated. Thus other people have a duty to respect your rights and to not punch you in the nose.
3. Your right in legal terms is only as good as your society's willingness to provide legal remedies through the courts and political institutions of society.

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

work, and environment) and political or civic rights (the right to vote, the right to equal protection of the laws, the right to due process).

## Aristotle and Virtue Theory

**Virtue theory**<sup>5</sup>, or virtue ethics, has received increasing attention over the past twenty years, particularly in contrast to utilitarian and deontological approaches to ethics. Virtue theory emphasizes the value of virtuous qualities rather than formal rules or useful results. Aristotle is often recognized as the first philosopher to advocate the ethical value of certain qualities, or virtues, in a person's character. As LaRue Hosmer has noted, Aristotle saw the goal of human existence as the active, rational search for excellence, and excellence requires the personal virtues of honesty, truthfulness, courage, temperance, generosity, and high-mindedness. This pursuit is also termed "knowledge of the good" in Greek philosophy. LaRue Hosmer, *Moral Leadership in Business* (Chicago: Irwin Professional Publishing, 1994), 72.

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

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

From a modern perspective, some of these virtues seem old-fashioned or even odd. Magnificence, for example, is not something we commonly speak of. Three issues emerge: (1) How do we know what a virtue is these days? (2) How useful is a list of agreed-upon virtues anyway? (3) What do virtues have to do with companies,

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

particularly large ones where various groups and individuals may have little or no contact with other parts of the organization?

As to the third question, whether corporations can “have” virtues or values is a matter of lively debate. A corporation is obviously not the same as an individual. But there seems to be growing agreement that organizations do differ in their practices and that these practices are value driven. If all a company cares about is the bottom line, other values will diminish or disappear. Quite a few books have been written in the past twenty years that emphasize the need for businesses to define their values in order to be competitive in today’s global economy. James O’Toole and Don Mayer, eds., *Good Business: Exercising Effective and Ethical Leadership* (London: Routledge, 2010).

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

### Josephson’s Core Values Analysis and Decision Process

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

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

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

Among the virtues, are any especially important? Studies from the Josephson Institute of Ethics in Marina del Rey, California, have identified six **core values**<sup>6</sup> in our society, values that almost everyone agrees are important to them. When asked what values people hold dear, what values they wish to be known by, and what values they wish others would exhibit in their actions, six values consistently turn

up: (1) trustworthiness, (2) respect, (3) responsibility, (4) fairness, (5) caring, and (6) citizenship.

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

Notice also that these six core values share something in common with other ethical values that are less universally agreed upon. Many values taught in the family or in places of worship are not generally agreed on, practiced, or admired by all. Some families and individuals believe strongly in the virtue of saving money or in abstaining from alcohol or sex prior to marriage. Others clearly do not, or at least don't act on their beliefs. Moreover, it is possible to have and practice core ethical values even if you take on heavy debt, knock down several drinks a night, or have frequent premarital sex. Some would dispute this, saying that you can't really lead a virtuous life if you get into debt, drink heavily, or engage in premarital sex. But the point here is that since people do disagree in these areas, the ethical traits of thrift, temperance, and sexual abstinence do not have the unanimity of approval that the six core values do.

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



**KEY TAKEAWAY**

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

## EXERCISES

XYZ Motor Corporation begins to get customer complaints about two models of its automobiles. Customers have had near-death experiences from sudden acceleration; they would be driving along a highway at normal speed when suddenly the car would begin to accelerate, and efforts to stop the acceleration by braking fail to work. Drivers could turn off the ignition and come to a safe stop, but XYZ does not instruct buyers of its cars to do so, nor is this a common reaction among drivers who experience sudden acceleration.

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

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

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

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

## 2.3 An Ethical Decision Model

### LEARNING OBJECTIVE

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

### Josephson's Core Values Model

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

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

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

## The Core Values

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

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

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

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

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

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

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

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

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

#### KEY TAKEAWAY

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

#### EXERCISE

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

## 2.4 Corporations and Corporate Governance

### LEARNING OBJECTIVES

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

### Legal Organization of the Corporation

Figure 2.1 *Corporate Legal Structure*

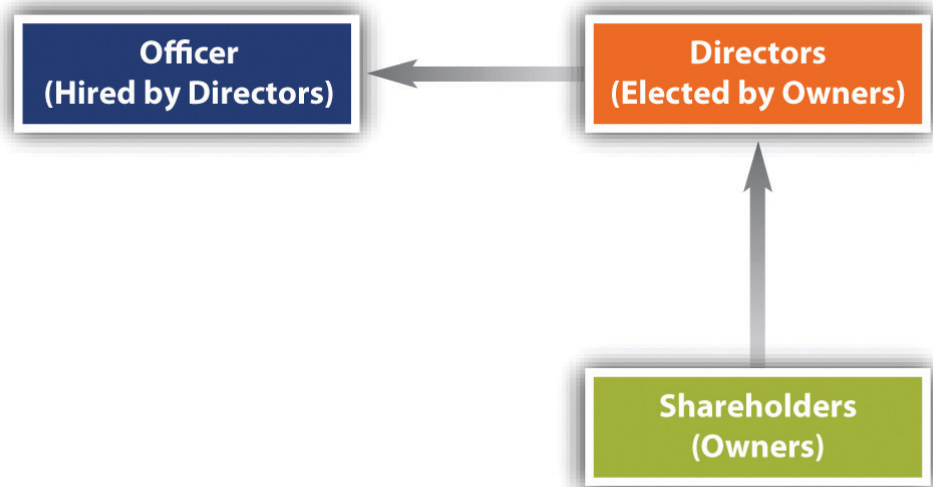


Figure 2.1 "Corporate Legal Structure", though somewhat oversimplified, shows the basic legal structure of a corporation under Delaware law and the laws of most other states in the United States. Shareholders elect directors, who then hire officers to manage the company. From this structure, some very basic realities follow. Because the directors of a corporation do not meet that often, it's possible for the officers hired (top management, or the "C-suite") to be selective of what the board knows about, and directors are not always ready and able to provide the oversight that the shareholders would like. Nor does the law require officers to be shareholders, so that officers' motivations may not align with the best interests of

the company. This is the “agency problem” often discussed in corporate governance: how to get officers and other top management to align their own interests with those of the shareholders. For example, a CEO might trade insider information to the detriment of the company’s shareholders. Even board members are susceptible to misalignment of interests; for example, board members might resist hostile takeover bids because they would likely lose their perks (short for *perquisites*) as directors, even though the tender offer would benefit stockholders. Among other attempted realignments, the use of stock options was an attempt to make managers more attentive to the value of company stock, but the law of unintended consequences was in full force; managers tweaked and managed earnings in the bubble of the 1990s bull market, and “managing by numbers” became an epidemic in corporations organized under US corporate law. The rights of shareholders can be bolstered by changes in state and federal law, and there have been some attempts to do that since the late 1990s. But as owners, shareholders have the ultimate power to replace nonperforming or underperforming directors, which usually results in changes at the C-suite level as well.

### **Shareholders and Stakeholders**

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

### **Maximizing Profits: Milton Friedman**

Economist Milton Friedman is often quoted as having said that the only moral duty a corporation has is to make the most possible money, or to maximize profits, for its stockholders. Friedman’s beliefs are noted at length (see sidebar on Friedman’s article from the *New York Times*), but he asserted in a now-famous 1970 article that in a free society, “there is one and only one social responsibility of business: to use its resources and engage in activities designed to increase its profits as long as it stays within the rules of the game, which is to say, engages in open and free

competition without deception and fraud.” What follows is a major portion of what Friedman had to say in 1970.



## **“The Social Responsibility of Business Is to Increase Its Profits”**

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

What does it mean to say that “business” has responsibilities? Only people can have responsibilities. A corporation is an artificial person and in this sense may have artificial responsibilities, but “business” as a whole cannot be said to have responsibilities, even in this vague sense....

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

...[T]he manager is that agent of the individuals who own the corporation or establish the eleemosynary institution, and his primary responsibility is to them...

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

What does it mean to say that the corporate executive has a “social responsibility” in his capacity as businessman? If this statement is not pure rhetoric, it must mean that he has to act in some way that is not in the interest of his employers. For example, that he is to refrain from increasing the price of

the product in order to contribute to the social objective of preventing inflation, even though a price increase would be in the best interests of the corporation. Or that he is to make expenditures on reducing pollution beyond the amount that is in the best interests of the corporation or that is required by law in order to contribute to the social objective of improving the environment. Or that, at the expense of corporate profits, he is to hire “hardcore” unemployed instead of better qualified available workmen to contribute to the social objective of reducing poverty.

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

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

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

### **Stakeholder Theory**

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

There is one vital fact about corporations: the corporation is a creation of the law. Without law (and government), corporations would not have existence. The key

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

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

Implicitly, then, there is a social contract between governments and corporations: as long as corporations are considered socially useful, they can exist. But do they have explicit social responsibilities? Milton Friedman’s position suggests that having gone along with legal duties, the corporation can ignore any other social obligations. But there are others (such as advocates of **stakeholder theory**<sup>7</sup>) who would say that a corporation’s social responsibilities go beyond just staying within the law and go beyond the corporation’s shareholders to include a number of other important stakeholders, those whose lives can be affected by corporate decisions.

According to stakeholder theorists, corporations (and other business organizations) must pay attention not only to the bottom line but also to their overall effect on the community. Public perception of a company’s unfairness, uncaring, disrespect, or lack of trustworthiness often leads to long-term failure, whatever the short-term successes or profits may be. A socially responsible corporation is likely to consider the impact of its decisions on a wide range of stakeholders, not just shareholders. As [Table 2.1 "The Stakes of Various Stakeholders"](#) indicates, stakeholders have very different kinds of interests (“stakes”) in the actions of a corporation.

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

Table 2.1 The Stakes of Various Stakeholders

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

### Corporate Culture and Codes of Ethics

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

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

#### Ethical Leadership Is Top-Down

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

### **Accountability Is Often Weak**

Clever managers can learn to shift blame to others, take credit for others' work, and move on before "funny numbers" or other earnings management tricks come to light. See Robert Jackall, *Moral Mazes: The World of Corporate Managers* (New York: Oxford University Press, 1988). Again, we see that the manager is often an agent for himself or herself and will often act more in his or her self-interest than for the corporate interest.

### **Killing the Messenger**

Where organizations no longer function, inevitably some employees are unhappy. If they call attention to problems that are being covered up by coworkers or supervisors, they bring bad news. Managers like to hear good news and discourage bad news. Intentionally or not, those who told on others, or blew the whistle, have rocked the boat and become unpopular with those whose defalcations they report on and with the managers who don't really want to hear the bad news. In many organizations, "killing the messenger" solves the problem. Consider James Alexander at Enron Corporation, who was deliberately shut out after bringing problems to CEO Ken Lay's attention. John Schwartz, "An Enron Unit Chief Warned, and Was Rebuffed," *New York Times*, February 20, 2002. When Sherron Watkins sent Ken Lay a letter warning him about Enron's accounting practices, CFO Andrew Fastow tried to fire her. Warren Bennis, "A Corporate Fear of Too Much Truth," *New York Times*, February 17, 2002.

### **Ethics Codes**

Without strong leadership and a willingness to listen to bad news as well as good news, managers do not have the feedback necessary to keep the organization healthy. Ethics codes have been put in place—partly in response to federal sentencing guidelines and partly to encourage feedback loops to top management. The best ethics codes are aspirational, or having an ideal to be pursued, not legalistic or compliance driven. The Johnson & Johnson ethics code predated the Tylenol scare and the company's oft-celebrated corporate response. University of Oklahoma Department of Defense Joint Course in Communication, *Case Study: The Johnson & Johnson Tylenol Crisis*, accessed April 5, 2011. The corporate response was consistent with that code, which was lived and modeled by the top of the organization.

It's often noted that a code of ethics is only as important as top management is willing to make it. If the code is just a document that goes into a drawer or onto a shelf, it will not effectively encourage good conduct within the corporation. The same is true of any kind of training that the company undertakes, whether it be in

racial sensitivity or sexual harassment. If the message is not continuously reinforced, or (worse yet) if the message is undermined by management's actions, the real message to employees is that violations of the ethics code will not be taken seriously, or that efforts to stop racial discrimination or sexual harassment are merely token efforts, and that the important things are profits and performance. The ethics code at Enron seems to have been one of those "3-P" codes that wind up sitting on shelves—"Print, Post, and Pray." Worse, the Enron board twice suspended the code in 1999 to allow outside partnerships to be led by a top Enron executive who stood to gain financially from them. FindLaw, *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.*, February 1, 2002, accessed April 5, 2011, <http://news.findlaw.com/wsj/docs/enron/sicreport>.

### **Ethics Hotlines and Federal Sentencing Guidelines**

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

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

### **Managing by the Numbers**

If you manage by the numbers, there is a temptation to lie about those numbers, based on the need to get stock price ever higher. At Enron, "15 percent a year or better earnings growth" was the mantra. Jeffrey Pfeffer, professor of organizational behavior at Stanford University, observes how the belief that "stock price is all that matters" has been hardwired into the corporate psyche. It dictates not only how people judge the worth of their company but also how they feel about themselves and the work that they are doing. And, over time, it has clouded judgments about what is acceptable corporate behavior. Steven Pearlstein, "Debating the Enron Effect," *Washington Post*, February 17, 2002.

### **Managing by Numbers: The Sears Auto Center Story**

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

—Michael Josephson

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

Sears Roebuck & Company has been a fixture in American retailing throughout the twentieth century. At one time, people in rural America could order virtually anything (including a house) from Sears. Not without some accuracy, the company billed itself as “the place where Americans shop.” But in 1992, Sears was charged by California authorities with gross and deliberate fraud in many of its auto centers.

The authorities were alerted by a 50 percent increase in consumer complaints over a three-year period. New Jersey's division of consumer affairs also investigated Sears Auto Centers and found that all six visited by investigators had recommended unnecessary repairs. California's department of consumer affairs found that Sears had systematically overcharged by an average of \$223 for repairs and routinely billed for work that was not done. Sears Auto Centers were the largest providers of auto repair services in the state.

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

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

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

- People generally choose short-term gains over potential long-term losses.
- People often justify the harm to others as being minimal or “necessary” to achieve the desired sales quota or financial goal.
- In working as a group, we often form an “us versus them” mentality. In the Sears case, it is likely that Sears “insiders” looked at customers as “outsiders,” effectively treating them (in Kantian terms) as means rather than ends in themselves. In short, outsiders were used for the benefit of insiders.
- The long-term losses to Sears are difficult to quantify, while the short-term gains were easy to measure and (at least for a brief while) quite satisfying financially.
- Sears' ongoing rip-offs were possible only because individual consumers lacked the relevant information about the service being offered. This lack of information is a market failure, since many consumers were demanding more of Sears Auto Center services than they would have (and at a higher price) if relevant information had been available to them earlier. Sears, like other sellers of goods and services, took advantage of a market system, which, in its ideal form, would not permit such information distortions.
- People in the organization probably thought that the actions they took were necessary.

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



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

### Conscious Capitalism

One effort to integrate the two viewpoints of stakeholder theory and shareholder primacy is the conscious capitalism movement. Companies that practice **conscious capitalism**<sup>8</sup> embrace the idea that profit and prosperity can and must go hand in hand with social justice and environmental stewardship. They operate with a holistic or systems view. This means that they understand that all stakeholders are connected and interdependent. They reject false trade-offs between stakeholder interests and strive for creative ways to achieve win-win-win outcomes for all. Milton Friedman, John Mackey, and T. J. Rodgers, “Rethinking the Social Responsibility of Business,” Reason.com, October 2005, <http://reason.com/archives/2005/10/01/rethinking-the-social-responsi>.

The “conscious business” has a purpose that goes beyond maximizing profits. It is designed to maximize profits but is focused more on its higher purpose and does not fixate solely on the bottom line. To do so, it focuses on delivering value to all its stakeholders, harmonizing as best it can the interests of consumers, partners, investors, the community, and the environment. This requires that company managers take a “servant leadership” role, serving as stewards to the company’s deeper purpose and to the company’s stakeholders.

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

8. Companies that practice conscious capitalism embrace the idea that profit and prosperity can and must go hand in hand with social justice and environmental stewardship.

## 2.5 Summary and Exercises

### Summary

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

## EXERCISES

1. Consider again Milton Friedman's article.
  - a. What does Friedman mean by "ethical custom"?
  - b. If the laws of the society are limiting the company's profitability, would the company be within its rights to disobey the law?
  - c. What if the law is "on the books," but the company could count on a lack of enforcement from state officials who were overworked and underpaid? Should the company limit its profits? Suppose that it could save money by discharging a pollutant into a nearby river, adversely affecting fish and, potentially, drinking water supplies for downstream municipalities. In polluting against laws that aren't enforced, is it still acting "within the rules of the game"? What if almost all other companies in the industry were saving money by doing similar acts?
2. Consider again the *Harris v. Forklift* case at the end of [Chapter 1 "Introduction to Law and Legal Systems"](#). The Supreme Court ruled that Ms. Harris was entitled to be heard again by the federal district court, which means that there would be a trial on her claim that Mr. Hardy, owner of Forklift Systems, had created a "hostile working environment" for Ms. Harris. Apart from the legal aspects, did he really do anything unethical? How can you tell?
  - a. Which of his actions, if any, were contrary to utilitarian thinking?
  - b. If Kant were his second-in-command and advising him on ethical matters, would he have approved of Mr. Hardy's behavior? Why or why not?
3. Consider the behaviors alleged by Ms. Harris and assume for a moment that they are all true. In terms of core values, which of these behaviors are not consistent with the core values Josephson points to? Be specific.
4. Assume that Forklift Systems is a large public corporation and that the CEO engages in these kinds of behaviors. Assume also that the board of directors knows about it. What action should the board take, and why?

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

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

## SELF-TEST QUESTIONS

1. Milton Friedman would have been most likely to agree to which of the following statements?
  - a. The purpose of the corporation is to find a path to sustainable corporate profits by paying careful attention to key stakeholders.
  - b. The business of business is business.
  - c. The CEO and the board should have a single-minded focus on delivering maximum value to shareholders of the business.
  - d. All is fair in love, war, and business.
  
2. Milton Friedman meant (using the material quoted in this chapter) that companies should
  - a. Find a path to sustainable profits by looking at the interconnected needs and desires of all the stakeholders.
  - b. Always remember that the business of business is business.
  - c. Remind the CEO that he or she has one duty: to maximize shareholder wealth by any means possible.
  - d. Maximize shareholder wealth by engaging in open competition without fraud or deceit.
  
3. What are some key drawbacks to utilitarian thinking at the corporate level?
  - a. The corporation may do a cost-benefit analysis that puts the greatest good of the firm above all other considerations.
  - b. It is difficult to predict future consequences; decision makers in for-profit organizations will tend to overestimate the upside of certain decisions and underestimate the downside.
  - c. Short-term interests will be favored over long-term consequences.
  - d. all of the above
  - e. a and b only
  
4. Which ethical perspective would allow that under certain circumstances, it might be ethical to lie to a liar?

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

#### SELF-TEST ANSWERS

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

## Chapter 3

### Courts and the Legal Process

#### LEARNING OBJECTIVES

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

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

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

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

### ***Robinson v. Audi***

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

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



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

### LEARNING OBJECTIVES

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

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

State and local courts must honor both federal law and the laws of the other states. First, state courts must honor federal law where state laws are in conflict with federal laws (under the supremacy clause of the Constitution; see [Chapter 4 "Constitutional Law and US Commerce"](#)). Second, claims arising under federal statutes can often be tried in the state courts, where the Constitution or Congress has not explicitly required that only federal courts can hear that kind of claim. Third, under the full faith and credit clause, each state court is obligated to respect the final judgments of courts in other states. Thus a contract dispute resolved by an Arkansas court cannot be relitigated in North Dakota when the plaintiff wants to collect on the Arkansas judgment in North Dakota. Fourth, state courts often must consider the laws of other states in deciding cases involving issues where two states have an interest, such as when drivers from two different states collide in a third state. Under these circumstances, state judges will consult their own state's case decisions involving conflicts of laws and sometimes decide that they must apply another state's laws to decide the case (see [Table 3.1 "Sample Conflict-of-Law Principles"](#)).

As state courts are concerned with federal law, so federal courts are often concerned with state law and with what happens in state courts. Federal courts will consider state-law-based claims when a case involves claims using both state and federal law. Claims based on federal laws will permit the federal court to take jurisdiction over the whole case, including any state issues raised. In those cases,

the federal court is said to exercise “pendent jurisdiction” over the state claims. Also, the Supreme Court will occasionally take appeals from a state supreme court where state law raises an important issue of federal law to be decided. For example, a convict on death row may claim that the state’s chosen method of execution using the injection of drugs is unusually painful and involves “cruel and unusual punishment,” raising an Eighth Amendment issue.

There is also a broad category of cases heard in federal courts that concern only state legal issues—namely, cases that arise between citizens of different states. The federal courts are permitted to hear these cases under their so-called **diversity of citizenship jurisdiction**<sup>1</sup> (or diversity jurisdiction). A citizen of New Jersey may sue a citizen of New York over a contract dispute in federal court, but if both were citizens of New Jersey, the plaintiff would be limited to the state courts. The Constitution established diversity jurisdiction because it was feared that local courts would be hostile toward people from other states and that they would need separate courts. In 2009, nearly a third of all lawsuits filed in federal court were based on diversity of citizenship. In these cases, the federal courts were applying state law, rather than taking **federal question jurisdiction**<sup>2</sup>, where federal law provided the basis for the lawsuit or where the United States was a party (as plaintiff or defendant).

Why are there so many diversity cases in federal courts? Defense lawyers believe that there is sometimes a “home-court advantage” for an in-state plaintiff who brings a lawsuit against a nonresident in his local state court. The defense attorney is entitled to ask for **removal**<sup>3</sup> to a federal court where there is diversity. This fits with the original reason for diversity jurisdiction in the Constitution—the concern that judges in one state court would favor the in-state plaintiff rather than a nonresident defendant. Another reason there are so many diversity cases is that plaintiffs’ attorneys know that removal is common and that it will move the case along faster by filing in federal court to begin with. Some plaintiffs’ attorneys also find advantages in pursuing a lawsuit in federal court. Federal court procedures are often more efficient than state court procedures, so that federal dockets are often less crowded. This means a case will get to trial faster, and many lawyers enjoy the higher status that comes in practicing before the federal bench. In some federal districts, judgments for plaintiffs may be higher, on average, than in the local state court. In short, not only law but also legal strategy factor into the popularity of diversity cases in federal courts.

1. Subject matter jurisdiction in federal court where the plaintiff is a citizen of one state, no defendant is also a citizen of that state, and the amount in controversy exceeds \$75,000.
2. Federal court subject matter jurisdiction based on a complaint that uses a federal statutory, regulatory, or constitutional law as a cause of action.
3. The right of a defendant to remove a case from state to federal court.
4. The jurisdiction that a judge has to hear witnesses and receive evidence in a trial proceeding.

### State Court Systems

The vast majority of civil lawsuits in the United States are filed in state courts. Two aspects of civil lawsuits are common to all state courts: trials and appeals. A court exercising a trial function has **original jurisdiction**<sup>4</sup>—that is, jurisdiction to

determine the facts of the case and apply the law to them. A court that hears appeals from the trial court is said to have **appellate jurisdiction**<sup>5</sup>—it must accept the facts as determined by the trial court and limit its review to the lower court’s theory of the applicable law.

### Limited Jurisdiction Courts

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

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

### General Jurisdiction Courts

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

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

5. the jurisdiction of an appellate court to review whether the parties received a fair trial in accordance with applicable law. Appellate jurisdiction does not include hearing witnesses or receiving new evidence.

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

### Appellate Courts

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

The last type of appeal within the state courts system is to the highest court, the state supreme court, which is composed of a single panel of between five and nine judges and is usually located in the state capital. (The intermediate appellate courts are usually composed of panels of three judges and are situated in various locations around the state.) In a few states, the highest court goes by a different name: in New York, it is known as the court of appeals. In certain cases, appellants to the highest court in a state have the right to have their appeals heard, but more often the supreme court selects the cases it wishes to hear. For most litigants, the ruling of the state supreme court is final. In a relatively small class of cases—those in which federal constitutional claims are made—appeal to the US Supreme Court to issue a **writ of certiorari**<sup>6</sup> remains a possibility.

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

## The Federal Court System

### District Courts

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

four district judges and fifteen magistrates in this district. The district judges throughout the United States commonly preside over all federal trials, both criminal and civil.

### **Courts of Appeal**

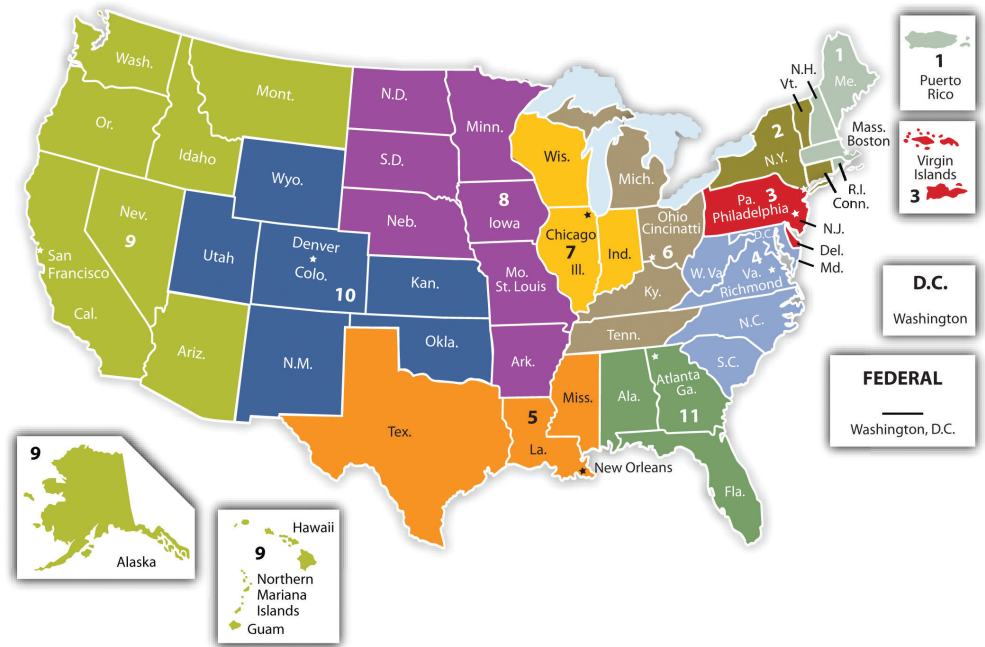
Cases from the district courts can then be appealed to the circuit courts of appeal, of which there are thirteen ([Figure 3.1 "The Federal Judicial Circuits"](#)). Each circuit oversees the work of the district courts in several states. For example, the US Court of Appeals for the Second Circuit hears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

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

### **United States Supreme Court**

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

Figure 3.1 The Federal Judicial Circuits



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

### KEY TAKEAWAY

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

## EXERCISES

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

## 3.2 The Problem of Jurisdiction

### LEARNING OBJECTIVES

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

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

There are two questions about jurisdiction in each case that must be answered before a judge will hear a case: the question of **subject matter jurisdiction**<sup>7</sup> and the question of personal jurisdiction. We will consider the question of subject matter jurisdiction first, because judges do; if they determine, on the basis of the initial documents in the case (the “pleadings”), that they have no power to hear and decide that kind of case, they will dismiss it.

### The Federal-State Balance: Federalism

State courts have their origins in colonial era courts. After the American Revolution, state courts functioned (with some differences) much like they did in colonial times. The big difference after 1789 was that state courts coexisted with federal courts. **Federalism**<sup>8</sup> was the system devised by the nation’s founders in which power is shared between states and the federal government. This sharing requires a division of labor between the states and the federal government. It is Article III of the US Constitution that spells out the respective spheres of authority (jurisdiction) between state and federal courts.

Take a close look at Article III of the Constitution. (You can find a printable copy of the Constitution at <http://www.findlaw.com>.) Article III makes clear that federal courts are courts of limited power or jurisdiction. Notice that the only kinds of cases federal courts are authorized to deal with have strong federal connections. For example, federal courts have jurisdiction when a federal law is being used by

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

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



the plaintiff or prosecutor (a “federal question” case) or the case arises “in admiralty” (meaning that the problem arose not on land but on sea, beyond the territorial jurisdiction of any state, or in navigable waters within the United States). Implied in this list is the clear notion that states would continue to have their own laws, interpreted by their own courts, and that federal courts were needed only where the issues raised by the parties had a clear federal connection. The exception to this is diversity jurisdiction, discussed later.

The Constitution was constructed with the idea that state courts would continue to deal with basic kinds of claims such as tort, contract, or property claims. Since states sanction marriages and divorce, state courts would deal with “domestic” (family) issues. Since states deal with birth and death records, it stands to reason that paternity suits, probate disputes, and the like usually wind up in state courts. You wouldn’t go to the federal building or courthouse to get a marriage license, ask for a divorce, or probate a will: these matters have traditionally been dealt with by the states (and the thirteen original colonies before them). Matters that historically get raised and settled in state court under state law include not only domestic and probate matters but also law relating to corporations, partnerships, agency, contracts, property, torts, and commercial dealings generally. You cannot get married or divorced in federal court, because federal courts have no jurisdiction over matters that are historically (and are still) exclusively within the domain of state law.

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

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

that court. The question of which defendants are appropriately before the court is a question of **personal jurisdiction**<sup>9</sup>.

Because there are two court systems, it is important for a plaintiff to file in the right court to begin with. The right court is the one that has subject matter jurisdiction over the case—that is, the power to hear and decide the kind of case that is filed. Not only is it a waste of time to file in the wrong court system and be dismissed, but if the dismissal comes after the filing period imposed by the applicable **statute of limitations**<sup>10</sup>, it will be too late to refile in the correct court system. Such cases will be routinely dismissed, regardless of how deserving the plaintiff might be in his quest for justice. (The plaintiff's only remedy at that point would be to sue his lawyer for negligence for failing to mind the clock and get to the right court in time!)

### Exclusive Jurisdiction in Federal Courts

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

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

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

1. *Suits between states.* Cases in which two or more states are a party.
2. *Cases involving ambassadors and other high-ranking public figures.* Cases arising between foreign ambassadors and other high-ranking public officials.
3. *Federal crimes.* Crimes defined by or mentioned in the US Constitution or those defined or punished by federal statute. Such crimes include treason against the United States, piracy, counterfeiting, crimes

9. Each court must have subject matter jurisdiction and personal jurisdiction over at least one named defendant. If the defendant is a nonresident where the lawsuit is filed, there may be constitutional issues of personal jurisdiction arising from the due process clause of the Fourteenth Amendment. One state should not claim personal jurisdiction over a nonresident unless various tests are met, such as minimum contacts and the "purposeful availment" test.

10. Each state and the federal government has legislated certain time periods beyond which plaintiffs are not allowed to file civil lawsuits. (There are some statutes of limitations for some kinds of criminal offenses, as well.)

against the law of nations, and crimes relating to the federal government's authority to regulate interstate commerce. However, most crimes are state matters.

4. *Bankruptcy*. The statutory procedure, usually triggered by insolvency, by which a person is relieved of most debts and undergoes a judicially supervised reorganization or liquidation for the benefit of the person's creditors.
5. *Patent, copyright, and trademark cases*
  - a. *Patent*. The exclusive right to make, use, or sell an invention for a specified period (usually seventeen years), granted by the federal government to the inventor if the device or process is novel, useful, and nonobvious.
  - b. *Copyright*. The body of law relating to a property right in an original work of authorship (such as a literary, musical, artistic, photographic, or film work) fixed in any tangible medium of expression, giving the holder the exclusive right to reproduce, adapt, distribute, perform, and display the work.
  - c. *Trademark*. A word, phrase, logo, or other graphic symbol used by a manufacturer or seller to distinguish its product or products from those of others.
6. *Admiralty*. The system of laws that has grown out of the practice of admiralty courts: courts that exercise jurisdiction over all maritime contracts, torts, injuries, and offenses.
7. *Antitrust*. Federal laws designed to protect trade and commerce from restraining monopolies, price fixing, and price discrimination.
8. *Securities and banking regulation*. The body of law protecting the public by regulating the registration, offering, and trading of securities and the regulation of banking practices.
9. *Other cases specified by federal statute*. Any other cases specified by a federal statute where Congress declares that federal courts will have exclusive jurisdiction.

### Concurrent Jurisdiction

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

plaintiff(s) and the defendant(s) are from different states and the amount in controversy is more than \$75,000. State courts can have subject matter jurisdiction over certain cases that have only a federal-based cause of action. The Supreme Court has now made clear that state courts have **concurrent jurisdiction**<sup>11</sup> of any federal cause of action unless Congress has given exclusive jurisdiction to federal courts.

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

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

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

### Summary of Rules on Subject Matter Jurisdiction

1. A court must always have subject matter jurisdiction, and personal jurisdiction over at least one defendant, to hear and decide a case.
2. A state court will have subject matter jurisdiction over any case that is not required to be brought in a federal court.

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

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

OR

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

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

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

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

4. In diversity cases, the following rules apply.
  - (1) Federal civil procedure rules apply to how the case is conducted before and during trial and any appeals, but

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

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

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

(3) Why do some nonresident defendants prefer to be in federal court?

(a) In the state court, the judge is elected, and the jury may be familiar with or sympathetic to the “local” plaintiff.

(b) The federal court provides a more neutral forum, with an appointed, life-tenured judge and a wider pool of potential jurors (drawn from a wider geographical area).

(4) If a defendant does not want to be in state court and there is diversity, what is to be done?

(a) Make a motion for removal to the federal court.

(b) The federal court will not want to add to its caseload, or docket, but must take the case unless there is *not* complete diversity of citizenship or the amount in controversy is *less than* \$75,000.

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

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

### ***Robinson v. Audi***

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

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

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



Table 3.1 Sample Conflict-of-Law Principles

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

### Legal Procedure, Including Due Process and Personal Jurisdiction

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

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

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

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

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

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

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

Criminal prosecutions carry the most rigorous burden of proof: the government must prove its case against the defendant *beyond a reasonable doubt*. That is, even if it seems very likely that the defendant committed the crime, as long as there remains some reasonable doubt—perhaps he was not clearly identified as the culprit, perhaps he has an alibi that could be legitimate—the jury must vote to acquit rather than convict.

By contrast, the burden of proof in ordinary civil cases—those dealing with contracts, personal injuries, and most of the cases in this book—is a *preponderance of*

*the evidence*, which means that the plaintiff's evidence must outweigh whatever evidence the defendant can muster that casts doubts on the plaintiff's claim. This is not merely a matter of counting the number of witnesses or of the length of time that they talk: the judge in a trial without a jury (a bench trial), or the jury where one is impaneled, must apply the preponderance of evidence test by determining which side has the greater weight of credible, relevant evidence.

Adjudication and the adversary system imply certain other characteristics of courts. Judges must be impartial; those with a personal interest in a matter must refuse to hear it. The ruling of a court, after all appeals are exhausted, is final. This principle is known as **res judicata**<sup>12</sup> (Latin for "the thing is decided"), and it means that the same parties may not take up the same dispute in another court at another time. Finally, a court must proceed according to a public set of formal procedural rules; a judge cannot make up the rules as he goes along. To these rules we now turn.

### How a Case Proceeds Complaint and Summons

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

The timing of the filing can be important. Almost every possible legal complaint is governed by a federal or state statute of limitations, which requires a lawsuit to be filed within a certain period of time. For example, in many states a lawsuit for injuries resulting from an automobile accident must be filed within two years of the accident or the plaintiff forfeits his right to proceed. As noted earlier, making a correct initial filing in a court that has subject matter jurisdiction is critical to avoiding statute of limitations problems.

12. "The matter has been adjudicated." The same case or controversy cannot be heard and concluded in one court and relitigated in another. The same parties may have different issues and disputes, but a final judgment in a court that has jurisdiction over the case or controversy forever settles the matter.

### Jurisdiction and Venue

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

Likewise, a claim for copyright violation cannot be brought in a state superior court, since federal courts have exclusive jurisdiction over copyright cases.

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

### **Service of Process and Personal Jurisdiction**

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

One of the most troublesome problems is service on an out-of-state defendant. The personal jurisdiction of a state court over persons is clear for those defendants found within the state. If the plaintiff claims that an out-of-state defendant injured him in some way, must the plaintiff go to the defendant’s home state to serve him? Unless the defendant had some significant contact with the plaintiff’s state, the plaintiff may indeed have to. For instance, suppose a traveler from Maine stopped at a roadside diner in Montana and ordered a slice of homemade pie that was tainted and caused him to be sick. The traveler may not simply return home and mail the diner a notice that he is suing it in a Maine court. But if out-of-state defendants have some contact with the plaintiff’s state of residence, there might be grounds to bring them within the jurisdiction of the plaintiff’s state courts. In *Burger King v. Rudzewicz*, [Section 3.9 "Cases"](#), the federal court in Florida had to consider whether it was constitutionally permissible to exercise personal jurisdiction over a Michigan franchisee.

Again, recall that even if a court has subject matter jurisdiction, it must also have personal jurisdiction over each defendant against whom an enforceable judgment can be made. Often this is not a problem; you might be suing a person who lives in your state or regularly does business in your state. Or a nonresident may answer your complaint without objecting to the court’s “in personam” (personal) jurisdiction. But many defendants who do not reside in the state where the lawsuit

is filed would rather not be put to the inconvenience of contesting a lawsuit in a distant forum. Fairness—and the due process clause of the Fourteenth Amendment—dictates that nonresidents should not be required to defend lawsuits far from their home base, especially where there is little or no contact or connection between the nonresident and the state where a lawsuit is brought.

### Summary of Rules on Personal Jurisdiction

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

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

3. Service of process is a necessary (but not sufficient) condition for getting personal jurisdiction over a particular defendant (see rule 4).
  1. In order to get a judgment in a civil action, the plaintiff must serve a copy of the complaint and a summons on the defendant.
  2. There are many ways to do this.
    - The process server personally serves a complaint on the defendant.
    - The process server leaves a copy of the summons and complaint at the residence of the defendant, in the hands of a competent person.
    - The process server sends the summons and complaint by certified mail, return receipt requested.

- The process server, if all other means are not possible, notifies the defendant by publication in a newspaper having a minimum number of readers (as may be specified by law).
4. In addition to successfully serving the defendant with process, a plaintiff must convince the court that exercising personal jurisdiction over the defendant is consistent with due process and any statutes in that state that prescribe the jurisdictional reach of that state (the so-called long-arm statutes). The Supreme Court has long recognized various bases for judging whether such process is fair.
    1. Consent. The defendant agrees to the court's jurisdiction by coming to court, answering the complaint, and having the matter litigated there.
    2. Domicile. The defendant is a permanent resident of that state.
    3. Event. The defendant did something in that state, related to the lawsuit, that makes it fair for the state to say, "Come back and defend!"
    4. Service of process within the state will effectively provide personal jurisdiction over the nonresident.

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

Almost every state in the United States has a statute regarding personal jurisdiction, instructing judges when it is permissible to assert personal jurisdiction over an out-of-state resident. These are called long-arm statutes. But no state can reach out beyond the limits of what is constitutionally permissible under the Fourteenth Amendment, which binds the states with its proviso to guarantee the due process rights of the citizens of every state in the union. The "minimum

contacts” test in *Burger King v. Rudzewicz* ([Section 3.9 "Cases"](#)) tries to make the fairness mandate of the due process clause more specific. So do other tests articulated in the case (such as “does not offend traditional notions of fair play and substantial justice”). These tests are posed by the Supreme Court and heeded by all lower courts in order to honor the provisions of the Fourteenth Amendment’s due process guarantees. These tests are *in addition to* any state long-arm statute’s instructions to courts regarding the assertion of personal jurisdiction over nonresidents.

### **Choice of Law and Choice of Forum Clauses**

In a series of cases, the Supreme Court has made clear that it will honor contractual choices of parties in a lawsuit. Suppose the parties to a contract wind up in court arguing over the application of the contract’s terms. If the parties are from two different states, the judge may have difficulty determining which law to apply (see [Table 3.1 "Sample Conflict-of-Law Principles"](#)). But if the contract says that a particular state’s law will be applied if there is a dispute, then ordinarily the judge will apply that state’s law as a rule of decision in the case. For example, Kumar Patel (a Missouri resident) opens a brokerage account with Goldman, Sachs and Co., and the contractual agreement calls for “any disputes arising under this agreement” to be determined “according to the laws of the state of New York.” When Kumar claims in a Missouri court that his broker is “churning” his account, and, on the other hand, Goldman, Sachs claims that Kumar has failed to meet his margin call and owes \$38,568.25 (plus interest and attorney’s fees), the judge in Missouri will apply New York law based on the contract between Kumar and Goldman, Sachs.

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



**KEY TAKEAWAY**

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

## EXERCISES

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

## 3.3 Motions and Discovery

### LEARNING OBJECTIVES

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

The early phases of a civil action are characterized by many different kinds of motions and a complex process of mutual fact-finding between the parties that is known as discovery. A lawsuit will start with the **pleadings**<sup>13</sup> (complaint and answer in every case, and in some cases a counterclaim by the defendant against the plaintiff and the plaintiff's reply to the defendant's counterclaim). After the pleadings, the parties may make various **motions**<sup>14</sup>, which are requests to the judge. Motions in the early stages of a lawsuit usually aim to dismiss the lawsuit, to have it moved to another venue, or to compel the other party to act in certain ways during the discovery process.

### Initial Pleadings, and Motions to Dismiss

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

State and federal rules of civil procedure require that the complaint must state the nature of the plaintiff's claim, the jurisdiction of the court, and the nature of the relief that is being asked for (usually an award of money, but sometimes an injunction, or a declaration of legal rights). In an answer, the defendant will often deny all the allegations of the complaint or will admit to certain of its allegations and deny others.

A complaint and subsequent pleadings are usually quite general and give little detail. Cases can be decided on the pleadings alone in the following situations: (1) If the defendant fails to answer the complaint, the court can enter a default judgment, awarding the plaintiff what he seeks. (2) The defendant can move to dismiss the complaint on the grounds that the plaintiff failed to "state a claim on which relief can be granted," or on the basis that there is no subject matter jurisdiction for the

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

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

court chosen by the plaintiff, or on the basis that there is no personal jurisdiction over the defendant. The defendant is saying, in effect, that even if all the plaintiff's allegations are true, they do not amount to a legal claim that can be heard by the court. For example, a claim that the defendant induced a woman to stop dating the plaintiff (a so-called alienation of affections cause of action) is no longer actionable in US state courts, and any court will dismiss the complaint without any further proceedings. (This type of dismissal is occasionally still called a demurrer.)

A third kind of dismissal can take place on a motion for **summary judgment**<sup>15</sup>. If there is no triable question of fact or law, there is no reason to have a trial. For example, the plaintiff sues on a promissory note and, at deposition (an oral examination under oath), the defendant admits having made no payment on the note and offers no excuse that would be recognizable as a reason not to pay. There is no reason to have a trial, and the court should grant summary judgment.

## Discovery

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

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

The lawyers, not the court, run the discovery process. For example, one party simply makes a written demand, stating the time at which the deposition will take

15. As in a directed verdict, when a judge grants summary judgment, she has concluded that there are no matters of law or fact on which reasonable people would disagree. Summary judgment is a final order, and it is appealable.

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

### KEY TAKEAWAY

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

### EXERCISES

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

## 3.4 The Pretrial and Trial Phase

### LEARNING OBJECTIVES

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

After considerable discovery, one of the parties may believe that there is no triable issue of law or fact for the court to consider and may file a motion with the court for summary judgment. Unless it is very clear, the judge will deny a summary judgment motion, because that ends the case at the trial level; it is a “final order” in the case that tells the plaintiff “no” and leaves no room to bring another lawsuit against the defendant for that particular set of facts (*res judicata*). If the plaintiff successfully appeals a summary judgment motion, the case will come back to the trial court.

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

### Pretrial Conference

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

### Trial

At trial, the first order of business is to select a jury. (In a civil case of any consequence, either party can request one, based on the Sixth Amendment to the US Constitution.) The judge and sometimes the lawyers are permitted to question the jurors to be sure that they are unbiased. This questioning is known as the *voir*

dire (pronounced vwahr-DEER). This is an important process, and a great deal of thought goes into selecting the jury, especially in high-profile cases. A jury panel can be as few as six persons, or as many as twelve, with alternates selected and sitting in court in case one of the jurors is unable to continue. In a long trial, having alternates is essential; even in shorter trials, most courts will have at least two alternate jurors.

In both criminal and civil trials, each side has opportunities to challenge potential jurors for cause. For example, in the Robinsons' case against Audi, the attorneys representing Audi will want to know if any prospective jurors have ever owned an Audi, what their experience has been, and if they had a similar problem (or worse) with their Audi that was not resolved to their satisfaction. If so, the defense attorney could well believe that such a juror has a potential for a bias against her client. In that case, she could use a challenge for cause, explaining to the judge the basis for her challenge. The judge, at her discretion, could either accept the for-cause reason or reject it.

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

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

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

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

After direct testimony of each witness is over, the opposing lawyer may conduct cross-examination. This is a crucial constitutional right; in criminal cases it is preserved in the Constitution's Sixth Amendment (the right to confront one's accusers in open court). The formal rules of direct testimony are then relaxed, and the cross-examiner may probe the witness more informally, asking questions that may not seem immediately relevant. This is when the opposing attorney may become harsh, casting doubt on a witness's credibility, trying to trip her up and show that the answers she gave are false or not to be trusted. This use of cross-examination, along with the requirement that the witness must respond to questions that are at all relevant to the questions raised by the case, distinguishes common-law courts from those of authoritarian regimes around the world.

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

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

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

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

When all testimony has been introduced, either party may ask the judge for a **directed verdict**<sup>16</sup>—a verdict decided by the judge without advice from the jury.

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



This motion may be granted if the plaintiff has failed to introduce evidence that is legally sufficient to meet her burden of proof or if the defendant has failed to do the same on issues on which she has the burden of proof. (For example, the plaintiff alleges that the defendant owes him money and introduces a signed promissory note. The defendant cannot show that the note is invalid. The defendant must lose the case unless he can show that the debt has been paid or otherwise discharged.)

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

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

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

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

## Posttrial Motions

The losing party is allowed to ask the judge for a new trial or for a judgment notwithstanding the verdict (often called a **judgment n.o.v.**<sup>17</sup>, from the Latin *non obstante veredicto*). A judge who decides that a directed verdict is appropriate will usually wait to see what the jury's verdict is. If it is favorable to the party the judge thinks should win, she can rely on that verdict. If the verdict is for the other party, he can grant the motion for judgment n.o.v. This is a safer way to proceed because if the judge is reversed on appeal, a new trial is not necessary. The jury's verdict always can be restored, whereas without a jury verdict (as happens when a directed verdict is granted before the case goes to the jury), the entire case must be presented to a new jury. *Ferlito v. Johnson & Johnson* (Section 3.9 "Cases") illustrates the judgment n.o.v. process in a case where the judge allowed the case to go to a jury that was overly sympathetic to the plaintiffs.

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

Rule 50(b) says,

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

17. Judgment "notwithstanding the verdict" may be awarded after the jury returns a verdict that the judge believes no rational jury could have come to. Judgment n.o.v. reverses the verdict and awards judgment to the party against whom the jury's verdict was made.

### KEY TAKEAWAY

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

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

### EXERCISES

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

## 3.5 Judgment, Appeal, and Execution

### LEARNING OBJECTIVES

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

### Judgment or Order

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

### Appeal

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

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

Appellate and trial procedures are different. The appellate court does not hear witnesses or accept evidence. It reviews the *record* of the case—the transcript of the witnesses’ testimony and the documents received into evidence at trial—to try to find a legal error on a specific request of one or both of the parties. The parties’ lawyers prepare briefs (written statements containing the facts in the case), the procedural steps taken, and the argument or discussion of the meaning of the law and how it applies to the facts. After reading the briefs on appeal, the appellate court may dispose of the appeal without argument, issuing a written opinion that may be very short or many pages. Often, though, the appellate court will hear oral argument. (This can be months, or even more than a year after the briefs are filed.) Each lawyer is given a short period of time, usually no more than thirty minutes, to present his client’s case. The lawyer rarely gets a chance for an extended statement because he is usually interrupted by questions from the judges. Through this exchange between judges and lawyers, specific legal positions can be tested and their limits explored.

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

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

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

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

## Judgment and Order

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

### KEY TAKEAWAY

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

## EXERCISES

1. Mrs. Robinson has a key witness on auto safety that the judge believes is not qualified as an expert. The judge examines the witness while the jury is in the jury room and disqualifies him from testifying. The jury does not get to hear this witness. Her attorney objects. She loses her case. What argument would you expect Mrs. Robinson's attorney to make in an appeal?
2. Why don't appellate courts need a witness box for witnesses to give testimony under oath?
3. A trial judge in Nevada is wondering whether to enforce a surrogate motherhood contract. Penelope Barr, of Reno, Nevada, has contracted with Reuben and Tina Goldberg to bear the in vitro fertilized egg of Mrs. Goldberg. After carrying the child for nine months, Penelope gives birth, but she is reluctant to give up the child, even though she was paid \$20,000 at the start of the contract and will earn an additional \$20,000 on handing over the baby to the Goldbergs. (Barr was an especially good candidate for surrogate motherhood: she had borne two perfect children and at age 28 drinks no wine, does not smoke or use drugs of any kind, practices yoga, and maintains a largely vegetarian diet with just enough meat to meet the needs of the fetus within.)

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

## 3.6 When Can Someone Bring a Lawsuit?

### LEARNING OBJECTIVES

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

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

### Case or Controversy: Standing to Sue

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

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

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



## Class Actions

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

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

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

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

Usually a person who doesn't want to be in the class can decide to leave. If she does, she will not be included in an eventual judgment or settlement. But a potential plaintiff who is included in the class cannot, after a final judgment is awarded, seek to relitigate the issue if she is dissatisfied with the outcome, even though she did not participate at all in the legal proceeding.

### KEY TAKEAWAY

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

### EXERCISE

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

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

## 3.7 Relations with Lawyers

### LEARNING OBJECTIVES

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

### Legal Fees

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

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

A contingent fee is one that is paid only if the lawyer wins—that is, it is contingent, or depends upon, the success of the case. This type of fee arrangement is used most often in personal injury cases (e.g., automobile accidents, products liability, and professional malpractice). Although used quite often, the contingent fee is controversial. Trial lawyers justify it by pointing to the high cost of preparing for such lawsuits. A typical automobile accident case can cost at least ten thousand dollars to prepare, and a complicated products-liability case can cost tens of thousands of dollars. Few people have that kind of money or would be willing to spend it on the chance that they might win a lawsuit. Corporate and professional defendants complain that the contingent fee gives lawyers a license to go big game hunting, or to file suits against those with deep pockets in the hopes of forcing them to settle.

Trial lawyers respond that the contingent fee arrangement forces them to screen cases and weed out cases that are weak, because it is not worth their time to spend

the hundreds of hours necessary on such cases if their chances of winning are slim or nonexistent.

### Costs

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

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

#### KEY TAKEAWAY

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

## EXERCISES

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

## 3.8 Alternative Means of Resolving Disputes

### LEARNING OBJECTIVES

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

Disputes do not have to be settled in court. No law requires parties who have a legal dispute to seek judicial resolution if they can resolve their disagreement privately or through some other public forum. In fact, the threat of a lawsuit can frequently motivate parties toward private negotiation. Filing a lawsuit may convince one party that the other party is serious. Or the parties may decide that they will come to terms privately rather than wait the three or four years it can frequently take for a case to move up on the court calendar.

### Arbitration

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

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

**Arbitration**<sup>18</sup> is a type of adjudication. The parties use a private decision maker, the arbitrator, and the rules of procedure are considerably more relaxed than those that apply in the courtroom. Arbitrators might be retired judges, lawyers, or anyone with the kind of specialized knowledge and training that would be useful in making a final, binding decision on the dispute. In a contractual relationship, the parties can decide even before a dispute arises to use arbitration when the time comes. Or parties can decide after a dispute arises to use arbitration instead of

18. A process agreed to by disputing parties, involving an arbitrator or arbitral panel (usually three), in which a final and binding award is made, enforceable through the courts if necessary.

litigation. In a predispute arbitration agreement (often part of a larger contract), the parties can spell out the rules of procedure to be used and the method for choosing the arbitrator. For example, they may name the specific person or delegate the responsibility of choosing to some neutral person, or they may each designate a person and the two designees may jointly pick a third arbitrator.

Many arbitrations take place under the auspices of the American Arbitration Association, a private organization headquartered in New York, with regional offices in many other cities. The association uses published sets of rules for various types of arbitration (e.g., labor arbitration or commercial arbitration); parties who provide in contracts for arbitration through the association are agreeing to be bound by the association's rules. Similarly, the National Association of Securities Dealers provides arbitration services for disputes between clients and brokerage firms. International commercial arbitration often takes place through the auspices of the International Chamber of Commerce. A multilateral agreement known as the Convention on the Recognition and Enforcement of Arbitral Awards provides that agreements to arbitrate—and arbitral awards—will be enforced across national boundaries.

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

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

## Mediation

19. A process where disputing parties agree to bring their differences to an experienced mediator, knowledgeable about the type of dispute involved, and in which the mediator's recommendations may be accepted or rejected by either or both parties.

Unlike adjudication, **mediation**<sup>19</sup> gives the neutral party no power to impose a decision. The mediator is a go-between who attempts to help the parties negotiate a solution. The mediator will communicate the parties' positions to each other, will facilitate the finding of common ground, and will suggest outcomes. But the parties have complete control: they may ignore the recommendations of the mediator entirely, settle in their own way, find another mediator, agree to binding arbitration, go to court, or forget the whole thing!

### KEY TAKEAWAY

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

### EXERCISES

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



## 3.9 Cases

### ***Burger King v. Rudzewicz***

Burger King Corp. v. Rudzewicz

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

#### **Summary**

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

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

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

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

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

Justice Brennan delivered the opinion of the court.

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

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

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

The unilateral activity of those who claim some relationship with a nonresident defendant cannot satisfy the requirement of contact with the forum State. The

application of that rule will vary with the quality and nature of the defendant's activity, but it is essential in each case that there be some act by which the defendant purposefully avails itself of the privilege of conducting activities within the forum State, thus invoking the benefits and protections of its laws.

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

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

Once it has been decided that a defendant purposefully established minimum contacts within the forum State, these contacts may be considered in light of other factors to determine whether the assertion of personal jurisdiction would comport with "fair play and substantial justice." International Shoe Co. v. Washington, 326 U.S., at 320. Thus courts in "appropriate case[s]" may evaluate "the burden on the defendant," "the forum State's interest in adjudicating the dispute," "the plaintiff's interest in obtaining convenient and effective relief," "the interstate judicial system's interest in obtaining the most efficient resolution of controversies," and the "shared interest of the several States in furthering fundamental substantive social policies." These considerations sometimes serve to establish the reasonableness of jurisdiction upon a lesser showing of minimum contacts than would otherwise be required. [Citations] Applying these principles to the case at hand, we believe there is substantial record evidence supporting the District Court's

conclusion that the assertion of personal jurisdiction over Rudzewicz in Florida for the alleged breach of his franchise agreement did not offend due process....

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

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

It is so ordered.

## CASE QUESTIONS

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

### *Ferlito v. Johnson & Johnson*

Ferlito v. Johnson & Johnson Products, Inc.

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

Gadola, J.

Plaintiffs Susan and Frank Ferlito, husband and wife, attended a Halloween party in 1984 dressed as Mary (Mrs. Ferlito) and her little lamb (Mr. Ferlito). Mrs. Ferlito had constructed a lamb costume for her husband by gluing cotton batting manufactured by defendant Johnson & Johnson Products (“JJP”) to a suit of long underwear. She had also used defendant’s product to fashion a headpiece, complete with ears. The costume covered Mr. Ferlito from his head to his ankles, except for his face and hands, which were blackened with Halloween paint. At the party Mr. Ferlito attempted to light his cigarette by using a butane lighter. The flame passed close to his left arm, and the cotton batting on his left sleeve ignited. Plaintiffs sued defendant for injuries they suffered from burns which covered approximately one-third of Mr. Ferlito’s body.

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

MOTION FOR JUDGMENT NOTWITHSTANDING THE VERDICT

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

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

In determining whether the evidence is sufficient, the trial court may neither weigh the evidence, pass on the credibility of witnesses nor substitute its judgment for that of the jury. Rather, the evidence must be viewed in the light most favorable to the party against whom the motion is made, drawing from that evidence all reasonable inferences in his favor. If after reviewing the evidence...the trial court is of the opinion that reasonable minds could not come to the result reached by the jury, then the motion for j.n.o.v. should be granted.

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

To establish a *prima facie* case that a manufacturer's breach of its duty to warn was a proximate cause of an injury sustained, a plaintiff must present evidence that the product would have been used differently had the proffered warnings been given. By "prima facie case," the court means a case in which the plaintiff has presented all the basic elements of the cause of action alleged in the complaint. If one or more elements of proof are missing, then the plaintiff has fallen short of establishing a prima facie case, and the case should be dismissed (usually on the basis of a directed verdict). [Citations omitted] In the absence of evidence that a warning would have prevented the harm complained of by altering the plaintiff's conduct, the failure to warn cannot be deemed a proximate cause of the plaintiff's injury as a matter of law. [In accordance with procedure in a diversity of citizenship case, such as this one, the court cites Michigan case law as the basis for its legal interpretation.]

...

A manufacturer has a duty “to warn the purchasers or users of its product about dangers associated with intended use.” Conversely, a manufacturer has no duty to warn of a danger arising from an unforeseeable misuse of its product. [Citation] Thus, whether a manufacturer has a duty to warn depends on whether the use of the product and the injury sustained by it are foreseeable. *Gootee v. Colt Industries Inc.*, 712 F.2d 1057, 1065 (6th Cir. 1983); *Owens v. Allis-Chalmers Corp.*, 414 Mich. 413, 425, 326 N.W.2d 372 (1982). Whether a plaintiff’s use of a product is foreseeable is a legal question to be resolved by the court. *Trotter, supra*. Whether the resulting injury is foreseeable is a question of fact for the jury. Note the division of labor here: questions of law are for the judge, while questions of “fact” are for the jury. Here, “foreseeability” is a fact question, while the judge retains authority over questions of law. The division between questions of fact and questions of law is not an easy one, however. *Thomas v. International Harvester Co.*, 57 Mich. App. 79, 225 N.W.2d 175 (1974).

In the instant action no reasonable jury could find that JJP’s failure to warn of the flammability of cotton batting was a proximate cause of plaintiffs’ injuries because plaintiffs failed to offer any evidence to establish that a flammability warning on JJP’s cotton batting would have dissuaded them from using the product in the manner that they did.

Plaintiffs repeatedly stated in their response brief that plaintiff Susan Ferlito testified that “she would never again use cotton batting to make a costume...However, a review of the trial transcript reveals that plaintiff Susan Ferlito never testified that she would never again use cotton batting to make a costume. More importantly, the transcript contains no statement by plaintiff Susan Ferlito that a flammability warning on defendant JJP’s product would have dissuaded her from using the cotton batting to construct the costume in the first place. At oral argument counsel for plaintiffs conceded that there was no testimony during the trial that either plaintiff Susan Ferlito or her husband, plaintiff Frank J. Ferlito, would have acted any different if there had been a flammability warning on the product’s package. The absence of such testimony is fatal to plaintiffs’ case; for without it, plaintiffs have failed to prove proximate cause, one of the essential elements of their negligence claim.

In addition, both plaintiffs testified that they knew that cotton batting burns when it is exposed to flame. Susan Ferlito testified that she knew at the time she purchased the cotton batting that it would burn if exposed to an open flame. Frank Ferlito testified that he knew at the time he appeared at the Halloween party that cotton batting would burn if exposed to an open flame. His additional testimony that he would not have intentionally put a flame to the cotton batting shows that he recognized the risk of injury of which he claims JJP should have warned. Because both plaintiffs were already aware of the danger, a warning by JJP would have been

superfluous. Therefore, a reasonable jury could not have found that JJP's failure to provide a warning was a proximate cause of plaintiffs' injuries.

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

ORDER

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

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

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

### CASE QUESTIONS

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



## Chapter 4

# Constitutional Law and US Commerce

### LEARNING OBJECTIVES

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

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

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

The US Constitution is the foundation for all of US law. Business and commerce are directly affected by the words, meanings, and interpretations of the Constitution. Because it speaks in general terms, its provisions raise all kinds of issues for scholars, lawyers, judges, politicians, and commentators. For example, arguments still rage over the nature and meaning of “federalism,” the concept that there is shared governance between the states and the federal government. The US Supreme Court is the ultimate arbiter of those disputes, and as such it has a unique role in the legal system. It has assumed the power of **judicial review**<sup>1</sup>, unique among federal systems globally, through which it can strike down federal or state statutes that it believes violate the Constitution and can even void the president’s executive orders if they are contrary to the Constitution’s language. No knowledgeable citizen or businessperson can afford to be ignorant of its basic provisions.

## 4.1 Basic Aspects of the US Constitution

### LEARNING OBJECTIVES

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

### The Constitution as Reflecting American Values

In the US, the one document to which all public officials and military personnel pledge their unswerving allegiance is the Constitution. If you serve, you are asked to “support and defend” the Constitution “against all enemies, foreign and domestic.” The oath usually includes a statement that you swear that this oath is taken freely, honestly, and without “any purpose of evasion.” This loyalty oath may be related to a time—fifty years ago—when “un-American” activities were under investigation in Congress and the press; the fear of communism (as antithetical to American values and principles) was paramount. As you look at the Constitution and how it affects the legal environment of business, please consider what basic values it may impart to us and what makes it uniquely American and worth defending “against all enemies, foreign and domestic.”

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

The Constitution itself speaks of rights in fairly general terms, and the judicial interpretation of various rights has been in flux. The “right” of a person to own another person was notably affirmed by the Supreme Court in the *Dred Scott* decision in 1857. In *Scott v. Sanford* (the Dred Scott decision), the court states that

Scott should remain a slave, that as a slave he is not a citizen of the United States and thus not eligible to bring suit in a federal court, and that as a slave he is personal property and thus has never been free. The “right” of a child to freely contract for long, tedious hours of work was upheld by the court in *Hammer v. Dagenhart* in 1918. Both decisions were later repudiated, just as the decision that a woman has a “right” to an abortion in the first trimester of pregnancy could later be repudiated if *Roe v. Wade* is overturned by the Supreme Court. *Roe v. Wade*, 410 US 113 (1973).

## General Structure of the Constitution

Look at the Constitution. Notice that there are seven articles, starting with Article I (legislative powers), Article II (executive branch), and Article III (judiciary). Notice that there is no separate article for administrative agencies. The Constitution also declares that it is “the supreme Law of the Land” (Article VI). Following Article VII are the ten amendments adopted in 1791 that are referred to as the Bill of Rights. Notice also that in 1868, a new amendment, the Fourteenth, was adopted, requiring states to provide “due process” and “equal protection of the laws” to citizens of the United States.

## Federalism

The partnership created in the Constitution between the states and the federal government is called **federalism**<sup>2</sup>. The Constitution is a document created by the states in which certain powers are delegated to the national government, and other powers are reserved to the states. This is made explicit in the Tenth Amendment.

## Separation of Powers and Judicial Review

Because the Founding Fathers wanted to ensure that no single branch of the government, especially the executive branch, would be ascendant over the others, they created various checks and balances to ensure that each of the three principal branches had ways to limit or modify the power of the others. This is known as the **separation of powers**<sup>3</sup>. Thus the president retains veto power, but the House of Representatives is entrusted with the power to initiate spending bills.

Power sharing was evident in the basic design of Congress, the federal legislative branch. The basic power imbalance was between the large states (with greater population) and the smaller ones (such as Delaware). The smaller ones feared a loss of sovereignty if they could be outvoted by the larger ones, so the federal legislature was constructed to guarantee two Senate seats for every state, no matter how small. The Senate was also given great responsibility in ratifying treaties and

2. The idea, built into the structure of the Constitution, that states and the federal government have concurrent powers. In effect, federalism is the concept of shared governance between the states and the federal government.

3. In the original design of the Constitution, the executive, legislative, and judicial branches were all given powers that could modify or limit the powers of the other branches of government. For example, the president wields a veto power over congressional legislation.

judicial nominations. The net effect of this today is that senators from a very small number of states can block treaties and other important legislation. The power of small states is also magnified by the Senate's cloture rule, which currently requires sixty out of one hundred senators to vote to bring a bill to the floor for an up-or-down vote.

Because the Constitution often speaks in general terms (with broad phrases such as "due process" and "equal protection"), reasonable people have disagreed as to how those terms apply in specific cases. The United States is unique among industrialized democracies in having a Supreme Court that reserves for itself that exclusive power to interpret what the Constitution means. The famous case of *Marbury v. Madison* began that tradition in 1803, when the Supreme Court had marginal importance in the new republic. The decision in *Bush v. Gore*, decided in December of 2000, illustrates the power of the court to shape our destiny as a nation. In that case, the court overturned a ruling by the Florida Supreme Court regarding the way to proceed on a recount of the Florida vote for the presidency. The court's ruling was purportedly based on the "equal protection of the laws" provision in the Fourteenth Amendment.

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

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

Because the Supreme Court has this power of judicial review, there have been many arguments about how it should be exercised and what kind of "philosophy" a Supreme Court justice should have. President Richard Nixon often said that a Supreme Court justice should "strictly construe" the Constitution and not add to its language. Finding law in the Constitution was "judicial activism" rather than "judicial restraint." The general philosophy behind the call for "strict constructionist" justices is that legislatures make laws in accord with the wishes of the majority, and so unelected judges should not make law according to their own views and values. Nixon had in mind the 1960s Warren court, which "found" rights in the Constitution that were not specifically mentioned—the right of privacy, for

example. In later years, critics of the Rehnquist court would charge that it “found” rights that were not specifically mentioned, such as the right of states to be free from federal antidiscrimination laws. See, for example, *Kimel v. Florida Board of Regents*, or the *Citizens United v. Federal Election Commission* case ([Section 4.6.5](#)), which held that corporations are “persons” with “free speech rights” that include spending unlimited amounts of money in campaign donations and political advocacy. *Kimel v. Florida Board of Regents*, 528 US 62 (2000).

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

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

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

### KEY TAKEAWAY

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

### EXERCISES

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

## 4.2 The Commerce Clause

### LEARNING OBJECTIVES

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

First, turn to Article I, Section 8. The **commerce clause**<sup>4</sup> gives Congress the exclusive power to make laws relating to foreign trade and commerce and to commerce among the various states. Most of the federally created legal environment springs from this one clause: if Congress is not authorized in the Constitution to make certain laws, then it acts unconstitutionally and its actions may be ruled unconstitutional by the Supreme Court. Lately, the Supreme Court has not been shy about ruling acts of Congress unconstitutional.

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

### Section 8

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

[Clause 2] To borrow Money on the credit of the United States;

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

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

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

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

### Early Commerce Clause Cases

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

The Supreme Court saw the issue as whether Congress had the power under the commerce clause to control interstate shipment of goods made by children under the age of fourteen. The court found that Congress did not. The court cited several cases that had considered what interstate commerce could be constitutionally regulated by Congress. In *Hipolite Egg Co. v. United States*, the Supreme Court had sustained the power of Congress to pass the Pure Food and Drug Act, which prohibited the introduction into the states by means of interstate commerce impure foods and drugs. *Hipolite Egg Co. v. United States*, 220 US 45 (1911). In *Hoke v. United States*, the Supreme Court had sustained the constitutionality of the so-called White Slave Traffic Act of 1910, whereby the transportation of a woman in interstate commerce for the purpose of prostitution was forbidden. In that case, the court said that Congress had the power to protect the channels of interstate commerce: "If the facility of interstate transportation can be taken away from the demoralization of lotteries, the debasement of obscene literature, the contagion of diseased cattle or persons, the impurity of food and drugs, the like facility can be taken away from the systematic enticement to, and the enslavement in prostitution and debauchery of women, and, more insistently, of girls." *Hoke v. United States*, 227 US 308 (1913).



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

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

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

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

In *NLRB v. Jones & Laughlin Steel Corporation*, a union dispute with management at a large steel-producing facility near Pittsburgh, Pennsylvania, became a court case. In this case, the NLRB had charged the Jones & Laughlin Steel Corporation with discriminating against employees who were union members. The company’s position was that the law authorizing the NLRB was unconstitutional, exceeding Congress’s powers. The court held that the act was narrowly constructed so as to regulate industrial activities that had the potential to restrict interstate commerce. The earlier decisions under the commerce clause to the effect that labor relations had only an indirect effect on commerce were effectively reversed. Since the ability of employees to engage in collective bargaining (one activity protected by the act) is “an essential condition of industrial peace,” the national government was justified

in penalizing corporations engaging in interstate commerce that “refuse to confer and negotiate” with their workers. This was, however, a close decision, and the switch of one justice made this ruling possible. Without this switch, the New Deal agenda would have been effectively derailed.

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

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

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

Ollie McClung’s barbeque place in Birmingham, Alabama, allowed “colored” people to buy takeout at the back of the restaurant but not to sit down with “white” folks inside. The US attorney sought a court order to require Ollie to serve all races and colors, but Ollie resisted on commerce clause grounds: the federal government had no business regulating a purely local establishment. Indeed, Ollie did not advertise nationally, or even regionally, and had customers only from the local area. But the court found that some 42 percent of the supplies for Ollie’s restaurant had moved in the channels of interstate commerce. This was enough to sustain federal regulation based on the commerce clause. *Katzenbach v. McClung*, 379 US 294 (1964).

For nearly thirty years following, it was widely assumed that Congress could almost always find some interstate commerce connection for any law it might pass. It thus came as something of a shock in 1995 when the Rehnquist court decided *U.S. v. Lopez*. Lopez had been convicted under a federal law that prohibited possession of firearms within 1,000 feet of a school. The law was part of a twenty-year trend (roughly 1970 to 1990) for senators and congressmen to pass laws that were tough on crime. Lopez’s lawyer admitted that Lopez had had a gun within 1,000 feet of a San Antonio school yard but challenged the law itself, arguing that Congress exceeded its authority under the commerce clause in passing this legislation. The US government’s Solicitor General argued on behalf of the Department of Justice to the Supreme Court that Congress was within its constitutional rights under the

commerce clause because education of the future workforce was the foundation for a sound economy and because guns at or near school yards detracted from students' education. The court rejected this analysis, noting that with the government's analysis, an interstate commerce connection could be conjured from almost anything. Lopez went free because the law itself was unconstitutional, according to the court.

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

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

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

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

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

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

### KEY TAKEAWAY

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

### EXERCISES

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

## 4.3 Dormant Commerce Clause

### LEARNING OBJECTIVES

1. Understand that when Congress does not exercise its powers under the commerce clause, the Supreme Court may still limit state legislation that discriminates against interstate commerce or places an undue burden on interstate commerce.
2. Distinguish between “discrimination” dormant-commerce-clause cases and “undue burden” dormant-commerce-clause cases.

Congress has the power to legislate under the commerce clause and often does legislate. For example, Congress might say that trucks moving on interstate highways must not be more than seventy feet in length. But if Congress does not exercise its powers and regulate in certain areas (such as the size and length of trucks on interstate highways), states may make their own rules. States may do so under the so-called historic police powers of states that were never yielded up to the federal government.

These police powers can be broadly exercised by states for purposes of health, education, welfare, safety, morals, and the environment. But the Supreme Court has reserved for itself the power to determine when state action is excessive, even when Congress has not used the commerce clause to regulate. This power is claimed to exist in the **dormant commerce clause**<sup>5</sup>.

There are two ways that a state may violate the dormant commerce clause. If a state passes a law that is an “undue burden” on interstate commerce or that “discriminates” against interstate commerce, it will be struck down. *Kassel v. Consolidated Freightways*, in [Section 4.7 "Summary and Exercises"](#), is an example of a case where Iowa imposed an undue burden on interstate commerce by prohibiting double trailers on its highways. *Kassell v. Consolidated Freightways*, 450 US 662 (1981). Iowa’s prohibition was judicially declared void when the Supreme Court judged it to be an undue burden.

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

Discrimination cases such as *Hunt v. Washington Apple Advertising Commission* ([Section 4.6 "Cases"](#)) pose a different standard. The court has been fairly inflexible here: if one state discriminates in its treatment of any article of commerce based on its state of origin, the court will strike down the law. For example, in *Oregon Waste Systems v. Department of Environmental Quality*, the state wanted to place a slightly

higher charge on waste coming from out of state. *Oregon Waste Systems v. Department of Environmental Quality*, 511 US 93 (1994). The state's reasoning was that in-state residents had already contributed to roads and other infrastructure and that tipping fees at waste facilities should reflect the prior contributions of in-state companies and residents. Out-of-state waste handlers who wanted to use Oregon landfills objected and won their dormant commerce clause claim that Oregon's law discriminated "on its face" against interstate commerce. Under the Supreme Court's rulings, anything that moves in channels of interstate commerce is "commerce," even if someone is paying to get rid of something instead of buying something.

Thus the states are bound by Supreme Court decisions under the dormant commerce clause to do nothing that differentiates between articles of commerce that originate from within the state from those that originate elsewhere. If Michigan were to let counties decide for themselves whether to take garbage from outside of the county or not, this could also be a discrimination based on a place of origin outside the state. (Suppose, for instance, each county were to decide not to take waste from outside the county; then all Michigan counties would effectively be excluding waste from outside of Michigan, which is discriminatory.) *Fort Gratiot Sanitary Landfill v. Michigan Dep't of Natural Resources*, 504 US 353 (1992).

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

## Dealing with Unwelcome Waste

Senator Carl Levin, January 2003

Michigan is facing an intolerable situation with regard to the importation of waste from other states and Canada.

Canada is the largest source of waste imports to Michigan. Approximately 65 truckloads of waste come in to Michigan per day from Toronto alone, and an estimated 110–130 trucks come in from Canada each day.

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

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

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

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

We have protections contained in a 17 year-old international agreement between the U.S. and Canada called the Agreement Concerning the



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

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

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

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

#### KEY TAKEAWAY

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

## EXERCISES

1. Suppose that the state of New Jersey wishes to limit the amount of hazardous waste that enters into its landfills. The general assembly in New Jersey passes a law that specifically forbids any hazardous waste from entering into the state. All landfills are subject to tight regulations that will allow certain kinds of hazardous wastes originating in New Jersey to be put in New Jersey landfills but that impose significant criminal fines on landfill operators that accept out-of-state hazardous waste. The Baldessari Brothers Landfill in Linden, New Jersey, is fined for taking hazardous waste from a New York State transporter and appeals that ruling on the basis that New Jersey's law is unconstitutional. What is the result?
2. The state of Arizona determines through its legislature that trains passing through the state cannot be longer than seventy cars. There is some evidence that in Eastern US states longer trains pose some safety hazards. There is less evidence that long trains are a problem in Western states. Several major railroads find the Arizona legislation costly and burdensome and challenge the legislation after applied-for permits for longer trains are denied. What kind of dormant commerce clause challenge is this, and what would it take for the challenge to be successful?

## 4.4 Preemption: The Supremacy Clause

### LEARNING OBJECTIVES

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

When Congress does use its power under the commerce clause, it can expressly state that it wishes to have exclusive regulatory authority. For example, when Congress determined in the 1950s to promote nuclear power (“atoms for peace”), it set up the Nuclear Regulatory Commission and provided a limitation of liability for nuclear power plants in case of a nuclear accident. The states were expressly told to stay out of the business of regulating nuclear power or the movement of nuclear materials. Thus Rochester, Minnesota, or Berkeley, California, could declare itself a nuclear-free zone, but the federal government would have preempted such legislation. If Michigan wished to set safety standards at Detroit Edison’s Fermi II nuclear reactor that were more stringent than the federal Nuclear Regulatory Commission’s standards, Michigan’s standards would be preempted and thus be void.

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

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

most automakers have made both a federal car and a California car, because federal Clean Air Act emissions restrictions do not preempt more rigorous state standards.

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

The cigarette warning legislation of the 1960s (where the federal government required warning labels on cigarette packages) effectively preempted state negligence claims based on failure to warn. When the family of a lifetime smoker who had died sued in New Jersey court, one cause of action was the company's failure to warn of the dangers of its product. The Supreme Court reversed the jury's award based on the federal preemption of failure to warn claims under state law. *Cipollone v. Liggett Group*, 505 US 504 (1993).

## The Supremacy Clause

### Article VI

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

The **preemption**<sup>6</sup> doctrine derives from the supremacy clause of the Constitution, which states that the “Constitution and the Laws of the United States...shall be the supreme Law of the Land...any Thing in the Constitutions or Laws of any State to the Contrary notwithstanding.” This means of course, that *any* federal law—even a regulation of a federal agency—would control over *any* conflicting state law.

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

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

conflicts with federal law, or whether enforcement of the state law might frustrate federal purposes.

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

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

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

#### KEY TAKEAWAY

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

## EXERCISES

1. For many years, the United States engaged in discussions with friendly nations as to the reciprocal use of ports and harbors. These discussions led to various multilateral agreements between the nations as to the configuration of oceangoing vessels and how they would be piloted. At the same time, concern over oil spills in Puget Sound led the state of Washington to impose fairly strict standards on oil tankers and requirements for the training of oil tanker pilots. In addition, Washington's state law imposed many other requirements that went above and beyond agreed-upon requirements in the international agreements negotiated by the federal government. Are the Washington state requirements preempted by federal law?
2. The Federal Arbitration Act of 1925 requires that all contracts for arbitration be treated as any other contract at common law. Suppose that the state of Alabama wishes to protect its citizens from a variety of arbitration provisions that they might enter into unknowingly. Thus the legislation provides that all predispute arbitration clauses be in bold print, that they be of twelve-point font or larger, that they be clearly placed within the first two pages of any contract, and that they have a separate signature line where the customer, client, or patient acknowledges having read, understood, and signed the arbitration clause in addition to any other signatures required on the contract. The legislation does preserve the right of consumers to litigate in the event of a dispute arising with the product or service provider; that is, with this legislation, consumers will not unknowingly waive their right to a trial at common law. Is the Alabama law preempted by the Federal Arbitration Act?

## 4.5 Business and the Bill of Rights

### LEARNING OBJECTIVES

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

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

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

Here are some very basic principles to remember:

1. The guarantees of the Bill of Rights apply *only* to state and federal government action. They do not limit what a company or person in the private sector may do. For example, states may not impose censorship

on the media or limit free speech in a way that offends the First Amendment, but your boss (in the private sector) may order you not to talk to the media.

2. In some cases, a private company may be regarded as participating in “state action.” For example, a private defense contractor that gets 90 percent of its business from the federal government has been held to be public for purposes of enforcing the constitutional right to free speech (the company had a rule barring its employees from speaking out in public against its corporate position). It has even been argued that public regulation of private activity is sufficient to convert the private into public activity, thus subjecting it to the requirements of due process. But the Supreme Court rejected this extreme view in 1974 when it refused to require private power companies, regulated by the state, to give customers a hearing before cutting off electricity for failure to pay the bill. *Jackson v. Metropolitan Edison Co.*, 419 US 345 (1974).
3. States have rights, too. While “states rights” was a battle cry of Southern states before the Civil War, the question of what balance to strike between state sovereignty and federal union has never been simple. In *Kimel v. Florida*, for example, the Supreme Court found in the words of the Eleventh Amendment a basis for declaring that states may not have to obey certain federal statutes.

## First Amendment

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

Because of its higher level of protection, political speech can be false, malicious, mean-spirited, or even a pack of lies. A public official in the United States must be prepared to withstand all kinds of false accusations and cannot succeed in an action for defamation unless the defendant has acted with “malice” and “reckless



disregard” of the truth. Public figures, such as CEOs of the largest US banks, must also be prepared to withstand accusations that are false. In any defamation action, truth is a defense, but a defamation action brought by a public figure or public official must prove that the defendant not only has his facts wrong but also lies to the public in a malicious way with reckless disregard of the truth. Celebrities such as Lindsay Lohan and Jon Stewart have the same burden to go forward with a defamation action. It is for this reason that the *National Enquirer* writes exclusively about public figures, public officials, and celebrities; it is possible to say many things that aren’t completely true and still have the protection of the First Amendment.

Political speech is so highly protected that the court has recognized the right of people to support political candidates through campaign contributions and thus promote the particular viewpoints and speech of those candidates. Fearing the influence of money on politics, Congress has from time to time placed limitations on corporate contributions to political campaigns. But the Supreme Court has had mixed reactions over time. Initially, the court recognized the First Amendment right of a corporation to donate money, subject to certain limits. *Buckley v. Valeo*, 424 US 1 (1976). In another case, *Austin v. Michigan Chamber of Commerce* (1990), the Michigan Campaign Finance Act prohibited corporations from using treasury money for independent expenditures to support or oppose candidates in elections for state offices. But a corporation could make such expenditures if it set up an independent fund designated solely for political purposes. The law was passed on the assumption that “the unique legal and economic characteristics of corporations necessitate some regulation of their political expenditures to avoid corruption or the appearance of corruption.”

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

## Fourth Amendment

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

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

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

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

## Fifth Amendment

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

The Fifth Amendment has three principal aspects: **procedural due process**<sup>7</sup>, the **takings clause**<sup>8</sup>, and **substantive due process**<sup>9</sup>. In terms of procedural due process, the amendment prevents government from arbitrarily taking the life of a criminal defendant. In civil lawsuits, it is also constitutionally essential that the proceedings be fair. This is why, for example, the defendant in *Burger King v. Rudzewicz* had a serious constitutional argument, even though he lost.

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

In *Kelo v. City of New London*, Mrs. Kelo and other residents fought the city of New London, in its attempt to use powers of eminent domain to create an industrial park and recreation area that would have Pfizer & Co. as a principal tenant. *Kelo v. City of New London*, 545 US 469 (2005). The city argued that increasing its tax base was a sufficient public purpose. In a very close decision, the Supreme Court determined that New London's actions did not violate the takings clause. However, political reactions in various states resulted in a great deal of new state legislation that would limit the scope of public purpose in eminent domain takings and provide additional compensation to property owners in many cases.

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

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

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

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

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

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

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

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

But substantive due process has seen fairly limited use since the 1930s. During the 1990s, the Supreme Court was asked to recognize a general right to die under the doctrine of substantive due process. Although the court stopped short of establishing such a far-reaching right, certain patients may exercise a constitutional liberty to hasten their deaths under a narrow set of circumstances. In *Cruzan v. Missouri Department of Health*, the Supreme Court ruled that the due process clause guarantees the right of competent adults to make advanced directives for the withdrawal of life-sustaining measures should they become incapacitated by a disability that leaves them in a persistent vegetative state. *Cruzan v. Missouri Department of Health*, 497 US 261 (1990). Once it has been established by clear and convincing evidence that a mentally incompetent and persistently vegetative patient made such a prior directive, a spouse, parent, or other appropriate guardian may seek to terminate any form of artificial hydration or nutrition.

### **Fourteenth Amendment: Due Process and Equal Protection Guarantees**

The Fourteenth Amendment (1868) requires that states treat citizens of other states with due process. This can be either an issue of procedural due process (as in [Section 3.9 "Cases"](#), *Burger King v. Rudzewicz*) or an issue of substantive due process. For substantive due process, consider what happened in an Alabama court not too long ago. *BMW of North America, Inc. v. Gore*, 517 U.S. 559 (1996)

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

"Equal protection of the laws" is a phrase that originates in the Fourteenth Amendment, adopted in 1868. The amendment provides that no state shall "deny to

any person within its jurisdiction the equal protection of the laws.” This is the equal protection clause. It means that, generally speaking, governments must treat people equally. Unfair classifications among people or corporations will not be permitted. A well-known example of unfair classification would be race discrimination: requiring white children and black children to attend different public schools or requiring “separate but equal” public services, such as water fountains or restrooms. Yet despite the clear intent of the 1868 amendment, “separate but equal” was the law of the land until *Brown v. Board of Education* (1954). *Plessy v. Ferguson*, 163 US 537 (1896).

Governments make classifications every day, so not all classifications can be illegal under the equal protection clause. People with more income generally pay a greater percentage of their income in taxes. People with proper medical training are licensed to become doctors; people without that training cannot be licensed and commit a criminal offense if they do practice medicine. To know what classifications are permissible under the Fourteenth Amendment, we need to know what is being classified. The court has created three classifications, and the outcome of any equal protection case can usually be predicted by knowing how the court is likely to classify the case:

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

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

Under intermediate scrutiny, the city of New Orleans might limit the number of street vendors who are men. For example, suppose that the city council decreed that all street vendors must be women, thinking that would attract even more tourism. A classification like this, based on sex, will have to meet a sterner test than a classification resulting from economic or social regulation. A law like this would have to substantially relate to important government objectives. Increasingly, courts have nullified government sex classifications as societal concern with gender

equality has grown. (See Shannon Faulkner's case against The Citadel, an all-male state school.) *United States v. Virginia*, 518 US 515 (1996).

Suppose, however, that the city of New Orleans decided that no one of Middle Eastern heritage could drive a taxicab or be a street vendor. That kind of classification would be examined with strict scrutiny to see if there was any compelling justification for it. As noted, classifications such as this one are almost never upheld. The law would be upheld only if it were necessary to promote a compelling state interest. Very few laws that have a racial or ethnic classification meet that test.

The strict scrutiny test will be applied to classifications involving racial and ethnic criteria as well as classifications that interfere with a fundamental right. In *Palmore v. Sidoti*, the state refused to award custody to the mother because her new spouse was racially different from the child. *Palmore v. Sidoti*, 466 US 429 (1984). This practice was declared unconstitutional because the state had made a racial classification; this was presumptively invalid, and the government could not show a compelling need to enforce such a classification through its law. An example of government action interfering with a fundamental right will also receive strict scrutiny. When New York State gave an employment preference to veterans who had been state residents at the time of entering the military, the court declared that veterans who were new to the state were less likely to get jobs and that therefore the statute interfered with the right to travel, which was deemed a fundamental right. *Atty. Gen. of New York v. Soto-Lopez*, 476 US 898 (1986).

#### KEY TAKEAWAY

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

## EXERCISES

1. John Hanks works at ProLogis. The company decides to institute a drug-testing policy. John is a good and longtime employee but enjoys smoking marijuana on the weekends. The drug testing will involve urine samples and, semiannually, a hair sample. It is nearly certain that the drug-testing protocol that ProLogis proposes will find that Hanks is a marijuana user. The company has made it clear that it will have zero tolerance for any kind of nonprescribed controlled substances. John and several fellow employees wish to go to court to challenge the proposed testing as “an unreasonable search and seizure.” Can he possibly succeed?
2. Larry Reed, majority leader in the Senate, is attacked in his reelection campaign by a series of ads sponsored by a corporation (Global Defense, Inc.) that does not like his voting record. The corporation is upset that Reed would not write a special provision that would favor Global Defense in a defense appropriations bill. The ads run constantly on television and radio in the weeks immediately preceding election day and contain numerous falsehoods. For example, in order to keep the government running financially, Reed found it necessary to vote for a bill that included a last-minute rider that defunded a small government program for the handicapped, sponsored by someone in the opposing party that wanted to privatize all programs for the handicapped. The ad is largely paid for by Global Defense and depicts a handicapped child being helped by the existing program and large letters saying “Does Larry Reed Just Not Care?” The ad proclaims that it is sponsored by Citizens Who Care for a Better Tomorrow. Is this protected speech? Why or why not? Can Reed sue for defamation? Why or why not?



## 4.6 Cases

### ***Griswold v. Connecticut***

Griswold v. Connecticut

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

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

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

Plurality Opinion by Justice William O. Douglass

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

[Previous] cases suggest that specific guarantees in the Bill of Rights have penumbras, formed by emanations from those guarantees that help give them life and substance.... Various guarantees create zones of privacy. The right of association contained in the penumbra of the First Amendment is one.... The Third Amendment in its prohibition against the quartering of soldiers "in any house" in time of peace without the consent of the owner is another facet of that privacy. The Fourth Amendment explicitly affirms the "right of the people to be secure in their persons, houses, papers and effects, against unreasonable searches and seizures." The Fifth Amendment in its Self-Incrimination Clause enables the citizen to create a zone of privacy which the government may not force him to surrender to his detriment.

The Ninth Amendment provides: “The enumeration in the Constitution, of certain rights, shall not be construed to deny or disparage others retained by the people.”

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

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

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

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

Since 1879 Connecticut has had on its books a law which forbids the use of contraceptives by anyone. I think this is an uncommonly silly law. As a practical matter, the law is obviously unenforceable, except in the oblique context of the present case. As a philosophical matter, I believe the use of contraceptives in the relationship of marriage should be left to personal and private choice, based upon each individual’s moral, ethical, and religious beliefs. As a matter of social policy, I think professional counsel about methods of birth control should be available to all, so that each individual’s choice can be meaningfully made. But we are not asked in this case to say whether we think this law is unwise, or even asinine. We are asked to hold that it violates the United States Constitution. And that I cannot do.

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

...

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

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

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

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

elected representatives to repeal it. That is the constitutional way to take this law off the books.

### CASE QUESTIONS

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

### ***Wickard v. Filburn***

Wickard v. Filburn

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

Mr. Justice Jackson delivered the opinion of the Court.

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

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

The general scheme of the Agricultural Adjustment Act of 1938 as related to wheat is to control the volume moving in interstate and foreign commerce in order to avoid surpluses and shortages and the consequent abnormally low or high wheat prices and obstructions to commerce. [T]he Secretary of Agriculture is directed to

ascertain and proclaim each year a national acreage allotment for the next crop of wheat, which is then apportioned to the states and their counties, and is eventually broken up into allotments for individual farms.

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

***Kassel v. Consolidated Freightways Corp.***

*Kassel v. Consolidated Freightways Corp.*

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

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

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

**I**

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

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

routed separately if necessary. Consolidated would like to use 65-foot doubles on many of its trips through Iowa.

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

...

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

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

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

In light of these findings, the District Court applied the standard we enunciated in *Raymond Motor Transportation, Inc. v. Rice*, 434 U.S. 429 (1978), and concluded that the state law impermissibly burdened interstate commerce: "[T]he balance here must be struck in favor of the federal interests. The *total effect* of the law as a safety measure in reducing accidents and casualties is so slight and problematical that it

does not outweigh the national interest in keeping interstate commerce free from interferences that seriously impede it.”

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

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

## II

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

The Commerce Clause does not, of course, invalidate all state restrictions on commerce. It has long been recognized that, “in the absence of conflicting legislation by Congress, there is a residuum of power in the state to make laws governing matters of local concern which nevertheless in some measure affect interstate commerce or even, to some extent, regulate it.” *Southern Pacific Co. v. Arizona*, 325 U.S. 761 (1945).

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

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

### III

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

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



A

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

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

The first two of these characteristics are of limited relevance on modern interstate highways. As the District Court found, the negligible difference in the time required to pass, and to cross intersections, is insignificant on 4-lane divided highways, because passing does not require crossing into oncoming traffic lanes, *Raymond*, 434 U.S. at 444, and interstates have few, if any, intersections. The concern over backing capability also is insignificant, because it seldom is necessary to back up on an interstate. In any event, no evidence suggested any difference in backing capability between the 60-foot doubles that Iowa permits and the 65-foot doubles that it bans. Similarly, although doubles tend to jackknife somewhat more than singles, 65-foot doubles actually are less likely to jackknife than 60-foot doubles.

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

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

**B**

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

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

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

**[IV. Omitted]**

**V**

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

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

It is so ordered.

### CASE QUESTIONS

1. Under the Constitution, what gives Iowa the right to make rules regarding the size or configuration of trucks upon highways within the state?
2. Did Iowa try to exempt trucking lines based in Iowa, or was the statutory rule nondiscriminatory as to the origin of trucks that traveled on Iowa highways?
3. Are there any federal size or weight standards noted in the case? Is there any kind of truck size or weight that could be limited by Iowa law, or must Iowa simply accept federal standards or, if none, impose no standards at all?

### ***Hunt v. Washington Apple Advertising Commission***

Hunt v. Washington Apple Advertising Commission

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

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

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

[In] 1972, the North Carolina Board of Agriculture adopted an administrative regulation, unique in the 50 States, which in effect required all closed containers of apples shipped into or sold in the State to display either the applicable USDA grade or a notice indicating no classification. State grades were expressly prohibited. In

addition to its obvious consequence—prohibiting the display of Washington State apple grades on containers of apples shipped into North Carolina—the regulation presented the Washington apple industry with a marketing problem of potentially nationwide significance. Washington apple growers annually ship in commerce approximately 40 million closed containers of apples, nearly 500,000 of which eventually find their way into North Carolina, stamped with the applicable Washington State variety and grade. [Compliance] with North Carolina’s unique regulation would have required Washington growers to obliterate the printed labels on containers shipped to North Carolina, thus giving their product a damaged appearance. Alternatively, they could have changed their marketing practices to accommodate the needs of the North Carolina market, i.e., repack apples to be shipped to North Carolina in containers bearing only the USDA grade, and/or store the estimated portion of the harvest destined for that market in such special containers. As a last resort, they could discontinue the use of the preprinted containers entirely. None of these costly and less efficient options was very attractive to the industry. Moreover, in the event a number of other States followed North Carolina’s lead, the resultant inability to display the Washington grades could force the Washington growers to abandon the State’s expensive inspection and grading system which their customers had come to know and rely on over the 60-odd years of its existence....

Unsuccessful in its attempts to secure administrative relief [with North Carolina], the Commission instituted this action challenging the constitutionality of the statute. [The] District Court found that the North Carolina statute, while neutral on its face, actually discriminated against Washington State growers and dealers in favor of their local counterparts [and] concluded that this discrimination [was] not justified by the asserted local interest—the elimination of deception and confusion from the marketplace—arguably furthered by the [statute].

...

[North Carolina] maintains that [the] burdens on the interstate sale of Washington apples were far outweighed by the local benefits flowing from what they contend was a valid exercise of North Carolina’s [police powers]. Prior to the statute’s enactment,...apples from 13 different States were shipped into North Carolina for sale. Seven of those States, including [Washington], had their own grading systems which, while differing in their standards, used similar descriptive labels (e.g., fancy, extra fancy, etc.). This multiplicity of inconsistent state grades [posed] dangers of deception and confusion not only in the North Carolina market, but in the Nation as a whole. The North Carolina statute, appellants claim, was enacted to eliminate this source of deception and confusion. [Moreover], it is contended that North Carolina sought to accomplish this goal of uniformity in an evenhanded manner as

evidenced by the fact that its statute applies to all apples sold in closed containers in the State without regard to their point of origin.

[As] the appellants properly point out, not every exercise of state authority imposing some burden on the free flow of commerce is invalid, [especially] when the State acts to protect its citizenry in matters pertaining to the sale of foodstuffs. By the same token, however, a finding that state legislation furthers matters of legitimate local concern, even in the health and consumer protection areas, does not end the inquiry. Rather, when such state legislation comes into conflict with the Commerce Clause's overriding requirement of a national "common market," we are confronted with the task of effecting an accommodation of the competing national and local interests. We turn to that task.

As the District Court correctly found, the challenged statute has the practical effect of not only burdening interstate sales of Washington apples, but also discriminating against them. This discrimination takes various forms. The first, and most obvious, is the statute's consequence of raising *the costs* of doing business in the North Carolina market for Washington apple growers and dealers, while leaving those of their North Carolina counterparts unaffected. [This] disparate effect results from the fact that North Carolina apple producers, unlike their Washington competitors, were not forced to alter their marketing practices in order to comply with the statute. They were still free to market their wares under the USDA grade or none at all as they had done prior to the statute's enactment. Obviously, the increased costs imposed by the statute would tend to shield the local apple industry from the competition of Washington apple growers and dealers who are already at a competitive disadvantage because of their great distance from the North Carolina market.

Second, the statute has the effect of *stripping away* from the Washington apple industry the competitive and economic advantages it has earned for itself through its expensive inspection and grading system. The record demonstrates that the Washington apple-grading system has gained nationwide acceptance in the apple trade. [The record] contains numerous affidavits [stating a] preference [for] apples graded under the Washington, as opposed to the USDA, system because of the former's greater consistency, its emphasis on color, and its supporting mandatory inspections. Once again, the statute had no similar impact on the North Carolina apple industry and thus operated to its benefit.

Third, by *prohibiting* Washington growers and dealers from marketing apples under their State's grades, the statute has a *leveling effect* which insidiously operates to the advantage of local apple producers. [With] free market forces at work, Washington sellers would normally enjoy a distinct market advantage vis-à-vis local producers

in those categories where the Washington grade is superior. However, because of the statute's operation, Washington apples which would otherwise qualify for and be sold under the superior Washington grades will now have to be marketed under their inferior USDA counterparts. Such "downgrading" offers the North Carolina apple industry the very sort of protection against competing out-of-state products that the Commerce Clause was designed to prohibit. At worst, it will have the effect of an embargo against those Washington apples in the superior grades as Washington dealers withhold them from the North Carolina market. At best, it will deprive Washington sellers of the market premium that such apples would otherwise command.

Despite the statute's facial neutrality, the Commission suggests that its discriminatory impact on interstate commerce was not an unintended by-product, and there are some indications in the record to that effect. The most glaring is the response of the North Carolina Agriculture Commissioner to the Commission's request for an exemption following the statute's passage in which he indicated that before he could support such an exemption, he would "want to have the sentiment from our apple producers *since they were mainly responsible for this legislation being passed.*" [Moreover], we find it somewhat suspect that North Carolina singled out only closed containers of apples, the very means by which apples are transported in commerce, to effectuate the statute's ostensible consumer protection purpose when apples are not generally sold at retail in their shipping containers. However, we need not ascribe an economic protection motive to the North Carolina Legislature to resolve this case; we conclude that the challenged statute cannot stand insofar as it prohibits the display of Washington State grades even if enacted for the declared purpose of protecting consumers from deception and fraud in the marketplace.

...

Finally, we note that any potential for confusion and deception created by the Washington grades was not of the type that led to the statute's enactment. Since Washington grades are in all cases equal or superior to their USDA counterparts, they could only "deceive" or "confuse" a consumer to his benefit, hardly a harmful result.

In addition, it appears that nondiscriminatory alternatives to the outright ban of Washington State grades are readily available. For example, North Carolina could effectuate its goal by permitting out-of-state growers to utilize state grades only if they also marked their shipments with the applicable USDA label. In that case, the USDA grade would serve as a benchmark against which the consumer could evaluate the quality of the various state grades....

[The court affirmed the lower court's holding that the North Carolina statute was unconstitutional.]

### CASE QUESTIONS

1. Was the North Carolina law discriminatory on its face? Was it, possibly, an undue burden on interstate commerce? Why wouldn't it be?
2. What evidence was there of discriminatory intent behind the North Carolina law? Did that evidence even matter? Why or why not?

### ***Citizens United v. Federal Election Commission***

Citizens United v. Federal Election Commission

588 U.S. \_\_\_\_; 130 S.Ct. 876 (U.S. Supreme Court 2010)

Justice Kennedy delivered the opinion of the Court.

Federal law prohibits corporations and unions from using their general treasury funds to make independent expenditures for speech defined as an “electioneering communication” or for speech expressly advocating the election or defeat of a candidate. 2 U.S.C. §441b. Limits on electioneering communications were upheld in *McConnell v. Federal Election Comm’n*, 540 U.S. 93, 203–209 (2003). The holding of *McConnell* rested to a large extent on an earlier case, *Austin v. Michigan Chamber of Commerce*, 494 U.S. 652 (1990). *Austin* had held that political speech may be banned based on the speaker’s corporate identity.

In this case we are asked to reconsider *Austin* and, in effect, *McConnell*. It has been noted that “*Austin* was a significant departure from ancient First Amendment principles,” *Federal Election Comm’n v. Wisconsin Right to Life, Inc.*, 551 U.S. 449, 490 (2007) (*WRTL*) (Scalia, J., concurring in part and concurring in judgment). We agree with that conclusion and hold that *stare decisis* does not compel the continued acceptance of *Austin*. The Government may regulate corporate political speech through disclaimer and disclosure requirements, but it may not suppress that speech altogether. We turn to the case now before us.

I

A

Citizens United is a nonprofit corporation. It has an annual budget of about \$12 million. Most of its funds are from donations by individuals; but, in addition, it accepts a small portion of its funds from for-profit corporations.

In January 2008, Citizens United released a film entitled *Hillary: The Movie*. We refer to the film as *Hillary*. It is a 90-minute documentary about then-Senator Hillary Clinton, who was a candidate in the Democratic Party's 2008 Presidential primary elections. *Hillary* mentions Senator Clinton by name and depicts interviews with political commentators and other persons, most of them quite critical of Senator Clinton....

In December 2007, a cable company offered, for a payment of \$1.2 million, to make *Hillary* available on a video-on-demand channel called "Elections '08."...Citizens United was prepared to pay for the video-on-demand; and to promote the film, it produced two 10-second ads and one 30-second ad for *Hillary*. Each ad includes a short (and, in our view, pejorative) statement about Senator Clinton, followed by the name of the movie and the movie's Website address. Citizens United desired to promote the video-on-demand offering by running advertisements on broadcast and cable television.

B

Before the Bipartisan Campaign Reform Act of 2002 (BCRA), federal law prohibited—and still does prohibit—corporations and unions from using general treasury funds to make direct contributions to candidates or independent expenditures that expressly advocate the election or defeat of a candidate, through any form of media, in connection with certain qualified federal elections....BCRA §203 amended §441b to prohibit any "electioneering communication" as well. An electioneering communication is defined as "any broadcast, cable, or satellite communication" that "refers to a clearly identified candidate for Federal office" and is made within 30 days of a primary or 60 days of a general election. §434(f)(3)(A). The Federal Election Commission's (FEC) regulations further define an electioneering communication as a communication that is "publicly distributed." 11 CFR §100.29(a)(2) (2009). "In the case of a candidate for nomination for President...publicly distributed means" that the communication "[c]an be received by 50,000 or more persons in a State where a primary election...is being held within 30 days." 11 CFR §100.29(b)(3)(ii). Corporations and unions are barred from using their general treasury funds for express advocacy or electioneering communications. They may establish, however, a "separate segregated fund" (known as a political action committee, or PAC) for these purposes. 2 U.S.C. §441b(b)(2). The moneys



received by the segregated fund are limited to donations from stockholders and employees of the corporation or, in the case of unions, members of the union. *Ibid.*

## C

Citizens United wanted to make *Hillary* available through video-on-demand within 30 days of the 2008 primary elections. It feared, however, that both the film and the ads would be covered by §441b's ban on corporate-funded independent expenditures, thus subjecting the corporation to civil and criminal penalties under §437g. In December 2007, Citizens United sought declaratory and injunctive relief against the FEC. It argued that (1) §441b is unconstitutional as applied to *Hillary*; and (2) BCRA's disclaimer and disclosure requirements, BCRA §§201 and 311, are unconstitutional as applied to *Hillary* and to the three ads for the movie.

The District Court denied Citizens United's motion for a preliminary injunction, and then granted the FEC's motion for summary judgment.

...

The court held that §441b was facially constitutional under *McConnell*, and that §441b was constitutional as applied to *Hillary* because it was "susceptible of no other interpretation than to inform the electorate that Senator Clinton is unfit for office, that the United States would be a dangerous place in a President Hillary Clinton world, and that viewers should vote against her." 530 F. Supp. 2d, at 279. The court also rejected Citizens United's challenge to BCRA's disclaimer and disclosure requirements. It noted that "the Supreme Court has written approvingly of disclosure provisions triggered by political speech even though the speech itself was constitutionally protected under the First Amendment." *Id.* at 281.

## II

[Omitted: the court considers whether it is possible to reject the BCRA without declaring certain provisions unconstitutional. The court concludes it cannot find a basis to reject the BCRA that does not involve constitutional issues.]

## III

The First Amendment provides that "Congress shall make no law...abridging the freedom of speech." Laws enacted to control or suppress speech may operate at different points in the speech process....The law before us is an outright ban, backed by criminal sanctions. Section 441b makes it a felony for all corporations—including nonprofit advocacy corporations—either to expressly advocate the election or

defeat of candidates or to broadcast electioneering communications within 30 days of a primary election and 60 days of a general election. Thus, the following acts would all be felonies under §441b: The Sierra Club runs an ad, within the crucial phase of 60 days before the general election, that exhorts the public to disapprove of a Congressman who favors logging in national forests; the National Rifle Association publishes a book urging the public to vote for the challenger because the incumbent U.S. Senator supports a handgun ban; and the American Civil Liberties Union creates a Web site telling the public to vote for a Presidential candidate in light of that candidate's defense of free speech. These prohibitions are classic examples of censorship.

Section 441b is a ban on corporate speech notwithstanding the fact that a PAC created by a corporation can still speak. PACs are burdensome alternatives; they are expensive to administer and subject to extensive regulations. For example, every PAC must appoint a treasurer, forward donations to the treasurer promptly, keep detailed records of the identities of the persons making donations, preserve receipts for three years, and file an organization statement and report changes to this information within 10 days.

And that is just the beginning. PACs must file detailed monthly reports with the FEC, which are due at different times depending on the type of election that is about to occur....

PACs have to comply with these regulations just to speak. This might explain why fewer than 2,000 of the millions of corporations in this country have PACs. PACs, furthermore, must exist before they can speak. Given the onerous restrictions, a corporation may not be able to establish a PAC in time to make its views known regarding candidates and issues in a current campaign.

Section 441b's prohibition on corporate independent expenditures is thus a ban on speech. As a "restriction on the amount of money a person or group can spend on political communication during a campaign," that statute "necessarily reduces the quantity of expression by restricting the number of issues discussed, the depth of their exploration, and the size of the audience reached." *Buckley v. Valeo*, 424 U.S. 1 at 19 (1976)....

Speech is an essential mechanism of democracy, for it is the means to hold officials accountable to the people. See *Buckley, supra*, at 14–15 ("In a republic where the people are sovereign, the ability of the citizenry to make informed choices among candidates for office is essential.") The right of citizens to inquire, to hear, to speak, and to use information to reach consensus is a precondition to enlightened self-government and a necessary means to protect it. The First Amendment "has its

fullest and most urgent application' to speech uttered during a campaign for political office.”

For these reasons, political speech must prevail against laws that would suppress it, whether by design or inadvertence. Laws that burden political speech are “subject to strict scrutiny,” which requires the Government to prove that the restriction “furthers a compelling interest and is narrowly tailored to achieve that interest.”

...

The Court has recognized that First Amendment protection extends to corporations. This protection has been extended by explicit holdings to the context of political speech. Under the rationale of these precedents, political speech does not lose First Amendment protection “simply because its source is a corporation.” *Bellotti, supra*, at 784. The Court has thus rejected the argument that political speech of corporations or other associations should be treated differently under the First Amendment simply because such associations are not “natural persons.”

The purpose and effect of this law is to prevent corporations, including small and nonprofit corporations, from presenting both facts and opinions to the public. This makes *Austin*'s antidistortion rationale all the more an aberration. “[T]he First Amendment protects the right of corporations to petition legislative and administrative bodies.” *Bellotti*, 435 U.S., at 792, n. 31....

Even if §441b's expenditure ban were constitutional, wealthy corporations could still lobby elected officials, although smaller corporations may not have the resources to do so. And wealthy individuals and unincorporated associations can spend unlimited amounts on independent expenditures. See, e.g., *WRTL*, 551 U.S., at 503–504 (opinion of Scalia, J.) (“In the 2004 election cycle, a mere 24 individuals contributed an astounding total of \$142 million to [26 U.S.C. §527 organizations]”). Yet certain disfavored associations of citizens—those that have taken on the corporate form—are penalized for engaging in the same political speech.

When Government seeks to use its full power, including the criminal law, to command where a person may get his or her information or what distrusted source he or she may not hear, it uses censorship to control thought. This is unlawful. The First Amendment confirms the freedom to think for ourselves.

What we have said also shows the invalidity of other arguments made by the Government. For the most part relinquishing the anti-distortion rationale, the

Government falls back on the argument that corporate political speech can be banned in order to prevent corruption or its appearance....

When Congress finds that a problem exists, we must give that finding due deference; but Congress may not choose an unconstitutional remedy. If elected officials succumb to improper influences from independent expenditures; if they surrender their best judgment; and if they put expediency before principle, then surely there is cause for concern. We must give weight to attempts by Congress to seek to dispel either the appearance or the reality of these influences. The remedies enacted by law, however, must comply with the First Amendment; and, it is our law and our tradition that more speech, not less, is the governing rule. An outright ban on corporate political speech during the critical preelection period is not a permissible remedy. Here Congress has created categorical bans on speech that are asymmetrical to preventing *quid pro quo* corruption.

Our precedent is to be respected unless the most convincing of reasons demonstrates that adherence to it puts us on a course that is sure error. “Beyond workability, the relevant factors in deciding whether to adhere to the principle of *stare decisis* include the antiquity of the precedent, the reliance interests at stake, and of course whether the decision was well reasoned.” [citing prior cases]

These considerations counsel in favor of rejecting *Austin*, which itself contravened this Court’s earlier precedents in *Buckley* and *Bellotti*. “This Court has not hesitated to overrule decisions offensive to the First Amendment.” *WRTL*, 551 U.S., at 500 (opinion of Scalia, J.). “[*S*]tare decisis is a principle of policy and not a mechanical formula of adherence to the latest decision.” *Helvering v. Hallock*, 309 U.S. 106 at 119 (1940).

*Austin* is undermined by experience since its announcement. Political speech is so ingrained in our culture that speakers find ways to circumvent campaign finance laws. See, e.g., *McConnell*, 540 U.S., at 176–177 (“Given BCRA’s tighter restrictions on the raising and spending of soft money, the incentives...to exploit [26 U.S.C. §527] organizations will only increase”). Our Nation’s speech dynamic is changing, and informative voices should not have to circumvent onerous restrictions to exercise their First Amendment rights. Speakers have become adept at presenting citizens with sound bites, talking points, and scripted messages that dominate the 24-hour news cycle. Corporations, like individuals, do not have monolithic views. On certain topics corporations may possess valuable expertise, leaving them the best equipped to point out errors or fallacies in speech of all sorts, including the speech of candidates and elected officials.

Rapid changes in technology—and the creative dynamic inherent in the concept of free expression—counsel against upholding a law that restricts political speech in certain media or by certain speakers. Today, 30-second television ads may be the most effective way to convey a political message. Soon, however, it may be that Internet sources, such as blogs and social networking Web sites, will provide citizens with significant information about political candidates and issues. Yet, §441b would seem to ban a blog post expressly advocating the election or defeat of a candidate if that blog were created with corporate funds. The First Amendment does not permit Congress to make these categorical distinctions based on the corporate identity of the speaker and the content of the political speech.

Due consideration leads to this conclusion: *Austin* should be and now is overruled. We return to the principle established in *Buckley* and *Bellotti* that the Government may not suppress political speech on the basis of the speaker's corporate identity. No sufficient governmental interest justifies limits on the political speech of nonprofit or for-profit corporations.

#### [IV. Omitted]

V

When word concerning the plot of the movie *Mr. Smith Goes to Washington* reached the circles of Government, some officials sought, by persuasion, to discourage its distribution. See Smoodin, "Compulsory" Viewing for Every Citizen: *Mr. Smith* and the Rhetoric of Reception, 35 *Cinema Journal* 3, 19, and n. 52 (Winter 1996) (citing *Mr. Smith Riles Washington*, *Time*, Oct. 30, 1939, p. 49); Nugent, *Capra's Capitol Offense*, *N. Y. Times*, Oct. 29, 1939, p. X5. Under *Austin*, though, officials could have done more than discourage its distribution—they could have banned the film. After all, it, like *Hillary*, was speech funded by a corporation that was critical of Members of Congress. *Mr. Smith Goes to Washington* may be fiction and caricature; but fiction and caricature can be a powerful force.

Modern day movies, television comedies, or skits on YouTube.com might portray public officials or public policies in unflattering ways. Yet if a covered transmission during the blackout period creates the background for candidate endorsement or opposition, a felony occurs solely because a corporation, other than an exempt media corporation, has made the "purchase, payment, distribution, loan, advance, deposit, or gift of money or anything of value" in order to engage in political speech. 2 U.S.C. §431(9)(A)(i). Speech would be suppressed in the realm where its necessity is most evident: in the public dialogue preceding a real election. Governments are often hostile to speech, but under our law and our tradition it seems stranger than fiction for our Government to make this political speech a crime. Yet this is the statute's purpose and design.

Some members of the public might consider *Hillary* to be insightful and instructive; some might find it to be neither high art nor a fair discussion on how to set the Nation's course; still others simply might suspend judgment on these points but decide to think more about issues and candidates. Those choices and assessments, however, are not for the Government to make. "The First Amendment underwrites the freedom to experiment and to create in the realm of thought and speech. Citizens must be free to use new forms, and new forums, for the expression of ideas. The civic discourse belongs to the people, and the Government may not prescribe the means used to conduct it." *McConnell*, *supra*, at 341 (opinion of Kennedy, J.).

The judgment of the District Court is reversed with respect to the constitutionality of 2 U.S.C. §441b's restrictions on corporate independent expenditures. The case is remanded for further proceedings consistent with this opinion.

It is so ordered.

### CASE QUESTIONS

1. What does the case say about disclosure? Corporations have a right of free speech under the First Amendment and may exercise that right through unrestricted contributions of money to political parties and candidates. Can the government condition that right by requiring that the parties and candidates disclose to the public the amount and origin of the contribution? What would justify such a disclosure requirement?
2. Are a corporation's contributions to political parties and candidates tax deductible as a business expense? Should they be?
3. How is the donation of money equivalent to speech? Is this a strict construction of the Constitution to hold that it is?
4. Based on the Court's description of the *Austin* case, what purpose do you think the *Austin* court was trying to achieve by limiting corporate campaign contributions? Was that purpose consistent (or inconsistent) with anything in the Constitution, or is the Constitution essentially silent on this issue?

## 4.7 Summary and Exercises

### Summary

The US Constitution sets the framework for all other laws of the United States, at both the federal and the state level. It creates a shared balance of power between states and the federal government (federalism) and shared power among the branches of government (separation of powers), establishes individual rights against governmental action (Bill of Rights), and provides for federal oversight of matters affecting interstate commerce and commerce with foreign nations. Knowing the contours of the US legal system is not possible without understanding the role of the US Constitution.

The Constitution is difficult to amend. Thus when the Supreme Court uses its power of judicial review to determine that a law is unconstitutional, it actually shapes what the Constitution means. New meanings that emerge must do so by the process of amendment or by the passage of time and new appointments to the court. Because justices serve for life, the court changes its philosophical outlook slowly.

The Bill of Rights is an especially important piece of the Constitutional framework. It provides legal causes of action for infringements of individual rights by government, state or federal. Through the due process clause of the Fifth Amendment and the Fourteenth Amendment, both procedural and (to some extent) substantive due process rights are given to individuals.

## EXERCISES

1. For many years, the Supreme Court believed that “commercial speech” was entitled to less protection than other forms of speech. One defining element of commercial speech is that its dominant theme is to propose a commercial transaction. This kind of speech is protected by the First Amendment, but the government is permitted to regulate it more closely than other forms of speech. However, the government must make reasonable distinctions, must narrowly tailor the rules restricting commercial speech, and must show that government has a legitimate goal that the law furthers.

Edward Salib owned a Winchell’s Donut House in Mesa, Arizona. To attract customers, he displayed large signs in store windows. The city ordered him to remove the signs because they violated the city’s sign code, which prohibited covering more than 30 percent of a store’s windows with signs. Salib sued, claiming that the sign code violated his First Amendment rights. What was the result, and why?

2. Jennifer is a freshman at her local public high school. Her sister, Jackie, attends a nearby private high school. Neither school allows them to join its respective wrestling team; only boys can wrestle at either school. Do either of them have a winning case based on the equal protection clause of the Fourteenth Amendment?
3. The employees of the US Treasury Department that work the border crossing between the United States and Mexico learned that they will be subject to routine drug testing. The customs bureau, which is a division of the treasury department, announces this policy along with its reasoning: since customs agents must routinely search for drugs coming into the United States, it makes sense that border guards must themselves be completely drug-free. Many border guards do not use drugs, have no intention of using drugs, and object to the invasion of their privacy. What is the constitutional basis for their objection?
4. Happy Time Chevrolet employs Jim Bydalek as a salesman. Bydalek takes part in a Gay Pride March in Los Angeles, is interviewed by a local news camera crew, and reports that he is gay and proud of it. His employer is not, and he is fired. Does he have any constitutional causes of action against his employer?
5. You begin work at the Happy-Go-Lucky Corporation on Halloween. On your second day at work, you wear a political button on your coat,



supporting your choice for US senator in the upcoming election. Your boss, who is of a different political persuasion, looks at the button and says, “Take that stupid button off or you’re fired.” Has your boss violated your constitutional rights?

6. David Lucas paid \$975,000 for two residential parcels on the Isle of Palms near Charleston, South Carolina. His intention was to build houses on them. Two years later, the South Carolina legislature passed a statute that prohibited building beachfront properties. The purpose was to leave the dunes system in place to mitigate the effects of hurricanes and strong storms. The South Carolina Coastal Commission created the rules and regulations with substantial input from the community and from experts and with protection of the dune system primarily in mind. People had been building on the shoreline for years, with harmful results to localities and the state treasury. When Lucas applied for permits to build two houses near the shoreline, his permits were rejected. He sued, arguing that the South Carolina legislation had effectively “taken” his property. At trial, South Carolina conceded that because of the legislation, Lucas’s property was effectively worth zero. Has there been a taking under the Fifth Amendment (as incorporated through the Fourteenth Amendment), and if so, what should the state owe to Lucas? Suppose that Lucas could have made an additional \$1 million by building a house on each of his parcels. Is he entitled to recover his original purchase price or his potential profits?

## SELF-TEST QUESTIONS

1. Harvey filed a suit against the state of Colorado, claiming that a Colorado state law violates the commerce clause. The court will agree if the statute
  - a. places an undue burden on interstate commerce
  - b. promotes the public health, safety, morals, or general welfare of Colorado
  - c. regulates economic activities within the state's borders
  - d. a and b
  - e. b and c
  
2. The state legislature in Maine enacts a law that directly conflicts with a federal law. Mapco Industries, located in Portland, Maine, cannot comply with both the state and the federal law.
  - a. Because of federalism, the state law will have priority, as long as Maine is using its police powers.
  - b. Because there's a conflict, both laws are invalid; the state and the federal government will have to work out a compromise of some sort.
  - c. The federal law preempts the state law.
  - d. Both laws govern concurrently.
  
3. Hannah, who lives in Ada, is the owner of Superior Enterprises, Inc. She believes that certain actions in the state of Ohio infringe on her federal constitutional rights, especially those found in the Bill of Rights. Most of these rights apply to the states under
  - a. the supremacy clause
  - b. the protection clause
  - c. the due process clause of the Fourteenth Amendment
  - d. the Tenth Amendment
  
4. Minnesota enacts a statute that bans all advertising that is in "bad taste," "vulgar," or "indecent." In Michigan, Aaron Calloway and his brother, Clarence "Cab" Calloway, create unique beer that they decide to call Old Fart Ale. In their marketing, the brothers have a label in which an older man in a dirty T-shirt is sitting in easy chair, looking disheveled and

having a three-day growth of stubble on his chin. It appears that the man is in the process of belching. He is also holding a can of Old Fart Ale. The Minnesota liquor commission orders all Minnesota restaurants, bars, and grocery stores to remove Old Fart Ale from their shelves. The state statute and the commission's order are likely to be held by a court to be

- a. a violation of the Tenth Amendment
  - b. a violation of the First Amendment
  - c. a violation of the Calloways' right to equal protection of the laws
  - d. a violation of the commerce clause, since only the federal laws can prevent an article of commerce from entering into Minnesota's market
5. Raunch Unlimited, a Virginia partnership, sells smut whenever and wherever it can. Some of its material is "obscene" (meeting the Supreme Court's definition under *Miller v. California*) and includes child pornography. North Carolina has a statute that criminalizes obscenity. What are possible results if a store in Raleigh, North Carolina, carries Raunch merchandise?
- a. The partners could be arrested in North Carolina and may well be convicted.
  - b. The materials in Raleigh may be the basis for a criminal conviction.
  - c. The materials are protected under the First Amendment's right of free speech.
  - d. The materials are protected under state law.
  - e. a and b

#### SELF-TEST ANSWERS

1. a
2. c
3. c
4. b
5. e

## Chapter 5

# Administrative Law

### LEARNING OBJECTIVES

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

1. Understand the purpose served by federal administrative agencies.
2. Know the difference between executive branch agencies and independent agencies.
3. Understand the political control of agencies by the president and Congress.
4. Describe how agencies make rules and conduct hearings.
5. Describe how courts can be used to challenge administrative rulings.

From the 1930s on, administrative agencies, law, and procedures have virtually remade our government and much of private life. Every day, business must deal with rules and decisions of state and federal administrative agencies. Informally, such rules are often called regulations, and they differ (only in their source) from laws passed by Congress and signed into law by the president. The rules created by agencies are voluminous: thousands of new regulations pour forth each year. The overarching question of whether there is too much regulation—or the wrong kind of regulation—of our economic activities is an important one but well beyond the scope of this chapter, in which we offer an overview of the purpose of administrative agencies, their structure, and their impact on business.

## 5.1 Administrative Agencies: Their Structure and Powers

### LEARNING OBJECTIVES

1. Explain the reasons why we have federal administrative agencies.
2. Explain the difference between executive branch agencies and independent agencies.
3. Describe the constitutional issue that questions whether administrative agencies could have authority to make enforceable rules that affect business.

### Why Have Administrative Agencies?

The US Constitution mentions only three branches of government: legislative, executive, and judicial (Articles I, II, and III). There is no mention of agencies in the Constitution, even though federal agencies are sometimes referred to as “the fourth branch of government.” The Supreme Court has recognized the legitimacy of federal **administrative agencies**<sup>1</sup> to make rules that have the same binding effect as statutes by Congress.

Most commentators note that having agencies with rule-making power is a practical necessity: (1) Congress does not have the expertise or continuity to develop specialized knowledge in various areas (e.g., communications, the environment, aviation). (2) Because of this, it makes sense for Congress to set forth broad statutory guidance to an agency and delegate authority to the agency to propose rules that further the statutory purposes. (3) As long as Congress makes this delegating guidance sufficiently clear, it is not delegating improperly. If Congress’s guidelines are too vague or undefined, it is (in essence) giving away its constitutional power to some other group, and this it cannot do.

### Why Regulate the Economy at All?

The market often does not work properly, as economists often note. Monopolies, for example, happen in the natural course of human events but are not always desirable. To fix this, well-conceived and objectively enforced competition law (what is called antitrust law in the United States) is needed.

Negative externalities must be “fixed,” as well. For example, as we see in tort law ([Chapter 7 "Introduction to Tort Law"](#)), people and business organizations often do

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

things that impose costs (damages) on others, and the legal system will try—through the award of compensatory damages—to make fair adjustments. In terms of the ideal conditions for a free market, think of tort law as the legal system’s attempt to compensate for negative externalities: those costs imposed on people who have not voluntarily consented to bear those costs.

In terms of freedoms to enter or leave the market, the US constitutional guarantees of equal protection can prevent local, state, and federal governments from imposing discriminatory rules for commerce that would keep minorities, women, and gay people from full participation in business. For example, if the small town of Xenophobia, Colorado, passed a law that required all business owners and their employees to be Christian, heterosexual, and married, the equal protection clause (as well as numerous state and federal equal opportunity employment laws) would empower plaintiffs to go to court and have the law struck down as unconstitutional.

Knowing that information is power, we will see many laws administered by regulatory agencies that seek to level the playing field of economic competition by requiring disclosure of the most pertinent information for consumers (consumer protection laws), investors (securities laws), and citizens (e.g., the toxics release inventory laws in environmental law).

### **Ideal Conditions for a Free Market**

1. There are many buyers and many sellers, and none of them has a substantial share of the market.
2. All buyers and sellers in the market are free to enter the market or leave it.
3. All buyers and all sellers have full and perfect knowledge of what other buyers and sellers are up to, including knowledge of prices, quantity, and quality of all goods being bought or sold.
4. The goods being sold in the market are similar enough to each other that participants do not have strong preferences as to which seller or buyer they deal with.
5. The costs and benefits of making or using the goods that are exchanged in the market are borne only by those who buy or sell those goods and not by third parties or people “external” to the market transaction. (That is, there are no “externalities.”)
6. All buyers and sellers are utility maximizers; each participant in the market tries to get as much as possible for as little as possible.
7. There are no parties, institutions, or governmental units regulating the price, quantity, or quality of any of the goods being bought and sold in the market.

In short, some forms of legislation and regulation are needed to counter a tendency toward consolidation of economic power and discriminatory attitudes toward certain individuals and groups and to insist that people and companies clean up their own messes and not hide information that would empower voluntary choices in the free market.

But there are additional reasons to regulate. For example, in economic systems, it is likely for natural monopolies to occur. These are where one firm can most efficiently supply all of the good or service. Having duplicate (or triplicate) systems for supplying electricity, for example, would be inefficient, so most states have a public utilities commission to determine both price and quality of service. This is direct regulation.

Sometimes destructive competition can result if there is no regulation. Banking and insurance are good examples of this. Without government regulation of banks (setting standards and methods), open and fierce competition would result in widespread bank failures. That would erode public confidence in banks and

business generally. The current situation (circa 2011) of six major banks that are “too big to fail” is, however, an example of destructive *noncompetition*.

Other market imperfections can yield a demand for regulation. For example, there is a need to regulate frequencies for public broadcast on radio, television, and other wireless transmissions (for police, fire, national defense, etc.). Many economists would also list an adequate supply of public goods as something that must be created by government. On its own, for example, the market would not provide public goods such as education, a highway system, lighthouses, a military for defense.

True laissez-faire capitalism—a market free from any regulation—would not try to deal with market imperfections and would also allow people to freely choose products, services, and other arrangements that historically have been deemed socially unacceptable. These would include making enforceable contracts for the sale and purchase of persons (slavery), sexual services, “street drugs” such as heroin or crack cocaine, votes for public office, grades for this course in business law, and even marriage partnership.

Thus the free market in actual terms—and not in theory—consists of commerce legally constrained by what is economically desirable and by what is socially desirable as well. Public policy objectives in the social arena include ensuring equal opportunity in employment, protecting employees from unhealthy or unsafe work environments, preserving environmental quality and resources, and protecting consumers from unsafe products. Sometimes these objectives are met by giving individuals statutory rights that can be used in bringing a complaint (e.g., Title VII of the Civil Rights Act of 1964, for employment discrimination), and sometimes they are met by creating agencies with the right to investigate and monitor and enforce statutory law and regulations created to enforce such law (e.g., the Environmental Protection Agency, for bringing a lawsuit against a polluting company).

## History of Federal Agencies

Through the commerce clause in the US Constitution, Congress has the power to regulate trade between the states and with foreign nations. The earliest federal agency therefore dealt with trucking and railroads, to literally set the rules of the road for interstate commerce. The first federal agency, the Interstate Commerce Commission (ICC), was created in 1887. Congress delegated to the ICC the power to enforce federal laws against railroad rate discrimination and other unfair pricing practices. By the early part of this century, the ICC gained the power to fix rates. From the 1970s through 1995, however, Congress passed deregulatory measures,



and the ICC was formally abolished in 1995, with its powers transferred to the Surface Transportation Board.

Beginning with the Federal Trade Commission (FTC) in 1914, Congress has created numerous other agencies, many of them familiar actors in American government. Today more than eighty-five federal agencies have jurisdiction to regulate some form of private activity. Most were created since 1930, and more than a third since 1960. A similar growth has occurred at the state level. Most states now have dozens of regulatory agencies, many of them overlapping in function with the federal bodies.

### **Classification of Agencies**

Independent agencies are different from federal executive departments and other executive agencies by their structural and functional characteristics. Most executive departments have a single director, administrator, or secretary appointed by the president of the United States. Independent agencies almost always have a commission or board consisting of five to seven members who share power over the agency. The president appoints the commissioners or board subject to Senate confirmation, but they often serve with staggered terms and often for longer terms than a usual four-year presidential term. They cannot be removed except for “good cause.” This means that most presidents will not get to appoint all the commissioners of a given independent agency. Most independent agencies have a statutory requirement of bipartisan membership on the commission, so the president cannot simply fill vacancies with members of his own political party.

In addition to the ICC and the FTC, the major independent agencies are the Federal Communications Commission (1934), Securities and Exchange Commission (1934), National Labor Relations Board (1935), and Environmental Protection Agency (1970). See [Note 5.4 "Ideal Conditions for a Free Market"](#) in the sidebar.

By contrast, members of executive branch agencies serve at the pleasure of the president and are therefore far more amenable to political control. One consequence of this distinction is that the rules that independent agencies promulgate may not be reviewed by the president or his staff—only Congress may directly overrule them—whereas the White House or officials in the various cabinet departments may oversee the work of the agencies contained within them (unless specifically denied the power by Congress).

## Powers of Agencies

Agencies have a variety of powers. Many of the original statutes that created them, like the Federal Communications Act, gave them licensing power. No party can enter into the productive activity covered by the act without prior license from the agency—for example, no utility can start up a nuclear power plant unless first approved by the Nuclear Regulatory Commission. In recent years, the move toward deregulation of the economy has led to diminution of some licensing power. Many agencies also have the authority to set the rates charged by companies subject to the agency’s jurisdiction. Finally, the agencies can regulate business practices. The FTC has general jurisdiction over all business in interstate commerce to monitor and root out “unfair acts” and “deceptive practices.” The Securities and Exchange Commission (SEC) oversees the issuance of corporate securities and other investments and monitors the practices of the stock exchanges.

Unlike courts, administrative agencies are charged with the responsibility of carrying out a specific assignment or reaching a goal or set of goals. They are not to remain neutral on the various issues of the day; they must act. They have been given legislative powers because in a society growing ever more complex, Congress does not know how to legislate with the kind of detail that is necessary, nor would it have the time to approach all the sectors of society even if it tried. Precisely because they are to do what general legislative bodies cannot do, agencies are specialized bodies. Through years of experience in dealing with similar problems they accumulate a body of knowledge that they can apply to accomplish their statutory duties.

All administrative agencies have two different sorts of personnel. The heads, whether a single administrator or a collegial body of commissioners, are political appointees and serve for relatively limited terms. Below them is a more or less permanent staff—the bureaucracy. Much policy making occurs at the staff level, because these employees are in essential control of gathering facts and presenting data and argument to the commissioners, who wield the ultimate power of the agencies.

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

### The Constitution and Agencies

Congress can establish an agency through legislation. When Congress gives powers to an agency, the legislation is known as an **enabling act**<sup>2</sup>. The concept that Congress can delegate power to an agency is known as the **delegation doctrine**<sup>3</sup>. Usually, the agency will have all three kinds of power: executive, legislative, and judicial. (That is, the agency can set the rules that business must comply with, can investigate and prosecute those businesses, and can hold administrative hearings for violations of those rules. They are, in effect, rule maker, prosecutor, and judge.)

Because agencies have all three types of governmental powers, important constitutional questions were asked when Congress first created them. The most important question was whether Congress was giving away its legislative power. Was the separation of powers violated if agencies had power to make rules that were equivalent to legislative statutes?

In 1935, in *Schechter Poultry Corp. v. United States*, the Supreme Court overturned the National Industrial Recovery Act on the ground that the congressional delegation of power was too broad. *Schechter Poultry Corp. v. United States*, 295 US 495 (1935). Under the law, industry trade groups were granted the authority to devise a code of fair competition for the entire industry, and these codes became law if approved by the president. No administrative body was created to scrutinize the arguments for a particular code, to develop evidence, or to test one version of a code against another. Thus it was unconstitutional for the Congress to transfer all of its legislative powers to an agency. In later decisions, it was made clear that Congress could delegate some of its legislative powers, but only if the delegation of authority was not overly broad.

Still, some congressional enabling acts are very broad, such as the enabling legislation for the Occupational Safety and Health Administration (OSHA), which is given the authority to make rules to provide for safe and healthful working conditions in US workplaces. Such a broad initiative power gives OSHA considerable discretion. But, as noted in [Section 5.2 "Controlling Administrative Agencies"](#), there are both executive and judicial controls over administrative agency activities, as well as ongoing control by Congress through funding and the continuing oversight of agencies, both in hearings and through subsequent statutory amendments.

#### KEY TAKEAWAY

Congress creates administrative agencies through enabling acts. In these acts, Congress must delegate authority by giving the agency some direction as to what it wants the agency to do. Agencies are usually given broad powers to investigate, set standards (promulgating regulations), and enforce those standards. Most agencies are executive branch agencies, but some are independent.

## EXERCISES

1. Explain why Congress needs to delegate rule-making authority to a specialized agency.
2. Explain why there is any need for interference in the market by means of laws or regulations.

## 5.2 Controlling Administrative Agencies

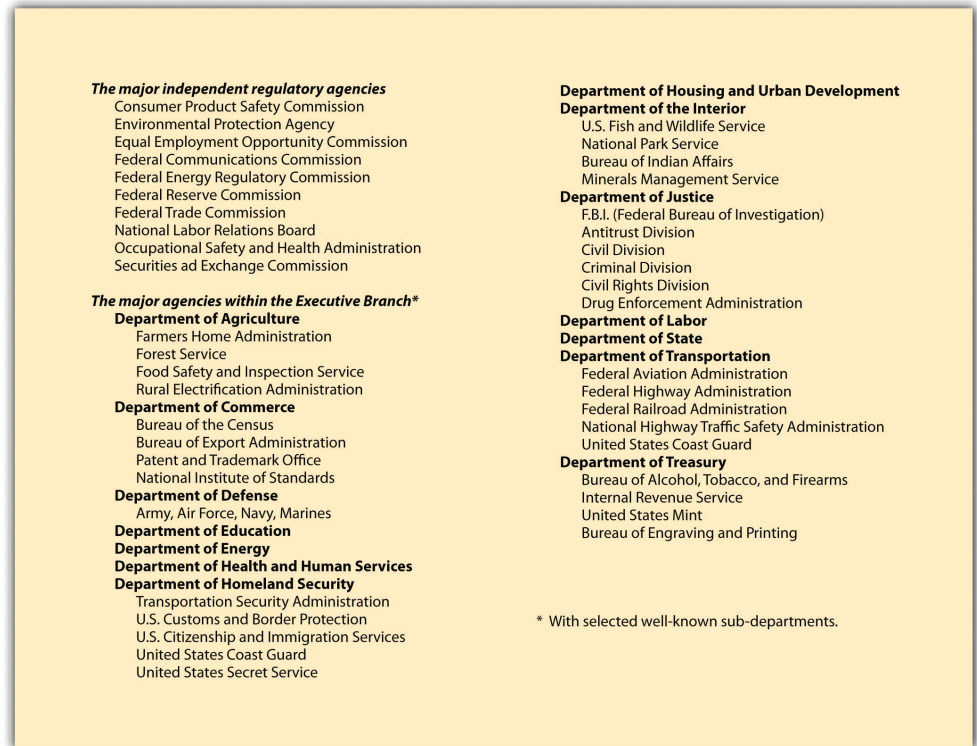
### LEARNING OBJECTIVES

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

During the course of the past seventy years, a substantial debate has been conducted, often in shrill terms, about the legitimacy of administrative lawmaking. One criticism is that agencies are “captured” by the industry they are directed to regulate. Another is that they overregulate, stifling individual initiative and the ability to compete. During the 1960s and 1970s, a massive outpouring of federal law created many new agencies and greatly strengthened the hands of existing ones. In the late 1970s during the Carter administration, Congress began to deregulate American society, and deregulation increased under the Reagan administration. But the accounting frauds of WorldCom, Enron, and others led to the Sarbanes-Oxley Act of 2002, and the financial meltdown of 2008 has led to reregulation of the financial sector. It remains to be seen whether the Deepwater Horizon oil blowout of 2010 will lead to more environmental regulations or a rethinking on how to make agencies more effective regulators.

Administrative agencies are the focal point of controversy because they are policy-making bodies, incorporating facets of legislative, executive, and judicial power in a hybrid form that fits uneasily at best in the framework of American government (see [Figure 5.1 "Major Administrative Agencies of the United States"](#)). They are necessarily at the center of tugging and hauling by the legislature, the executive branch, and the judiciary, each of which has different means of exercising political control over them. In early 1990, for example, the Bush administration approved a Food and Drug Administration regulation that limited disease-prevention claims by food packagers, reversing a position by the Reagan administration in 1987 permitting such claims.

Figure 5.1 Major Administrative Agencies of the United States



## Legislative Control

Congress can always pass a law repealing a regulation that an agency promulgates. Because this is a time-consuming process that runs counter to the reason for creating administrative bodies, it happens rarely. Another approach to controlling agencies is to reduce or threaten to reduce their appropriations. By retaining ultimate control of the purse strings, Congress can exercise considerable informal control over regulatory policy.

## Executive Control

The president (or a governor, for state agencies) can exercise considerable control over agencies that are part of his cabinet departments and that are not statutorily defined as independent. Federal agencies, moreover, are subject to the fiscal scrutiny of the Office of Management and Budget (OMB), subject to the direct control of the president. Agencies are not permitted to go directly to Congress for increases in budget; these requests must be submitted through the OMB, giving the president indirect leverage over the continuation of administrators' programs and policies.

## Judicial Review of Agency Actions

Administrative agencies are creatures of law and like everyone else must obey the law. The courts have jurisdiction to hear claims that the agencies have overstepped their legal authority or have acted in some unlawful manner.

Courts are unlikely to overturn administrative actions, believing in general that the agencies are better situated to judge their own jurisdiction and are experts in rulemaking for those matters delegated to them by Congress. Some agency activities are not reviewable, for a number of reasons. However, after a business (or some other interested party) has exhausted all administrative remedies, it may seek judicial review of a final agency decision. The reviewing court is often asked to strike down or modify agency actions on several possible bases (see [Section 5.5.2 "Strategies for Obtaining Judicial Review"](#) on “Strategies for Obtaining Judicial Review”).

### KEY TAKEAWAY

Administrative agencies are given unusual powers: to legislate, investigate, and adjudicate. But these powers are limited by executive and legislative controls and by judicial review.

### EXERCISES

1. Find the website of the Consumer Product Safety Commission (CPSC). Identify from that site a product that has been banned by the CPSC for sale in the United States. What reasons were given for its exclusion from the US market?
2. What has Congress told the CPSC to do in its enabling act? Is this a clear enough mandate to guide the agency? What could Congress do if the CPSC does something that may be outside of the scope of its powers? What can an affected business do?

## 5.3 The Administrative Procedure Act

### LEARNING OBJECTIVES

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

In 1946, Congress enacted the **Administrative Procedure Act (APA)**<sup>4</sup>. This fundamental statute detailed for all federal administrative agencies how they must function when they are deciding cases or issuing regulations, the two basic tasks of administration. At the state level, the Model State Administrative Procedure Act, issued in 1946 and revised in 1961, has been adopted in twenty-eight states and the District of Columbia; three states have adopted the 1981 revision. The other states have statutes that resemble the model state act to some degree.

### Trial-Type Hearings

Deciding cases is a major task of many agencies. For example, the Federal Trade Commission (FTC) is empowered to charge a company with having violated the Federal Trade Commission Act. Perhaps a seller is accused of making deceptive claims in its advertising. Proceeding in a manner similar to a court, staff counsel will prepare a case against the company, which can defend itself through its lawyers. The case is tried before an **administrative law judge**<sup>5</sup> (ALJ), formerly known as an administrative hearing examiner. The change in nomenclature was made in 1972 to enhance the prestige of ALJs and more accurately reflect their duties. Although not appointed for life as federal judges are, the ALJ must be free of assignments inconsistent with the judicial function and is not subject to supervision by anyone in the agency who carries on an investigative or prosecutorial function.

The accused parties are entitled to receive notice of the issues to be raised, to present evidence, to argue, to cross-examine, and to appear with their lawyers. Ex parte (eks PAR-tay) communications—contacts between the ALJ and outsiders or one party when both parties are not present—are prohibited. However, the usual burden-of-proof standard followed in a civil proceeding in court does not apply: the ALJ is not bound to decide in favor of that party producing the more persuasive evidence. The rule in most administrative proceedings is “substantial evidence,” evidence that is not flimsy or weak, but is not necessarily overwhelming evidence, either. The ALJ in most cases will write an opinion. That opinion is not the decision

4. The federal act that governs all agency procedures in both hearings and rulemaking.

5. The primary hearing officer in an administrative agency, who provides the initial ruling of the agency (often called an order) in any contested proceeding.



of the agency, which can be made only by the commissioners or agency head. In effect, the ALJ's opinion is appealed to the commission itself.

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

## Rulemaking

Trial-type hearings generally impose on particular parties liabilities based on past or present facts. Because these cases will serve as precedents, they are a partial guide to future conduct by others. But they do not directly apply to nonparties, who may argue in a subsequent case that their conduct does not fit within the holding announced in the case. Agencies can affect future conduct far more directly by announcing rules that apply to all who come within the agency's jurisdiction.

The acts creating most of the major federal agencies expressly grant them authority to engage in rulemaking. This means, in essence, authority to legislate. The outpouring of federal regulations has been immense. The APA directs agencies about to engage in rulemaking to give notice in the ***Federal Register***<sup>6</sup> of their intent to do so. The *Federal Register* is published daily, Monday through Friday, in Washington, DC, and contains notice of various actions, including announcements of proposed rulemaking and regulations as adopted. The notice must specify the time, place, and nature of the rulemaking and offer a description of the proposed rule or the issues involved. Any interested person or organization is entitled to participate by submitting written "data, views or arguments." Agencies are not legally required to air debate over proposed rules, though they often do so.

The procedure just described is known as "informal" rulemaking. A different procedure is required for "formal" rulemaking, defined as those instances in which the enabling legislation directs an agency to make rules "on the record after opportunity for an agency hearing." When engaging in formal rulemaking, agencies must *hold* an adversary hearing.

Administrative regulations are not legally binding unless they are published. Agencies must publish in the *Federal Register* the text of final regulations, which ordinarily do not become effective until thirty days later. Every year the annual output of regulations is collected and reprinted in the ***Code of Federal Regulations (CFR)***<sup>7</sup>, a multivolume paperback series containing all federal rules and regulations

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

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

keyed to the fifty titles of the US Code (the compilation of *all* federal statutes enacted by Congress and grouped according to subject).

### KEY TAKEAWAY

Agencies make rules that have the same effect as laws passed by Congress and the president. But such rules (regulations) must allow for full participation by interested parties. The Administrative Procedure Act (APA) governs both rulemaking and the agency enforcement of regulations, and it provides a process for fair hearings.

### EXERCISES

1. Go to <http://www.regulations.gov/search/Regs/home.html#home>. Browse the site. Find a topic that interests you, and then find a proposed regulation. Notice how comments on the proposed rule are invited.
2. Why would there be a trial by an administrative agency? Describe the process.

## 5.4 Administrative Burdens on Business Operations

### LEARNING OBJECTIVES

1. Describe the paperwork burden imposed by administrative agencies.
2. Explain why agencies have the power of investigation, and what limits there are to that power.
3. Explain the need for the Freedom of Information Act and how it works in the US legal system.

### The Paperwork Burden

The administrative process is not frictionless. The interplay between government agency and private enterprise can burden business operations in a number of ways. Several of these are noted in this section.

Deciding whether and how to act are not decisions that government agencies reach out of the blue. They rely heavily on information garnered from business itself. Dozens of federal agencies require corporations to keep hundreds of types of records and to file numerous periodic reports. The Commission on Federal Paperwork, established during the Ford administration to consider ways of reducing the paperwork burden, estimated in its final report in 1977 that the total annual cost of federal paperwork amounted to \$50 billion and that the 10,000 largest business enterprises spent \$10 billion annually on paperwork alone. The paperwork involved in licensing a single nuclear power plant, the commission said, costs upward of \$15 million.

Not surprisingly, therefore, businesses have sought ways of avoiding requests for data. Since the 1940s, the Federal Trade Commission (FTC) has collected economic data on corporate performance from individual companies for statistical purposes. As long as each company engages in a single line of business, data are comparable. When the era of conglomerates began in the 1970s, with widely divergent types of businesses brought together under the roof of a single corporate parent, the data became useless for purposes of examining the competitive behavior of different industries. So the FTC ordered dozens of large companies to break out their economic information according to each line of business that they carried on. The companies resisted, but the US Court of Appeals for the District of Columbia Circuit, where much of the litigation over federal administrative action is decided, directed the companies to comply with the commission's order, holding that the Federal

Trade Commission Act clearly permits the agency to collect information for investigatory purposes. *In re FTC Line of Business Report Litigation*, 595 F.2d 685 (D.C. Cir. 1978).

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

## Inspections

No one likes surprise inspections. A section of the Occupational Safety and Health Act of 1970 empowers agents of the Occupational Safety and Health Administration (OSHA) to search work areas for safety hazards and for violations of OSHA regulations. The act does not specify whether inspectors are required to obtain search warrants, required under the Fourth Amendment in criminal cases. For many years, the government insisted that surprise inspections are not unreasonable and that the time required to obtain a warrant would defeat the surprise element. The Supreme Court finally ruled squarely on the issue in 1978. In *Marshall v. Barlow's, Inc.*, the court held that no less than private individuals, businesses are entitled to refuse police demands to search the premises unless a court has issued a search warrant. *Marshall v. Barlow's, Inc.*, 436 US 307 (1978).

But where a certain type of business is closely regulated, surprise inspections are the norm, and no warrant is required. For example, businesses with liquor licenses that might sell to minors are subject to both overt and covert inspections (e.g., an undercover officer may "search" a liquor store by sending an underage patron to the store). Or a junkyard that specializes in automobiles and automobile parts may also be subject to surprise inspections, on the rationale that junkyards are highly likely to be active in the resale of stolen autos or stolen auto parts. *New York v. Burger*, 482 US 691 (1987).

It is also possible for inspections to take place without a search warrant and without the permission of the business. For example, the Environmental Protection Agency (EPA) wished to inspect parts of the Dow Chemical facility in Midland, Michigan,

without the benefit of warrant. When they were refused, agents of the EPA obtained a fairly advanced aerial mapping camera and rented an airplane to fly over the Dow facility. Dow went to court for a restraining order against the EPA and a request to have the EPA turn over all photographs taken. But the Supreme Court ruled that the areas photographed were “open fields” and not subject to the protections of the Fourth Amendment. *Dow Chemical Co. v. United States Environmental Protection Agency*, 476 US 227 (1986).

### **Access to Business Information in Government Files**

In 1966, Congress enacted the Freedom of Information Act (FOIA), opening up to the citizenry many of the files of the government. (The act was amended in 1974 and again in 1976 to overcome a tendency of many agencies to stall or refuse access to their files.) Under the FOIA, any person has a legally enforceable right of access to all government documents, with nine specific exceptions, such as classified military intelligence, medical files, and trade secrets and commercial or financial information if “obtained from a person and privileged or confidential.” Without the trade-secret and financial-information exemptions, business competitors could, merely by requesting it, obtain highly sensitive competitive information sitting in government files.

A federal agency is required under the FOIA to respond to a document request within ten days. But in practice, months or even years may pass before the government actually responds to an FOIA request. Requesters must also pay the cost of locating and copying the records. Moreover, not all documents are available for public inspection. Along with the trade-secret and financial-information exemptions, the FOIA specifically exempts the following:

- records required by executive order of the president to be kept secret in the interest of national defense or public policy
- records related solely to the internal personnel rules and practice of an agency
- records exempted from disclosure by another statute
- interagency memos or decisions reflecting the deliberative process
- personnel files and other files that if disclosed, would constitute an unwarranted invasion of personal privacy
- information compiled for law enforcement purposes
- geological information concerning wells

Note that the government may provide such information but is not required to provide such information; it retains discretion to provide information or not.

Regulated companies are often required to submit confidential information to the government. For these companies, submitting such information presents a danger under the FOIA of disclosure to competitors. To protect information from disclosure, the company is well advised to mark each document as privileged and confidential so that government officials reviewing it for a FOIA request will not automatically disclose it. Most agencies notify a company whose data they are about to disclose. But these practices are not legally required under the FOIA.

#### KEY TAKEAWAY

Government agencies, in order to do their jobs, collect a great deal of information from businesses. This can range from routine paperwork (often burdensome) to inspections, those with warrants and those without. Surprise inspections are allowed for closely regulated industries but are subject to Fourth Amendment requirements in general. Some information collected by agencies can be accessed using the Freedom of Information Act.

#### EXERCISES

1. Give two examples of a closely regulated industry. Explain why some warrantless searches would be allowed.
2. Find out why FOIA requests often take months or years to accomplish.

## 5.5 The Scope of Judicial Review

### LEARNING OBJECTIVES

1. Describe the “exhaustion of remedies” requirement.
2. Detail various strategies for obtaining judicial review of agency rules.
3. Explain under what circumstances it is possible to sue the government.

Neither an administrative agency’s adjudication nor its issuance of a regulation is necessarily final. Most federal agency decisions are appealable to the federal circuit courts. To get to court, the appellant must overcome numerous complex hurdles. He or she must have standing—that is, be in some sense directly affected by the decision or regulation. The case must be ripe for review; administrative remedies such as further appeal within the agency must have been exhausted.

### Exhaustion of Administrative Remedies

Before you can complain to court about an agency’s action, you must first try to get the agency to reconsider its action. Generally, you must have asked for a hearing at the hearing examiner level, there must have been a decision reached that was unfavorable to you, and you must have appealed the decision to the full board. The full board must rule against you, and only then will you be heard by a court. The broadest exception to this **exhaustion of administrative remedies**<sup>8</sup> requirement is if the agency had no authority to issue the rule or regulation in the first place, if exhaustion of remedies would be impractical or futile, or if great harm would happen should the rule or regulation continue to apply. Also, if the agency is not acting in good faith, the courts will hear an appeal without exhaustion.

### Strategies for Obtaining Judicial Review

Once these obstacles are cleared, the court may look at one of a series of claims. The appellant might assert that the agency’s action was *ultra vires* (UL-truh VI-reez)—beyond the scope of its authority as set down in the statute. This attack is rarely successful. A somewhat more successful claim is that the agency did not abide by its own procedures or those imposed upon it by the Administrative Procedure Act.

In formal rulemaking, the appellant also might insist that the agency lacked substantial evidence for the determination that it made. If there is virtually no

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

evidence to support the agency's findings, the court may reverse. But findings of fact are not often overturned by the courts.

Likewise, there has long been a presumption that when an agency issues a regulation, it has the authority to do so: those opposing the regulation must bear a heavy burden in court to upset it. This is not a surprising rule, for otherwise courts, not administrators, would be the authors of regulations. Nevertheless, regulations cannot exceed the scope of the authority conferred by Congress on the agency. In an important 1981 case before the Supreme Court, the issue was whether the secretary of labor, acting through the Occupational Health and Safety Administration (OSHA), could lawfully issue a standard limiting exposure to cotton dust in the workplace without first undertaking a cost-benefit analysis. A dozen cotton textile manufacturers and the American Textile Manufacturers Institute, representing 175 companies, asserted that the cotton dust standard was unlawful because it did not rationally relate the benefits to be derived from the standard to the costs that the standard would impose. See Section 5.6 "Cases", *American Textile Manufacturers Institute v. Donovan*.

In summary, then, an individual or a company may (after exhaustion of administrative remedies) challenge agency action where such action is the following:

- not in accordance with the agency's scope of authority
- not in accordance with the US Constitution or the Administrative Procedure Act
- not in accordance with the substantial evidence test
- unwarranted by the facts
- arbitrary, capricious, an abuse of discretion, or otherwise not in accord with the law

Section 706 of the Administrative Procedure Act sets out those standards. While it is difficult to show that an agency's action is arbitrary and capricious, there are cases that have so held. For example, after the Reagan administration set aside a Carter administration rule from the National Highway Traffic and Safety Administration on passive restraints in automobiles, State Farm and other insurance companies challenged the reversal as arbitrary and capricious. Examining the record, the Supreme Court found that the agency had failed to state enough reasons for its reversal and required the agency to review the record and the rule and provide adequate reasons for its reversal. State Farm and other insurance companies thus gained a legal benefit by keeping an agency rule that placed costs on automakers for increased passenger safety and potentially reducing the number of injury claims



from those it had insured. *Motor Vehicle Manufacturers' Assn. v. State Farm Mutual Ins.*, 463 US 29 (1983).

## Suing the Government

In the modern administrative state, the range of government activity is immense, and administrative agencies frequently get in the way of business enterprise. Often, bureaucratic involvement is wholly legitimate, compelled by law; sometimes, however, agencies or government officials may overstep their bounds, in a fit of zeal or spite. What recourse does the private individual or company have?

Mainly for historical reasons, it has always been more difficult to sue the government than to sue private individuals or corporations. For one thing, the government has long had recourse to the doctrine of sovereign immunity as a shield against lawsuits. Yet in 1976, Congress amended the Administrative Procedure Act to waive any federal claim to sovereign immunity in cases of injunctive or other nonmonetary relief. Earlier, in 1946, in the Federal Tort Claims Act, Congress had waived sovereign immunity of the federal government for most tort claims for money damages, although the act contains several exceptions for specific agencies (e.g., one cannot sue for injuries resulting from fiscal operations of the Treasury Department or for injuries stemming from activities of the military in wartime). The act also contains a major exception for claims “based upon [an official’s] exercise or performance or the failure to exercise or perform a discretionary function or duty.” This exception prevents suits against parole boards for paroling dangerous criminals who then kill or maim in the course of another crime and suits against officials whose decision to ship explosive materials by public carrier leads to mass deaths and injuries following an explosion en route. *Dalehite v. United States*, 346 US 15 (1953).

In recent years, the Supreme Court has been stripping away the traditional immunity enjoyed by many government officials against personal suits. Some government employees—judges, prosecutors, legislators, and the president, for example—have absolute immunity against suit for official actions. But many public administrators and government employees have at best a qualified immunity. Under a provision of the Civil Rights Act of 1871 (so-called Section 1983 actions), *state* officials can be sued in federal court for money damages whenever “under color of any state law” they deprive anyone of his rights under the Constitution or federal law. In *Bivens v. Six Unknown Federal Narcotics Agents*, the Supreme Court held that *federal* agents may be sued for violating the plaintiff’s Fourth Amendment rights against an unlawful search of his home. *Bivens v. Six Unknown Federal Narcotics Agents*, 403 US 388 (1971). Subsequent cases have followed this logic to permit suits for violations of other constitutional provisions. This area of the law is in a state of flux, and it is likely to continue to evolve.

Sometimes damage is done to an individual or business because the government has given out erroneous information. For example, suppose that Charles, a bewildered, disabled navy employee, is receiving a federal disability annuity. Under the regulations, he would lose his pension if he took a job that paid him in each of two succeeding years more than 80 percent of what he earned in his old navy job. A few years later, Congress changed the law, making him ineligible if he earned more than 80 percent in anyone year. For many years, Charles earned considerably less than the ceiling amount. But then one year he got the opportunity to make some extra money. Not wishing to lose his pension, he called an employee relations specialist in the US Navy and asked how much he could earn and still keep his pension. The specialist gave him erroneous information over the telephone and then sent him an out-of-date form that said Charles could safely take on the extra work. Unfortunately, as it turned out, Charles did exceed the salary limit, and so the government cut off his pension during the time he earned too much. Charles sues to recover his lost pension. He argues that he relied to his detriment on false information supplied by the navy and that in fairness the government should be estopped from denying his claim.

Unfortunately for Charles, he will lose his case. In *Office of Personnel Management v. Richmond*, the Supreme Court reasoned that it would be unconstitutional to permit recovery. *Office of Personnel Management v. Richmond*, 110 S. Ct. 2465 (1990). The appropriations clause of Article I says that federal money can be paid out only through an appropriation made by law. The law prevented this particular payment to be made. If the court were to make an exception, it would permit executive officials in effect to make binding payments, even though unauthorized, simply by misrepresenting the facts. The harsh reality, therefore, is that mistakes of the government are generally held against the individual, not the government, unless the law specifically provides for recompense (as, for example, in the Federal Tort Claims Act just discussed).

#### KEY TAKEAWAY

After exhausting administrative remedies, there are numerous grounds for seeking judicial review of an agency's order or of a final rule. While courts defer to agencies to some degree, an agency must follow its own rules, comply with the Administrative Procedure Act, act within the scope of its delegated authority, avoid acting in an arbitrary manner, and make final rules that are supported by substantial evidence.

## EXERCISES

1. Why would US courts require that someone seeking judicial review of an agency order first exhaust administrative remedies?
2. On the Internet, find a case where someone has successfully sued the US government under the Federal Tort Claims Act. What kind of case was it? Did the government argue sovereign immunity? Does sovereign immunity even make sense to you?

## 5.6 Cases

### *Marshall v. Barlow's, Inc.*

Marshall v. Barlow's, Inc.

436 U.S. 307 (U.S. Supreme Court 1978)

MR. JUSTICE WHITE delivered the opinion of the Court.

Section 8(a) of the Occupational Safety and Health Act of 1970 (OSHA or Act) empowers agents of the Secretary of Labor (Secretary) to search the work area of any employment facility within the Act's jurisdiction. The purpose of the search is to inspect for safety hazards and violations of OSHA regulations. No search warrant or other process is expressly required under the Act.

On the morning of September 11, 1975, an OSHA inspector entered the customer service area of Barlow's, Inc., an electrical and plumbing installation business located in Pocatello, Idaho. The president and general manager, Ferrol G. "Bill" Barlow, was on hand; and the OSHA inspector, after showing his credentials, informed Mr. Barlow that he wished to conduct a search of the working areas of the business. Mr. Barlow inquired whether any complaint had been received about his company. The inspector answered no, but that Barlow's, Inc., had simply turned up in the agency's selection process. The inspector again asked to enter the nonpublic area of the business; Mr. Barlow's response was to inquire whether the inspector had a search warrant.

The inspector had none. Thereupon, Mr. Barlow refused the inspector admission to the employee area of his business. He said he was relying on his rights as guaranteed by the Fourth Amendment of the United States Constitution.

Three months later, the Secretary petitioned the United States District Court for the District of Idaho to issue an order compelling Mr. Barlow to admit the inspector. The requested order was issued on December 30, 1975, and was presented to Mr. Barlow on January 5, 1976. Mr. Barlow again refused admission, and he sought his own injunctive relief against the warrantless searches assertedly permitted by OSHA....The Warrant Clause of the Fourth Amendment protects commercial buildings as well as private homes. To hold otherwise would belie the origin of that Amendment, and the American colonial experience.

An important forerunner of the first 10 Amendments to the United States Constitution, the Virginia Bill of Rights, specifically opposed “general warrants, whereby an officer or messenger may be commanded to search suspected places without evidence of a fact committed.” The general warrant was a recurring point of contention in the Colonies immediately preceding the Revolution. The particular offensiveness it engendered was acutely felt by the merchants and businessmen whose premises and products were inspected for compliance with the several parliamentary revenue measures that most irritated the colonists....

\* \* \*

This Court has already held that warrantless searches are generally unreasonable, and that this rule applies to commercial premises as well as homes. In *Camara v. Municipal Court*, we held:

[E]xcept in certain carefully defined classes of cases, a search of private property without proper consent is ‘unreasonable’ unless it has been authorized by a valid search warrant.

On the same day, we also ruled: As we explained in *Camara*, a search of private houses is presumptively unreasonable if conducted without a warrant. The businessman, like the occupant of a residence, has a constitutional right to go about his business free from unreasonable official entries upon his private commercial property. The businessman, too, has that right placed in jeopardy if the decision to enter and inspect for violation of regulatory laws can be made and enforced by the inspector in the field without official authority evidenced by a warrant. These same cases also held that the Fourth Amendment prohibition against unreasonable searches protects against warrantless intrusions during civil as well as criminal investigations. The reason is found in the “basic purpose of this Amendment...[which] is to safeguard the privacy and security of individuals against arbitrary invasions by governmental officials.” If the government intrudes on a person’s property, the privacy interest suffers whether the government’s motivation is to investigate violations of criminal laws or breaches of other statutory or regulatory standards....

[A]n exception from the search warrant requirement has been recognized for “pervasively regulated business[es],” *United States v. Biswell*, 406 U.S. 311, 316 (1972), and for “closely regulated” industries “long subject to close supervision and inspection,” *Colonnade Catering Corp. v. United States*, 397 U.S. 72, 74, 77 (1970). These cases are indeed exceptions, but they represent responses to relatively unique circumstances. Certain industries have such a history of government oversight that no reasonable expectation of privacy could exist for a proprietor over the stock of

such an enterprise. Liquor (*Colonnade*) and firearms (*Biswell*) are industries of this type when an entrepreneur embarks upon such a business, he has voluntarily chosen to subject himself to a full arsenal of governmental regulation.

\* \* \*

The clear import of our cases is that the closely regulated industry of the type involved in *Colonnade* and *Biswell* is the exception. The Secretary would make it the rule. Invoking the Walsh-Healey Act of 1936, 41 U.S.C. § 35 et seq., the Secretary attempts to support a conclusion that all businesses involved in interstate commerce have long been subjected to close supervision of employee safety and health conditions. But...it is quite unconvincing to argue that the imposition of minimum wages and maximum hours on employers who contracted with the Government under the Walsh-Healey Act prepared the entirety of American interstate commerce for regulation of working conditions to the minutest detail. Nor can any but the most fictional sense of voluntary consent to later searches be found in the single fact that one conducts a business affecting interstate commerce. Under current practice and law, few businesses can be conducted without having some effect on interstate commerce.

\* \* \*

The critical fact in this case is that entry over Mr. Barlow's objection is being sought by a Government agent. Employees are not being prohibited from reporting OSHA violations. What they observe in their daily functions is undoubtedly beyond the employer's reasonable expectation of privacy. The Government inspector, however, is not an employee. Without a warrant he stands in no better position than a member of the public. What is observable by the public is observable, without a warrant, by the Government inspector as well. The owner of a business has not, by the necessary utilization of employees in his operation, thrown open the areas where employees alone are permitted to the warrantless scrutiny of Government agents. That an employee is free to report, and the Government is free to use, any evidence of noncompliance with OSHA that the employee observes furnishes no justification for federal agents to enter a place of business from which the public is restricted and to conduct their own warrantless search.

\* \* \*

[The District Court judgment is affirmed.]

## CASE QUESTIONS

1. State, as briefly and clearly as possible, the argument that Barlow's is making in this case.
2. Why would some industries or businesses be "closely regulated"? What are some of those businesses?
3. The Fourth Amendment speaks of "people" being secure in their "persons, houses, papers, and effects." Why would the Fourth Amendment apply to a business, which is not in a "house"?
4. If the Fourth Amendment does not distinguish between closely regulated industries and those that are not, why does the court do so?

### *American Textile Manufacturers Institute v. Donovan*

American Textile Manufacturers Institute v. Donovan

452 U.S. 490 (1981)

JUSTICE BRENNAN delivered the opinion of the Court.

Congress enacted the Occupational Safety and Health Act of 1970 (Act) "to assure so far as possible every working man and woman in the Nation safe and healthful working conditions...." The Act authorizes the Secretary of Labor to establish, after notice and opportunity to comment, mandatory nationwide standards governing health and safety in the workplace. In 1978, the Secretary, acting through the Occupational Safety and Health Administration (OSHA), promulgated a standard limiting occupational exposure to cotton dust, an airborne particle byproduct of the preparation and manufacture of cotton products, exposure to which produces a "constellation of respiratory effects" known as "byssinosis." This disease was one of the expressly recognized health hazards that led to passage of the Act.

Petitioners in these consolidated cases representing the interests of the cotton industry, challenged the validity of the "Cotton Dust Standard" in the Court of Appeals for the District of Columbia Circuit pursuant to § 6 (f) of the Act, 29 U.S.C. § 655 (f). They contend in this Court, as they did below, that the Act requires OSHA to demonstrate that its Standard reflects a reasonable relationship between the costs and benefits associated with the Standard. Respondents, the Secretary of Labor and two labor organizations, counter that Congress balanced the costs and benefits in the Act itself, and that the Act should therefore be construed not to require OSHA to do so. They interpret the Act as mandating that OSHA enact the most protective

standard possible to eliminate a significant risk of material health impairment, subject to the constraints of economic and technological feasibility.

The Court of Appeals held that the Act did not require OSHA to compare costs and benefits.

We granted certiorari, 449 U.S. 817 (1980), to resolve this important question, which was presented but not decided in last Term's *Industrial Union Dept. v. American Petroleum Institute*, 448 U.S. 607 (1980), and to decide other issues related to the Cotton Dust Standard.

\* \* \*

Not until the early 1960's was byssinosis recognized in the United States as a distinct occupational hazard associated with cotton mills. In 1966, the American Conference of Governmental Industrial Hygienists (ACGIH), a private organization, recommended that exposure to total cotton dust be limited to a "threshold limit value" of 1,000 micrograms per cubic meter of air (1,000 g/m<sup>3</sup>.) averaged over an 8-hour workday. See 43 Fed. Reg. 27351, col. 1 (1978). The United States Government first regulated exposure to cotton dust in 1968, when the Secretary of Labor, pursuant to the Walsh-Healey Act, 41 U.S.C. 35 (e), promulgated airborne contaminant threshold limit values, applicable to public contractors, that included the 1,000 g/m<sup>3</sup> limit for total cotton dust. 34 Fed. Reg. 7953 (1969). Following passage of the Act in 1970, the 1,000 g/m<sup>3</sup> standard was adopted as an "established Federal standard" under 6 (a) of the Act, 84 Stat. 1593, 29 U.S.C. 655 (a), a provision designed to guarantee immediate protection of workers for the period between enactment of the statute and promulgation of permanent standards.

That same year, the Director of the National Institute for Occupational Safety and Health (NIOSH), pursuant to the Act, 29 U.S.C. §§ 669(a)(3), 671 (d)(2), submitted to the Secretary of Labor a recommendation for a cotton dust standard with a permissible exposure limit (PEL) that "should be set at the lowest level feasible, but in no case at an environmental concentration as high as 0.2 mg lint-free cotton dust/cu m," or 200 g/m<sup>3</sup>. of lint-free respirable dust. Several months later, OSHA published an Advance Notice of Proposed Rulemaking, 39 Fed.Reg. 44769 (1974), requesting comments from interested parties on the NIOSH recommendation and other related matters. Soon thereafter, the Textile Worker's Union of America, joined by the North Carolina Public Interest Research Group, petitioned the Secretary, urging a more stringent PEL of 100 g/m<sup>3</sup>.



On December 28, 1976, OSHA published a proposal to replace the existing federal standard on cotton dust with a new permanent standard, pursuant to § 6(b)(5) of the Act, 29 U.S.C. § 655(b)(5). 41 Fed.Reg. 56498. The proposed standard contained a PEL of 200 g/m<sup>3</sup> of vertical elutriated lint-free respirable cotton dust for all segments of the cotton industry. *Ibid.* It also suggested an implementation strategy for achieving the PEL that relied on respirators for the short term and engineering controls for the long-term. OSHA invited interested parties to submit written comments within a 90-day period.

\* \* \*

The starting point of our analysis is the language of the statute itself. Section 6(b)(5) of the Act, 29 U.S.C. § 655(b)(5) (emphasis added), provides:

The Secretary, in promulgating standards dealing with toxic materials or harmful physical agents under this subsection, shall set the standard which most adequately assures, **to the extent feasible**, on the basis of the best available evidence, that no employee will suffer material impairment of health or functional capacity even if such employee has regular exposure to the hazard dealt with by such standard for the period of his working life. Although their interpretations differ, all parties agree that the phrase “to the extent feasible” contains the critical language in § 6(b)(5) for purposes of these cases.

The plain meaning of the word “feasible” supports respondents’ interpretation of the statute. According to Webster’s Third New International Dictionary of the English Language 831 (1976), “feasible” means “capable of being done, executed, or effected.” In accord, the Oxford English Dictionary 116 (1933) (“Capable of being done, accomplished or carried out”); Funk & Wagnalls New “Standard” Dictionary of the English Language 903 (1957) (“That may be done, performed or effected”). Thus, § 6(b)(5) directs the Secretary to issue the standard that “most adequately assures...that no employee will suffer material impairment of health,” limited only by the extent to which this is “capable of being done.” In effect then, as the Court of Appeals held, Congress itself defined the basic relationship between costs and benefits, by placing the “benefit” of worker health above all other considerations save those making attainment of this “benefit” unachievable. Any standard based on a balancing of costs and benefits by the Secretary that strikes a different balance than that struck by Congress would be inconsistent with the command set forth in § 6(b)(5). Thus, cost-benefit analysis by OSHA is not required by the statute because feasibility analysis is.

When Congress has intended that an agency engage in cost-benefit analysis, it has clearly indicated such intent on the face of the statute. One early example is the Flood Control Act of 1936, 33 U.S.C. § 701:

[T]he Federal Government should improve or participate in the improvement of navigable waters or their tributaries, including watersheds thereof, for flood control purposes if the **benefits to whomsoever they may accrue are in excess of the estimated costs**, and if the lives and social security of people are otherwise adversely affected. (emphasis added)

A more recent example is the Outer Continental Shelf Lands Act Amendments of 1978, providing that offshore drilling operations shall use the best available and safest technologies which the Secretary determines to be economically *feasible*, wherever failure of equipment would have a significant effect on safety, health, or the environment, except where the Secretary determines that the *incremental benefits are clearly insufficient to justify the incremental costs of using such technologies*.

These and other statutes demonstrate that Congress uses specific language when intending that an agency engage in cost-benefit analysis. Certainly in light of its ordinary meaning, the word “feasible” cannot be construed to articulate such congressional intent. We therefore reject the argument that Congress required cost-benefit analysis in § 6(b)(5).

### CASE QUESTIONS

1. What is byssinosis? Why should byssinosis be anything that the textile companies are responsible for, ethically or legally? If it is well-known that textile workers get cotton dust in their systems and develop brown lung, don't they nevertheless choose to work there and assume the risk of all injuries?
2. By imposing costs on the textile industry, what will be the net effect on US textile manufacturing jobs?
3. How is byssinosis a “negative externality” that is not paid for by either the manufacturer or the consumer of textile products? How should the market, to be fair and efficient, adjust for these negative externalities *other* than by setting a reasonable standard that shares the burden between manufacturers and their employees? Should *all* the burden be on the manufacturer?

## 5.7 Summary and Exercises

### Summary

Administrative rules and regulations constitute the largest body of laws that directly affect business. These regulations are issued by dozens of federal and state agencies that regulate virtually every aspect of modern business life, including the natural environment, corporate finance, transportation, telecommunications, energy, labor relations, and trade practices. The administrative agencies derive their power to promulgate regulations from statutes passed by Congress or state legislatures.

The agencies have a variety of powers. They can license companies to carry on certain activities or prohibit them from doing so, lay down codes of conduct, set rates that companies may charge for their services, and supervise various aspects of business.

## EXERCISES

1. The Equal Employment Opportunity Commission seeks data about the racial composition of Terrific Textiles' labor force. Terrific refuses on the grounds that inadvertent disclosure of the numbers might cause certain "elements" to picket its factories. The EEOC takes Terrific to court to get the data. What is the result?
2. In order to police the profession, the state legislature has just passed a law permitting the State Plumbers' Association the power to hold hearings to determine whether a particular plumber has violated the plumbing code of ethics, written by the association. Sam, a plumber, objects to the convening of a hearing when he is accused by Roger, a fellow plumber, of acting unethically by soliciting business from Roger's customers. Sam goes to court, seeking to enjoin the association's disciplinary committee from holding the hearing. What is the result? How would you argue Sam's case? The association's case?
3. Assume that the new president of the United States was elected overwhelmingly by pledging in his campaign to "do away with bureaucrats who interfere in your lives." The day he takes the oath of office he determines to carry out his pledge. Discuss which of the following courses he may lawfully follow: (a) Fire all incumbent commissioners of federal agencies in order to install new appointees. (b) Demand that all pending regulations being considered by federal agencies be submitted to the White House for review and redrafting, if necessary. (c) Interview potential nominees for agency positions to determine whether their regulatory philosophy is consistent with his.
4. Dewey owned a mine in Wisconsin. He refused to allow Department of Labor agents into the mine to conduct warrantless searches to determine whether previously found safety violations had been corrected. The Federal Mine Safety and Health Amendments Act of 1977 authorizes four warrantless inspections per year. Is the provision for warrantless inspections by this agency constitutional? *Donovan v. Dewey*, 452 US 594 (1981).
5. In determining the licensing requirements for nuclear reactors, the Nuclear Regulatory Commission (NRC) adopted a zero-release assumption: that the permanent storage of certain nuclear waste would have no significant environmental impact and that potential storage leakages should not be a factor discussed in the appropriate environmental impact statement (EIS) required before permitting construction of a nuclear power plant. This assumption is based on the NRC's belief that technology would be developed to isolate the wastes from the environment, and it was clear from the record that the NRC had "digested a massive material and disclosed all substantial risks" and

had considered that the zero-release assumption was uncertain. There was a remote possibility of contamination by water leakage into the storage facility. An environmental NGO sued, asserting that the NRC had violated the regulations governing the EIS by arbitrarily and capriciously ignoring the potential contamination. The court of appeals agreed, and the power plant appealed. Had the NRC acted arbitrarily and capriciously? *Baltimore Gas and Electric Co. v. Natural Resources Defense Council Inc.*, 462 US 87 (1983).

## SELF-TEST QUESTIONS

1. Most federal administrative agencies are created by
  - a. an executive order by the president
  - b. a Supreme Court decision
  - c. the passage of enabling legislation by Congress, signed by the president
  - d. a and c
  
2. The Federal Trade Commission, like most administrative agencies of the federal government, is part of
  - a. the executive branch of government
  - b. the legislative branch of government
  - c. the judicial branch of government
  - d. the administrative branch of government
  
3. In the Clean Water Act, Congress sets broad guidelines, but it is the Environmental Protection Agency that proposes rules to regulate industrial discharges. Where do proposed rules originally appear?
  - a. in the Congressional record
  - b. in the *Federal Register*
  - c. in the *Code of Federal Regulations*
  - d. in the United States code service
  
4. The legal basis for all administrative law, including regulations of the Federal Trade Commission, is found in
  - a. the Administrative Procedure Act
  - b. the US Constitution
  - c. the commerce clause
  - d. none of the above
  
5. The Federal Trade Commission, like other administrative agencies, has the power to
  - a. issue proposed rules

- b. undertake investigations of firms that may have violated FTC regulations
- c. prosecute firms that have violated FTC regulations
- d. none of the above
- e. all of the above

#### SELF-TEST ANSWERS

1. c
2. a
3. b
4. b
5. e

## Chapter 6

### Criminal Law

#### LEARNING OBJECTIVES

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

1. Explain how criminal law differs from civil law.
2. Categorize the various types of crimes and define the most serious felonies.
3. Discuss and question the criminal “intent” of a corporation.
4. Explain basic criminal procedure and the rights of criminal defendants.

At times, unethical behavior by businesspeople can be extreme enough that society will respond by criminalizing certain kinds of activities. Ponzi schemes, arson, various kinds of fraud, embezzlement, racketeering, foreign corrupt practices, tax evasion, and insider trading are just a few. A corporation can face large fines, and corporate managers can face both fines and jail sentences for violating criminal laws. This chapter aims to explain how criminal law differs from civil law, to discuss various types of crimes, and to relate the basic principles of criminal procedure.



## 6.1 The Nature of Criminal Law

Criminal law is the most ancient branch of the law. Many wise observers have tried to define and explain it, but the explanations often include many complex and subtle distinctions. A traditional criminal law course would include a lot of discussions on criminal intent, the nature of criminal versus civil responsibility, and the constitutional rights accorded the accused. But in this chapter, we will consider only the most basic aspects of intent, responsibility, and constitutional rights.

Unlike civil actions, where plaintiffs seek compensation or other remedies for themselves, crimes involve “the state” (the federal government, a state government, or some subunit of state government). This is because crimes involve some “harm to society” and not just harm to certain individuals. But “harm to society” is not always evident in the act itself. For example, two friends of yours at a party argue, take the argument outside, and blows are struck; one has a bloody nose and immediately goes home. The crimes of assault and battery have been committed, even though no one else knows about the fight and the friends later make up. By contrast, suppose a major corporation publicly announces that it is closing operations in your community and moving operations to Southeast Asia. There is plenty of harm to society as the plant closes down and no new jobs take the place of the company’s jobs. Although the effects on society are greater in the second example, only the first example is a crime.

Crimes are generally defined by legislatures, in statutes; the statutes describe in general terms the nature of the conduct they wish to criminalize. For government punishment to be fair, citizens must have clear notice of what is criminally prohibited. Ex post facto laws—laws created “after the fact” to punish an act that was legal at the time—are expressly prohibited by the US Constitution. Overly vague statutes can also be struck down by courts under a constitutional doctrine known as “void for vagueness.”

What is considered a crime will also vary from society to society and from time to time. For example, while cocaine use was legal in the United States at one time, it is now a controlled substance, and unauthorized use is now a crime. Medical marijuana was not legal fifty years ago when its use began to become widespread, and in some states its use or possession was a felony. Now, some states make it legal to use or possess it under some circumstances. In the United States, you can criticize and make jokes about the president of the United States without committing a crime, but in many countries it is a serious criminal act to criticize a public official.

Attitudes about appropriate punishment for crimes will also vary considerably from nation to nation. Uganda has decreed long prison sentences for homosexuals and death to repeat offenders. In Saudi Arabia, the government has proposed to deliberately paralyze a criminal defendant who criminally assaulted someone and unintentionally caused the victim's paralysis. Limits on punishment are set in the United States through the Constitution's prohibition on "cruel or unusual punishments."

It is often said that ignorance of the law is no excuse. But there are far too many criminal laws for anyone to know them all. Also, because most people do not actually read statutes, the question of "criminal intent" comes up right away: if you don't know that the legislature has made driving without a seat belt fastened a misdemeanor, you cannot have intended to harm society. You might even argue that there is no harm to anyone but yourself!

The usual answer to this is that the phrase "ignorance of the law is no excuse" means that society (through its elected representatives) gets to decide what is harmful to society, not you. Still, you may ask, "Isn't it my choice whether to take the risk of failing to wear a seat belt? Isn't this a victimless crime? Where is the harm to society?" A policymaker or social scientist may answer that your injuries, statistically, are generally going to be far greater if you don't wear one and that your choice may actually impose costs on society. For example, you might not have enough insurance, so that a public hospital will have to take care of your head injuries, injuries that would likely have been avoided by your use of a seat belt.

But, as just noted, it is hard to know the meaning of some criminal laws. Teenagers hanging around the sidewalks on Main Street were sometimes arrested for "loitering." The constitutional void-for-vagueness doctrine has led the courts to overturn statutes that are not clear. For example, "vagrancy" was long held to be a crime, but US courts began some forty years ago to overturn vagrancy and "suspicious person" statutes on the grounds that they are too vague for people to know what they are being asked not to do.

This requirement that criminal statutes not be vague does not mean that the law always defines crimes in ways that can be easily and clearly understood. Many statutes use terminology developed by the common-law courts. For example, a California statute defines murder as "the unlawful killing of a human being, with malice aforethought." If no history backed up these words, they would be unconstitutionally vague. But there is a rich history of judicial decisions that provides meaning for much of the arcane language like "malice aforethought" strewn about in the statute books.

Because a crime is an act that the legislature has defined as socially harmful, the parties involved cannot agree among themselves to forget a particular incident, such as a barroom brawl, if the authorities decide to prosecute. This is one of the critical distinctions between criminal and civil law. An assault is both a crime and a tort. The person who was assaulted may choose to forgive his assailant and not to sue him for damages. But he cannot stop the prosecutor from bringing an indictment against the assailant. (However, because of crowded dockets, a victim that declines to press charges may cause a busy prosecutor to choose to not to bring an indictment.)

A crime consists of an act defined as criminal—an actus reus—and the requisite “criminal intent.” Someone who has a burning desire to kill a rival in business or romance and who may actually intend to murder but does not act on his desire has not committed a crime. He may have a “guilty mind”—the translation of the Latin phrase mens rea—but he is guilty of no crime. A person who is forced to commit a crime at gunpoint is not guilty of a crime, because although there was an act defined as criminal—an actus reus—there was no criminal intent.

#### KEY TAKEAWAY

Crimes are usually defined by statute and constitute an offense against society. In each case, there must be both an act and some mens rea (criminal intent).

#### EXERCISES

1. Other than deterring certain kinds of conduct, what purpose does the criminal law serve?
2. Why is ignorance of the law no excuse? Why shouldn't it be an excuse, when criminal laws can be complicated and sometimes ambiguous?

## 6.2 Types of Crimes

### LEARNING OBJECTIVES

1. Categorize various types of crimes.
2. Name and define the major felonies in criminal law.
3. Explain how white-collar crime differs from other crimes.
4. Define a variety of white-collar crimes.

Most classifications of crime turn on the seriousness of the act. In general, seriousness is defined by the nature or duration of the punishment set out in the statute. A **felony**<sup>1</sup> is a crime punishable (usually) by imprisonment of more than one year or by death. (Crimes punishable by death are sometimes known as capital crimes; they are increasingly rare in the United States.) The major felonies include murder, rape, kidnapping, armed robbery, embezzlement, insider trading, fraud, and racketeering. All other crimes are usually known as **misdemeanors**<sup>2</sup>, petty offenses, or infractions. Another way of viewing crimes is by the type of social harm the statute is intended to prevent or deter, such as offenses against the person, offenses against property, and white-collar crime.

### Offenses against the Person

#### Homicide

**Homicide**<sup>3</sup> is the killing of one person by another. Not every killing is criminal. When the law permits one person to kill another—for example, a soldier killing an enemy on the battlefield during war, or a killing in self-defense—the death is considered the result of **justifiable homicide**<sup>4</sup>. An *excusable homicide*, by contrast, is one in which death results from an accident in which the killer is not at fault.

All other homicides are criminal. The most severely punished form is murder, defined as homicide committed with “malice aforethought.” This is a term with a very long history. Boiled down to its essentials, it means that the defendant had the intent to kill. A killing need not be premeditated for any long period of time; the premeditation might be quite sudden, as in a bar fight that escalates in that moment when one of the fighters reaches for a knife with the intent to kill.

Sometimes a homicide can be murder even if there is no intent to kill; an intent to inflict great bodily harm can be murder if the result is the death of another person. A killing that takes place while a felony (such as armed robbery) is being committed

1. A serious kind of crime, usually involving potential imprisonment of six months or more.
2. Crimes that are less serious than a felony, usually involving punishment of six months in prison or less.
3. The killing of one person by another without legal excuse.
4. When the law permits one person to kill another.

is also murder, whether or not the killer intended any harm. This is the so-called felony murder rule. Examples are the accidental discharge of a gun that kills an innocent bystander or the asphyxiation death of a fireman from smoke resulting from a fire set by an arsonist. The felony murder rule is more significant than it sounds, because it also applies to the accomplices of one who does the killing. Thus the driver of a getaway car stationed a block away from the scene of the robbery can be convicted of murder if a gun accidentally fires during the robbery and someone is killed. Manslaughter is an act of killing that does not amount to murder. Voluntary manslaughter is an intentional killing, but one carried out in the “sudden heat of passion” as the result of some provocation. An example is a fight that gets out of hand. Involuntary manslaughter entails a lesser degree of willfulness; it usually occurs when someone has taken a reckless action that results in death (e.g., a death resulting from a traffic accident in which one driver recklessly runs a red light).

### Assault and Battery

Ordinarily, we would say that a person who has struck another has “assaulted” him. Technically, that is a **battery**<sup>5</sup>—the unlawful application of force to another person. The force need not be violent. Indeed, a man who kisses a woman is guilty of a battery if he does it against her will. The other person may consent to the force. That is one reason why surgeons require patients to sign consent forms, giving the doctor permission to operate. In the absence of such a consent, an operation is a battery. That is also why football players are not constantly being charged with battery. Those who agree to play football agree to submit to the rules of the game, which of course include the right to tackle. But the consent does not apply to all acts of physical force: a hockey player who hits an opponent over the head with his stick can be prosecuted for the crime of battery.

Criminal **assault**<sup>6</sup> is an *attempt* to commit a battery or the deliberate placing of another in fear of receiving an immediate battery. If you throw a rock at a friend, but he manages to dodge it, you have committed an assault. Some states limit an assault to an attempt to commit a battery by one who has a “present ability” to do so. Pointing an unloaded gun and threatening to shoot would not be an assault, nor, of course, could it be a battery. The modern tendency, however, is to define an assault as an attempt to commit a battery by one with an *apparent* ability to do so.

5. The unlawful application of force to another person. The force need not be violent.

6. An attempt to commit a battery, or the deliberate placing of another in fear of receiving an immediate battery.

Assault and battery may be excused. For example, a bar owner (or her agent, the bouncer) may use reasonable force to remove an unruly patron. If the use of force is excessive, the bouncer can be found guilty of assault and battery, and a civil action could arise against the bar owner as well.

## Offenses against Property

### Theft: Larceny, Robbery, Embezzlement, False Pretenses

The concept of theft is familiar enough. Less familiar is the way the law has treated various aspects of the act of stealing. Criminal law distinguishes among many different crimes that are popularly known as theft. Many technical words have entered the language—burglary, larceny, robbery—but are often used inaccurately. Brief definitions of the more common terms are discussed here.

The basic crime of stealing personal property is **larceny**<sup>7</sup>. By its old common-law definition, still in use today, larceny is the wrongful “taking and carrying away of the personal property of another with intent to steal the same.”

The separate elements of this offense have given rise to all kinds of difficult cases. Take the theft of fruit, for example, with regard to the essential element of “personal property.” If a man walking through an orchard plucks a peach from a tree and eats it, he is not guilty of larceny because he has not taken away *personal* property (the peach is part of the land, being connected to the tree). But if he picks up a peach lying on the ground, he is guilty of larceny. Or consider the element of “taking” or “carrying away.” Sneaking into a movie theater without paying is not an act of larceny (though in most states it is a criminal act). Taking electricity by tapping into the power lines of an electric utility was something that baffled judges late in the nineteenth century because it was not clear whether electricity is a “something” that can be taken. Modern statutes have tended to make clear that electricity can be the object of larceny. Or consider the element of an “intent to steal the same.” If you borrow your friend’s BMW without his permission in order to go to the grocery store, intending to return it within a few minutes and then do return it, you have not committed larceny. But if you meet another friend at the store who convinces you to take a long joyride with the car and you return hours later, you may have committed larceny.

7. The wrongful taking and carrying away of the personal property of another with intent to steal the same.

8. Larceny from a person by means of violence or intimidation.

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

A particular form of larceny is **robbery**<sup>8</sup>, which is defined as larceny from a person by means of violence or intimidation.

Larceny involves the taking of property from the possession of another. Suppose that a person legitimately comes to possess the property of another and wrongfully appropriates it—for example, an automobile mechanic entrusted with your car refuses to return it, or a bank teller who is entitled to temporary possession of cash in his drawer takes it home with him. The common law had trouble with such cases because the thief in these cases already had possession; his crime was in assuming ownership. Today, such wrongful conversion, known as **embezzlement**<sup>9</sup>, has been made a statutory offense in all states.

Statutes against larceny and embezzlement did not cover all the gaps in the law. A conceptual problem arises in the case of one who is tricked into giving up his title to property. In larceny and embezzlement, the thief gains possession or ownership without any consent of the owner or custodian of the property. Suppose, however, that an automobile dealer agrees to take his customer's present car as a trade-in. The customer says that he has full title to the car. In fact, the customer is still paying off an installment loan and the finance company has an interest in the old car. If the finance company repossesses the car, the customer—who got a new car at a discount because of his false representation—cannot be said to have taken the new car by larceny or embezzlement. Nevertheless, he tricked the dealer into selling, and the dealer will have lost the value of the repossessed car. Obviously, the customer is guilty of a criminal act; the statutes outlawing it refer to this trickery as the crime of **false pretenses**<sup>10</sup>, defined as obtaining ownership of the property of another by making untrue representations of fact with intent to defraud.

A number of problems have arisen in the judicial interpretation of false-pretense statutes. One concerns whether the taking is permanent or only temporary. The case of *State v. Mills* (Section 6.7 "Cases") shows the subtle questions that can be presented and the dangers inherent in committing "a little fraud."

In the *Mills* case, the claim was that a mortgage instrument dealing with one parcel of land was used instead for another. This is a false representation of fact. Suppose, by contrast, that a person misrepresents his state of mind: "I will pay you back tomorrow," he says, knowing full well that he does not intend to. Can such a misrepresentation amount to false pretenses punishable as a criminal offense? In most jurisdictions it cannot. A false-pretense violation relates to a past event or existing fact, not to a statement of intention. If it were otherwise, anyone failing to pay a debt might find himself facing criminal prosecution, and business would be less prone to take risks.

The problem of proving intent is especially difficult when a person has availed himself of the services of another without paying. A common example is someone leaving a restaurant without paying for the meal. In most states, this is specifically defined in the statutes as *theft of services*.

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

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

### Receiving Stolen Property

One who engages in **receiving stolen property**<sup>11</sup> with knowledge that it is stolen is guilty of a felony or misdemeanor, depending on the value of the property. The receipt need not be personal; if the property is delivered to a place under the control of the receiver, then he is deemed to have received it. "Knowledge" is construed broadly: not merely actual knowledge, but (correct) belief and suspicion

(strong enough not to investigate for fear that the property will turn out to have been stolen) are sufficient for conviction.

### Forgery

**Forgery**<sup>12</sup> is false writing of a document of legal significance (or apparent legal significance!) with intent to defraud. It includes the making up of a false document or the alteration of an existing one. The writing need not be done by hand but can be by any means—typing, printing, and so forth. Documents commonly the subject of forgery are negotiable instruments (checks, money orders, and the like), deeds, receipts, contracts, and bills of lading. The forged instrument must itself be false, not merely contain a falsehood. If you fake your neighbor’s signature on one of his checks made out to cash, you have committed forgery. But if you sign a check of your own that is made out to cash, knowing that there is no money in your checking account, the instrument is not forged, though the act may be criminal if done with the intent to defraud.

The mere making of a forged instrument is unlawful. So is the “uttering” (or presentation) of such an instrument, whether or not the one uttering it actually forged it. The usual example of a false signature is by no means the only way to commit forgery. If done with intent to defraud, the backdating of a document, the modification of a corporate name, or the filling in of lines left blank on a form can all constitute forgery.

### Extortion

Under common law, **extortion**<sup>13</sup> could only be committed by a government official, who corruptly collected an unlawful fee under color of office. A common example is a salaried building inspector who refuses to issue a permit unless the permittee pays him. Under modern statutes, the crime of extortion has been broadened to include the wrongful collection of money or something else of value by anyone by means of a threat (short of a threat of immediate physical violence, for such a threat would make the demand an act of robbery). This kind of extortion is usually called blackmail. The blackmail threat commonly is to expose some fact of the victim’s private life or to make a false accusation about him.

12. False writing of a document of legal significance (or apparent legal significance) with intent to defraud.

13. The wrongful collection of money or something else of value by anyone by means of a threat.

14. The crime of breaking and entering the dwelling place of another with intent to commit a felony therein.

## Offenses against Habitation and Other Offenses

### Burglary

**Burglary**<sup>14</sup> is not a crime against property. It is defined as “the breaking and entering of the dwelling of another in the nighttime with intent to commit a felony.” The intent to steal is not an issue: a man who sneaks into a woman’s home



intent on raping her has committed a burglary, even if he does not carry out the act. The student doing critical thinking will no doubt notice that the definition provides plenty of room for argument. What is “breaking”? (The courts do not require actual destruction; the mere opening of a closed door, even if unlocked, is enough.) What is entry? When does night begin? What kind of intent? Whose dwelling? Can a landlord burglarize the dwelling of his tenant? (Yes.) Can a person burglarize his own home? (No.)

### Arson

Under common law, **arson**<sup>15</sup> was the malicious burning of the dwelling of another. Burning one’s own house for purposes of collecting insurance was not an act of arson under common law. The statutes today make it a felony intentionally to set fire to any building, whether or not it is a dwelling and whether or not the purpose is to collect insurance.

### Bribery

**Bribery**<sup>16</sup> is a corrupt payment (or receipt of such a payment) for official action. The payment can be in cash or in the form of any goods, intangibles, or services that the recipient would find valuable. Under common law, only a public official could be bribed. In most states, bribery charges can result from the bribe of anyone performing a public function.

Bribing a public official in government procurement (contracting) can result in serious criminal charges. Bribing a public official in a foreign country to win a contract can result in charges under the Foreign Corrupt Practices Act.

### Perjury

**Perjury**<sup>17</sup> is the crime of giving a false oath, either orally or in writing, in a judicial or other official proceeding (lies made in proceedings other than courts are sometimes termed “false swearing”). To be perjurious, the oath must have been made corruptly—that is, with knowledge that it was false or without sincere belief that it was true. An innocent mistake is not perjury. A statement, though true, is perjury if the maker of it believes it to be false. Statements such as “I don’t remember” or “to the best of my knowledge” are not sufficient to protect a person who is lying from conviction for perjury. To support a charge of perjury, however, the false statement must be “material,” meaning that the statement is relevant to whatever the court is trying to find out.

15. The intentional setting of a fire to any building, whether commercial or residential, and whether or not for the purpose of collecting insurance proceeds.

16. A secret payment to another to get them to favor the payer of the bribe, or his business organization. A bribe could be offered in a commercial transaction, which usually raises ethical issues, or could be offered to get a public official to act (or ignore a criminal act) in favor of the person or firm paying. Bribery of a state or federal public official is generally a criminal offense, both for the bribe payer and the official accepting the bribe.

17. The crime of giving a false oath, either orally or in writing, in a judicial or other official proceeding.

## White-Collar Crime

**White-collar crime**<sup>18</sup>, as distinguished from “street crime,” refers generally to fraud-related acts carried out in a nonviolent way, usually connected with business. Armed bank robbery is not a white-collar crime, but embezzlement by a teller or bank officer is. Many white-collar crimes are included within the statutory definitions of embezzlement and false pretenses. Most are violations of state law. Depending on how they are carried out, many of these same crimes are also violations of federal law.

Any act of fraud in which the United States postal system is used or which involves interstate phone calls or Internet connections is a violation of federal law. Likewise, many different acts around the buying and selling of securities can run afoul of federal securities laws. Other white-collar crimes include tax fraud; price fixing; violations of food, drug, and environmental laws; corporate bribery of foreign companies; and—the newest form—computer fraud. Some of these are discussed here; others are covered in later chapters.

## Mail and Wire Fraud

Federal law prohibits the use of the mails or any interstate electronic communications medium for the purpose of furthering a “scheme or artifice to defraud.” The statute is broad, and it is relatively easy for prosecutors to prove a violation. The law also bans attempts to defraud, so the prosecutor need not show that the scheme worked or that anyone suffered any losses. “Fraud” is broadly construed: anyone who uses the mails or telephone to defraud anyone else of virtually anything, not just of money, can be convicted under the law. In one case, a state governor was convicted of mail fraud when he took bribes to influence the setting of racing dates. The court’s theory was that he defrauded the citizenry of its right to his “honest and faithful services” as governor. *United States v. Isaacs*, 493 F.2d 1124 (7th Cir. 1974), cert. denied, 417 US 976 (1974).

## Violations of the Food and Drug Act

The federal Food, Drug, and Cosmetic Act prohibits any person or corporation from sending into interstate commerce any adulterated or misbranded food, drug, cosmetics, or related device. For example, in a 2010 case, Allergen had to pay a criminal fine for marketing Botox as a headache or pain reliever, a use that had not been approved by the Food and Drug Administration. Unlike most criminal statutes, willfulness or deliberate misconduct is not an element of the act. As the *United States v. Park* case ([Section 6.7 "Cases"](#)) shows, an executive can be held criminally liable even though he may have had no personal knowledge of the violation.

18. Any number of crimes, usually involving a business context; any illegal act committed by nonviolent means to obtain a personal or business advantage.

## Environmental Crimes

Many federal environmental statutes have criminal provisions. These include the Federal Water Pollution Control Act (commonly called the Clean Water Act); the Rivers and Harbors Act of 1899 (the Refuse Act); the Clean Air Act; the Federal Insecticide, Fungicide, and Rodenticide Act (FIFRA); the Toxic Substances Control Act (TSCA); and the Resource Conservation and Recovery Act (RCRA). Under the Clean Water Act, for example, wrongful discharge of pollutants into navigable waters carries a fine ranging from \$2,500 to \$25,000 per day and imprisonment for up to one year. “Responsible corporate officers” are specifically included as potential defendants in criminal prosecutions under the act. They can include officers who have responsibility over a project where subcontractors and their employees actually caused the discharge. *U.S. v. Hanousek*, 176 F.3d 1116 (9th Cir. 1999).

## Violations of the Foreign Corrupt Practices Act

As a byproduct of Watergate, federal officials at the Securities and Exchange Commission and the Internal Revenue Service uncovered many instances of bribes paid by major corporations to officials of foreign governments to win contracts with those governments. Congress responded in 1977 with the Foreign Corrupt Practices Act, which imposed a stringent requirement that the disposition of assets be accurately and fairly accounted for in a company’s books and records. The act also made illegal the payment of bribes to foreign officials or to anyone who will transmit the money to a foreign official to assist the payor (the one offering and delivering the money) in getting business.

## Violations of the Racketeering Influenced and Corrupt Organizations Act

In 1970 Congress enacted the Racketeering Influenced and Corrupt Organizations Act (RICO), aimed at ending organized crime’s infiltration into legitimate business. The act tells courts to construe its language broadly “to effectuate its remedial purpose,” and many who are not part of organized crime have been successfully prosecuted under the act. It bans a “pattern of racketeering,” defined as the commission of at least two acts within ten years of any of a variety of already-existing crimes, including mail, wire, and securities fraud. The act thus makes many types of fraud subject to severe penalties.

## Computer Crime

19. Any crime (usually theft of some sort, or sabotage) committed with the aid of a computer.

**Computer crime**<sup>19</sup> generally falls into four categories: (1) theft of money, financial instruments, or property; (2) misappropriation of computer time; (3) theft of programs; and (4) illegal acquisition of information. The main federal statutory

framework for many computer crimes is the Computer Fraud and Abuse Act (CFAA; see [Table 6.1 "Summary of Provisions of the Computer Fraud and Abuse Act"](#)). Congress only prohibited computer fraud and abuse where there was a federal interest, as where computers of the government were involved or where the crime was interstate in nature.

Table 6.1 Summary of Provisions of the Computer Fraud and Abuse Act

Obtaining national security information	Sec. (a)(1)	10 years maximum (20 years second offense)
Trespassing in a government computer	Sec. (a)(3)	1 year (5)
Compromising the confidentiality of a computer	Sec. (a)(2)	1 year (10)
Accessing a computer to defraud and obtain value	Sec. (a)4	5 years (10)
Intentional access and reckless damage	(a)(5)(A)(ii)	5 years (20)
Trafficking in passwords	(a)(6)	1 year (10)

**KEY TAKEAWAY**

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

## EXERCISES

1. Which does more serious harm to society: street crimes or white-collar crimes?
2. Why are various crimes so difficult to define precisely?
3. Hungry Harold goes by the home of Juanita Martinez. Juanita has just finished baking a cherry pie and sets it in the open windowsill to cool. Harold smells the pie from the sidewalk. It is twilight; while still light, the sun has officially set. Harold reaches into the window frame and removes the pie. Technically, has Harold committed burglary? What are the issues here based on the definition of burglary?
4. What is fraud? How is it different from dishonesty? Is being dishonest a criminal offense? If so, have you been a criminal already today?

## 6.3 The Nature of a Criminal Act

### LEARNING OBJECTIVES

1. Understand how it is possible to commit a criminal act without actually doing anything that you think might be criminal.
2. Analyze and explain the importance of intention in criminal law and criminal prosecutions.
3. Explain how a corporation can be guilty of a crime, even though it is a corporation's agents that commit the crime.

To be guilty of a crime, you must have acted. Mental desire or intent to do so is insufficient. But what constitutes an act? This question becomes important when someone begins to commit a crime, or does so in association with others, or intends to do one thing but winds up doing something else.

### Attempt

It is not necessary to commit the intended crime to be found guilty of a criminal offense. An *attempt* to commit the crime is punishable as well, though usually not as severely. For example, Brett points a gun at Ashley, intending to shoot her dead. He pulls the trigger but his aim is off, and he misses her heart by four feet. He is guilty of an attempt to murder. Suppose, however, that earlier in the day, when he was preparing to shoot Ashley, Brett had been overheard in his apartment muttering to himself of his intention, and that a neighbor called the police. When they arrived, he was just snapping his gun into his shoulder holster.

At that point, courts in most states would not consider him guilty of an attempt because he had not passed beyond the stage of *preparation*. After having buttoned his jacket he might have reconsidered and put the gun away. Determining when the accused has passed beyond mere preparation and taken an actual step toward *perpetrating* the crime is often difficult and is usually for the jury to decide.

### Impossibility

What if a defendant is accused of attempting a crime that is factually impossible? For example, suppose that men believed they were raping a drunken, unconscious woman, and were later accused of attempted rape, but defended on the grounds of factual impossibility because the woman was actually dead at the time sexual

intercourse took place? Or suppose that a husband intended to poison his wife with strychnine in her coffee, but put sugar in the coffee instead? The “mens rea” or criminal intent was there, but the act itself was not criminal (rape requires a live victim, and murder by poisoning requires the use of poison). States are divided on this, but thirty-seven states have ruled out factual impossibility as a defense to the crime of attempt.

Legal impossibility is different, and is usually acknowledged as a valid defense. If the defendant completes all of his intended acts, but those acts do not fulfill all the required elements of a crime, there could be a successful “impossibility” defense. If Barney (who has poor sight), shoots at a tree stump, thinking it is his neighbor, Ralph, intending to kill him, has he committed an attempt? Many courts would hold that he has not. But the distinction between factual impossibility and legal impossibility is not always clear, and the trend seems to be to punish the intended attempt.

## **Conspiracy**

Under both federal and state laws, it is a separate offense to work with others toward the commission of a crime. When two or more people combine to carry out an unlawful purpose, they are engaged in a conspiracy. The law of conspiracy is quite broad, especially when it is used by prosecutors in connection with white-collar crimes. Many people can be swept up in the net of conspiracy, because it is unnecessary to show that the actions they took were sufficient to constitute either the crime or an attempt. Usually, the prosecution needs to show only (1) an agreement and (2) a single overt act in furtherance of the conspiracy. Thus if three people agree to rob a bank, and if one of them goes to a store to purchase a gun to be used in the holdup, the three can be convicted of conspiracy to commit robbery. Even the purchase of an automobile to be used as the getaway car could support a conspiracy conviction.

The act of any one of the conspirators is imputed to the other members of the conspiracy. It does not matter, for instance, that only one of the bank robbers fired the gun that killed a guard. All can be convicted of murder. That is so even if one of the conspirators was stationed as a lookout several blocks away and even if he specifically told the others that his agreement to cooperate would end “just as soon as there is shooting.”

## **Agency and Corporations**

A person can be guilty of a crime if he acts through another. Again, the usual reason for “imputing” the guilt of the actor to another is that both were engaged in a

conspiracy. But imputation of guilt is not limited to a conspiracy. The agent may be innocent even though he participates. A corporate officer directs a junior employee to take a certain bag and deliver it to the officer's home. The employee reasonably believes that the officer is entitled to the bag. Unbeknownst to the employee, the bag contains money that belongs to the company, and the officer wishes to keep it. This is not a conspiracy. The employee is not guilty of larceny, but the officer is, because the agent's act is imputed to him.

Since intent is a necessary component of crime, an agent's intent cannot be imputed to his principal if the principal did not share the intent. The company president tells her sales manager, "Go make sure our biggest customer renews his contract for next year"—by which she meant, "Don't ignore our biggest customer." Standing before the customer's purchasing agent, the sales manager threatens to tell the purchasing agent's boss that the purchasing agent has been cheating on his expense account, unless he signs a new contract. The sales manager could be convicted of blackmail, but the company president could not.

Can a corporation be guilty of a crime? For many types of crimes, the guilt of individual employees may be imputed to the corporation. Thus the antitrust statutes explicitly state that the corporation may be convicted and fined for violations by employees. This is so even though the shareholders are the ones who ultimately must pay the price—and who may have had nothing to do with the crime nor the power to stop it. The law of corporate criminal responsibility has been changing in recent years. The tendency is to hold the corporation liable under criminal law if the act has been directed by a responsible officer or group within the corporation (the president or board of directors).

#### KEY TAKEAWAY

Although proving the intent to commit a crime (the mens rea) is essential, the intent can be established by inference (circumstantially). Conspirators may not actually commit a crime, for example, but in preparing for a criminal act, they may be guilty of the crime of conspiracy. Certain corporate officers, as well, may not be directly committing criminal acts but may be held criminally responsible for acts of their agents and contractors.



## EXERCISES

1. Give an example of how someone can intend to commit a crime but fail to commit one.
2. Describe a situation where there is a conspiracy to commit a crime without the crime actually taking place.
3. Create a scenario based on current events where a corporation could be found guilty of committing a crime even though the CEO, the board of directors, and the shareholders have not themselves done a criminal act.

## 6.4 Responsibility

### LEARNING OBJECTIVES

1. Explain why criminal law generally requires that the defendant charged with a crime have criminal "intent."
2. Know and explain the possible excuses relating to responsibility that are legally recognized by courts, including lack of capacity.

### In General

The mens rea requirement depends on the nature of the crime and all the circumstances surrounding the act. In general, though, the requirement means that the accused must in some way have intended the criminal consequences of his act. Suppose, for example, that Charlie gives Gabrielle a poison capsule to swallow. That is the act. If Gabrielle dies, is Charlie guilty of murder? The answer depends on what his state of mind was. Obviously, if he gave it to her intending to kill her, the act was murder.

What if he gave it to her knowing that the capsule was poison but believing that it would only make her mildly ill? The act is still murder, because we are all liable for the consequences of any intentional act that may cause harm to others. But suppose that Gabrielle had asked Harry for aspirin, and he handed her two pills that he reasonably believed to be aspirin (they came from the aspirin bottle and looked like aspirin) but that turned out to be poison, the act would not be murder, because he had neither intent nor a state of knowledge from which intent could be inferred.

Not every criminal law requires criminal intent as an ingredient of the crime. Many regulatory codes dealing with the public health and safety impose strict requirements. Failure to adhere to such requirements is a violation, whether or not the violator had mens rea. The *United States v. Park* case, [Section 6.7 "Cases"](#), a decision of the US Supreme Court, shows the different considerations involved in mens rea.

### Excuses That Limit or Overcome Responsibility

#### Mistake of Fact and Mistake of Law

Ordinarily, ignorance of the law is not an excuse. If you believe that it is permissible to turn right on a red light but the city ordinance prohibits it, your belief, even if

reasonable, does not excuse your violation of the law. Under certain circumstances, however, ignorance of law will be excused. If a statute imposes criminal penalties for an action taken without a license, and if the government official responsible for issuing the license formally tells you that you do not need one (though in fact you do), a conviction for violating the statute cannot stand. In rare cases, a lawyer's advice, contrary to the statute, will be held to excuse the client, but usually the client is responsible for his attorney's mistakes. Otherwise, as it is said, the lawyer would be superior to the law.

Ignorance or mistake of *fact* more frequently will serve as an excuse. If you take a coat from a restaurant, believing it to be yours, you cannot be convicted of larceny if it is not. Your honest mistake of fact negates the requisite intent. In general, the rule is that a mistaken belief of fact will excuse criminal responsibility if (1) the belief is honestly held, (2) it is reasonable to hold it, and (3) the act would not have been criminal if the facts were as the accused supposed them to have been.

### Entrapment

One common technique of criminal investigation is the use of an undercover agent or decoy—the policeman who poses as a buyer of drugs from a street dealer or the elaborate “sting” operations in which ostensibly stolen goods are “sold” to underworld “fences.” Sometimes these methods are the only way by which certain kinds of crime can be rooted out and convictions secured.

But a rule against **entrapment**<sup>20</sup> limits the legal ability of the police to play the role of criminals. The police are permitted to use such techniques to detect criminal activity; they are not permitted to do so to instigate crime. The distinction is usually made between a person who intends to commit a crime and one who does not. If the police provide the former with an opportunity to commit a criminal act—the sale of drugs to an undercover agent, for example—there is no defense of entrapment. But if the police knock on the door of one not known to be a drug user and persist in a demand that he purchase drugs from them, finally overcoming his will to resist, a conviction for purchase and possession of drugs can be overturned on the ground of entrapment.

### Other Excuses

A number of other circumstances can limit or excuse criminal liability. These include compulsion (a gun pointed at one's head by a masked man who apparently is unafraid to use the weapon and who demands that you help him rob a store), honest consent of the “victim” (the quarterback who is tackled), adherence to the requirements of legitimate public authority lawfully exercised (a policeman directs

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

a towing company to remove a car parked in a tow-away zone), the proper exercise of domestic authority (a parent may spank a child, within limits), and defense of self, others, property, and habitation. Each of these excuses is a complex subject in itself.

### **Lack of Capacity**

A further defense to criminal prosecution is the lack of mental capacity to commit the crime. Infants and children are considered incapable of committing a crime; under common law any child under the age of seven could not be prosecuted for any act. That age of incapacity varies from state to state and is now usually defined by statutes. Likewise, insanity or mental disease or defect can be a complete defense. Intoxication can be a defense to certain crimes, but the mere fact of drunkenness is not ordinarily sufficient.

#### **KEY TAKEAWAY**

In the United States, some crimes can be committed by not following strict regulatory requirements for health, safety, or the environment. The law does provide excuses from criminal liability for mistakes of fact, entrapment, and lack of capacity.

#### **EXERCISES**

1. Describe several situations in which compulsion, consent, or other excuses take away criminal liability.
2. Your employee is drunk on the job and commits the crime of assault and battery on a customer. He claims lack of capacity as an excuse. Should the courts accept this excuse? Why or why not?

## 6.5 Procedure

### LEARNING OBJECTIVES

1. Describe the basic steps in pretrial criminal procedure that follow a government's determination to arrest someone for an alleged criminal act.
2. Describe the basic elements of trial and posttrial criminal procedure.

The procedure for criminal prosecutions is complex. Procedures will vary from state to state. A criminal case begins with an arrest if the defendant is caught in the act or fleeing from the scene; if the defendant is not caught, a warrant for the defendant's arrest will issue. The warrant is issued by a judge or a magistrate upon receiving a complaint detailing the charge of a specific crime against the accused. It is not enough for a police officer to go before a judge and say, "I'd like you to arrest Bonnie because I think she's just murdered Clyde." She must supply enough information to satisfy the magistrate that there is probable cause (reasonable grounds) to believe that the accused committed the crime. The warrant will be issued to any officer or agency that has power to arrest the accused with warrant in hand.

The accused will be brought before the magistrate for a preliminary hearing. The purpose of the hearing is to determine whether there is sufficient reason to hold the accused for trial. If so, the accused can be sent to jail or be permitted to make bail. Bail is a sum of money paid to the court to secure the defendant's attendance at trial. If he fails to appear, he forfeits the money. Constitutionally, bail can be withheld only if there is reason to believe that the accused will flee the jurisdiction.

Once the arrest is made, the case is in the hands of the prosecutor. In the fifty states, prosecution is a function of the district attorney's office. These offices are usually organized on a county-by-county basis. In the federal system, criminal prosecution is handled by the office of the US attorney, one of whom is appointed for every federal district.

Following the preliminary hearing, the prosecutor must either file an **information**<sup>21</sup> (a document stating the crime of which the person being held is accused) or ask the **grand jury**<sup>22</sup> for an **indictment**<sup>23</sup>. The grand jury consists of twenty-three people who sit to determine whether there is sufficient evidence to warrant a prosecution. It does not sit to determine guilt or innocence. The

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

indictment is the grand jury's formal declaration of charges on which the accused will be tried. If indicted, the accused formally becomes a defendant.

The defendant will then be arraigned, that is, brought before a judge to answer the accusation in the indictment. The defendant may plead guilty or not guilty. If he pleads not guilty, the case will be tried before a jury (sometimes referred to as a petit jury). The jury cannot convict unless it finds the defendant guilty **beyond a reasonable doubt**<sup>24</sup>.

The defendant might have pleaded guilty to the offense or to a lesser charge (often referred to as a "lesser included offense"—simple larceny, for example, is a lesser included offense of robbery because the defendant may not have used violence but nevertheless stole from the victim). Such a plea is usually arranged through **plea bargaining**<sup>25</sup> with the prosecution. In return for the plea, the prosecutor promises to recommend to the judge that the sentence be limited. The judge most often, but not always, goes along with the prosecutor's recommendation.

The defendant is also permitted to file a plea of nolo contendere (no contest) in prosecutions for certain crimes. In so doing, he neither affirms nor denies his guilt. He may be sentenced as though he had pleaded guilty, although usually a nolo plea is the result of a plea bargain. Why plead nolo? In some offenses, such as violations of the antitrust laws, the statutes provide that private plaintiffs may use a conviction or a guilty plea as proof that the defendant violated the law. This enables a plaintiff to prove liability without putting on witnesses or evidence and reduces the civil trial to a hearing about the damages to plaintiff. The nolo plea permits the defendant to avoid this, so that any plaintiff will have to not only prove damages but also establish civil liability.

Following a guilty plea or a verdict of guilt, the judge will impose a sentence after presentencing reports are written by various court officials (often, probation officers). Permissible sentences are spelled out in statutes, though these frequently give the judge a range within which to work (e.g., twenty years to life). The judge may sentence the defendant to imprisonment, a fine, or both, or may decide to suspend sentence (i.e., the defendant will not have to serve the sentence as long as he stays out of trouble).

Sentencing usually comes before appeal. As in civil cases, the defendant, now convicted, has the right to take at least one appeal to higher courts, where issues of procedure and constitutional rights may be argued.

24. The prosecutor must prove how each element of the offense charged is "beyond a reasonable doubt."

25. A defendant's plea of guilty, given in exchange for a recommendation from the prosecutor to the judge for a limited or lesser sentence for the defendant.

### KEY TAKEAWAY

Criminal procedure in US courts is designed to provide a fair process to both criminal defendants and to society. The grand jury system, prosecutorial discretion, plea bargains, and appeals for lack of a fair trial are all part of US criminal procedure.

### EXERCISES

1. Harold is charged with the crime of assault with a deadly weapon with intent to kill or inflict serious bodily injury. It is a more serious crime than simple assault. Harold's attorney wants the prosecutor to give Harold a break, but Harold is guilty of at least simple assault and may also have had the intent to kill. What is Harold's attorney likely to do?
2. Kumar was driving his car, smoking marijuana, and had an accident with another vehicle. The other driver was slightly injured. When the officer arrived, she detected a strong odor of marijuana in Kumar's car and a small amount of marijuana in the glove compartment. The other driver expects to bring a civil action against Kumar for her injuries after Kumar's criminal case. What should Kumar plead in the criminal case—careless driving or driving under the influence?

## 6.6 Constitutional Rights of the Accused

### LEARNING OBJECTIVES

1. Describe the most significant constitutional rights of defendants in US courts, and name the source of these rights.
2. Explain the Exclusionary rule and the reason for its existence.

### Search and Seizure

The rights of those accused of a crime are spelled out in four of the ten constitutional amendments that make up the Bill of Rights (Amendments Four, Five, Six, and Eight). For the most part, these amendments have been held to apply to both the federal and the state governments. The Fourth Amendment says in part that “the right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated.” Although there are numerous and tricky exceptions to the general rule, ordinarily the police may not break into a person’s house or confiscate his papers or arrest him unless they have a warrant to do so. This means, for instance, that a policeman cannot simply stop you on a street corner and ask to see what is in your pockets (a power the police enjoy in many other countries), nor can your home be raided without probable cause to believe that you have committed a crime. What if the police do search or seize unreasonably?

The courts have devised a remedy for the use at trial of the fruits of an unlawful search or seizure. Evidence that is unconstitutionally seized is excluded from the trial. This is the so-called exclusionary rule, first made applicable in federal cases in 1914 and brought home to the states in 1961. The **exclusionary rule**<sup>26</sup> is highly controversial, and there are numerous exceptions to it. But it remains generally true that the prosecutor may not use evidence willfully taken by the police in violation of constitutional rights generally, and most often in the violation of Fourth Amendment rights. (The fruits of a coerced confession are also excluded.)

### Double Jeopardy

The Fifth Amendment prohibits the government from prosecuting a person twice for the same offense. The amendment says that no person shall be “subject for the same offence to be twice put in jeopardy of life or limb.” If a defendant is acquitted,

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



the government may not appeal. If a defendant is convicted and his conviction is upheld on appeal, he may not thereafter be re-prosecuted for the same crime.

### **Self-Incrimination**

The Fifth Amendment is also the source of a person's right against self-incrimination (no person "shall be compelled in any criminal case to be a witness against himself"). The debate over the limits of this right has given rise to an immense literature. In broadest outline, the right against self-incrimination means that the prosecutor may not call a defendant to the witness stand during trial and may not comment to the jury on the defendant's failure to take the stand. Moreover, a defendant's confession must be excluded from evidence if it was not voluntarily made (e.g., if the police beat the person into giving a confession). In *Miranda v. Arizona*, the Supreme Court ruled that no confession is admissible if the police have not first advised a suspect of his constitutional rights, including the right to have a lawyer present to advise him during the questioning. *Miranda v. Arizona*, 384 US 436 (1966). These so-called Miranda warnings have prompted scores of follow-up cases that have made this branch of jurisprudence especially complex.

### **Speedy Trial**

The Sixth Amendment tells the government that it must try defendants speedily. How long a delay is too long depends on the circumstances in each case. In 1975, Congress enacted the Speedy Trial Act to give priority to criminal cases in federal courts. It requires all criminal prosecutions to go to trial within seventy-five days (though the law lists many permissible reasons for delay).

### **Cross-Examination**

The Sixth Amendment also says that the defendant shall have the right to confront witnesses against him. No testimony is permitted to be shown to the jury unless the person making it is present and subject to cross-examination by the defendant's counsel.

### **Assistance of Counsel**

The Sixth Amendment guarantees criminal defendants the right to have the assistance of defense counsel. During the eighteenth century and before, the British courts frequently refused to permit defendants to have lawyers in the courtroom during trial. The right to counsel is much broader in this country, as the result of Supreme Court decisions that require the state to pay for a lawyer for indigent defendants in most criminal cases.

## Cruel and Unusual Punishment

Punishment under the common law was frequently horrifying. Death was a common punishment for relatively minor crimes. In many places throughout the world, punishments still persist that seem cruel and unusual, such as the practice of stoning someone to death. The guillotine, famously in use during and after the French Revolution, is no longer used, nor are defendants put in stocks for public display and humiliation. In pre-Revolutionary America, an unlucky defendant who found himself convicted could face brutal torture before death.

The Eighth Amendment banned these actions with the words that “cruel and unusual punishments [shall not be] inflicted.” Virtually all such punishments either never were enacted or have been eliminated from the statute books in the United States. Nevertheless, the Eighth Amendment has become a source of controversy, first with the Supreme Court’s ruling in 1976 that the death penalty, as haphazardly applied in the various states, amounted to cruel and unusual punishment. Later Supreme Court opinions have made it easier for states to administer the death penalty. As of 2010, there were 3,300 defendants on death row in the United States. Of course, no corporation is on death row, and no corporation’s charter has ever been revoked by a US state, even though some corporations have repeatedly been indicted and convicted of criminal offenses.

## Presumption of Innocence

The most important constitutional right in the US criminal justice system is the presumption of innocence. The Supreme Court has repeatedly cautioned lower courts in the United States that juries must be properly instructed that the defendant is innocent until proven guilty. This is the origin of the “beyond all reasonable doubt” standard of proof and is an instruction given to juries in each criminal case. The Fifth Amendment notes the right of “due process” in federal proceedings, and the Fourteenth Amendment requires that each state provide “due process” to defendants.

### KEY TAKEAWAY

The US Constitution provides several important protections for criminal defendants, including a prohibition on the use of evidence that has been obtained by unconstitutional means. This would include evidence seized in violation of the Fourth Amendment and confessions obtained in violation of the Fifth Amendment.

## EXERCISES

1. Do you think it is useful to have a presumption of innocence in criminal cases? What if there were not a presumption of innocence in criminal cases?
2. Do you think public humiliation, public execution, and unusual punishments would reduce the amount of crime? Why do you think so?
3. “Due process” is another phrase for “fairness.” Why should the public show fairness toward criminal defendants?

## 6.7 Cases

### False Pretenses

State v. Mills

96 Ariz. 377, 396 P.2d 5 (Ariz. 1964)

LOCKWOOD, VICE CHIEF JUSTICE

Defendants appeal from a conviction on two counts of obtaining money by false pretenses in violation of AR.S. §§ 13-661.A3. and 13-663.A1. The material facts, viewed "...in the light most favorable to sustaining the conviction," are as follows: Defendant William Mills was a builder and owned approximately 150 homes in Tucson in December, 1960. Mills conducted his business in his home. In 1960 defendant Winifred Mills, his wife, participated in the business generally by answering the telephone, typing, and receiving clients who came to the office.

In December 1960, Mills showed the complainant, Nathan Pivowar, a house at 1155 Knox Drive and another at 1210 Easy Street, and asked Pivowar if he would loan money on the Knox Drive house. Pivowar did not indicate at that time whether he would agree to such a transaction. Later in the same month Nathan Pivowar told the defendants that he and his brother, Joe Pivowar, would loan \$5,000 and \$4,000 on the two houses. Three or four days later Mrs. Mills, at Pivowar's request, showed him these homes again.

Mills had prepared two typed mortgages for Pivowar. Pivowar objected to the wording, so in Mills' office Mrs. Mills retyped the mortgages under Pivowar's dictation. After the mortgages had been recorded on December 31, 1960, Pivowar gave Mills a bank check for \$5,791.87, some cash, and a second mortgage formerly obtained from Mills in the approximate sum of \$3,000. In exchange Mills gave Pivowar two personal notes in the sums of \$5,250.00 and \$4,200.00 and the two mortgages as security for the loan.

Although the due date for Mills' personal notes passed without payment being made, the complainant did not present the notes for payment, did not demand that they be paid, and did not sue upon them. In 1962 the complainant learned that the mortgages which he had taken as security in the transaction were not first mortgages on the Knox Drive and Easy Street properties. These mortgages actually

covered two vacant lots on which there were outstanding senior mortgages. On learning this, Pivowar signed a complaint charging the defendants with the crime of theft by false pretenses.

On appeal defendants contend that the trial court erred in denying their motion to dismiss the information. They urge that a permanent taking of property must be proved in order to establish the crime of theft. Since the complainant had the right to sue on the defendants' notes, the defendants assert that complainant cannot be said to have been deprived of his property permanently. Defendants misconceive the elements of the crime of theft by false pretenses. Stated in a different form, their argument is that although the complainant has parted with his cash, a bank check, and a second mortgage, the defendants intend to repay the loan.

Defendants admit that the proposition of law which they assert is a novel one in this jurisdiction. Respectable authority in other states persuades us that their contention is without merit. A creditor has a right to determine for himself whether he wishes to be a secured or an unsecured creditor. In the former case, he has a right to know about the security. If he extends credit in reliance upon security which is falsely represented to be adequate, he has been defrauded even if the debtor intends to repay the debt. His position is now that of an unsecured creditor. At the very least, an unreasonable risk of loss has been forced upon him by reason of the deceit. This risk which he did not intend to assume has been imposed upon him by the intentional act of the debtor, and such action constitutes an intent to defraud.

\* \* \*

The cases cited by defendants in support of their contention are distinguishable from the instant case in that they involved theft by larceny. Since the crime of larceny is designed to protect a person's possessory interest in property whereas the crime of false pretenses protects one's title interest, the requirement of a permanent deprivation is appropriate to the former. Accordingly, we hold that an intent to repay a loan obtained on the basis of a false representation of the security for the loan is no defense.

\* \* \*

Affirmed in part, reversed in part, and remanded for resentencing.

## CASE QUESTIONS

1. False pretenses is a crime of obtaining ownership of property of another by making untrue representations of fact with intent to defraud. What were the untrue representations of fact made by Mills?
2. Concisely state the defendant's argument as to why Pivowar has not been deprived of any property.
3. If Pivowar had presented the notes and Mills had paid, would a crime have been committed?

### White-Collar Crimes

United States v. Park

421 U.S. 658 (1975)

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

We granted certiorari to consider whether the jury instructions in the prosecution of a corporate officer under § 301 (k) of the Federal Food, Drug, and Cosmetic Act, 52 Stat. 1042, as amended, 21 U.S.C. § 331 (k), were appropriate under *United States v. Dotterweich*, 320 U.S. 277 (1943). Acme Markets, Inc., is a national retail food chain with approximately 36,000 employees, 874 retail outlets, 12 general warehouses, and four special warehouses. Its headquarters, including the office of the president, respondent Park, who is chief executive officer of the corporation, are located in Philadelphia, Pennsylvania. In a five-count information filed in the United States District Court for the District of Maryland, the Government charged Acme and respondent with violations of the Federal Food, Drug, and Cosmetic Act. Each count of the information alleged that the defendants had received food that had been shipped in interstate commerce and that, while the food was being held for sale in Acme's Baltimore warehouse following shipment in interstate commerce, they caused it to be held in a building accessible to rodents and to be exposed to contamination by rodents. These acts were alleged to have resulted in the food's being adulterated within the meaning of 21 U.S.C. §§ 342 (a)(3) and (4), in violation of 21 U.S.C. § 331 (k).

Acme pleaded guilty to each count of the information. Respondent pleaded not guilty. The evidence at trial demonstrated that in April 1970 the Food and Drug Administration (FDA) advised respondent by letter of insanitary conditions in Acme's Philadelphia warehouse. In 1971 the FDA found that similar conditions

existed in the firm's Baltimore warehouse. An FDA consumer safety officer testified concerning evidence of rodent infestation and other insanitary conditions discovered during a 12-day inspection of the Baltimore warehouse in November and December 1971. He also related that a second inspection of the warehouse had been conducted in March 1972. On that occasion the inspectors found that there had been improvement in the sanitary conditions, but that "there was still evidence of rodent activity in the building and in the warehouses and we found some rodent-contaminated lots of food items."

The Government also presented testimony by the Chief of Compliance of the FDA's Baltimore office, who informed respondent by letter of the conditions at the Baltimore warehouse after the first inspection. There was testimony by Acme's Baltimore division vice president, who had responded to the letter on behalf of Acme and respondent and who described the steps taken to remedy the insanitary conditions discovered by both inspections. The Government's final witness, Acme's vice president for legal affairs and assistant secretary, identified respondent as the president and chief executive officer of the company and read a bylaw prescribing the duties of the chief executive officer. He testified that respondent functioned by delegating "normal operating duties" including sanitation, but that he retained "certain things, which are the big, broad, principles of the operation of the company and had "the responsibility of seeing that they all work together."

At the close of the Government's case in chief, respondent moved for a judgment of acquittal on the ground that "the evidence in chief has shown that Mr. Park is not personally concerned in this Food and Drug violation." The trial judge denied the motion, stating that *United States v. Dotterweich*, 320 U.S. 277 (1943), was controlling.

Respondent was the only defense witness. He testified that, although all of Acme's employees were in a sense under his general direction, the company had an "organizational structure for responsibilities for certain functions" according to which different phases of its operation were "assigned to individuals who, in turn, have staff and departments under them." He identified those individuals responsible for sanitation, and related that upon receipt of the January 1972 FDA letter, he had conferred with the vice president for legal affairs, who informed him that the Baltimore division vice president "was investigating the situation immediately and would be taking corrective action and would be preparing a summary of the corrective action to reply to the letter." Respondent stated that he did not "believe there was anything [he] could have done more constructively than what [he] found was being done."

On cross-examination, respondent conceded that providing sanitary conditions for food offered for sale to the public was something that he was "responsible for in the

entire operation of the company” and he stated that it was one of many phases of the company that he assigned to “dependable subordinates.” Respondent was asked about and, over the objections of his counsel, admitted receiving, the April 1970 letter addressed to him from the FDA regarding insanitary conditions at Acme’s Philadelphia warehouse. He acknowledged that, with the exception of the division vice president, the same individuals had responsibility for sanitation in both Baltimore and Philadelphia. Finally, in response to questions concerning the Philadelphia and Baltimore incidents, respondent admitted that the Baltimore problem indicated the system for handling sanitation “wasn’t working perfectly” and that as Acme’s chief executive officer he was “responsible for any result which occurs in our company.”

At the close of the evidence, respondent’s renewed motion for a judgment of acquittal was denied. The relevant portion of the trial judge’s instructions to the jury challenged by respondent is set out in the margin. Respondent’s counsel objected to the instructions on the ground that they failed fairly to reflect our decision in *United States v. Dotterweich supra*, and to define “responsible relationship.” The trial judge overruled the objection. The jury found respondent guilty on all counts of the information, and he was subsequently sentenced to pay a fine of \$50 on each count. The Court of Appeals reversed the conviction and remanded for a new trial.

\* \* \*

The question presented by the Government’s petition for certiorari in *United States v. Dotterweich*, and the focus of this Court’s opinion, was whether the manager of a corporation, as well as the corporation itself, may be prosecuted under the Federal Food, Drug, and Cosmetic Act of 1938 for the introduction of misbranded and adulterated articles into interstate commerce. In *Dotterweich*, a jury had disagreed as to the corporation, a jobber purchasing drugs from manufacturers and shipping them in interstate commerce under its own label, but had convicted Dotterweich, the corporation’s president and general manager. The Court of Appeals reversed the conviction on the ground that only the drug dealer, whether corporation or individual, was subject to the criminal provisions of the Act, and that where the dealer was a corporation, an individual connected therewith might be held personally only if he was operating the corporation as his ‘alter ego.’

In reversing the judgment of the Court of Appeals and reinstating Dotterweich’s conviction, this Court looked to the purposes of the Act and noted that they “touch phases of the lives and health of people which, in the circumstances of modern industrialism, are largely beyond self-protection. It observed that the Act is of “a now familiar type” which “dispenses with the conventional requirement for



criminal conduct-awareness of some wrongdoing: In the interest of the larger good it puts the burden of acting at hazard upon a person otherwise innocent but standing in responsible relation to a public danger. Central to the Court's conclusion that individuals other than proprietors are subject to the criminal provisions of the Act was the reality that the only way in which a corporation can act is through the individuals, who act on its behalf.

\* \* \*

The Court recognized that, because the Act dispenses with the need to prove "consciousness of wrongdoing," it may result in hardship even as applied to those who share "responsibility in the business process resulting in" a violation....The rule that corporate employees who have "a responsible share in the furtherance of the transaction which the statute outlaws" are subject to the criminal provisions of the Act was not formulated in a vacuum. Cf. *Morissette v. United States*, 342 U.S. 246, 258 (1952). Cases under the Federal Food and Drugs Act of 1906 reflected the view both that knowledge or intent were not required to be proved in prosecutions under its criminal provisions, and that responsible corporate agents could be subjected to the liability thereby imposed.

\* \* \*

The rationale of the interpretation given the Act in *Dotterweich*...has been confirmed in our subsequent cases. Thus, the Court has reaffirmed the proposition that the public interest in the purity of its food is so great as to warrant the imposition of the highest standard of care on distributors.

Thus *Dotterweich* and the cases which have followed reveal that in providing sanctions which reach and touch the individuals who execute the corporate mission—and this is by no means necessarily confined to a single corporate agent or employee—the Act imposes not only a positive duty to seek out and remedy violations when they occur but also, and primarily, a duty to implement measures that will insure that violations will not occur. The requirements of foresight and vigilance imposed on responsible corporate agents are beyond question demanding, and perhaps onerous, but they are no more stringent than the public has a right to expect of those who voluntarily assume positions of authority in business enterprises whose services and products affect the health and well-being of the public that supports them.

\* \* \*

Reading the entire charge satisfies us that the jury's attention was adequately focused on the issue of respondent's authority with respect to the conditions that formed the basis of the alleged violations. Viewed as a whole, the charge did not permit the jury to find guilt solely on the basis of respondent's position in the corporation; rather, it fairly advised the jury that to find guilt it must find respondent "had a responsible relation to the situation," and "by virtue of his position...had...authority and responsibility" to deal with the situation.

The situation referred to could only be "food...held in unsanitary conditions in a warehouse with the result that it consisted, in part, of filth or...may have been contaminated with filth."

Our conclusion that the Court of Appeals erred in its reading of the jury charge suggests as well our disagreement with that court concerning the admissibility of evidence demonstrating that respondent was advised by the FDA in 1970 of insanitary conditions in Acme's Philadelphia warehouse. We are satisfied that the Act imposes the highest standard of care and permits conviction of responsible corporate officials who, in light of this standard of care, have the power to prevent or correct violations of its provisions.

\* \* \*

Reversed.

### CASE QUESTIONS

1. Did Park have criminal intent to put adulterated food into commerce? If not, how can Park's conduct be criminalized?
2. To get a conviction, what does the prosecutor have to show, other than that Park was the CEO of Acme and therefore responsible for what his company did or didn't do?

## 6.8 Summary and Exercises

### Summary

Criminal law is that branch of law governing offenses against society. Most criminal law requires a specific intent to commit the prohibited act (although a very few economic acts, made criminal by modern legislation, dispense with the requirement of intent). In this way, criminal law differs from much of civil law—for example, from the tort of negligence, in which carelessness, rather than intent, can result in liability.

Major crimes are known as felonies. Minor crimes are known as misdemeanors. Most people have a general notion about familiar crimes, such as murder and theft. But conventional knowledge does not suffice for understanding technical distinctions among related crimes, such as larceny, robbery, and false pretenses. These distinctions can be important because an individual can be found guilty not merely for committing one of the acts defined in the criminal law but also for attempting or conspiring to commit such an act. It is usually easier to convict someone of attempt or conspiracy than to convict for the main crime, and a person involved in a conspiracy to commit a felony may find that very little is required to put him into serious trouble.

Of major concern to the business executive is white-collar crime, which encompasses a host of offenses, including bribery, embezzlement, fraud, restraints of trade, and computer crime. Anyone accused of crime should know that they always have the right to consult with a lawyer and should always do so.

## EXERCISES

1. Bill is the chief executive of a small computer manufacturing company that desperately needs funds to continue operating. One day a stranger comes to Bill to induce him to take part in a cocaine smuggling deal that would net Bill millions of dollars. Unbeknownst to Bill, the stranger is an undercover policeman. Bill tells the stranger to go away. The stranger persists, and after five months of arguing and cajoling, the stranger wears down Bill's will to resist. Bill agrees to take delivery of the cocaine and hands over a down payment of \$10,000 to the undercover agent, who promptly arrests him for conspiracy to violate the narcotics laws. What defenses does Bill have?
2. You are the manager of a bookstore. A customer becomes irritated at having to stand in line and begins to shout at the salesclerk for refusing to wait on him. You come out of your office and ask the customer to calm down. He shouts at you. You tell him to leave. He refuses. So you and the salesclerk pick him up and shove him bodily out the door. He calls the police to have you arrested for assault. Should the police arrest you? Assuming that they do, how would you defend yourself in court?
3. Marilyn is arrested for arson against a nuclear utility, a crime under both state and federal law. She is convicted in state court and sentenced to five years in jail. Then the federal government decides to prosecute her for the same offense. Does she have a double-jeopardy defense against the federal prosecution?
4. Tectonics, a US corporation, is bidding on a project in Nigeria, and its employee wins the bid by secretly giving \$100,000 to the Nigerian public official that has the most say about which company will be awarded the contract. The contract is worth \$80 million, and Tectonics expects to make at least \$50 million on the project. Has a crime under US law been committed?
5. Suppose that the CEO of Tectonics, Ted Nelson, is not actually involved in bribery of the Nigerian public official Adetutu Adeleke. Instead, suppose that the CFO, Jamie Skillset, is very accomplished at insulating both top management and the board of directors from some of the "operational realities" within the company. Skillset knows that Whoopi Goldmine, a Nigerian employee of Tectonics, has made the deal with Adeleke and secured the contract for Tectonics. Is it possible that Nelson, as well as Skillset, can be found guilty of a crime?
6. You have graduated from college and, after working hard for ten years, have scraped enough money together to make a down payment on a forty-acre farm within driving distance to the small city where you work in Colorado. In town at lunch one day, you run into an old friend from high school, Hayley Mills, who tells you that she is saving her money to

start a high-end consignment shop in town. You allow her to have a room in your house for a few months until she has enough money to go into business. Over the following weeks, however, you realize that old acquaintances from high school are stopping by almost daily for short visits. When you bring this up to Hayley, she admits that many old friends are now relying on her for marijuana. She is not a licensed caregiver in Colorado and is clearly violating the law. Out of loyalty, you tell her that she has three weeks to move out, but you do not prevent her from continuing sales while she is there. What crime have you committed?

7. The Center Art Galleries—Hawaii sells artwork, and much of it involves art by the famous surrealist painter Salvador Dali. The federal government suspected the center of selling forged Dali artwork and obtained search warrants for six locations controlled by the center. The warrants told the executing officer to seize any items that were “evidence of violations of federal criminal law.” The warrants did not describe the specific crime suspected, nor did the warrants limit the seizure of items solely to Dali artwork or suspected Dali forgeries. Are these search warrants valid? *Center Art Galleries—Hawaii, Inc. v. United States*, 875 F.2d 747 (9th Cir. 1989).

## SELF-TEST QUESTIONS

1. Jared has made several loans to debtors who have declared bankruptcy. These are unsecured claims. Jared “doctors” the documentation to show amounts owed that are higher than the debtors actually owe. Later, Jared is charged with the federal criminal offense of filing false claims. The standard (or “burden”) of proof that the US attorney must meet in the prosecution is
  - a. beyond all doubt
  - b. beyond a reasonable doubt
  - c. clear and convincing evidence
  - d. a preponderance of the evidence
  
2. Jethro, a businessman who resides in Atlanta, creates a disturbance at a local steakhouse and is arrested for being drunk and disorderly. Drunk and disorderly is a misdemeanor under Georgia law. A misdemeanor is a crime punishable by imprisonment for up to
  - a. one year
  - b. two years
  - c. five years
  - d. none of the above
  
3. Yuan is charged with a crime. To find him guilty, the prosecutor must show
  - a. actus reus and mens rea
  - b. mens rea only
  - c. the performance of a prohibited act
  - d. none of the above
  
4. Kira works for Data Systems Ltd. and may be liable for larceny if she steals
  - a. a competitor’s trade secrets
  - b. company computer time
  - c. the use of Data Systems’ Internet for personal business
  - d. any of the above

5. Candace is constructing a new office building that is near its completion. She offers Paul \$500 to overlook certain things that are noncompliant with the city's construction code. Paul accepts the money and overlooks the violations. Later, Candace is charged with the crime of bribery. This occurred when
- a. Candace offered the bribe.
  - b. Paul accepted the bribe.
  - c. Paul overlooked the violations.
  - d. none of the above

#### SELF-TEST ANSWERS

1. b
2. a
3. a
4. d
5. a

## Chapter 7

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### Introduction to Tort Law

#### LEARNING OBJECTIVES

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

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

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



## 7.1 Purpose of Tort Laws

### LEARNING OBJECTIVES

1. Explain why a sound market system requires tort law.
2. Define a tort and give two examples.
3. Explain the moral basis of tort liability.
4. Understand the purposes of damage awards in tort.

### Definition of *Tort*

The term *tort* is the French equivalent of the English word *wrong*. The word *tort* is also derived from the Latin word *tortum*, which means twisted or crooked or wrong, in contrast to the word *rectum*, which means straight (*rectitude* uses that Latin root). Thus conduct that is twisted or crooked and not straight is a tort. The term was introduced into the English law by the Norman jurists.

Long ago, *tort* was used in everyday speech; today it is left to the legal system. A judge will instruct a jury that a tort is usually defined as a wrong for which the law will provide a remedy, most often in the form of money damages. The law does not remedy all “wrongs.” The preceding definition of tort does not reveal the underlying principles that divide wrongs in the legal sphere from those in the moral sphere. Hurting someone’s feelings may be more devastating than saying something untrue about him behind his back; yet the law will not provide a remedy for saying something cruel to someone directly, while it may provide a remedy for “defaming” someone, orally or in writing, to others.

Although the word is no longer in general use, tort suits are the stuff of everyday headlines. More and more people injured by exposure to a variety of risks now seek redress (some sort of remedy through the courts). Headlines boast of multimillion-dollar jury awards against doctors who bungled operations, against newspapers that libeled subjects of stories, and against oil companies that devastate entire ecosystems. All are examples of tort suits.

The law of torts developed almost entirely in the common-law courts; that is, statutes passed by legislatures were not the source of law that plaintiffs usually relied on. Usually, plaintiffs would rely on the common law (judicial decisions). Through thousands of cases, the courts have fashioned a series of rules that govern the conduct of individuals in their noncontractual dealings with each other.

Through contracts, individuals can craft their own rights and responsibilities toward each other. In the absence of contracts, tort law holds individuals legally accountable for the consequences of their actions. Those who suffer losses at the hands of others can be compensated.

Many acts (like homicide) are both criminal and tortious. But torts and crimes are different, and the difference is worth noting. A crime is an act against the people as a whole. Society punishes the murderer; it does not usually compensate the family of the victim. Tort law, on the other hand, views the death as a private wrong for which damages are owed. In a civil case, the tort victim or his family, not the state, brings the action. The judgment against a defendant in a civil tort suit is usually expressed in monetary terms, not in terms of prison times or fines, and is the legal system's way of trying to make up for the victim's loss.

### **Kinds of Torts**

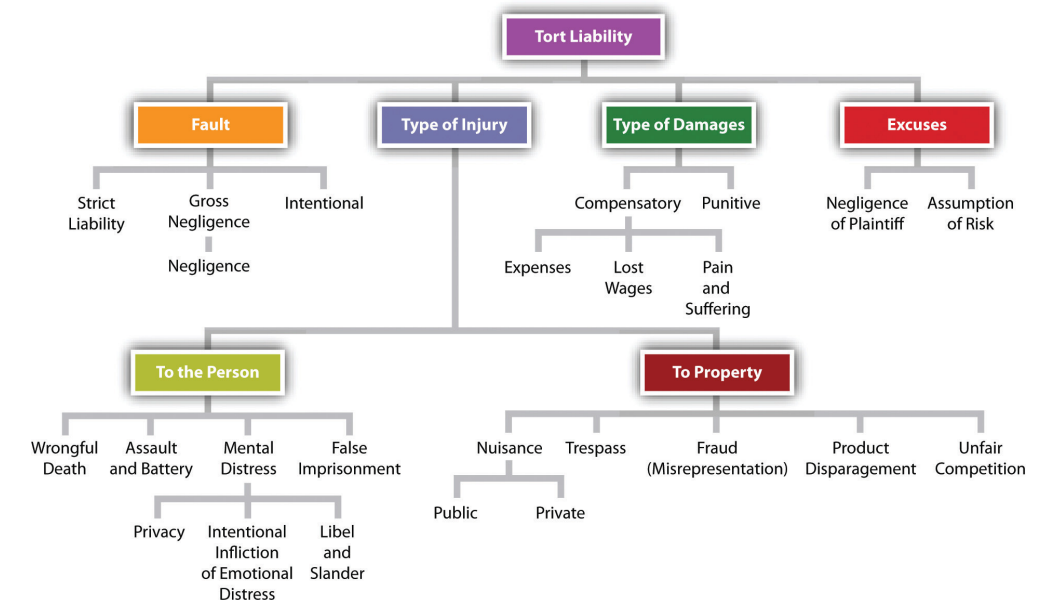
There are three kinds of torts: intentional torts, negligent torts, and strict liability torts. Intentional torts arise from intentional acts, whereas unintentional torts often result from carelessness (e.g., when a surgical team fails to remove a clamp from a patient's abdomen when the operation is finished). Both intentional torts and negligent torts imply some fault on the part of the defendant. In strict liability torts, by contrast, there may be no fault at all, but tort law will sometimes require a defendant to make up for the victim's losses even where the defendant was not careless and did not intend to do harm.

### **Dimensions of Tort Liability**

There is a clear moral basis for recovery through the legal system where the defendant has been careless (negligent) or has intentionally caused harm. Using the concepts that we are free and autonomous beings with basic rights, we can see that when others interfere with either our freedom or our autonomy, we will usually react negatively. As the old saying goes, "Your right to swing your arm ends at the tip of my nose." The law takes this even one step further: under intentional tort law, if you frighten someone by swinging your arms toward the tip of her nose, you may have committed the tort of assault, even if there is no actual touching (battery).

Under a capitalistic market system, rational economic rules also call for no negative externalities. That is, actions of individuals, either alone or in concert with others, should not negatively impact third parties. The law will try to compensate third parties who are harmed by your actions, even as it knows that a money judgment cannot actually mend a badly injured victim.

Figure 7.1 *Dimensions of Tort Liability*



### Dimensions of Tort: Fault

Tort principles can be viewed along different dimensions. One is the **fault** dimension. Like criminal law, tort law requires a wrongful act by a defendant for the plaintiff to recover. Unlike criminal law, however, there need not be a specific intent. Since tort law focuses on injury to the plaintiff, it is less concerned than criminal law about the reasons for the defendant’s actions. An innocent act or a relatively innocent one may still provide the basis for liability. Nevertheless, tort law—except for strict liability—relies on standards of fault, or blameworthiness.

The most obvious standard is willful conduct. If the defendant (often called the **tortfeasor**<sup>1</sup>—i.e., the one committing the tort) intentionally injures another, there is little argument about tort liability. Thus all crimes resulting in injury to a person or property (murder, assault, arson, etc.) are also torts, and the plaintiff may bring a separate lawsuit to recover damages for injuries to his person, family, or property.

Most tort suits do not rely on *intentional* fault. They are based, rather, on negligent conduct that in the circumstances is careless or poses unreasonable risks of causing damage. Most automobile accident and medical malpractice suits are examples of negligence suits.

1. A person or legal entity that commits a tort.

The fault dimension is a continuum. At one end is the deliberate desire to do injury. The middle ground is occupied by careless conduct. At the other end is conduct that

most would consider entirely blameless, in the moral sense. The defendant may have observed all possible precautions and yet still be held liable. This is called **strict liability**<sup>2</sup>. An example is that incurred by the manufacturer of a defective product that is placed on the market despite all possible precautions, including quality-control inspection. In many states, if the product causes injury, the manufacturer will be held liable.

### Dimensions of Tort: Nature of Injury

Tort liability varies by the type of injury caused. The most obvious type is physical harm to the person (assault, battery, infliction of emotional distress, negligent exposure to toxic pollutants, wrongful death) or property (trespass, nuisance, arson, interference with contract). Mental suffering can be redressed if it is a result of physical injury (e.g., shock and depression following an automobile accident). A few states now permit recovery for mental distress alone (a mother's shock at seeing her son injured by a car while both were crossing the street). Other protected interests include a person's reputation (injured by defamatory statements or writings), privacy (injured by those who divulge secrets of his personal life), and economic interests (misrepresentation to secure an economic advantage, certain forms of unfair competition).

### Dimensions of Tort: Excuses

A third element in the law of torts is the excuse for committing an apparent wrong. The law does not condemn every act that ultimately results in injury.

One common rule of exculpation is **assumption of risk**<sup>3</sup>. A baseball fan who sits along the third base line close to the infield assumes the risk that a line drive foul ball may fly toward him and strike him. He will not be permitted to complain in court that the batter should have been more careful or that management should have either warned him or put up a protective barrier.

Another excuse is negligence of the plaintiff. If two drivers are careless and hit each other on the highway, some states will refuse to permit either to recover from the other. Still another excuse is consent: two boxers in the ring consent to being struck with fists (but not to being bitten on the ear).

### Damages

Since the purpose of tort law is to compensate the victim for harm actually done, damages are usually measured by the extent of the injury. Expressed in money terms, these include replacement of property destroyed, compensation for lost

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

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

wages, reimbursement for medical expenses, and dollars that are supposed to approximate the pain that is suffered. Damages for these injuries are called **compensatory damages**<sup>4</sup>.

In certain instances, the courts will permit an award of **punitive damages**<sup>5</sup>. As the word *punitive* implies, the purpose is to punish the defendant's actions. Because a punitive award (sometimes called exemplary damages) is at odds with the general purpose of tort law, it is allowable only in aggravated situations. The law in most states permits recovery of punitive damages only when the defendant has deliberately committed a wrong with malicious intent or has otherwise done something outrageous.

Punitive damages are rarely allowed in negligence cases for that reason. But if someone sets out intentionally and maliciously to hurt another person, punitive damages may well be appropriate. Punitive damages are intended not only to punish the wrongdoer, by exacting an additional and sometimes heavy payment (the exact amount is left to the discretion of jury and judge), but also to deter others from similar conduct. The punitive damage award has been subject to heavy criticism in recent years in cases in which it has been awarded against manufacturers. One fear is that huge damage awards on behalf of a multitude of victims could swiftly bankrupt the defendant. Unlike compensatory damages, punitive damages are taxable.

#### KEY TAKEAWAY

There are three kinds of torts, and in two of them (negligent torts and strict liability torts), damages are usually limited to making the victim whole through an enforceable judgment for money damages. These compensatory damages awarded by a court accomplish only approximate justice for the injuries or property damage caused by a tortfeasor. Tort laws go a step further toward deterrence, beyond compensation to the plaintiff, in occasionally awarding punitive damages against a defendant. These are almost always in cases where an intentional tort has been committed.

4. An award of money damages to make the plaintiff whole, as opposed to additional damages (punitive) that punish the defendant or make an example of defendant.

5. Punitive damages are awarded in cases where the conduct of the defendant is deemed to be so outrageous that justice is only served by adding a penalty over and above compensatory damages.

## EXERCISES

1. Why is deterrence needed for intentional torts (where punitive damages are awarded) rather than negligent torts?
2. Why are costs imposed on others without their consent problematic for a market economy? What if the law did not try to reimpose the victim's costs onto the tortfeasor? What would a totally nonlitigious society be like?

## 7.2 Intentional Torts

### LEARNING OBJECTIVES

1. Distinguish intentional torts from other kinds of torts.
2. Give three examples of an intentional tort—one that causes injury to a person, one that causes injury to property, and one that causes injury to a reputation.

The analysis of most intentional torts is straightforward and parallels the substantive crimes already discussed in [Chapter 6 "Criminal Law"](#). When physical injury or damage to property is caused, there is rarely debate over liability if the plaintiff deliberately undertook to produce the harm. Certain other intentional torts are worth noting for their relevance to business.

### Assault and Battery

One of the most obvious intentional torts is assault and battery. Both criminal law and tort law serve to restrain individuals from using physical force on others. Assault is (1) the threat of immediate harm or offense of contact or (2) any act that would arouse reasonable apprehension of imminent harm. Battery is unauthorized and harmful or offensive physical contact with another person that causes injury.

Often an assault results in battery, but not always. In *Western Union Telegraph Co. v. Hill*, for example, the defendant did not touch the plaintiff's wife, but the case presented an issue of possible assault even without an actual battery; the defendant employee attempted to kiss a customer across the countertop, couldn't quite reach her, but nonetheless created actionable fear (or, as the court put it, "apprehension") on the part of the plaintiff's wife. It is also possible to have a battery without an assault. For example, if someone hits you on the back of the head with an iron skillet and you didn't see it coming, there is a battery but no assault. Likewise, if Andrea passes out from drinking too much at the fraternity party and a stranger (Andre) kisses her on the lips while she is passed out, she would not be aware of any threat of offensive contact and would have no apprehension of any harm. Thus there has been no tort of assault, but she could allege the tort of battery. (The question of what damages, if any, would be an interesting argument.)

Under the doctrine of transferred intent, if Draco aims his wand at Harry but Harry ducks just in time and the impact is felt by Hermione instead, English law (and American law) would transfer Draco's intent from the target to the actual victim of the act. Thus Hermione could sue Draco for battery for any damages she had suffered.

### **False Imprisonment**

The tort of false imprisonment originally implied a locking up, as in a prison, but today it can occur if a person is restrained in a room or a car or even if his or her movements are restricted while walking down the street. People have a right to be free to go as they please, and anyone who without cause deprives another of personal freedom has committed a tort. Damages are allowed for time lost, discomfort and resulting ill health, mental suffering, humiliation, loss of reputation or business, and expenses such as attorneys' fees incurred as a result of the restraint (such as a false arrest). But as the case of *Lester v. Albers Super Markets, Inc.* (Section 7.5 "Cases") shows, the defendant must be shown to have restrained the plaintiff in order for damages to be allowed.

### **Intentional Infliction of Emotional Distress**

Until recently, the common-law rule was that there could be no recovery for acts, even though intentionally undertaken, that caused purely mental or emotional distress. For a case to go to the jury, the courts required that the mental distress result from some physical injury. In recent years, many courts have overthrown the older rule and now recognize the so-called new tort. In an employment context, however, it is rare to find a case where a plaintiff is able to recover. The most difficult hurdle is proving that the conduct was "extreme" or "outrageous."

In an early California case, bill collectors came to the debtor's home repeatedly and threatened the debtor's pregnant wife. Among other things, they claimed that the wife would have to deliver her child in prison. The wife miscarried and had emotional and physical complications. The court found that the behavior of the collection company's two agents was sufficiently outrageous to prove the tort of intentional infliction of emotional distress. In *Roche v. Stern* (New York), the famous cable television talk show host Howard Stern had tastelessly discussed the remains of Deborah Roche, a topless dancer and cable access television host. *Roche v. Stern*, 675 N.Y.S.2d 133 (1998). The remains had been brought to Stern's show by a close friend of Roche, Chauncey Hayden, and a number of crude comments by Stern and Hayden about the remains were videotaped and broadcast on a national cable television station. Roche's sister and brother sued Howard Stern and Infinity broadcasting and were able to get past the defendant's motion to dismiss to have a jury consider their claim.



A plaintiff's burden in these cases is to show that the mental distress is severe. Many states require that this distress must result in physical symptoms such as nausea, headaches, ulcers, or, as in the case of the pregnant wife, a miscarriage. Other states have not required physical symptoms, finding that shame, embarrassment, fear, and anger constitute severe mental distress.

## Trespass and Nuisance

Trespass is intentionally going on land that belongs to someone else or putting something on someone else's property and refusing to remove it. This part of tort law shows how strongly the law values the rights of property owners. The right to enjoy your property without interference from others is also found in common law of nuisance. There are limits to property owners' rights, however. In *Katko v. Briney*, for example, the plaintiff was injured by a spring gun while trespassing on the defendant's property. *Katko v. Briney*, 183 N.W.2d 657 (Iowa 1971). The defendant had set up No Trespassing signs after ten years of trespassing and housebreaking events, with the loss of some household items. Windows had been broken, and there was "messing up of the property in general." The defendants had boarded up the windows and doors in order to stop the intrusions and finally had set up a shotgun trap in the north bedroom of the house. One defendant had cleaned and oiled his 20-gauge shotgun and taken it to the old house where it was secured to an iron bed with the barrel pointed at the bedroom door. "It was rigged with wire from the doorknob to the gun's trigger so would fire when the door was opened." The angle of the shotgun was adjusted to hit an intruder in the legs. The spring could not be seen from the outside, and no warning of its presence was posted.

The plaintiff, Katko, had been hunting in the area for several years and considered the property abandoned. He knew it had long been uninhabited. He and a friend had been to the house and found several old bottles and fruit jars that they took and added to their collection of antiques. When they made a second trip to the property, they entered by removing a board from a porch window. When the plaintiff opened the north bedroom door, the shotgun went off and struck him in the right leg above the ankle bone. Much of his leg was blown away. While Katko knew he had no right to break and enter the house with intent to steal bottles and fruit jars, the court held that a property owner could not protect an unoccupied boarded-up farmhouse by using a spring gun capable of inflicting death or serious injury.

In *Katko*, there is an intentional tort. But what if someone trespassing is injured by the negligence of the landowner? States have differing rules about trespass and negligence. In some states, a trespasser is only protected against the gross negligence of the landowner. In other states, trespassers may be owed the duty of due care on the part of the landowner. The burglar who falls into a drained swimming pool, for example, may have a case against the homeowner unless the

courts or legislature of that state have made it clear that trespassers are owed the limited duty to avoid gross negligence. Or a very small child may wander off his own property and fall into a gravel pit on a nearby property and suffer death or serious injury; if the pit should (in the exercise of due care) have been filled in or some barrier erected around it, then there was negligence. But if the state law holds that the duty to trespassers is only to avoid gross negligence, the child's family would lose, unless the state law makes an exception for very young trespassers. In general, guests, licensees, and invitees are owed a duty of due care; a trespasser may not be owed such a duty, but states have different rules on this.

### **Intentional Interference with Contractual Relations**

Tortious interference with a contract can be established by proving four elements:

1. There was a contract between the plaintiff and a third party.
2. The defendant knew of the contract.
3. The defendant improperly induced the third party to breach the contract or made performance of the contract impossible.
4. There was injury to the plaintiff.

In a famous case of contract interference, Texaco was sued by Pennzoil for interfering with an agreement that Pennzoil had with Getty Oil. After complicated negotiations between Pennzoil and Getty, a takeover share price was struck, a memorandum of understanding was signed, and a press release announced the agreement in principle between Pennzoil and Getty. Texaco's lawyers, however, believed that Getty oil was "still in play," and before the lawyers for Pennzoil and Getty could complete the paperwork for their agreement, Texaco announced it was offering Getty shareholders an additional \$12.50 per share over what Pennzoil had offered.

Texaco later increased its offer to \$228 per share, and the Getty board of directors soon began dealing with Texaco instead of Pennzoil. Pennzoil decided to sue in Texas state court for tortious interference with a contract. After a long trial, the jury returned an enormous verdict against Texaco: \$7.53 billion in actual damages and \$3 billion in punitive damages. The verdict was so large that it would have bankrupted Texaco. Appeals from the verdict centered on an obscure rule of the Securities and Exchange Commission (SEC), Rule 10(b)-13, and Texaco's argument was based on that rule and the fact that the contract had not been completed. If there was no contract, Texaco could not have legally interfered with one. After the SEC filed a brief that supported Texaco's interpretation of the law, Texaco agreed to pay \$3 billion to Pennzoil to dismiss its claim of tortious interference with a contract.

## Malicious Prosecution

Malicious prosecution is the tort of causing someone to be prosecuted for a criminal act, knowing that there was no probable cause to believe that the plaintiff committed the crime. The plaintiff must show that the defendant acted with malice or with some purpose other than bringing the guilty to justice. A mere complaint to the authorities is insufficient to establish the tort, but any official proceeding will support the claim—for example, a warrant for the plaintiff's arrest. The criminal proceeding must terminate in the plaintiff's favor in order for his suit to be sustained.

A majority of US courts, though by no means all, permit a suit for wrongful civil proceedings. Civil litigation is usually costly and burdensome, and one who forces another to defend himself against baseless accusations should not be permitted to saddle the one he sues with the costs of defense. However, because, as a matter of public policy, litigation is favored as the means by which legal rights can be vindicated—indeed, the Supreme Court has even ruled that individuals have a constitutional right to litigate—the plaintiff must meet a heavy burden in proving his case. The mere dismissal of the original lawsuit against the plaintiff is not sufficient proof that the suit was unwarranted. The plaintiff in a suit for wrongful civil proceedings must show that the defendant (who was the plaintiff in the original suit) filed the action for an improper purpose and had no reasonable belief that his cause was legally or factually well grounded.

## Defamation

Defamation is injury to a person's good name or reputation. In general, if the harm is done through the spoken word—one person to another, by telephone, by radio, or on television—it is called slander. If the defamatory statement is published in written form, it is called libel.

The Restatement (Second) of Torts defines a defamatory communication as one that “so tends to harm the reputation of another as to lower him in the estimation of the community or to deter third persons from associating or dealing with him.” Restatement (Second) of Torts, Section 559 (1965).

A statement is not defamatory unless it is false. Truth is an absolute defense to a charge of libel or slander. Moreover, the statement must be “published”—that is, communicated to a third person. You cannot be libeled by one who sends you a letter full of false accusations and scurrilous statements about you unless a third person opens it first (your roommate, perhaps). Any living person is capable of being defamed, but the dead are not. Corporations, partnerships, and other forms of

associations can also be defamed, if the statements tend to injure their ability to do business or to garner contributions.

The statement must have reference to a particular person, but he or she need not be identified by name. A statement that “the company president is a crook” is defamatory, as is a statement that “the major network weathermen are imposters.” The company president and the network weathermen could show that the words were aimed at them. But statements about large groups will not support an action for defamation (e.g., “all doctors are butchers” is not defamatory of any particular doctor).

The law of defamation is largely built on strict liability. That a person did not intend to defame is ordinarily no excuse; a typographical error that converts a true statement into a false one in a newspaper, magazine, or corporate brochure can be sufficient to make out a case of libel. Even the exercise of due care is usually no excuse if the statement is in fact communicated. Repeating a libel is itself a libel; a libel cannot be justified by showing that you were quoting someone else. Though a plaintiff may be able to prove that a statement was defamatory, he is not necessarily entitled to an award of damages. That is because the law contains a number of privileges that excuse the defamation.

Publishing false information about another business’s product constitutes the tort of slander of quality, or trade libel. In some states, this is known as the tort of product disparagement. It may be difficult to establish damages, however. A plaintiff must prove that actual damages proximately resulted from the slander of quality and must show the extent of the economic harm as well.

### **Absolute Privilege**

Statements made during the course of judicial proceedings are absolutely privileged, meaning that they cannot serve as the basis for a defamation suit. Accurate accounts of judicial or other proceedings are absolutely privileged; a newspaper, for example, may pass on the slanderous comments of a judge in court. “Judicial” is broadly construed to include most proceedings of administrative bodies of the government. The Constitution exempts members of Congress from suits for libel or slander for any statements made in connection with legislative business. The courts have constructed a similar privilege for many executive branch officials.

## Qualified Privilege

Absolute privileges pertain to those in the public sector. A narrower privilege exists for private citizens. In general, a statement that would otherwise be actionable is held to be justified if made in a reasonable manner and for a reasonable purpose. Thus you may warn a friend to beware of dealing with a third person, and if you had reason to believe that what you said was true, you are privileged to issue the warning, even though false. Likewise, an employee may warn an employer about the conduct or character of a fellow or prospective employee, and a parent may complain to a school board about the competence or conduct of a child's teacher. There is a line to be drawn, however, and a defendant with nothing but an idle interest in the matter (an "officious intermeddler") must take the risk that his information is wrong.

In 1964, the Supreme Court handed down its historic decision in *New York Times v. Sullivan*, holding that under the First Amendment a libel judgment brought by a public official against a newspaper cannot stand unless the plaintiff has shown "actual malice," which in turn was defined as "knowledge that [the statement] was false or with a reckless disregard of whether it was false or not." *Times v. Sullivan*, 376 US 254 (1964). In subsequent cases, the court extended the constitutional doctrine further, applying it not merely to government officials but to **public figures**<sup>6</sup>, people who voluntarily place themselves in the public eye or who involuntarily find themselves the objects of public scrutiny. Whether a private person is or is not a public figure is a difficult question that has so far eluded rigorous definition and has been answered only from case to case. A CEO of a private corporation ordinarily will be considered a private figure unless he puts himself in the public eye—for example, by starring in the company's television commercials.

## Invasion of Privacy

The right of privacy—the right "to be let alone"—did not receive judicial recognition until the twentieth century, and its legal formulation is still evolving. In fact there is no single right of privacy. Courts and commentators have discerned at least four different types of interests: (1) the right to control the appropriation of your name and picture for commercial purposes, (2) the right to be free of intrusion on your "personal space" or seclusion, (3) freedom from public disclosure of embarrassing and intimate facts of your personal life, and (4) the right not to be presented in a "false light."

6. Based on the First Amendment of the US Constitution, a public figure cannot recover in a defamation case unless the plaintiff's defamation was done with actual malice.

### **Appropriation of Name or Likeness**

The earliest privacy interest recognized by the courts was appropriation of name or likeness: someone else placing your photograph on a billboard or cereal box as a model or using your name as endorsing a product or in the product name. A New York statute makes it a misdemeanor to use the name, portrait, or picture of any person for advertising purposes or for the purposes of trade (business) without first obtaining written consent. The law also permits the aggrieved person to sue and to recover damages for unauthorized profits and also to have the court enjoin (judicially block) any further unauthorized use of the plaintiff's name, likeness, or image. This is particularly useful to celebrities.

Because the publishing and advertising industries are concentrated heavily in New York, the statute plays an important part in advertising decisions made throughout the country. Deciding what "commercial" or "trade" purposes are is not always easy. Thus a newsmagazine may use a baseball player's picture on its cover without first obtaining written permission, but a chocolate manufacturer could not put the player's picture on a candy wrapper without consent.

### **Personal Space**

One form of intrusion upon a person's solitude—trespass—has long been actionable under common law. Physical invasion of home or other property is not a new tort. But in recent years, the notion of intrusion has been broadened considerably. Now, taking photos of someone else with your cell phone in a locker room could constitute invasion of the right to privacy. Reading someone else's mail or e-mail could also constitute an invasion of the right to privacy. Photographing someone on a city street is not tortious, but subsequent use of the photograph could be. Whether the invasion is in a public or private space, the amount of damages will depend on how the image or information is disclosed to others.

### **Public Disclosure of Embarrassing Facts**

Circulation of false statements that do injury to a person are actionable under the laws of defamation. What about true statements that might be every bit as damaging—for example, disclosure of someone's income tax return, revealing how much he earned? The general rule is that if the facts are truly private and of no "legitimate" concern to the public, then their disclosure is a violation of the right to privacy. But a person who is in the public eye cannot claim the same protection.

### False Light

A final type of privacy invasion is that which paints a false picture in a publication. Though false, it might not be libelous, since the publication need contain nothing injurious to reputation. Indeed, the publication might even glorify the plaintiff, making him seem more heroic than he actually is. Subject to the First Amendment requirement that the plaintiff must show intent or extreme recklessness, statements that put a person in a false light, like a fictionalized biography, are actionable.

#### KEY TAKEAWAY

There are many kinds of intentional torts. Some of them involve harm to the physical person or to his or her property, reputation or feelings, or economic interests. In each case of intentional tort, the plaintiff must show that the defendant intended harm, but the intent to harm does not need to be directed at a particular person and need not be malicious, as long as the resulting harm is a direct consequence of the defendant's actions.

#### EXERCISES

1. Name two kinds of intentional torts that could result in damage to a business firm's bottom line.
2. Name two kinds of intentional torts that are based on protection of a person's property.
3. Why are intentional torts more likely to result in a verdict not only for compensatory damages but also for punitive damages?

## 7.3 Negligence

### LEARNING OBJECTIVES

1. Understand how the duty of due care relates to negligence.
2. Distinguish between actual and proximate cause.
3. Explain the primary defenses to a claim of negligence.

### Elements of Negligence

Physical harm need not be intentionally caused. A pedestrian knocked over by an automobile does not hurt less because the driver intended no wrong but was merely careless. The law imposes a duty of care on all of us in our everyday lives. Accidents caused by negligence are actionable.

Determining **negligence**<sup>7</sup> is not always easy. If a driver runs a red light, we can say that he is negligent because a driver must always be careful to ascertain whether the light is red and be able to stop if it is. Suppose that the driver was carrying a badly injured person to a nearby hospital and that after slowing down at an intersection, went through a red light, blowing his horn, whereupon a driver to his right, seeing him, drove into the intersection anyway and crashed into him. Must one always stop at a red light? Is proof that the light was red always proof of negligence? Usually, but not always: negligence is an abstract concept that must always be applied to concrete and often widely varying sets of circumstances. Whether someone was or was not negligent is almost always a question of fact for a jury to decide. Rarely is it a legal question that a judge can settle.

The tort of negligence has four elements: (1) a duty of due care that the defendant had, (2) the **breach of the duty of due care**<sup>8</sup>, (3) connection between cause and injury, and (4) actual damage or loss. Even if a plaintiff can prove each of these aspects, the defendant may be able to show that the law excuses the conduct that is the basis for the tort claim. We examine each of these factors below.

### Standard of Care

Not every unintentional act that causes injury is negligent. If you brake to a stop when you see a child dart out in front of your car, and if the noise from your tires gives someone in a nearby house a heart attack, you have not acted negligently toward the person in the house. The purpose of the negligence standard is to

7. A breach of the duty of due care.

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



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

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

Despite the many difficulties, the concept of the reasonable man is one on which most negligence cases ultimately turn. If a defendant has acted “unreasonably under the circumstances” and his conduct posed an unreasonable risk of injury, then he is liable for injury caused by his conduct. Perhaps in most instances, it is not difficult to divine what the reasonable man would do. The reasonable man stops for traffic lights and always drives at reasonable speeds, does not throw baseballs through windows, performs surgical operations according to the average standards of the medical profession, ensures that the floors of his grocery store are kept free of fluids that would cause a patron to slip and fall, takes proper precautions to avoid spillage of oil from his supertanker, and so on. The “reasonable man” standard imposes hindsight on the decisions and actions of people in society; the circumstances of life are such that courts may sometimes impose a standard of due care that many people might not find reasonable.

### **Duty of Care and Its Breach**

The law does not impose on us a duty to care for every person. If the rule were otherwise, we would all, in this interdependent world, be our brothers’ keepers, constantly unsure whether any action we took might subject us to liability for its effect on someone else. The law copes with this difficulty by limiting the number of people toward whom we owe a duty to be careful.

In general, the law imposes no obligation to act in a situation to which we are strangers. We may pass the drowning child without risking a lawsuit. But if we do act, then the law requires us to act carefully. The law of negligence requires us to

behave with due regard for the foreseeable consequences of our actions in order to avoid unreasonable risks of injury.

During the course of the twentieth century, the courts have constantly expanded the notion of “foreseeability,” so that today many more people are held to be within the zone of injury than was once the case. For example, it was once believed that a manufacturer or supplier owed a duty of care only to immediate purchasers, not to others who might use the product or to whom the product might be resold. This limitation was known as the rule of privity. And users who were not immediate purchasers were said not to be in privity with a supplier or manufacturer. In 1916, Judge Benjamin N. Cardozo, then on the New York Court of Appeals, penned an opinion in a celebrated case that exploded the theory of privity, though it would take half a century before the last state—Mississippi in 1966—would fall in line.

Determining a duty of care can be a vexing problem. Physicians, for example, are bound by principles of medical ethics to respect the confidences of their patients. Suppose a patient tells a psychiatrist that he intends to kill his girlfriend. Does the physician then have a higher legal duty to warn prospective victim? The California Supreme Court has said yes. *Tarasoff v. Regents of University of California*, 551 P.2d 334 (Calif. 1976).

Establishing a breach of the duty of due care where the defendant has violated a statute or municipal ordinance is eased considerably with the doctrine of **negligence per se**<sup>9</sup>, a doctrine common to all US state courts. If a legislative body sets a minimum standard of care for particular kinds of acts to protect a certain set of people from harm and a violation of that standard causes harm to someone in that set, the defendant is negligent per se. If Harvey is driving sixty-five miles per hour in a fifty-five-mile-per-hour zone when he crashes into Haley’s car and the police accident report establishes that or he otherwise admits to going ten miles per hour over the speed limit, Haley does not have to prove that Harvey has breached a duty of due care. She will only have to prove that the speeding was an actual and proximate cause of the collision and will also have to prove the extent of the resulting damages to her.

9. An act of the defendant that violates a statute regulation or ordinance can be used to establish a breach of the duty of due care.

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

### **Causation: Actual Cause and Proximate Cause**

“For want of a nail, the kingdom was lost,” as the old saying has it. Virtually any cause of an injury can be traced to some preceding cause. The problem for the law is to know when to draw the line between causes that are immediate and causes too remote for liability reasonably to be assigned to them. In tort theory, there are two kinds of causes that a plaintiff must prove: actual cause and proximate cause.

**Actual cause (causation in fact)**<sup>10</sup> can be found if the connection between the

defendant's act and the plaintiff's injuries passes the "but for" test: if an injury would not have occurred "but for" the defendant's conduct, then the defendant is the cause of the injury. Still, this is not enough causation to create liability. The injuries to the plaintiff must also be foreseeable, or not "too remote," for the defendant's act to create liability. This is **proximate cause**<sup>11</sup>: a cause that is not too remote or unforeseeable.

Suppose that the person who was injured was not one whom a reasonable person could have expected to be harmed. Such a situation was presented in one of the most famous US tort cases, *Palsgraf v. Long Island Railroad* ([Section 7.5 "Cases"](#)), which was decided by Judge Benjamin Cardozo. Although Judge Cardozo persuaded four of his seven brethren to side with his position, the closeness of the case demonstrates the difficulty that unforeseeable consequences and unforeseeable plaintiffs present.

## Damages

For a plaintiff to win a tort case, she must allege and prove that she was injured. The fear that she might be injured in the future is not a sufficient basis for a suit. This rule has proved troublesome in medical malpractice and industrial disease cases. A doctor's negligent act or a company's negligent exposure of a worker to some form of contamination might not become manifest in the body for years. In the meantime, the tort statute of limitations might have run out, barring the victim from suing at all. An increasing number of courts have eased the plaintiff's predicament by ruling that the statute of limitations does not begin to run until the victim discovers that she has been injured or contracted a disease.

The law allows an exception to the general rule that damages must be shown when the plaintiff stands in danger of immediate injury from a hazardous activity. If you discover your neighbor experimenting with explosives in his basement, you could bring suit to enjoin him from further experimentation, even though he has not yet blown up his house—and yours.

## Problems of Proof

The plaintiff in a tort suit, as in any other, has the burden of proving his allegations.

He must show that the defendant took the actions complained of as negligent, demonstrate the circumstances that make the actions negligent, and prove the occurrence and extent of injury. Factual issues are for the jury to resolve. Since it is frequently difficult to make out the requisite proof, the law allows certain presumptions and rules of evidence that ease the plaintiff's task, on the ground that

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

without them substantial injustice would be done. One important rule goes by the Latin phrase **res ipsa loquitur**<sup>12</sup>, meaning “the thing speaks for itself.” The best evidence is always the most direct evidence: an eyewitness account of the acts in question. But eyewitnesses are often unavailable, and in any event they frequently cannot testify directly to the reasonableness of someone’s conduct, which inevitably can only be inferred from the circumstances.

In many cases, therefore, **circumstantial evidence**<sup>13</sup> (evidence that is indirect) will be the only evidence or will constitute the bulk of the evidence. Circumstantial evidence can often be quite telling: though no one saw anyone leave the building, muddy footprints tracing a path along the sidewalk are fairly conclusive. Res ipsa loquitur is a rule of circumstantial evidence that permits the jury to draw an inference of negligence. A common statement of the rule is the following: “There must be reasonable evidence of negligence but where the thing is shown to be under the management of the defendant or his servants, and the accident is such as in the ordinary course of things does not happen if those who have the management use proper care, it affords reasonable evidence, in the absence of explanation by the defendants, that the accident arose from want of care.” *Scott v. London & St. Katherine Docks Co.*, 3 H. & C. 596, 159 Eng.Rep. 665 (Q.B. 1865).

If a barrel of flour rolls out of a factory window and hits someone, or a soda bottle explodes, or an airplane crashes, courts in every state permit juries to conclude, in the absence of contrary explanations by the defendants, that there was negligence. The plaintiff is not put to the impossible task of explaining precisely how the accident occurred. A defendant can always offer evidence that he acted reasonably—for example, that the flour barrel was securely fastened and that a bolt of lightning, for which he was not responsible, broke its bands, causing it to roll out the window. But testimony by the factory employees that they secured the barrel, in the absence of any further explanation, will not usually serve to rebut the inference. That the defendant was negligent does not conclude the inquiry or automatically entitle the plaintiff to a judgment. Tort law provides the defendant with several excuses, some of which are discussed briefly in the next section.

### Excuses

There are more excuses (defenses) than are listed here, but contributory negligence or comparative negligence, assumption of risk, and act of God are among the principal defenses that will completely or partially excuse the negligence of the defendant.

12. Literally, “the thing speaks for itself.” In tort cases, res ipsa loquitur creates a presumption that the defendant was negligent because he or she was in exclusive control of the situation and that the plaintiff would not have suffered injury but for someone’s negligence. Res ipsa loquitur shifts the burden to the defendant to prove that he or she was not negligent.

13. Evidence that is not “direct” but that provides judges and juries with facts that tend to show legal liability.

### Contributory and Comparative Negligence

Under an old common-law rule, it was a complete defense to show that the plaintiff in a negligence suit was himself negligent. Even if the plaintiff was only mildly negligent, most of the fault being chargeable to the defendant, the court would dismiss the suit if the plaintiff's conduct contributed to his injury. In a few states today, this rule of **contributory negligence**<sup>14</sup> is still in effect. Although referred to as negligence, the rule encompasses a narrower form than that with which the defendant is charged, because the plaintiff's only error in such cases is in being less careful of himself than he might have been, whereas the defendant is charged with conduct careless toward others. This rule was so manifestly unjust in many cases that most states, either by statute or judicial decision, have changed to some version of **comparative negligence**<sup>15</sup>. Under the rule of comparative negligence, damages are apportioned according to the defendant's degree of culpability. For example, if the plaintiff has sustained a \$100,000 injury and is 20 percent responsible, the defendant will be liable for \$80,000 in damages.

### Assumption of Risk

Risk of injury pervades the modern world, and plaintiffs should not win a lawsuit simply because they took a risk and lost. The law provides, therefore, that when a person knowingly takes a risk, he or she must suffer the consequences.

The assumption of risk doctrine comes up in three ways. The plaintiff may have formally agreed with the defendant before entering a risky situation that he will relieve the defendant of liability should injury occur. ("You can borrow my car if you agree not to sue me if the brakes fail, because they're worn and I haven't had a chance to replace them.") Or the plaintiff may have entered into a relationship with the defendant knowing that the defendant is not in a position to protect him from known risks (the fan who is hit by a line drive in a ballpark). Or the plaintiff may act in the face of a risky situation known in advance to have been created by the defendant's negligence (failure to leave, while there was an opportunity to do so, such as getting into an automobile when the driver is known to be drunk).

The difficulty in many cases is to determine the dividing line between subjectivity and objectivity. If the plaintiff had no actual knowledge of the risk, he cannot be held to have assumed it. On the other hand, it is easy to claim that you did not appreciate the danger, and the courts will apply an objective standard of community knowledge (a "but you should have known" test) in many situations. When the plaintiff has no real alternative, however, assumption of risk fails as a defense (e.g., a landlord who negligently fails to light the exit to the street cannot claim that his tenants assumed the risk of using it).

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

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

At the turn of the century, courts applied assumption of risk in industrial cases to bar relief to workers injured on the job. They were said to assume the risk of dangerous conditions or equipment. This rule has been abolished by workers' compensation statutes in most states.

### **Act of God**

Technically, the rule that no one is responsible for an “act of God,” or *force majeure* as it is sometimes called, is not an excuse but a defense premised on a lack of causation. If a force of nature caused the harm, then the defendant was not negligent in the first place. A marina, obligated to look after boats moored at its dock, is not liable if a sudden and fierce storm against which no precaution was possible destroys someone's vessel. However, if it is foreseeable that harm will flow from a negligent condition triggered by a natural event, then there is liability. For example, a work crew failed to remove residue explosive gas from an oil barge. Lightning hit the barge, exploded the gas, and injured several workmen. The plaintiff recovered damages against the company because the negligence consisted in the failure to guard against any one of a number of chance occurrences that could ignite the gas. *Johnson v. Kosmos Portland Cement Co.*, 64 F.2d 193 (6th Cir. 1933).

### **Vicarious Liability**

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

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

### KEY TAKEAWAY

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

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

### EXERCISES

1. Explain the difference between comparative negligence and contributory negligence.
2. How is actual cause different from probable cause?
3. What is an example of assumption of risk?
4. How does res ipsa loquitur help a plaintiff establish a case of negligence?

## 7.4 Strict Liability

### LEARNING OBJECTIVES

1. Understand how strict liability torts differ from negligent torts.
2. Understand the historical origins of strict liability under common law.
3. Be able to apply strict liability concepts to liability for defective products.
4. Distinguish strict liability from absolute liability, and understand the major defenses to a lawsuit in products-liability cases.

### Historical Basis of Strict Liability: Animals and Ultrahazardous Activities

To this point, we have considered principles of liability that in some sense depend upon the “fault” of the tortfeasor. This fault is not synonymous with moral blame.

Aside from acts intended to harm, the fault lies in a failure to live up to a standard of reasonableness or due care. But this is not the only basis for tort liability. Innocent mistakes can be a sufficient basis. As we have already seen, someone who unknowingly trespasses on another’s property is liable for the damage that he does, even if he has a reasonable belief that the land is his. And it has long been held that someone who engages in ultrahazardous (or sometimes, abnormally dangerous) activities is liable for damage that he causes, even though he has taken every possible precaution to avoid harm to someone else.

Likewise, the owner of animals that escape from their pastures or homes and damage neighboring property may be liable, even if the reason for their escape was beyond the power of the owner to stop (e.g., a fire started by lightning that burns open a barn door). In such cases, the courts invoke the principle of strict liability, or, as it is sometimes called, liability without fault. The reason for the rule is explained in *Klein v. Pyrodyne Corporation* ([Section 7.5 "Cases"](#)).

### Strict Liability for Products

Because of the importance of products liability, this text devotes an entire chapter to it ([Chapter 20 "Products Liability"](#)). Strict liability may also apply as a legal standard for products, even those that are not ultrahazardous. In some national legal systems, strict liability is not available as a cause of action to plaintiffs seeking



to recover a judgment of products liability against a manufacturer, wholesaler, distributor, or retailer. (Some states limit liability to the manufacturer.) But it is available in the United States and initially was created by a California Supreme Court decision in the 1962 case of *Greenman v. Yuba Power Products, Inc.*

In *Greenman*, the plaintiff had used a home power saw and bench, the Shopsmith, designed and manufactured by the defendant. He was experienced in using power tools and was injured while using the approved lathe attachment to the Shopsmith to fashion a wooden chalice. The case was decided on the premise that Greenman had done nothing wrong in using the machine but that the machine had a defect that was “latent” (not easily discoverable by the consumer). Rather than decide the case based on warranties, or requiring that Greenman prove how the defendant had been negligent, Justice Traynor found for the plaintiff based on the overall social utility of strict liability in cases of defective products. According to his decision, the purpose of such liability is to ensure that the “cost of injuries resulting from defective products is borne by the manufacturers...rather than by the injured persons who are powerless to protect themselves.”

Today, the majority of US states recognize strict liability for defective products, although some states limit strict liability actions to damages for personal injuries rather than property damage. Injured plaintiffs have to prove the product caused the harm but do not have to prove exactly how the manufacturer was careless. Purchasers of the product, as well as injured guests, bystanders, and others with no direct relationship with the product, may sue for damages caused by the product.

The Restatement of the Law of Torts, Section 402(a), was originally issued in 1964. It is a widely accepted statement of the liabilities of sellers of goods for defective products. The Restatement specifies six requirements, all of which must be met for a plaintiff to recover using strict liability for a product that the plaintiff claims is defective:

1. The product must be in a defective condition when the defendant sells it.
2. The defendant must normally be engaged in the business of selling or otherwise distributing the product.
3. The product must be unreasonably dangerous to the user or consumer because of its defective condition.
4. The plaintiff must incur physical harm to self or to property by using or consuming the product.
5. The defective condition must be the proximate cause of the injury or damage.

6. The goods must not have been substantially changed from the time the product was sold to the time the injury was sustained.

Section 402(a) also explicitly makes clear that a defendant can be held liable even though the defendant has exercised “all possible care.” Thus in a strict liability case, the plaintiff does not need to show “fault” (or negligence).

For defendants, who can include manufacturers, distributors, processors, assemblers, packagers, bottlers, retailers, and wholesalers, there are a number of defenses that are available, including assumption of risk, product misuse and comparative negligence, commonly known dangers, and the knowledgeable-user defense. We have already seen assumption of risk and comparative negligence in terms of negligence actions; the application of these is similar in products-liability actions.

Under product misuse, a plaintiff who uses a product in an unexpected and unusual way will not recover for injuries caused by such misuse. For example, suppose that someone uses a rotary lawn mower to trim a hedge and that after twenty minutes of such use loses control because of its weight and suffers serious cuts to his abdomen after dropping it. Here, there would be a defense of product misuse, as well as contributory negligence. Consider the urban (or Internet) legend of Mervin Gratz, who supposedly put his Winnebago on autopilot to go back and make coffee in the kitchen, then recovered millions after his Winnebago turned over and he suffered serious injuries. There are multiple defenses to this alleged action; these would include the defenses of contributory negligence, comparative negligence, and product misuse. (There was never any such case, and certainly no such recovery; it is not known who started this legend, or why.)

Another defense against strict liability as a cause of action is the knowledgeable user defense. If the parents of obese teenagers bring a lawsuit against McDonald’s, claiming that its fast-food products are defective and that McDonald’s should have warned customers of the adverse health effects of eating its products, a defense based on the knowledgeable user is available. In one case, the court found that the high levels of cholesterol, fat, salt, and sugar in McDonald’s food is well known to users. The court stated, “If consumers know (or reasonably should know) the potential ill health effects of eating at McDonald’s, they cannot blame McDonald’s if they, nonetheless, choose to satiate their appetite with a surfeit of supersized McDonald’s products.” *Pellman v. McDonald’s Corp.*, 237 F.2d 512 (S.D.N.Y. 2003).

### KEY TAKEAWAY

Common-law courts have long held that certain activities are inherently dangerous and that those who cause damage to others by engaging in those activities will be held strictly liable. More recently, courts in the United States have applied strict liability to defective products. Strict liability, however, is not absolute liability, as there are many defenses available to defendants in lawsuits based on strict liability, such as comparative negligence and product abuse.

### EXERCISES

1. Someone says, “Strict liability means that you’re liable for whatever you make, no matter what the consumer does with your product. It’s a crazy system.” Respond to and refute this statement.
2. What is the essential difference between strict liability torts and negligent torts? Should the US legal system even allow strict liability torts? What reasons seem persuasive to you?

## 7.5 Cases

### **Intentional Torts: False Imprisonment**

Lester v. Albers Super Markets, Inc.

94 Ohio App. 313, 114 N.E.2d 529 (Ohio 1952)

Facts: The plaintiff, carrying a bag of rolls purchased at another store, entered the defendant's grocery store to buy some canned fruit. Seeing her bus outside, she stepped out of line and put the can on the counter. The store manager intercepted her and repeatedly demanded that she submit the bag to be searched. Finally she acquiesced; he looked inside and said she could go. She testified that several people witnessed the scene, which lasted about fifteen minutes, and that she was humiliated. The jury awarded her \$800. She also testified that no one laid a hand on her or made a move to restrain her from leaving by any one of numerous exits.

\* \* \*

MATTHEWS, JUDGE.

As we view the record, it raises the fundamental question of what is imprisonment. Before any need for a determination of illegality arises there must be proof of imprisonment. In 35 Corpus Juris Secundum (C.J.S.), False Imprisonment, § II, pages 512-13, it is said: "Submission to the mere verbal direction of another, unaccompanied by force or by threats of any character, cannot constitute a false imprisonment, and there is no false imprisonment where an employer interviewing an employee declines to terminate the interview if no force or threat of force is used and false imprisonment may not be predicated on a person's unfounded belief that he was restrained."

Many cases are cited in support of the text.

\* \* \*

In Fenn v. Kroger Grocery & Baking Co., Mo. Sup., 209 S.W. 885, 887, the court said:

A case was not made out for false arrest. The plaintiff said she was intercepted as she started to leave the store; that Mr. Krause stood where she could not pass him in going out. She does not say that he made any attempt to intercept her. She says he escorted her back to the desk, that he asked her to let him see the change.

...She does not say that she went unwillingly...Evidence is wholly lacking to show that she was detained by force or threats. It was probably a disagreeable experience, a humiliating one to her, but she came out victorious and was allowed to go when she desired with the assurance of Mr. Krause that it was all right. The demurrer to the evidence on both counts was properly sustained.

The result of the cases is epitomized in 22 Am.Jur. 368, as follows:

A customer or patron who apparently has not paid for what he has received may be detained for a reasonable time to investigate the circumstances, but upon payment of the demand, he has the unqualified right to leave the premises without restraint, so far as the proprietor is concerned, and it is false imprisonment for a private individual to detain one for an unreasonable time, or under unreasonable circumstances, for the purpose of investigating a dispute over the payment of a bill alleged to be owed by the person detained for cash services.

\* \* \*

For these reasons, the judgment is reversed and final judgment entered for the defendant-appellant.

### CASE QUESTIONS

1. The court begins by saying what false imprisonment is not. What is the legal definition of false imprisonment?
2. What kinds of detention are permissible for a store to use in accosting those that may have been shoplifting?
3. Jody broke up with Jeremy and refused to talk to him. Jeremy saw Jody get into her car near the business school and parked right behind her so she could not move. He then stood next to the driver's window for fifteen minutes, begging Jody to talk to him. She kept saying, "No, let me leave!" Has Jeremy committed the tort of false imprisonment?

## Negligence: Duty of Due Care

Whitlock v. University of Denver

744 P.2d 54 (Supreme Court of Colorado 1987)

On June 19, 1978, at approximately 10:00 p.m., plaintiff Oscar Whitlock suffered a paralyzing injury while attempting to complete a one-and-three-quarters front flip on a trampoline. The injury rendered him a quadriplegic. The trampoline was owned by the Beta Theta Pi fraternity (the Beta house) and was situated on the front yard of the fraternity premises, located on the University campus. At the time of his injury, Whitlock was twenty years old, attended the University of Denver, and was a member of the Beta house, where he held the office of acting house manager. The property on which the Beta house was located was leased to the local chapter house association of the Beta Theta Pi fraternity by the defendant University of Denver.

Whitlock had extensive experience jumping on trampolines. He began using trampolines in junior high school and continued to do so during his brief tenure as a cadet at the United States Military Academy at West Point, where he learned to execute the one-and-three-quarters front flip. Whitlock testified that he utilized the trampoline at West Point every other day for a period of two months. He began jumping on the trampoline owned by the Beta house in September of 1977. Whitlock recounted that in the fall and spring prior to the date of his injury, he jumped on the trampoline almost daily. He testified further that prior to the date of his injury, he had successfully executed the one-and-three-quarters front flip between seventy-five and one hundred times.

During the evening of June 18 and early morning of June 19, 1978, Whitlock attended a party at the Beta house, where he drank beer, vodka and scotch until 2:00 a.m. Whitlock then retired and did not awaken until 2:00 p.m. on June 19. He testified that he jumped on the trampoline between 2:00 p.m. and 4:00 p.m., and again at 7:00 p.m. At 10:00 p.m., the time of the injury, there again was a party in progress at the Beta house, and Whitlock was using the trampoline with only the illumination from the windows of the fraternity house, the outside light above the front door of the house, and two street lights in the area. As Whitlock attempted to perform the one-and-three-quarters front flip, he landed on the back of his head, causing his neck to break.

Whitlock brought suit against the manufacturer and seller of the trampoline, the University, the Beta Theta Pi fraternity and its local chapter, and certain individuals in their capacities as representatives of the Beta Theta Pi organizations. Whitlock

reached settlements with all of the named defendants except the University, so only the negligence action against the University proceeded to trial. The jury returned a verdict in favor of Whitlock, assessing his total damages at \$ 7,300,000. The jury attributed twenty-eight percent of causal negligence to the conduct of Whitlock and seventy-two percent of causal negligence to the conduct of the University. The trial court accordingly reduced the amount of the award against the University to \$ 5,256,000.

The University moved for judgment notwithstanding the verdict, or, in the alternative, a new trial. The trial court granted the motion for judgment notwithstanding the verdict, holding that as a matter of law, no reasonable jury could have found that the University was more negligent than Whitlock, and that the jury's monetary award was the result of sympathy, passion or prejudice.

A panel of the court of appeals reversed...by a divided vote. *Whitlock v. University of Denver*, 712 P.2d 1072 (Colo. App. 1985). The court of appeals held that the University owed Whitlock a duty of due care to remove the trampoline from the fraternity premises or to supervise its use....The case was remanded to the trial court with orders to reinstate the verdict and damages as determined by the jury. The University then petitioned for certiorari review, and we granted that petition.

## II.

A negligence claim must fail if based on circumstances for which the law imposes no duty of care upon the defendant for the benefit of the plaintiff. [Citations] Therefore, if Whitlock's judgment against the University is to be upheld, it must first be determined that the University owed a duty of care to take reasonable measures to protect him against the injury that he sustained.

Whether a particular defendant owes a legal duty to a particular plaintiff is a question of law. [Citations] "The court determines, as a matter of law, the existence and scope of the duty—that is, whether the plaintiff's interest that has been infringed by the conduct of the defendant is entitled to legal protection." [Citations] In *Smith v. City & County of Denver*, 726 P.2d 1125 (Colo. 1986), we set forth several factors to be considered in determining the existence of duty in a particular case:

Whether the law should impose a duty requires consideration of many factors including, for example, the risk involved, the foreseeability and likelihood of injury as weighed against the social utility of the actor's conduct, the magnitude of the burden of guarding against injury or harm, and the consequences of placing the burden upon the actor.

...A court's conclusion that a duty does or does not exist is "an expression of the sum total of those considerations of policy which lead the law to say that the plaintiff is [or is not] entitled to protection."

...

We believe that the fact that the University is charged with negligent failure to act rather than negligent affirmative action is a critical factor that strongly militates against imposition of a duty on the University under the facts of this case. In determining whether a defendant owes a duty to a particular plaintiff, the law has long recognized a distinction between action and a failure to act—"that is to say, between active misconduct working positive injury to others [misfeasance] and passive inaction or a failure to take steps to protect them from harm [nonfeasance]." W. Keeton, § 56, at 373. Liability for nonfeasance was slow to receive recognition in the law. "The reason for the distinction may be said to lie in the fact that by 'misfeasance' the defendant has created a new risk of harm to the plaintiff, while by 'nonfeasance' he has at least made his situation no worse, and has merely failed to benefit him by interfering in his affairs." *Id.* The *Restatement (Second) of Torts* § 314 (1965) summarizes the law on this point as follows:

The fact that an actor realizes or should realize that action on his part is necessary for another's aid or protection does not of itself impose upon him a duty to take such action.

Imposition of a duty in all such cases would simply not meet the test of fairness under contemporary standards.

In nonfeasance cases the existence of a duty has been recognized only during the last century in situations involving a limited group of special relationships between parties. Such special relationships are predicated on "some definite relation between the parties, of such a character that social policy justifies the imposition of a duty to act." W. Keeton, § 56, at 374. Special relationships that have been recognized by various courts for the purpose of imposition of a duty of care include common carrier/passenger, innkeeper/guest, possessor of land/invited entrant, employer/employee, parent/child, and hospital/patient. *See Restatement (Second) of Torts* § 314 A (1965); 3 Harper and James, § 18.6, at 722-23. The authors of the *Restatement (Second) of Torts* § 314 A, comment b (1965), state that "the law appears...to be working slowly toward a recognition of the duty to aid or protect in any relation of dependence or of mutual dependence."

...



**III.**

The present case involves the alleged negligent failure to act, rather than negligent action. The plaintiff does not complain of any affirmative action taken by the University, but asserts instead that the University owed to Whitlock the duty to assure that the fraternity's trampoline was used only under supervised conditions comparable to those in a gymnasium class, or in the alternative to cause the trampoline to be removed from the front lawn of the Beta house....If such a duty is to be recognized, it must be grounded on a special relationship between the University and Whitlock. According to the evidence, there are only two possible sources of a special relationship out of which such a duty could arise in this case: the status of Whitlock as a student at the University, and the lease between the University and the fraternity of which Whitlock was a member. We first consider the adequacy of the student-university relationship as a possible basis for imposing a duty on the University to control or prohibit the use of the trampoline, and then examine the provisions of the lease for that same purpose.

**A.**

The student-university relationship has been scrutinized in several jurisdictions, and it is generally agreed that a university is not an insurer of its students' safety. [Citations] The relationship between a university and its students has experienced important change over the years. At one time, college administrators and faculties stood in loco parentis to their students, which created a special relationship "that imposed a duty on the college to exercise control over student conduct and, reciprocally, gave the students certain rights of protection by the college." *Bradshaw*, 612 F.2d at 139. However, in modern times there has evolved a gradual reapportionment of responsibilities from the universities to the students, and a corresponding departure from the in loco parentis relationship. *Id.* at 139-40. Today, colleges and universities are regarded as educational institutions rather than custodial ones. *Beach*, 726 P.2d at 419 (contrasting colleges and universities with elementary and high schools).

...

...By imposing a duty on the University in this case, the University would be encouraged to exercise more control over private student recreational choices, thereby effectively taking away much of the responsibility recently recognized in students for making their own decisions with respect to private entertainment and personal safety. Such an allocation of responsibility would "produce a repressive and inhospitable environment, largely inconsistent with the objectives of a modern college education." *Beach*, 726 P.2d at 419.

The evidence demonstrates that only in limited instances has the University attempted to impose regulations or restraints on the private recreational pursuits of its students, and the students have not looked to the University to assure the safety of their recreational choices. Nothing in the University's student handbook, which contains certain regulations concerning student conduct, reflects an effort by the University to control the risk-taking decisions of its students in their private recreation....Indeed, fraternity and sorority self-governance with minimal supervision appears to have been fostered by the University.

...

Aside from advising the Beta house on one occasion to put the trampoline up when not in use, there is no evidence that the University officials attempted to assert control over trampoline use by the fraternity members. We conclude from this record that the University's very limited actions concerning safety of student recreation did not give Whitlock or the other members of campus fraternities or sororities any reason to depend upon the University for evaluation of the safety of trampoline use....Therefore, we conclude that the student-university relationship is not a special relationship of the type giving rise to a duty of the University to take reasonable measures to protect the members of fraternities and sororities from risks of engaging in extra-curricular trampoline jumping.

The plaintiff asserts, however, that we should recognize a duty of the University to take affirmative action to protect fraternity members because of the foreseeability of the injury, the extent of the risks involved in trampoline use, the seriousness of potential injuries, and the University's superior knowledge concerning these matters. The argument in essence is that a duty should spring from the University's natural interest in the welfare and safety of its students, its superior knowledge of the nature and degree of risk involved in trampoline use, and its knowledge of the use of trampolines on the University campus. The evidence amply supports a conclusion that trampoline use involves risks of serious injuries and that the potential for an injury such as that experienced by Whitlock was foreseeable. It shows further that prior injuries resulting from trampoline accidents had been reported to campus security and to the student clinic, and that University administrators were aware of the number and severity of trampoline injuries nationwide.

The record, however, also establishes through Whitlock's own testimony that he was aware of the risk of an accident and injury of the very nature that he experienced....

We conclude that the relationship between the University and Whitlock was not one of dependence with respect to the activities at issue here, and provides no basis for the recognition of a duty of the University to take measures for protection of Whitlock against the injury that he suffered.

**B.**

We next examine the lease between the University and the fraternity to determine whether a special relationship between the University and Whitlock can be predicated on that document. The lease was executed in 1929, extends for a ninety-nine year term, and gives the fraternity the option to extend the term for another ninety-nine years. The premises are to be occupied and used by the fraternity “as a fraternity house, clubhouse, dormitory and boarding house, and generally for religious, educational, social and fraternal purposes.” Such occupation is to be “*under control of the tenant.*” (emphasis added) The annual rental at all times relevant to this case appears from the record to be one dollar. The University has the obligation to maintain the grounds and make necessary repairs to the building, and the fraternity is to bear the cost of such maintenance and repair.

...

We conclude that the lease, and the University’s actions pursuant to its rights under the lease, provide no basis of dependence by the fraternity members upon which a special relationship can be found to exist between the University and the fraternity members that would give rise to a duty upon the University to take affirmative action to assure that recreational equipment such as a trampoline is not used under unsafe conditions.

**IV.**

Considering all of the factors presented, we are persuaded that under the facts of this case the University of Denver had no duty to Whitlock to eliminate the private use of trampolines on its campus or to supervise that use. There exists no special relationship between the parties that justifies placing a duty upon the University to protect Whitlock from the well-known dangers of using a trampoline. Here, a conclusion that a special relationship existed between Whitlock and the University sufficient to warrant the imposition of liability for nonfeasance would directly contravene the competing social policy of fostering an educational environment of student autonomy and independence.

We reverse the judgment of the court of appeals and return this case to that court with directions to remand it to the trial court for dismissal of Whitlock's complaint against the University.

### CASE QUESTIONS

1. How are comparative negligence numbers calculated by the trial court? How can the jury say that the university is 72 percent negligent and that Whitlock is 28 percent negligent?
2. Why is this not an assumption of risk case?
3. Is there any evidence that Whitlock was contributorily negligent? If not, why would the court engage in comparative negligence calculations?

### Negligence: Proximate Cause

Palsgraf v. Long Island R.R.

248 N.Y. 339, 162 N.E. 99 (N.Y. 1928)

CARDOZO, Chief Judge

Plaintiff was standing on a platform of defendant's railroad after buying a ticket to go to Rockaway Beach. A train stopped at the station, bound for another place. Two men ran forward to catch it. One of the men reached the platform of the car without mishap, though the train was already moving. The other man, carrying a package, jumped aboard the car, but seemed unsteady as if about to fall. A guard on the car, who had held the door open, reached forward to help him in, and another guard on the platform pushed him from behind. In this act, the package was dislodged, and fell upon the rails. It was a package of small size, about fifteen inches long, and was covered by a newspaper. In fact it contained fireworks, but there was nothing in its appearance to give notice of its contents. The fireworks when they fell exploded. The shock of the explosion threw down some scales at the other end of the platform many feet away. The scales struck the plaintiff, causing injuries for which she sues.

The conduct of the defendant's guard, if a wrong in its relation to the holder of the package, was not a wrong in its relation to the plaintiff, standing far away. Relatively to her it was not negligence at all. Nothing in the situation gave notice that the falling package had in it the potency of peril to persons thus removed. Negligence is not actionable unless it involves the invasion of a legally protected

interest, the violation of a right. “Proof of negligence in the air, so to speak, will not do....If no hazard was apparent to the eye of ordinary vigilance, an act innocent and harmless, at least to outward seeming, with reference to her, did not take to itself the quality of a tort because it happened to be a wrong, though apparently not one involving the risk of bodily insecurity, with reference to someone else....The plaintiff sues in her own right for a wrong personal to her, and not as the vicarious beneficiary of a breach of duty to another.

A different conclusion will involve us, and swiftly too, in a maze of contradictions. A guard stumbles over a package which has been left upon a platform.

It seems to be a bundle of newspapers. It turns out to be a can of dynamite. To the eye of ordinary vigilance, the bundle is abandoned waste, which may be kicked or trod on with impunity. Is a passenger at the other end of the platform protected by the law against the unsuspected hazard concealed beneath the waste? If not, is the result to be any different, so far as the distant passenger is concerned, when the guard stumbles over a valise which a truckman or a porter has left upon the walk?...The orbit of the danger as disclosed to the eye of reasonable vigilance would be the orbit of the duty. One who jostles one’s neighbor in a crowd does not invade the rights of others standing at the outer fringe when the unintended contact casts a bomb upon the ground. The wrongdoer as to them is the man who carries the bomb, not the one who explodes it without suspicion of the danger. Life will have to be made over, and human nature transformed, before prevision so extravagant can be accepted as the norm of conduct, the customary standard to which behavior must conform.

The argument for the plaintiff is built upon the shifting meanings of such words as “wrong” and “wrongful” and shares their instability. For what the plaintiff must show is a “wrong” to herself; i.e., a violation of her own right, and not merely a “wrong” to someone else, nor conduct “wrongful” because unsocial, but not a “wrong” to anyone. We are told that one who drives at reckless speed through a crowded city street is guilty of a negligent act and therefore of a wrongful one, irrespective of the consequences.

Negligent the act is, and wrongful in the sense that it is unsocial, but wrongful and unsocial in relation to other travelers, only because the eye of vigilance perceives the risk of damage. If the same act were to be committed on a speedway or a race course, it would lose its wrongful quality. The risk reasonably to be perceived defines the duty to be obeyed, and risk imports relation; it is risk to another or to others within the range of apprehension. This does not mean, of course, that one who launches a destructive force is always relieved of liability, if the force, though known to be destructive, pursues an unexpected path....Some acts, such as shooting

are so imminently dangerous to anyone who may come within reach of the missile however unexpectedly, as to impose a duty of prevision not far from that of an insurer. Even today, and much oftener in earlier stages of the law, one acts sometimes at one's peril....These cases aside, wrong-is defined in terms of the natural or probable, at least when unintentional....Negligence, like risk, is thus a term of relation.

Negligence in the abstract, apart from things related, is surely not a tort, if indeed it is understandable at all....One who seeks redress at law does not make out a cause of action by showing without more that there has been damage to his person. If the harm was not willful, he must show that the act as to him had possibilities of danger so many and apparent as to entitle him to be protected against the doing of it though the harm was unintended.

\* \* \*

The judgment of the Appellate Division and that of the Trial Term should be reversed, and the complaint dismissed, with costs in all courts.

### CASE QUESTIONS

1. Is there actual cause in this case? How can you tell?
2. Why should Mrs. Palsgraf (or her insurance company) be made to pay for injuries that were caused by the negligence of the Long Island Rail Road?
3. How is this accident *not* foreseeable?

### ***Klein v. Pyrodyne Corporation***

Klein v. Pyrodyne Corporation

810 P.2d 917 (Supreme Court of Washington 1991)

Pyrodyne Corporation (Pyrodyne) is a licensed fireworks display company that contracted to display fireworks at the Western Washington State Fairgrounds in Puyallup, Washington, on July 4, 1987. During the fireworks display, one of the mortar launchers discharged a rocket on a horizontal trajectory parallel to the earth. The rocket exploded near a crowd of onlookers, including Danny Klein. Klein's clothing was set on fire, and he suffered facial burns and serious injury to

his eyes. Klein sued Pyrodyne for strict liability to recover for his injuries. Pyrodyne asserted that the Chinese manufacturer of the fireworks was negligent in producing the rocket and therefore Pyrodyne should not be held liable. The trial court applied the doctrine of strict liability and held in favor of Klein. Pyrodyne appealed.

Section 519 of the Restatement (Second) of Torts provides that any party carrying on an “abnormally dangerous activity” is strictly liable for ensuing damages. The public display of fireworks fits this definition. The court stated: “Any time a person ignites rockets with the intention of sending them aloft to explode in the presence of large crowds of people, a high risk of serious personal injury or property damage is created. That risk arises because of the possibility that a rocket will malfunction or be misdirected.” Pyrodyne argued that its liability was cut off by the Chinese manufacturer’s negligence. The court rejected this argument, stating, “Even if negligence may properly be regarded as an intervening cause, it cannot function to relieve Pyrodyne from strict liability.”

The Washington Supreme Court held that the public display of fireworks is an abnormally dangerous activity that warrants the imposition of strict liability.

Affirmed.

### CASE QUESTIONS

1. Why would certain activities be deemed ultrahazardous or abnormally dangerous so that strict liability is imposed?
2. If the activities are known to be abnormally dangerous, did Klein assume the risk?
3. Assume that the fireworks were negligently manufactured in China. Should Klein’s only remedy be against the Chinese company, as Pyrodyne argues? Why or why not?

## 7.6 Summary and Exercises

### Summary

The principles of tort law pervade modern society because they spell out the duties of care that we owe each other in our private lives. Tort law has had a significant impact on business because modern technology poses significant dangers and the modern market is so efficient at distributing goods to a wide class of consumers.

Unlike criminal law, tort law does not require the tortfeasor to have a specific intent to commit the act for which he or she will be held liable to pay damages. Negligence—that is, carelessness—is a major factor in tort liability. In some instances, especially in cases involving injuries caused by products, a no-fault standard called strict liability is applied.

What constitutes a legal injury depends very much on the circumstances. A person can assume a risk or consent to the particular action, thus relieving the person doing the injury from tort liability. To be liable, the tortfeasor must be the proximate cause of the injury, not a remote cause. On the other hand, certain people are held to answer for the torts of another—for example, an employer is usually liable for the torts of his employees, and a bartender might be liable for injuries caused by someone to whom he sold too many drinks. Two types of statutes—workers' compensation and no-fault automobile insurance—have eliminated tort liability for certain kinds of accidents and replaced it with an immediate insurance payment plan.

Among the torts of particular importance to the business community are wrongful death and personal injury caused by products or acts of employees, misrepresentation, defamation, and interference with contractual relations.



## EXERCISES

1. What is the difference in objectives between tort law and criminal law?
2. A woman fell ill in a store. An employee put the woman in an infirmary but provided no medical care for six hours, and she died. The woman's family sued the store for wrongful death. What arguments could the store make that it was not liable? What arguments could the family make? Which seem the stronger arguments? Why?
3. The signals on a railroad crossing are defective. Although the railroad company was notified of the problem a month earlier, the railroad inspector has failed to come by and repair them. Seeing the all-clear signal, a car drives up and stalls on the tracks as a train rounds the bend. For the past two weeks the car had been stalling, and the driver kept putting off taking the car to the shop for a tune-up. As the train rounds the bend, the engineer is distracted by a conductor and does not see the car until it is too late to stop. Who is negligent? Who must bear the liability for the damage to the car and to the train?
4. Suppose in the *Katko v. Briney* case ([Section 7.2 "Intentional Torts"](#)) that instead of setting such a device, the defendants had simply let the floor immediately inside the front door rot until it was so weak that anybody who came in and took two steps straight ahead would fall through the floor and to the cellar. Will the defendant be liable in this case? What if they invited a realtor to appraise the place and did not warn her of the floor? Does it matter whether the injured person is a trespasser or an invitee?
5. Plaintiff's husband died in an accident, leaving her with several children and no money except a valid insurance policy by which she was entitled to \$5,000. Insurance Company refused to pay, delaying and refusing payment and meanwhile "inviting" Plaintiff to accept less than \$5,000, hinting that it had a defense. Plaintiff was reduced to accepting housing and charity from relatives. She sued the insurance company for bad-faith refusal to settle the claim and for the intentional infliction of emotional distress. The lower court dismissed the case. Should the court of appeals allow the matter to proceed to trial?

## SELF-TEST QUESTIONS

1. Catarina falsely accuses Jeff of stealing from their employer. The statement is defamatory only if
  - a. a third party hears it
  - b. Nick suffers severe emotional distress as a result
  - c. the statement is the actual and proximate cause of his distress
  - d. the statement is widely circulated in the local media and on Twitter
  
2. Garrett files a suit against Colossal Media Corporation for defamation. Colossal has said that Garrett is a “sleazy, corrupt public official” (and provided some evidence to back the claim). To win his case, Garrett will have to show that Colossal acted with
  - a. malice
  - b. ill will
  - c. malice aforethought
  - d. actual malice
  
3. Big Burger begins a rumor, using social media, that the meat in Burger World is partly composed of ground-up worms. The rumor is not true, as Big Burger well knows. Its intent is to get some customers to shift loyalty from Burger World to Big Burger. Burger World’s best cause of action would be
  - a. trespass on the case
  - b. nuisance
  - c. product disparagement
  - d. intentional infliction of emotional distress
  
4. Wilfred Phelps, age 65, is driving his Nissan Altima down Main Street when he suffers the first seizure of his life. He loses control of his vehicle and runs into three people on the sidewalk. Which statement is true?
  - a. He is liable for an intentional tort.

- b. He is liable for a negligent tort.
  - c. He is not liable for a negligent tort.
  - d. He is liable under strict liability, because driving a car is abnormally dangerous.
5. Jonathan carelessly bumps into Amanda, knocking her to the ground. He has committed the tort of negligence
- a. only if Amanda is injured
  - b. only if Amanda is not injured
  - c. whether or not Amanda is injured

#### SELF-TEST ANSWERS

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

## Chapter 8

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### Introduction to Contract Law

#### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. Why and how contract law has developed
2. What a contract is
3. What topics will be discussed in the contracts chapter of this book
4. What the sources of contract law are
5. How contracts are classified (basic taxonomy)

## 8.1 General Perspectives on Contracts

### LEARNING OBJECTIVES

1. Explain contract law's cultural roots: how it has evolved as capitalism has evolved.
2. Understand that contracts serve essential economic purposes.
3. Define contract.
4. Understand the basic issues in contract law.

### The Role of Contracts in Modern Society

Contract is probably the most familiar legal concept in our society because it is so central to the essence of our political, economic, and social life. In common parlance, contract is used interchangeably with *agreement*, *bargain*, *undertaking*, or *deal*. Whatever the word, the concept it embodies is our notion of freedom to pursue our own lives together with others. Contract is central because it is the means by which a free society orders what would otherwise be a jostling, frenetic anarchy.

So commonplace is the concept of contract—and our freedom to make contracts with each other—that it is difficult to imagine a time when contracts were rare, when people's everyday associations with one another were not freely determined. Yet in historical terms, it was not so long ago that contracts were rare, entered into if at all by very few: that affairs should be ordered based on mutual assent was mostly unknown. In primitive societies and in feudal Europe, relationships among people were largely fixed; traditions spelled out duties that each person owed to family, tribe, or manor. People were born into an ascribed position—a status (not unlike the caste system still existing in India)—and social mobility was limited. Sir Henry Maine, a nineteenth-century British historian, wrote that “the movement of the progressive societies has...been a movement from status to contract.” Sir Henry Maine, *Ancient Law* (1869), 180–82. This movement was not accidental—it developed with the emerging industrial order. From the fifteenth to the nineteenth century, England evolved into a booming mercantile economy, with flourishing trade, growing cities, an expanding monetary system, the commercialization of agriculture, and mushrooming manufacturing. With this evolution, contract law was created of necessity.

Contract law did not develop according to a conscious plan, however. It was a response to changing conditions, and the judges who created it frequently resisted,

preferring the imagined quieter pastoral life of their forefathers. Not until the nineteenth century, in both the United States and England, did a full-fledged law of contracts arise together with, and help create, modern capitalism.

Modern capitalism, indeed, would not be possible without contract law. So it is that in planned economies, like those of the former Soviet Union and precapitalistic China, the contract did not determine the nature of an economic transaction. That transaction was first set forth by the state's planning authorities; only thereafter were the predetermined provisions set down in a written contract. Modern capitalism has demanded new contract regimes in Russia and China; the latter adopted its Revised Contract Law in 1999.

Contract law may be viewed economically as well as culturally. In *An Economic Analysis of Law*, Judge Richard A. Posner (a former University of Chicago law professor) suggests that contract law performs three significant economic functions. First, it helps maintain incentives for individuals to exchange goods and services efficiently. Second, it reduces the costs of economic transactions because its very existence means that the parties need not go to the trouble of negotiating a variety of rules and terms already spelled out. Third, the law of contracts alerts the parties to troubles that have arisen in the past, thus making it easier to plan the transactions more intelligently and avoid potential pitfalls. Richard A. Posner, *Economic Analysis of Law* (New York: Aspen, 1973).

### The Definition of Contract

As usual in the law, the legal definition of **contract**<sup>1</sup> is formalistic. The Restatement (Second) of Contracts (Section 1) says, "A contract is a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty." Similarly, the Uniform Commercial Code says, "Contract' means the total legal obligation which results from the parties' agreement as affected by this Act and any other applicable rules of law." Uniform Commercial Code, Section 1-201(11). As operational definitions, these two are circular; in effect, a contract is defined as an agreement that the law will hold the parties to.

Most simply, a contract is a legally enforceable promise. This implies that not every promise or agreement creates a binding contract; if every promise did, the simple definition set out in the preceding sentence would read, "A contract is a promise." But—again—a contract is not simply a promise: it is a legally enforceable promise. The law takes into account the way in which contracts are made, by whom they are made, and for what purposes they are made. For example, in many states, a wager is

1. A legally enforceable set of promises.

unenforceable, even though both parties “shake” on the bet. We will explore these issues in the chapters to come.

## Overview of the Contracts Chapter

Although contract law has many wrinkles and nuances, it consists of four principal inquiries, each of which will be taken up in subsequent chapters:

1. Did the parties create a valid contract? Four elements are necessary for a valid contract:
  - a. Mutual assent (i.e., offer and acceptance), Chapter 9 "The Agreement"
  - b. Real assent (no duress, undue influence, misrepresentation, mistake, or incapacity), Chapter 10 "Real Assent"
  - c. Consideration, Chapter 11 "Consideration"
  - d. Legality, Chapter 12 "Legality"
2. What does the contract mean, and is it in the proper form to carry out this meaning? Sometimes contracts need to be in writing (or evidenced by some writing), or they can't be enforced. Sometimes it isn't clear what the contract means, and a court has to figure that out. These problems are taken up in Chapter 13 "Form and Meaning".
3. Do persons other than the contracting parties have rights or duties under the contract? Can the right to receive a benefit from the contract be assigned, and can the duties be delegated so that a new person is responsible? Can persons not a party to the contract sue to enforce its terms? These questions are addressed in Chapter 14 "Third-Party Rights".
4. How do contractual duties terminate, and what remedies are available if a party has breached the contract? These issues are taken up in Chapter 15 "Discharge of Obligations" and Chapter 16 "Remedies".

Together, the answers to these four basic inquiries determine the rights and obligations of contracting parties.

### KEY TAKEAWAY

Contract law developed when the strictures of feudalism dissipated, when a person's position in society came to be determined by personal choice (by mutual agreement) and not by status (by how a person was born). Capitalism and contract law have developed together, because having choices in society means that people decide and agree to do things with and to each other, and those agreements bind the parties; the agreements must be enforceable.

### EXERCISES

1. Why is contract law necessary in a society where a person's status is not predetermined by birth?
2. Contract law serves some economic functions. What are they?



## 8.2 Sources of Contract Law

### LEARNING OBJECTIVES

1. Understand that contract law comes from two sources: judges (cases) and legislation.
2. Know what the Restatement of Contracts is.
3. Recognize the Convention on Contracts for the International Sale of Goods.

The most important sources of contract law are state case law and state statutes (though there are also many federal statutes governing how contracts are made by and with the federal government).

### Case Law

Law made by judges is called **case law**<sup>2</sup>. Because contract law was made up in the common-law courtroom by individual judges as they applied rules to resolve disputes before them, it grew over time to formidable proportions. By the early twentieth century, tens of thousands of contract disputes had been submitted to the courts for resolution, and the published opinions, if collected in one place, would have filled dozens of bookshelves. Clearly this mass of material was too unwieldy for efficient use. A similar problem also had developed in the other leading branches of the common law.

Disturbed by the profusion of cases and the resulting uncertainty of the law, a group of prominent American judges, lawyers, and law teachers founded the American Law Institute (ALI) in 1923 to attempt to clarify, simplify, and improve the law. One of the ALI's first projects, and ultimately one of its most successful, was the drafting of the **Restatement of the Law of Contracts**<sup>3</sup>, completed in 1932. A revision—the Restatement (Second) of Contracts—was undertaken in 1964 and completed in 1979. Hereafter, references to “the Restatement” pertain to the Restatement (Second) of Contracts.

2. Law decided by judges as recorded in cases and published.
3. An organized codification of the common law of contracts.

The Restatements—others exist in the fields of torts, agency, conflicts of laws, judgments, property, restitution, security, and trusts—are detailed analyses of the decided cases in each field. These analyses are made with an eye to discerning the various principles that have emerged from the courts, and to the maximum extent possible, the Restatements declare the law as the courts have determined it to be.

The Restatements, guided by a reporter (the director of the project) and a staff of legal scholars, go through several so-called tentative drafts—sometimes as many as fifteen or twenty—and are screened by various committees within the ALI before they are eventually published as final documents.

The Restatement (Second) of Contracts won prompt respect in the courts and has been cited in innumerable cases. The Restatements are not authoritative, in the sense that they are not actual judicial precedents; but they are nevertheless weighty interpretive texts, and judges frequently look to them for guidance. They are as close to “black letter” rules of law as exist anywhere in the American common-law legal system.

Common law, case law (the terms are synonymous), governs contracts for the sale of real estate and services. “Services” refer to acts or deeds (like plumbing, drafting documents, driving a car) as opposed to the sale of property.

### Statutory Law: The Uniform Commercial Code

Common-law contract principles govern contracts for real estate and services. Because of the historical development of the English legal system, contracts for the sale of goods came to be governed by a different body of legal rules. In its modern American manifestation, that body of rules is an important statute: the **Uniform Commercial Code (UCC)**<sup>4</sup>, especially **Article 2**<sup>5</sup>, which deals with the sale of goods.

#### History of the UCC

A bit of history is in order. Before the UCC was written, commercial law varied, sometimes greatly, from state to state. This first proved a nuisance and then a serious impediment to business as the American economy became nationwide during the twentieth century. Although there had been some uniform laws concerned with commercial deals—including the Uniform Sales Act, first published in 1906—few were widely adopted and none nationally. As a result, the law governing sales of goods, negotiable instruments, warehouse receipts, securities, and other matters crucial to doing business in an industrial market economy was a crazy quilt of untidy provisions that did not mesh well from state to state.

4. The modern American state statutory law governing commercial transactions.

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

The UCC is a model law developed by the ALI and the National Conference of Commissioners on Uniform State Laws; it has been adopted in one form or another by the legislatures in all fifty states, the District of Columbia, and the American territories. It is a “national” law not enacted by Congress—it is not federal law but uniform state law.

Initial drafting of the UCC began in 1942 and was ten years in the making, involving the efforts of hundreds of practicing lawyers, law teachers, and judges. A final draft, promulgated by the ALI, was endorsed by the American Bar Association and published in 1951. Various revisions followed in different states, threatening the uniformity of the UCC. The ALI responded by creating a permanent editorial board to oversee future revisions. In one or another of its various revisions, the UCC has been adopted in whole or in part in all American jurisdictions. The UCC is now a basic law of relevance to every business and business lawyer in the United States, even though it is not entirely uniform because different states have adopted it at various stages of its evolution—an evolution that continues still.

### **Organization of the UCC**

The UCC consists of nine major substantive articles; each deals with separate though related subjects. The articles are as follows:

- Article 1: General Provisions
- Article 2: Sales
- Article 2A: Leases
- Article 3: Commercial Paper
- Article 4: Bank Deposits and Collections
- Article 4A: Funds Transfers
- Article 5: Letters of Credit
- Article 6: Bulk Transfers
- Article 7: Warehouse Receipts, Bills of Lading, and Other Documents of Title
- Article 8: Investment Securities
- Article 9: Secured Transactions

Article 2 deals only with the sale of goods, which the UCC defines as “all things...which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid.”Uniform Commercial Code, Section 2-105. The only contracts and agreements covered by Article 2 are those relating to the present or future sale of goods.

Article 2 is divided in turn into six major parts: (1) Form, Formation, and Readjustment of Contract; (2) General Obligation and Construction of Contract; (3) Title, Creditors, and Good Faith Purchasers; (4) Performance; (5) Breach, Repudiation, and Excuse; and (6) Remedies. These topics will be discussed in [Chapter 17 "Introduction to Sales and Leases"](#), [Chapter 18 "Title and Risk of Loss"](#), [Chapter 19 "Performance and Remedies"](#), [Chapter 20 "Products Liability"](#), and [Chapter 21 "Bailments and the Storage, Shipment, and Leasing of Goods"](#).

Figure 8.1 Sources of Law

Type of Contract	Source of Law	
	Common Law	UCC
Real Estate	✓	
Services	✓	
Sale of Goods		✓

## International Sales Law

### The Convention on Contracts for the International Sale of Goods

A **Convention on Contracts for the International Sale of Goods (CISG)**<sup>6</sup> was approved in 1980 at a diplomatic conference in Vienna. (A convention is a preliminary agreement that serves as the basis for a formal treaty.) The CISG has been adopted by more than forty countries, including the United States.

The CISG is significant for three reasons. First, it is a uniform law governing the sale of goods—in effect, an international Uniform Commercial Code. The major goal of the drafters was to produce a uniform law acceptable to countries with different legal, social, and economic systems. Second, although provisions in the CISG are generally consistent with the UCC, there are significant differences. For instance, under the CISG, consideration (discussed in [Chapter 11 "Consideration"](#)) is not required to form a contract, and there is no Statute of Frauds (a requirement that certain contracts be evidenced by a writing). Third, the CISG represents the first attempt by the US Senate to reform the private law of business through its treaty powers, for the CISG preempts the UCC. The CISG is not mandatory: parties to an international contract for the sale of goods may choose to have their agreement governed by different law, perhaps the UCC, or perhaps, say, Japanese contract law. The CISG does not apply to contracts for the sale of (1) ships or aircraft, (2) electricity, or (3) goods bought for personal, family, or household use, nor does it apply (4) where the party furnishing the goods does so only incidentally to the labor or services part of the contract.

6. An international body of contract law.

### KEY TAKEAWAY

Judges have made contract law over several centuries by deciding cases that create, extend, or change the developing rules affecting contract formation, performance, and enforcement. The rules from the cases have been abstracted and organized in the Restatements of Contracts. To facilitate interstate commerce, contract law for many commercial transactions—especially the sale of goods—not traditionally within the purview of judges has been developed by legal scholars and presented for the states to adopt as the Uniform Commercial Code. There is an analogous Convention on Contracts for the International Sale of Goods, to which the United States is a party.

### EXERCISES

1. How do judges make contract law?
2. What is the Restatement of the Law of Contracts, and why was it necessary?
3. Why was the Uniform Commercial Code developed, and by whom?
4. Who adopts the UCC as governing law?
5. What is the Convention on Contracts for the International Sale of Goods?

## 8.3 Basic Taxonomy of Contracts

### LEARNING OBJECTIVES

1. Understand that contracts are classified according to the criteria of explicitness, mutuality, enforceability, and degree of completion and that some noncontract promises are nevertheless enforceable under the doctrine of promissory estoppel.
2. Keep your eyes (and ears) alert to the use of suffixes (word endings) in legal terminology that express relationships between parties.

Some contracts are written, some oral; some are explicit, some not. Because contracts can be formed, expressed, and enforced in a variety of ways, a taxonomy of contracts has developed that is useful in grouping together like legal consequences. In general, contracts are classified along four different dimensions: explicitness, mutuality, enforceability, and degree of completion. Explicitness is the degree to which the agreement is manifest to those not party to it. Mutuality takes into account whether promises are given by two parties or only one. Enforceability is the degree to which a given contract is binding. Completion considers whether the contract is yet to be performed or whether the obligations have been fully discharged by one or both parties. We will examine each of these concepts in turn.

### Explicitness

#### Express Contract

An **express contract**<sup>7</sup> is one in which the terms are spelled out directly. The parties to an express contract, whether it is written or oral, are conscious that they are making an enforceable agreement. For example, an agreement to purchase your neighbor's car for \$5,500 and to take title next Monday is an express contract.

#### Implied Contract (Implied in Fact)

An **implied contract**<sup>8</sup> is one that is inferred from the actions of the parties. When parties have not discussed terms, an implied contract exists if it is clear from the conduct of both parties that they intended there be one. A delicatessen patron who asks for a turkey sandwich to go has made a contract and is obligated to pay when the sandwich is made. By ordering the food, the patron is implicitly agreeing to the price, whether posted or not.

7. A contract in words, orally or in writing.

8. A contract that is not expressed but is inferred from the actions of the parties.

The distinction between express and implied contracts has received a degree of notoriety in the so-called palimony cases, in which one member of an unmarried couple seeks a division of property after a long-standing live-together relationship has broken up. When a married couple divorces, their legal marriage contract is dissolved, and financial rights and obligations are spelled out in a huge body of domestic relations statutes and judicial decisions. No such laws exist for unmarried couples. However, about one-third of the states recognize common-law marriage, under which two people are deemed to be married if they live together with the intent to be married, regardless of their failure to have obtained a license or gone through a ceremony. Although there is no actual contract of marriage (no license), their behavior implies that the parties intended to be treated as if they were married.

### Quasi-Contract

A **quasi-contract (implied in law)**<sup>9</sup> is—unlike both express and implied contracts, which embody an actual agreement of the parties—an obligation said to be “imposed by law” in order to avoid unjust enrichment of one person at the expense of another. A quasi-contract is not a contract at all; it is a fiction that the courts created to prevent injustice. Suppose, for example, that the local lumberyard mistakenly delivers a load of lumber to your house, where you are repairing your deck. It was a neighbor on the next block who ordered the lumber, but you are happy to accept the load for free; since you never talked to the lumberyard, you figure you need not pay the bill. Although it is true there is no contract, the law implies a contract for the value of the material: of course you will have to pay for what you got and took. The existence of this implied contract does not depend on the intention of the parties.

### Mutuality

#### Bilateral Contract

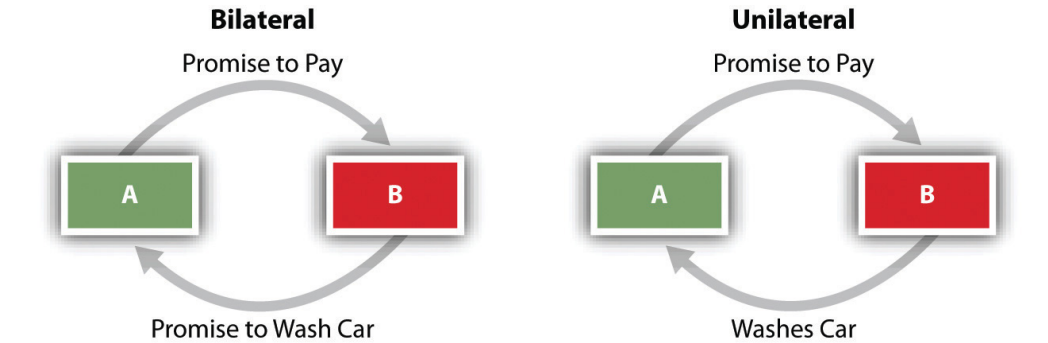
The typical contract is one in which the parties make mutual promises. Each is both promisor and promisee; that is, each pledges to do something, and each is the recipient of such a pledge. This type of contract is called a **bilateral contract**<sup>10</sup>.

#### Unilateral Contract

Mutual promises are not necessary to constitute a contract. **Unilateral contracts**<sup>11</sup>, in which one party performs an act in exchange for the other party’s promise, are equally valid. An offer of a reward—for catching a criminal or for returning a lost cat—is an example of a unilateral contract: there is an offer on one side, and the other side accepts by taking the action requested.

- 9. A contract imposed on a party when there was none, to avoid unjust enrichment.
- 10. A contract in which each party makes a promise to the other.
- 11. A contract that is accepted by performance of the requested action, not by a promise.

Figure 8.2 *Bilateral and Unilateral Contracts*



## Enforceability

### Void

Not every agreement between two people is a binding contract. An agreement that is lacking one of the legal elements of a contract is said to be a **void contract**<sup>12</sup>—that is, not a contract at all. An agreement that is illegal—for example, a promise to commit a crime in return for a money payment—is void. Neither party to a void “contract” may enforce it.

### Voidable

By contrast, a **voidable contract**<sup>13</sup> is one that may become unenforceable by one party but can be enforced by the other. For example, a minor (any person under eighteen, in most states) may “avoid” a contract with an adult; the adult may not enforce the contract against the minor if the minor refuses to carry out the bargain. But the adult has no choice if the minor wishes the contract to be performed. (A contract may be voidable by both parties if both are minors.)

Ordinarily, the parties to a voidable contract are entitled to be restored to their original condition. Suppose you agree to buy your seventeen-year-old neighbor’s car. He delivers it to you in exchange for your agreement to pay him next week. He has the legal right to terminate the deal and recover the car, in which case you will of course have no obligation to pay him. If you have already paid him, he still may legally demand a return to the status quo ante (previous state of affairs). You must return the car to him; he must return the cash to you.

12. An agreement that never was a contract.

13. A contract that is capable of being annulled.

A voidable contract remains a valid contract until it is voided. Thus a contract with a minor remains in force unless the minor decides he or she does not wish to be bound by it. When the minor reaches majority, he or she may “ratify” the



contract—that is, agree to be bound by it—in which case the contract will no longer be voidable and will thereafter be fully enforceable.

### Unenforceable

An **unenforceable contract**<sup>14</sup> is one that some rule of law bars a court from enforcing. For example, Tom owes Pete money, but Pete has waited too long to collect it and the statute of limitations has run out. The contract for repayment is unenforceable and Pete is out of luck, unless Tom makes a new promise to pay or actually pays part of the debt. (However, if Pete is holding collateral as security for the debt, he is entitled to keep it; not all rights are extinguished because a contract is unenforceable.) A debt becomes unenforceable, too, when the debtor declares bankruptcy.

A bit more on enforceability is in order. A promise or what seems to be a promise is usually enforceable only if it is otherwise embedded in the elements necessary to make that promise a contract. Those elements are mutual assent, real assent, consideration, capacity, and legality. Sometimes, though, people say things that seem like promises, and on which another person relies. In the early twentieth century, courts began, in some circumstances, to recognize that insisting on the existence of the traditional elements of contract to determine whether a promise is enforceable could work an injustice where there has been reliance. Thus developed the equitable doctrine of **promissory estoppel**<sup>15</sup>, which has become an important adjunct to contract law. The Restatement (Section 90) puts it this way: “A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise. The remedy granted for breach may be limited as justice requires.”

To be “estopped” means to be prohibited from denying now the validity of a promise you made before.

The doctrine has an interesting background. In 1937, High Trees House Ltd. (a British corporation) leased a block of London apartments from Central London Properties. As World War II approached, vacancy rates soared because people left the city. In 1940 the parties agreed to reduce the rent rates by half, but no term was set for how long the reduction would last. By mid-1945, as the war was ending, occupancy was again full, and Central London sued for the full rental rates from June on. The English court, under Judge Alfred Thompson Denning (1899–1999), had no difficulty finding that High Trees owed the full amount once full occupancy was again achieved, but Judge Denning went on. In an aside (called a dicta—a statement “by the way”—that is, not necessary as part of the decision), he mused about what

14. A contract for which the nonbreaching party has no remedy for its breach.

15. To be prohibited from denying a promise when another subsequently has relied on it.

would have happened if in 1945 Central London had sued for the full-occupancy rate back to 1940. Technically, the 1940 amendment to the 1937 contract was not binding on Central London—it lacked consideration—and Central London could have reached back to demand full-rate payment. But Judge Denning said that High Trees would certainly have relied on Central London’s promise that a reduced-rate rent would be acceptable, and that would have been enough to bind it, to prevent it from acting inconsistently with the promise. He wrote, “The courts have not gone so far as to give a cause of action in damages for the breach of such a promise, but they have refused to allow the party making it to act inconsistently with it.” *Central London Property Trust Ltd. v. High Trees House Ltd.* (1947) KB 130.

In the years since, though, courts *have* gone so far as to give a cause of action in damages for various noncontract promises. Contract protects agreements; promissory estoppel protects reliance, and that’s a significant difference. The law of contracts continues to evolve.

### Degree of Completion

An agreement consisting of a set of promises is called an **executory contract**<sup>16</sup> before any promises are carried out. Most executory contracts are enforceable. If John makes an agreement to deliver wheat to Humphrey and does so, the contract is called a **partially executed contract**<sup>17</sup>: one side has performed, the other has not. When John pays for the wheat, the contract is fully performed. A contract that has been carried out fully by both parties is called an **executed contract**<sup>18</sup>.

### Terminology: Suffixes Expressing Relationships

Although not really part of the taxonomy of contracts (i.e., the orderly classification of the subject), an aspect of contractual—indeed, legal—terminology should be highlighted here. *Suffixes* (the end syllables of words) in the English language are used to express relationships between parties in legal terminology. Here are examples:

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

- **Offeror.** One who makes an offer.
- **Offeree.** One to whom an offer is made.
- **Promisor.** One who makes a promise.
- **Promisee.** One to whom a promise is made.
- **Obligor.** One who makes and has an obligation.
- **Obligee.** One to whom an obligation is made.
- **Transferor.** One who makes a transfer.
- **Transferee.** One to whom a transfer is made.

### KEY TAKEAWAY

Contracts are described and thus defined on the basis of four criteria: explicitness (express, implied, or quasi-contracts), mutuality (bilateral or unilateral), enforceability (void, voidable, unenforceable), and degree of completion (executory, partially executed, executed). Legal terminology in English often describes relationships between parties by the use of suffixes, to which the eye and ear must pay attention.

### EXERCISES

1. Able *writes* to Baker: "I will mow your lawn for \$20." If Baker accepts, is this an express or implied contract?
2. Able *telephones* Baker: "I will mow your lawn for \$20." Is this an express or implied contract?
3. What is the difference between a void contract and a voidable one?
4. Carr staples this poster to a utility pole: "\$50 reward for the return of my dog, Argon." Describe this in contractual terms regarding explicitness, mutuality, enforceability, and degree of completion.
5. Is a voidable contract always unenforceable?
6. Contractor bids on a highway construction job, incorporating Guardrail Company's bid into its overall bid to the state. Contractor cannot accept Guardrail's offer until it gets the nod from the state. Contractor gets the nod from the state, but before it can accept Guardrail's offer, the latter revokes it. Usually a person can revoke an offer any time before it is accepted. Can Guardrail revoke its offer in this case?

## 8.4 Cases

### **Explicitness: Implied Contract**

Roger's Backhoe Service, Inc. v. Nichols

681 N.W.2d 647 (Iowa 2004)

Carter, J.

Defendant, Jeffrey S. Nichols, is a funeral director in Muscatine....In early 1998 Nichols decided to build a crematorium on the tract of land on which his funeral home was located. In working with the Small Business Administration, he was required to provide drawings and specifications and obtain estimates for the project. Nichols hired an architect who prepared plans and submitted them to the City of Muscatine for approval. These plans provided that the surface water from the parking lot would drain onto the adjacent street and alley and ultimately enter city storm sewers. These plans were approved by the city.

Nichols contracted with Roger's [Backhoe Service, Inc.] for the demolition of the foundation of a building that had been razed to provide room for the crematorium and removal of the concrete driveway and sidewalk adjacent to that foundation. Roger's completed that work and was paid in full.

After construction began, city officials came to the jobsite and informed Roger's that the proposed drainage of surface water onto the street and alley was unsatisfactory. The city required that an effort be made to drain the surface water into a subterranean creek, which served as part of the city's storm sewer system. City officials indicated that this subterranean sewer system was about fourteen feet below the surface of the ground....Roger's conveyed the city's mandate to Nichols when he visited the jobsite that same day.

It was Nichols' testimony at trial that, upon receiving this information, he advised...Roger's that he was refusing permission to engage in the exploratory excavation that the city required. Nevertheless, it appears without dispute that for the next three days Roger's did engage in digging down to the subterranean sewer system, which was located approximately twenty feet below the surface. When the underground creek was located, city officials examined the brick walls in which it was encased and determined that it was not feasible to penetrate those walls in

order to connect the surface water drainage with the underground creek. As a result of that conclusion, the city reversed its position and once again gave permission to drain the surface water onto the adjacent street and alley.

[T]he invoices at issue in this litigation relate to charges that Roger's submitted to Nichols for the three days of excavation necessary to locate the underground sewer system and the cost for labor and materials necessary to refill the excavation with compactable materials and attain compaction by means of a tamping process....The district court found that the charges submitted on the...invoices were fair and reasonable and that they had been performed for Nichols' benefit and with his tacit approval....

The court of appeals...concluded that a necessary element in establishing an implied-in-fact contract is that the services performed be beneficial to the alleged obligor. It concluded that Roger's had failed to show that its services benefited Nichols....

In describing the elements of an action on an implied contract, the court of appeals stated in [Citation], that the party seeking recovery must show:

(1) the services were carried out under such circumstances as to give the recipient reason to understand:

(a) they were performed for him and not some other person, and

(b) they were not rendered gratuitously, but with the expectation of compensation from the recipient; and

(2) *the services were beneficial to the recipient.*

In applying the italicized language in [Citation] to the present controversy, it was the conclusion of the court of appeals that Roger's' services conferred no benefit on Nichols. We disagree. There was substantial evidence in the record to support a finding that, unless and until an effort was made to locate the subterranean sewer system, the city refused to allow the project to proceed. Consequently, it was necessary to the successful completion of the project that the effort be made. The fact that examination of the brick wall surrounding the underground creek indicated that it was unfeasible to use that source of drainage does not alter the fact that the project was stalemated until drainage into the underground creek was fully

explored and rejected. The district court properly concluded that Roger's services conferred a benefit on Nichols....

Decision of court of appeals vacated; district court judgment affirmed.

### CASE QUESTIONS

1. What facts must be established by a plaintiff to show the existence of an implied contract?
2. What argument did Nichols make as to why there was no implied contract here?
3. How would the facts have to be changed to make an express contract?

### Mutuality of Contract: Unilateral Contract

SouthTrust Bank v. Williams

775 So.2d 184 (Ala. 2000)

Cook, J.

SouthTrust Bank ("SouthTrust") appeals from an order denying its motion to compel arbitration of an action against it by checking-account customers Mark Williams and Bessie Daniels. We reverse and remand.

Daniels and Williams began their relationship with SouthTrust in 1981 and 1995, respectively, by executing checking-account "signature cards." The signature card each customer signed contained a "change-in-terms" clause. Specifically, when Daniels signed her signature card, she "agree[d] to be subject to the Rules and Regulations as may now or *hereafter* be adopted by the Bank." (Emphasis added.)...[Later,] SouthTrust added paragraph 33 to the regulations:...

ARBITRATION OF DISPUTES. You and we agree that the transactions in your account involve 'commerce' under the Federal Arbitration Act ('FAA'). ANY CONTROVERSY OR CLAIM BETWEEN YOU AND US...WILL BE SETTLED BY BINDING ARBITRATION UNDER THE FAA....

This action...challenges SouthTrust's procedures for paying overdrafts, and alleges that SouthTrust engages in a "uniform practice of paying the largest check(s) before paying multiple smaller checks...[in order] to generate increased service charges for [SouthTrust] at the expense of [its customers]."

SouthTrust filed a "motion to stay [the] lawsuit and to compel arbitration." It based its motion on paragraph 33 of the regulations. [T]he trial court...entered an order denying SouthTrust's motion to compel arbitration. SouthTrust appeals....

Williams and Daniels contend that SouthTrust's amendment to the regulations, adding paragraph 33, was ineffective because, they say, they did not *expressly assent* to the amendment. In other words, they object to submitting their claims to arbitration because, they say, when they opened their accounts, neither the regulations nor any other relevant document contained an arbitration provision. They argue that "mere failure to object to the addition of a material term cannot be construed as an acceptance of it."...They contend that SouthTrust could not unilaterally insert an arbitration clause in the regulations and make it binding on depositors like them.

SouthTrust, however, referring to its change-of-terms clause insists that it "notified" Daniels and Williams of the amendment in January 1997 by enclosing in each customer's "account statement" a complete copy of the regulations, as amended. Although it is undisputed that Daniels and Williams never affirmatively assented to these amended regulations, SouthTrust contends that their assent was evidenced by their failure to close their accounts after they received notice of the amendments....Thus, the disposition of this case turns on the legal effect of Williams and Daniels's continued use of the accounts after the regulations were amended.

Williams and Daniels argue that "[i]n the context of contracts between merchants [under the UCC], a written confirmation of an acceptance may modify the contract *unless* it adds a *material* term, and arbitration clauses are material terms."...

Williams and Daniels concede—as they must—...that Article 2 governs "transactions in goods," and, consequently, that it is not applicable to the transactions in this case. Nevertheless, they argue:

It would be astonishing if a Court were to consider the addition of an arbitration clause a material alteration to a contract between merchants, who by definition are sophisticated in the trade to which the contract applies, but *not* hold that the addition of an arbitration clause is a material alteration pursuant to a change-of-

terms clause in a contract between one sophisticated party, a bank, and an entire class of less sophisticated parties, its depositors....

In response, SouthTrust states that “because of the ‘at-will’ nature of the relationship, banks by necessity must contractually reserve the right to amend their deposit agreements from time to time.” In so stating, SouthTrust has precisely identified the fundamental difference between the transactions here and those transactions governed by [Article 2].

Contracts for the purchase and sale of goods are essentially *bilateral* and executory in nature. See [Citation] “An agreement whereby one party promises to sell and the other promises to buy a thing at a later time...is a bilateral promise of sale or contract to sell” .... “[A] unilateral contract results from an exchange of a promise for an act; a bilateral contract results from an exchange of promises.”...Thus, “in a unilateral contract, there is no bargaining process or exchange of promises by parties as in a bilateral contract.” [Citation] “[O]nly one party makes an offer (or promise) which invites performance by another, and performance constitutes both acceptance of that offer and consideration.” Because “a ‘unilateral contract’ is one in which no promisor receives promise as consideration for his promise,” only one party is bound....The difference is not one of semantics but of substance; it determines the rights and responsibilities of the parties, including the time and the conditions under which a cause of action accrues for a breach of the contract.

This case involves at-will, commercial relationships, based upon a series of unilateral transactions. Thus, it is more analogous to cases involving insurance policies, such as [Citations]. The common thread running through those cases was the *amendment* by one of the parties to a business relationship of a document underlying that relationship—without the express assent of the other party—to require the arbitration of disputes arising after the amendment....

The parties in [the cited cases], like Williams and Daniels in this case, took no action that could be considered inconsistent with an assent to the arbitration provision. In each case, they continued the business relationship after the interposition of the arbitration provision. In doing so, they implicitly assented to the addition of the arbitration provision....

Reversed and remanded.



## CASE QUESTIONS

1. Why did the plaintiffs think they should not be bound by the arbitration clause?
2. The court said this case involved a unilateral contract. What makes it that, as opposed to a bilateral contract?
3. What should the plaintiffs have done if they didn't like the arbitration requirement?

### Unilateral Contract and At-Will Employment

Woolley v. Hoffmann-La Roche, Inc.

491 A.2d 1257 (N.J. 1985)

Wilntz, C. J.

Plaintiff, Richard Woolley, was hired by defendant, Hoffmann-La Roche, Inc., in October 1969, as an Engineering Section Head in defendant's Central Engineering Department at Nutley. There was no written employment contract between plaintiff and defendant. Plaintiff began work in mid-November 1969. Sometime in December, plaintiff received and read the personnel manual on which his claims are based.

[The company's personnel manual had eight pages;] five of the eight pages are devoted to "termination." In addition to setting forth the purpose and policy of the termination section, it defines "the types of termination" as "layoff," "discharge due to performance," "discharge, disciplinary," "retirement" and "resignation." As one might expect, layoff is a termination caused by lack of work, retirement a termination caused by age, resignation a termination on the initiative of the employee, and discharge due to performance and discharge, disciplinary, are both terminations for cause. There is no category set forth for discharge without cause. The termination section includes "Guidelines for discharge due to performance," consisting of a fairly detailed procedure to be used before an employee may be fired for cause. Preceding these definitions of the five categories of termination is a section on "Policy," the first sentence of which provides: "It is the policy of Hoffmann-La Roche to retain to the extent consistent with company requirements, the services of all employees who perform their duties efficiently and effectively."

In 1976, plaintiff was promoted, and in January 1977 he was promoted again, this latter time to Group Leader for the Civil Engineering, the Piping Design, the Plant

Layout, and the Standards and Systems Sections. In March 1978, plaintiff was directed to write a report to his supervisors about piping problems in one of defendant's buildings in Nutley. This report was written and submitted to plaintiff's immediate supervisor on April 5, 1978. On May 3, 1978, stating that the General Manager of defendant's Corporate Engineering Department had lost confidence in him, plaintiff's supervisors requested his resignation. Following this, by letter dated May 22, 1978, plaintiff was formally asked for his resignation, to be effective July 15, 1978.

Plaintiff refused to resign. Two weeks later defendant again requested plaintiff's resignation, and told him he would be fired if he did not resign. Plaintiff again declined, and he was fired in July.

Plaintiff filed a complaint alleging breach of contract....The gist of plaintiff's breach of contract claim is that the express and implied promises in defendant's employment manual created a contract under which he could not be fired at will, but rather only for cause, and then only after the procedures outlined in the manual were followed. Plaintiff contends that he was not dismissed for good cause, and that his firing was a breach of contract.

Defendant's motion for summary judgment was granted by the trial court, which held that the employment manual was not contractually binding on defendant, thus allowing defendant to terminate plaintiff's employment at will. The Appellate Division affirmed. We granted certification.

The employer's contention here is that the distribution of the manual was simply an expression of the company's "philosophy" and therefore free of any possible contractual consequences. The former employee claims it could reasonably be read as an explicit statement of company policies intended to be followed by the company in the same manner as if they were expressed in an agreement signed by both employer and employees....

This Court has long recognized the capacity of the common law to develop and adapt to current needs....The interests of employees, employers, and the public lead to the conclusion that the common law of New Jersey should limit the right of an employer to fire an employee at will.

In order for an offer in the form of a promise to become enforceable, it must be accepted. Acceptance will depend on what the promisor bargained for: he may have bargained for a return promise that, if given, would result in a bilateral contract, both promises becoming enforceable. Or he may have bargained for some action or

nonaction that, if given or withheld, would render his promise enforceable as a unilateral contract. In most of the cases involving an employer's personnel policy manual, the document is prepared without any negotiations and is voluntarily distributed to the workforce by the employer. It seeks no return promise from the employees. It is reasonable to interpret it as seeking continued work from the employees, who, in most cases, are free to quit since they are almost always employees at will, not simply in the sense that the employer can fire them without cause, but in the sense that they can quit without breaching any obligation. Thus analyzed, the manual is an offer that seeks the formation of a unilateral contract—the employees' bargained-for action needed to make the offer binding being their continued work when they have no obligation to continue.

The unilateral contract analysis is perfectly adequate for that employee who was aware of the manual and who continued to work intending that continuation to be the action in exchange for the employer's promise; it is even more helpful in support of that conclusion if, but for the employer's policy manual, the employee would have quit. See generally M. Petit, "Modern Unilateral Contracts," 63 Boston Univ. Law Rev. 551 (1983) (judicial use of unilateral contract analysis in employment cases is widespread).

...All that this opinion requires of an employer is that it be fair. It would be unfair to allow an employer to distribute a policy manual that makes the workforce believe that certain promises have been made and then to allow the employer to renege on those promises. What is sought here is basic honesty: if the employer, for whatever reason, does not want the manual to be capable of being construed by the court as a binding contract, there are simple ways to attain that goal. All that need be done is the inclusion in a very prominent position of an appropriate statement that there is no promise of any kind by the employer contained in the manual; that regardless of what the manual says or provides, the employer promises nothing and remains free to change wages and all other working conditions without having to consult anyone and without anyone's agreement; and that the employer continues to have the absolute power to fire anyone with or without good cause.

Reversed and remanded for trial.

### CASE QUESTIONS

1. What did Woolley do to show his acceptance of the terms of employment offered to him?
2. In part of the case not included here, the court notes that Mr. Woolley died “before oral arguments on this case.” How can there be any damages if the plaintiff has died? Who now has any case to pursue?
3. The court here is changing the law of employment in New Jersey. It is making case law, and the rule here articulated governs similar future cases in New Jersey. Why did the court make this change? Why is it relevant that the court says it would be easy for an employer to avoid this problem?

## 8.5 Summary and Exercises

### Summary

Contract law developed as the status-centered organization of feudal society faded and people began to make choices about how they might order their lives. In the capitalistic system, people make choices about how to interact with others, and—necessarily—those choices expressed as promises must be binding and enforceable.

The two fundamental sources of contract law are (1) the common law as developed in the state courts and as summarized in the Restatement (Second) of Contracts and (2) the Uniform Commercial Code for the sale of goods. In general, the UCC is more liberal than the common law in upholding the existence of a contract.

Types of contracts can be distinguished by four criteria: (1) express and implied, including quasi-contracts implied by law; (2) bilateral and unilateral; (3) enforceable and unenforceable; and (4) completed (executed) and uncompleted (executory). To understand contract law, it is necessary to master these distinctions and their nuances.

## EXERCISES

1.
  - a. Mr. and Mrs. Smith, an elderly couple, had no relatives. When Mrs. Smith became ill, the Smiths asked a friend, Henrietta, to help with various housekeeping chores, including cleaning and cooking. Although the Smiths never promised to pay her, Henrietta performed the chores for eighteen months. Henrietta now claims that she is entitled to the reasonable value of the services performed. Is she correct? Explain.
  - b. Assume instead that the Smiths asked Mrs. Smith's sister, Caroline, who lived nearby, to help with the housekeeping. After eighteen months, Caroline claims she is entitled to the reasonable value of the services performed. Is she correct? Explain.
2. A letter from Bridge Builders Inc. to the Allied Steel Company stated, "We offer to purchase 10,000 tons of No. 4 steel pipe at today's quoted price for delivery two months from today. Your acceptance must be received in five days." Does Bridge Builders intend to create a bilateral or a unilateral contract? Why?
3. Roscoe's barber persuaded him to try a new hair cream called Sansfree, which the barber applied to Roscoe's hair and scalp. The next morning Roscoe had a very unpleasant rash along his hairline. Upon investigation he discovered that the rash was due to an improper chemical compound in Sansfree. If Roscoe filed a breach of contract action against the barber, would the case be governed by the Uniform Commercial Code or common law? Explain.
4. Rachel entered into a contract to purchase a 2004 Dodge from Hanna, who lived in the neighboring apartment. When a dispute arose over the terms of the contract, Hanna argued that, because neither she nor Rachel was a merchant, the dispute should be decided under general principles of common law. Rachel, on the other hand, argued that Hanna was legally considered to be a merchant because she sold the car for profit and that, consequently, the sale was governed by the Uniform Commercial Code. Who is correct? Explain.
5. Lee and Michelle decided to cohabit. When they set up house, Michelle gave up her career, and Lee promised to share his earnings with her on a fifty-fifty basis. Several years later they ended their relationship, and when Lee failed to turn over half of his earnings, Michelle filed suit on

the basis of Lee's promise. What kind of contract would Michelle allege that Lee had breached? Explain.

6. Harry and Wilma were divorced in 2008, and Harry was ordered in the divorce decree to pay his ex-wife \$10,000. In 2009 and 2010 Harry was hospitalized, incurring \$3,000 in bills. He and Wilma discussed the matter, and Wilma agreed to pay the bill with her own money, even though Harry still owed her \$5,000 from the divorce decree. When Harry died in late 2010, Wilma made a claim against his estate for \$8,000 (the \$3,000 in medical bills and the \$5,000 from the decree), but the estate was only willing to pay the \$5,000 from the decree, claiming she had paid the hospital bill voluntarily and had no contract for repayment. Is the estate correct? Explain.
7. Louie, an adult, entered into a contract to sell a case of scotch whiskey to Leroy, a minor. Is the contract void or voidable? Explain.
8. James Mann owned a manufacturing plant that assembled cell phones. A CPA audit determined that several phones were missing. Theft by one or more of the workers was suspected. Accordingly, under Mann's instructions, the following sign was placed in the employees' cafeteria:

*Reward.* We are missing phones. I want all employees to watch for thievery. A reward of \$500 will be paid for information given by any employee that leads to the apprehension of employee thieves.

—James Mann

Waldo, a plant employee, read the notice and immediately called Mann, stating, "I accept your offer. I promise to watch other employees and provide you with the requested information." Has a contract been formed? Explain.

9. Almost every day Sally took a break at lunch and went to the International News Stand—a magazine store—to browse the newspapers and magazines and chat with the owner, Conrad. Often she bought a magazine. One day she went there, browsed a bit, and took a magazine off the rack. Conrad was busy with three customers. Sally waved the magazine at Conrad and left the store with it. What kind of a contract, if any, was created?
10. Joan called Devon Sand & Gravel and ordered two "boxes" (dump-truck loads) of gravel to be spread on her rural driveway by the "shoot and run" method: the tailgate is partially opened, the dump-truck bed is lifted, and the truck moves down the driveway spreading gravel as it

goes. The driver mistakenly graveled the driveway of Joan's neighbor, Watson, instead of Joan's. Is Devon entitled to payment by Watson? Explain.



## SELF-TEST QUESTIONS

1. An implied contract
  - a. must be in writing
  - b. is one in which the terms are spelled out
  - c. is one inferred from the actions of the parties
  - d. is imposed by law to avoid an unjust result
  - e. may be avoided by one party
  
2. The Convention on Contracts for the International Sale of Goods is
  - a. an annual meeting of international commercial purchasing agents.
  - b. contract law used in overseas US federal territories
  - c. a customary format or template for drafting contracts
  - d. a kind of treaty setting out international contract law, to which the United States is a party
  - e. the organization that develops uniform international law
  
3. An unenforceable contract is
  - a. void, not a contract at all
  - b. one that a court will not enforce for either side because of a rule of law
  - c. unenforceable by one party but enforceable by the other
  - d. one that has been performed by one party but not the other
  - e. too indefinite to be valid
  
4. Betty Baker found a bicycle apparently abandoned near her house. She took it home and spent \$150 repairing and painting it, after which Carl appeared and proved his ownership of it. Under what theory is Betty able to get reimbursed for her expenditures?
  - a. express contract
  - b. implied contract
  - c. apparent or quasi-contract
  - d. executory contract

- e. none: she will not get reimbursed
5. Alice discusses with her neighbor Bob her plan to hire Woodsman to cut three trees on her side of their property line, mentioning that she can get a good deal because Woodsman is now between jobs. Bob says, "Oh, don't do that. My brother is going to cut some trees on my side, and he can do yours too for free." Alice agrees. But Bob's brother is preoccupied and never does the job. Three weeks later Alice discovers Woodsman's rates have risen prohibitively. Under what theory does Alice have a cause of action against Bob?
- a. express contract
  - b. promissory estoppel
  - c. quasi-contract
  - d. implied contract
  - e. none: she has no cause of action against Bob

#### SELF-TEST ANSWERS

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

## Chapter 9

### The Agreement

#### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. What a contract offer is, and what proposals are not offers
2. How an offer is communicated
3. How definite the offer needs to be
4. How long an offer is good for
5. How an offer is accepted, who can accept it, and when acceptance is effective

In this chapter, we begin the first of the four broad inquiries of contract law mentioned in [Chapter 8 "Introduction to Contract Law"](#): Did the parties create a valid contract? The answer is not always obvious; the range of factors that must be taken into account can be large, and their relationships subtle. Since businesspeople frequently conduct contract negotiations without the assistance of a lawyer, it is important to attend to the nuances in order to avoid legal trouble at the outset. Whether a contract has been formed depends in turn on whether

1. the parties reached an agreement (the focus of this chapter);
2. consideration was present;
3. the agreement was legal; and
4. the parties entered into the contract of their own free will, with knowledge of the facts, and with the capacity to make a contract.

Factors 2, 3, and 4 are the subjects of subsequent chapters.

## 9.1 The Agreement in General

### LEARNING OBJECTIVES

1. Recognize that not all agreements or promises are contracts.
2. Understand that whether a contract exists is based on an objective analysis of the parties' interaction, not on a subjective one.

### The Significance of Agreement

The core of a legal contract is the agreement between the parties. This is not a necessary ingredient; in Communist nations, contracts were (or are, in the few remaining Communist countries) routinely negotiated between parties who had the terms imposed on them. But in the West, and especially in the United States, agreement is of the essence. That is not merely a matter of convenience; it is at the heart of our philosophical and psychological beliefs. As the great student of contract law Samuel Williston put it, "It was a consequence of the emphasis laid on the ego and the individual will that the formation of a contract should seem impossible unless the wills of the parties concurred. Accordingly we find at the end of the eighteenth century, and the beginning of the nineteenth century, the prevalent idea that there must be a "meeting of the minds" (a new phrase) in order to form a contract." Samuel Williston, "Freedom of Contract," *Cornell Law Quarterly* 6 (1921), 365.

Although agreements may take any form, including unspoken conduct between the parties, they are usually structured in terms of an offer and an acceptance. Uniform Commercial Code, Section 2-204(1). These two components will be the focus of our discussion. Note, however, that not every agreement, in the broadest sense of the word, need consist of an offer and an acceptance, and that it is entirely possible, therefore, for two persons to reach agreement without forming a contract. For example, people may agree that the weather is pleasant or that it would be preferable to go out for Chinese food rather than to see a foreign film; in neither case has a contract been formed. One of the major functions of the law of contracts is to sort out those agreements that are legally binding—those that are contracts—from those that are not.

## The Objective Test

In interpreting agreements, courts generally apply an **objective standard**<sup>1</sup> (outwardly, as an observer would interpret; not subjectively). The Restatement (Second) of Contracts defines *agreement* as a “manifestation of mutual assent by two or more persons to one another.” Uniform Commercial Code, Section 3. The Uniform Commercial Code defines *agreement* as “the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance.” Uniform Commercial Code, Section 1-201(3). The critical question is what the parties said or did, not what they thought they said or did, or not what impression they thought they were making.

The distinction between objective and subjective standards crops up occasionally when one person claims he spoke in jest. The vice president of a company that manufactured punchboards, used in gambling, testified to the Washington State Game Commission that he would pay \$100,000 to anyone who found a “crooked board.” Barnes, a bartender, who had purchased two boards that were crooked some time before, brought one to the company office and demanded payment. The company refused, claiming that the statement was made in jest (the audience at the commission hearing had laughed when the offer was made). The court disagreed, holding that it was reasonable to interpret the pledge of \$100,000 as a means of promoting punchboards:

[I]f the jest is not apparent and a reasonable hearer would believe that an offer was being made, then the speaker risks the formation of a contract which was not intended. It is the objective manifestations of the offeror that count and not secret, unexpressed intentions. If a party’s words or acts, judged by a reasonable standard, manifest an intention to agree in regard to the matter in question, that agreement is established, and it is immaterial what may be the real but unexpressed state of the party’s mind on the subject. *Barnes v. Treece*, 549 P.2d 1152 (Wash. App. 1976).

*Lucy v. Zehmer* (Section 9.4.1 “Objective Intention” at the end of the chapter) illustrates that a party’s real state of mind must be expressed to the other party, rather than in an aside to one’s spouse.

1. Judging something as an outsider would understand it; not subjective.

### KEY TAKEAWAY

Fundamentally, a contract is a legally binding “meeting of the minds” between the parties. It is not the unexpressed intention in the minds of the parties that determines whether there was “a meeting.” The test is objective: how would a reasonable person interpret the interaction?

### EXERCISES

1. For the purposes of determining whether a party had a contractual intention, why do courts employ an objective rather than a subjective test?
2. What is the relationship between “the emphasis laid on the ego and the individual will” in modern times (Williston) and the concept of the contractual agreement?

## 9.2 The Offer

### LEARNING OBJECTIVES

1. Know the definition of *offer*.
2. Recognize that some proposals are not offers.
3. Understand the three essentials of an offer: intent, communication, and definiteness.
4. Know when an offer expires and can no longer be accepted.

Offer and acceptance may seem to be straightforward concepts, as they are when two people meet face-to-face. But in a commercial society, the ways of making offers and accepting them are nearly infinite. A retail store advertises its merchandise in the newspaper. A seller makes his offer by mail or over the Internet. A telephone caller states that his offer will stand for ten days. An offer leaves open a crucial term. An auctioneer seeks bids. An offeror gives the offeree a choice. All these situations can raise tricky questions, as can corresponding situations involving acceptances.

### The Definition of *Offer*

The Restatement defines **offer**<sup>2</sup> as “the manifestation of willingness to enter into a bargain, so made as to justify another person in understanding that his assent to that bargain is invited and will conclude it.” Restatement (Second) of Contracts, Section 24. Two key elements are implicit in that definition: the offer must be communicated, and it must be definite. Before considering these requirements, we examine the threshold question of whether an offer was intended. Let us look at proposals that may look like, but are not, offers.

### Proposals That Are Not Offers

#### Advertisements

Most advertisements, price quotations, and invitations to bid are not construed as offers. A notice in the newspaper that a bicycle is on sale for \$800 is normally intended only as an invitation to the public to come to the store to make a purchase. Similarly, a statement that a seller can “quote” a unit price to a prospective purchaser is not, by itself, of sufficient definiteness to constitute an offer; quantity, time of delivery, and other important factors are missing from such a statement. Frequently, in order to avoid construction of a statement about price

2. The proposal upon which the contract is based.

and quantity as an offer, a seller or buyer may say, “Make me an offer.” Such a statement obviously suggests that no offer has yet been made. This principle usually applies to invitations for bids (e.g., from contractors on a building project). Many forms used by sales representatives as contracts indicate that by signing, the customer is making an offer to be accepted by the home office and is not accepting an offer made by the sales representative.

Although advertisements, price quotations, and the like are generally not offers, the facts in each case are important. Under the proper circumstances, an advertised statement can be construed as an offer, as shown in the well-known *Lefkowitz* case ([Section 9.4.2 "Advertisements as Offers"](#) at the end of the chapter), in which the offended customer acted as his own lawyer and pursued an appeal to the Minnesota Supreme Court against a Minneapolis department store that took back its advertised offer.

Despite the common-law rule that advertisements are normally to be considered invitations rather than offers, legislation and government regulations may offer redress. For many years, retail food stores have been subject to a rule, promulgated by the Federal Trade Commission (FTC), that goods advertised as “specials” must be available and must be sold at the price advertised. It is unlawful for a retail chain not to have an advertised item in each of its stores and in sufficient quantity, unless the advertisement specifically states how much is stocked and which branch stores do not carry it. Many states have enacted consumer protection statutes that parallel the FTC rule.

### **Invitations to Bid**

Invitations to bid are also not generally construed as offers. An auctioneer does not make offers but solicits offers from the crowd: “May I have an offer?—\$500? \$450? \$450! I have an offer for \$450. Do I hear \$475? May I have an offer?”

### **Communication**

A contract is an agreement in which each party assents to the terms of the other party. Without mutual assent there cannot be a contract, and this implies that the assent each person gives must be with reference to that of the other. If Toni places several alternative offers on the table, only one of which can be accepted, and invites Sandy to choose, no contract is formed if Sandy says merely, “I accept your terms.” Sandy must specify which offer she is assenting to.

From this general proposition, it follows that no contract can be legally binding unless an offer is in fact communicated to the offeree. If you write an e-mail to a



friend with an offer to sell your car for a certain sum and then get distracted and forget to send it, no offer has been made. If your friend coincidentally e-mails you the following day and says that she wants to buy your car and names the same sum, no contract has been made. Her e-mail to you is not an acceptance, since she did not know of your offer; it is, instead, an offer or an invitation to make an offer. Nor would there have been a contract if you had sent your communication and the two e-mails crossed in cyberspace. Both e-mails would be offers, and for a valid contract to be formed, it would still be necessary for one of you to accept the other's offer. An offer is not effective until it is received by the offeree (and that's also true of a revocation of the offer, and a rejection of the offer by the offeree).

The requirement that an offer be communicated does not mean that every term must be communicated. You call up your friend and offer to sell him your car. You tell him the price and start to tell him that you will throw in the snow tires but will not pay for a new inspection, and that you expect to keep the car another three weeks. Impatiently, he cuts you off and says, "Never mind about all that; I'll accept your offer on whatever terms you want." You and he have a contract.

These principles apply to unknown offers of reward. An offer of a reward constitutes a unilateral contract that can be made binding only by performing the task for which the reward is offered. Suppose that Bonnie posts on a tree a sign offering a reward for returning her missing dog. If you saw the sign, found the dog, and returned it, you would have fulfilled the essentials of the offer. But if you chanced upon the dog, read the tag around its neck, and returned it without ever having been aware that a reward was offered, then you have not responded to the offer, even if you acted in the hope that the owner would reward you. There is no contractual obligation.

In many states, a different result follows from an offer of a reward by a governmental entity. Commonly, local ordinances provide that a standing reward of, say, \$1,000 will be paid to anyone providing information that leads to the arrest and conviction of arsonists. To collect the reward, it is not necessary for a person who does furnish local authorities with such information to know that a reward ordinance exists. In contract terms, the standing reward is viewed as a means of setting a climate in which people will be encouraged to act in certain ways in the expectation that they will earn unknown rewards. It is also possible to view the claim to a reward as noncontractual; the right to receive it is guaranteed, instead, by the local ordinance.

Although a completed act called for by an unknown private offer does not give rise to a contract, partial performance usually does. Suppose Apex Bakery posts a notice offering a one-week bonus to all bakers who work at least six months in the kitchen.

Charlene works two months before discovering the notice on the bulletin board. Her original ignorance of the offer will not defeat her claim to the bonus if she continues working, for the offer serves as an inducement to complete the performance called for.

## Definiteness

The common law reasonably requires that an offer spell out the essential proposed terms with sufficient **definiteness**<sup>3</sup>—certainty of terms that enables a court to order enforcement or measure damages in the event of a breach. As it has often been put, “The law does not make contracts for the parties; it merely enforces the duties which they have undertaken” (Simpson, 1965, p. 19). Thus a supposed promise to sell “such coal as the promisor may wish to sell” is not an enforceable term because the seller, the coal company, undertakes no duty to sell anything unless it wishes to do so. Essential terms certainly include price and the work to be done. But not every omission is fatal; for example, as long as a missing term can be fixed by referring to some external standard—such as “no later than the first frost”—the offer is sufficiently definite.

In major business transactions involving extensive negotiations, the parties often sign a preliminary “agreement in principle” before a detailed contract is drafted. These preliminary agreements may be definite enough to create contract liability even though they lack many of the terms found in a typical contract. For example, in a famous 1985 case, a Texas jury concluded that an agreement made “in principle” between the Pennzoil Company and the Getty Oil Company and not entirely finished was binding and that Texaco had unlawfully interfered with their contract. As a result, Texaco was held liable for over \$10 billion, which was settled for \$3 billion after Texaco went into bankruptcy.

Offers that state alternatives are definitive if each alternative is definite. David offers Sheila the opportunity to buy one of two automobiles at a fixed price, with delivery in two months and the choice of vehicle left to David. Sheila accepts. The contract is valid. If one of the cars is destroyed in the interval before delivery, David is obligated to deliver the other car. Sometimes, however, what appears to be an offer in the alternative may be something else. Charles makes a deal to sell his business to Bernie. As part of the bargain, Charles agrees not to compete with Bernie for the next two years, and if he does, to pay \$25,000. Whether this is an alternative contract depends on the circumstances and intentions of the parties. If it is, then Charles is free to compete as long as he pays Bernie \$25,000. On the other hand, the intention might have been to prevent Charles from competing in any event; hence a court could order payment of the \$25,000 as damages for a breach and still order Charles to refrain from competition until the expiration of the two-year period.

3. The requirement that contracts be certain enough to determine liabilities.

## The UCC Approach

The Uniform Commercial Code (UCC) is generally more liberal in its approach to definiteness than is the common law—at least as the common law was interpreted in the heyday of classical contract doctrine. Section 2-204(3) states the rule: “Even though one or more terms are left open, a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy.”

The drafters of the UCC sought to give validity to as many contracts as possible and grounded that validity on the intention of the parties rather than on formalistic requirements. As the official comment to Section 2-204(3) notes, “If the parties intend to enter into a binding agreement, this subsection recognizes that agreement as valid in law, despite missing terms, if there is any reasonably certain basis for granting a remedy....Commercial standards on the point of ‘indefiniteness’ are intended to be applied.” Other sections of the UCC spell out rules for filling in such open provisions as price, performance, and remedies. Chiefly, Uniform Commercial Code, Sections 2-305 through 2-310.

One of these sections, Section 2-306(1), provides that a contract term under which a buyer agrees to purchase the seller’s entire output of goods (an “outputs contract”) or a seller agrees to meet all the buyer’s requirements (a “requirements” or “needs” contract) means output or requirements that occur in good faith. A party to such a contract cannot offer or demand a quantity that is “unreasonably disproportionate” to a stated estimate or past quantities.

## Duration of Offer

An offer need not be accepted on the spot. Because there are numerous ways of conveying an offer and numerous contingencies that may be part of the offer’s subject matter, the offeror might find it necessary to give the offeree considerable time to accept or reject the offer. By the same token, an offer cannot remain open forever, so that once given, it never lapses and cannot be terminated. The law recognizes seven ways by which the offer can expire (besides acceptance, of course): revocation, rejection by the offeree, counteroffer, acceptance with counteroffer, lapse of time, death or insanity of a person or destruction of an essential term, and illegality. We will examine each of these in turn.

## Revocation

People are free to make contracts and, in general, to revoke them.

### Revocability

The general rule, both in common law and under the UCC, is that the offeror may revoke his or her offer at any time before acceptance, even if the offer states that it will remain open for a specified period of time. Neil offers Arlene his car for \$5,000 and promises to keep the offer open for ten days. Two days later, Neil calls Arlene to revoke the offer. The offer is terminated, and Arlene's acceptance thereafter, though within the ten days, is ineffective. But if Neil had sent his **revocation**<sup>4</sup> (the taking back of an offer before it is accepted) by mail, and if Arlene, before she received it, had telephoned her acceptance, there would be a contract, since revocation is effective only when the offeree actually receives it. There is an exception to this rule for offers made to the public through newspaper or like advertisements. The offeror may revoke a public offering by notifying the public by the same means used to communicate the offer. If no better means of notification is reasonably available, the offer is terminated even if a particular offeree had no actual notice.

Revocation may be communicated indirectly. If Arlene had learned from a friend that Neil had sold his car to someone else during the ten-day period, she would have had sufficient notice. Any attempt to accept Neil's offer would have been futile.

### Irrevocable Offers

Not every type of offer is revocable. One type of offer that cannot be revoked is the **option contract**<sup>5</sup> (the promisor explicitly agrees for consideration to limit his right to revoke). Arlene tells Neil that she cannot make up her mind in ten days but that she will pay him \$25 to hold the offer open for thirty days. Neil agrees. Arlene has an option to buy the car for \$5,000; if Neil should sell it to someone else during the thirty days, he will have breached the contract with Arlene. Note that the transactions involving Neil and Arlene consist of two different contracts. One is the promise of a thirty-day option for the promise of \$25. It is this contract that makes the option binding and is independent of the original offer to sell the car for \$5,000. The offer can be accepted and made part of an independent contract during the option period.

Partial performance of a unilateral contract creates an option. Although the option is not stated explicitly, it is recognized by law in the interests of justice. Otherwise, an offeror could induce the offeree to go to expense and trouble without ever being liable to fulfill his or her part of the bargain. Before the offeree begins to carry out the contract, the offeror is free to revoke the offer. But once performance begins, the law implies an option, allowing the offeree to complete performance according

4. The withdrawal of an offer by the offeror.

5. A promise to keep an offer open for some time; must be supported by consideration.

to the terms of the offer. If, after a reasonable time, the offeree does not fulfill the terms of the offer, then it may be revoked.

### Revocability under the UCC

The UCC changes the common-law rule for offers by merchants. Under Section 2-205, a **firm offer**<sup>6</sup> (a written and signed promise by a merchant to hold an offer to buy or sell goods for some period of time) is irrevocable. That is, an option is created, but no consideration is required. The offer must remain open for the time period stated or, if no time period is given, for a reasonable period of time, which may not exceed three months.

### Irrevocability by Law

By law, certain types of offers may not be revoked (statutory irrevocability), despite the absence of language to that effect in the offer itself. One major category of such offers is that of the contractor submitting a bid to a public agency. The general rule is that once the period of bidding opens, a bidder on a public contract may not withdraw his or her bid unless the contracting authority consents. The contractor who purports to withdraw is awarded the contract based on the original bid and may be sued for damages for nonperformance.

### Rejection by the Offeree

**Rejection**<sup>7</sup> (a manifestation of refusal to agree to the terms of an offer) of the offer is effective when the offeror receives it. A subsequent change of mind by the offeree cannot revive the offer. Donna calls Chuck to reject Chuck's offer to sell his lawn mower. Chuck is then free to sell it to someone else. If Donna changes her mind and calls Chuck back to accept after all, there still is no contract, even if Chuck has made no further effort to sell the lawn mower. Having rejected the original offer, Donna, by her second call, is not accepting but making an offer to buy. Suppose Donna had written Chuck to reject, but on changing her mind, decided to call to accept before the rejection letter arrived. In that case, the offer would have been accepted.

### Counteroffer

A **counteroffer**<sup>8</sup>, a response that varies the terms of an offer, is a rejection. Jones offers Smith a small parcel of land for \$10,000 and says the offer will remain open for one month. Smith responds ten days later, saying he will pay \$5,000. Jones's original offer has thereby been rejected. If Jones now declines Smith's counteroffer, may Smith bind Jones to his original offer by agreeing to pay the full \$10,000? He may not, because once an original offer is rejected, all the terms lapse. However, an

6. A UCC option made in writing and signed by a merchant, promising to keep an offer open; needs no consideration.
7. A manifestation of refusal to agree to the terms of an offer.
8. A response to an offer that changes its terms.

inquiry by Smith as to whether Jones would consider taking less is not a counteroffer and would not terminate the offer.

### Acceptance with Counteroffer

This is not really an acceptance at all but is a counteroffer: an acceptance that changes the terms of the offer is a counteroffer and terminates the offer. The common law imposes a **mirror image rule**<sup>9</sup>: the acceptance must match the offer in all its particulars or the offer is rejected. However, if an acceptance that requests a change or an addition to the offer does not require the offeror's assent, then the acceptance is valid. The broker at Friendly Real Estate offers you a house for \$320,000. You accept but include in your acceptance "the vacant lot next door." Your acceptance is a counteroffer, which serves to terminate the original offer. If, instead, you had said, "It's a deal, but I'd prefer it with the vacant lot next door," then there is a contract because you are not demanding that the broker abide by your request. If you had said, "It's a deal, and I'd also like the vacant lot next door," you have a contract, because the request for the lot is a separate offer, not a counteroffer rejecting the original proposal.

### The UCC and Counteroffers

The UCC is more liberal than the common law in allowing contracts to be formed despite counteroffers and in incorporating the counteroffers into the contracts. This UCC provision is necessary because the use of routine forms for contracts is very common, and if the rule were otherwise, much valuable time would be wasted by drafting clauses tailored to the precise wording of the routine printed forms. A buyer and a seller send out documents accompanying or incorporating their offers and acceptances, and the provisions in each document rarely correspond precisely. Indeed, it is often the case that one side's form contains terms favorable to it but inconsistent with terms on the other side's form. Section 2-207 of the UCC attempts to resolve this "battle of the forms" by providing that additional terms or conditions in an acceptance operate as such unless the acceptance is conditioned on the offeror's consent to the new or different terms. The new terms are construed as offers but are automatically incorporated in any contract between merchants for the sale of goods unless "(a) the offer expressly limits acceptance to the terms of the offer; (b) [the terms] materially alter it; or (c) notification of objection to them has already been given or is given within a reasonable time after notice of them is received."

An example of terms that become part of the contract without being expressly agreed to are clauses providing for interest payments on overdue bills. Examples of terms that would materially alter the contract and hence need express approval are

9. Common-law rule that the acceptance must be the same as the offer.

clauses that negate the standard warranties that sellers give buyers on their merchandise.

Frequently, parties use contract provisions to prevent the automatic introduction of new terms. A typical seller's provision is as follows:

#### Amendments

Any modification of this document by the Buyer, and all additional or different terms included in Buyer's purchase order or any other document responding to this offer, are hereby objected to. BY ORDERING THE GOODS HERE FOR SHIPMENT, BUYER AGREES TO ALL THE TERMS AND CONDITIONS CONTAINED ON BOTH SIDES OF THIS DOCUMENT.

Section 2-207 of the UCC, liberalizing the mirror image rule, is pervasive, covering all sorts of contracts, from those between industrial manufacturers to those between friends.

#### Lapse of Time

Offers are not open-ended; they lapse after some period of time. An offer may contain its own specific time limitation—for example, “until close of business today.”

In the absence of an expressly stated time limit, the common-law rule is that the offer expires at the end of a “reasonable” time. Such a period is a factual question in each case and depends on the particular circumstances, including the nature of the service or property being contracted for, the manner in which the offer is made, and the means by which the acceptance is expected to be made. Whenever the contract involves a speculative transaction—the sale of securities or land, for instance—the time period will depend on the nature of the security and the risk involved. In general, the greater the risk to the seller, the shorter the period of time. Karen offers to sell Gary a block of oil stocks that are fluctuating rapidly hour by hour. Gary receives the offer an hour before the market closes; he accepts by fax two hours after the market has opened the next morning and after learning that the stock has jumped up significantly. The time period has lapsed if Gary was accepting a fixed price that Karen set, but it may still be open if the price is market price at time of delivery. (Under Section 41 of the Restatement, an offer made by mail is “seasonably accepted if an acceptance is mailed at any time before midnight on the day on which the offer is received.”)

For unilateral contracts, both the common law and the UCC require the offeree to notify the offeror that he has begun to perform the terms of the contract. Without notification, the offeror may, after a reasonable time, treat the offer as having lapsed.

### **Death or Insanity of the Offeror**

The death or insanity of the offeror prior to acceptance terminates the offer; the offer is said to die with the offeror. (Notice, however, that the death of a party to a *contract* does not necessarily terminate the contract: the estate of a deceased person may be liable on a contract made by the person before death.)

### **Destruction of Subject Matter Essential to the Offer**

Destruction of something essential to the contract also terminates the offer. You offer to sell your car, but the car is destroyed in an accident before your offer is accepted; the offer is terminated.

### **Postoffer Illegality**

A statute making unlawful the object of the contract will terminate the offer if the statute takes effect after the offer was made. Thus an offer to sell a quantity of herbal weight-loss supplements will terminate if the Food and Drug Administration outlaws the sale of such supplements.

## **KEY TAKEAWAY**

An offer is a manifestation of willingness to enter into a contract, effective when received. It must be communicated to the offeree, be made intentionally (according to an objective standard), and be definite enough to determine a remedy in case of breach. An offer terminates in one of seven ways: revocation before acceptance (except for option contracts, firm offers under the UCC, statutory irrevocability, and unilateral offers where an offeree has commenced performance); rejection; counteroffer; acceptance with counteroffer; lapse of time (as stipulated or after a reasonable time); death or insanity of the offeror before acceptance or destruction of subject matter essential to the offer; and postoffer illegality.



## EXERCISES

1. Why is it said an offer is a “manifestation” of willingness to enter into a contract? How could willingness be “manifested”?
2. Which kind of standard is used to determine whether a person has made an offer—subjective or objective?
3. If Sandra posts a written notice offering “to the kitchen staff at Coldwater Bay (Alaska) transportation to Seattle at the end of the fishing season,” and if David, one of the maintenance workers, says to her, “I accept your offer of transportation to Seattle,” is there a contract?
4. What are the seven ways an offer can terminate?

## 9.3 The Acceptance

### LEARNING OBJECTIVES

1. Define *acceptance*.
2. Understand who may accept an offer.
3. Know when the acceptance is effective.
4. Recognize when silence is acceptance.

### General Definition of Acceptance

To result in a legally binding contract, an offer must be accepted by the offeree. Just as the law helps define and shape an offer and its duration, so the law governs the nature and manner of **acceptance**<sup>10</sup>. The Restatement defines acceptance of an offer as “a manifestation of assent to the terms thereof made by the offeree in a manner invited or required by the offer.” Restatement (Second) of Contracts, Section 24. The assent may be either by the making of a mutual promise or by performance or partial performance. If there is doubt about whether the offer requests a return promise or a return act, the Restatement, Section 32, provides that the offeree may accept with either a promise or performance. The Uniform Commercial Code (UCC) also adopts this view; under Section 2-206(1)(a), “an offer to make a contract shall be construed as inviting acceptance in any manner and by any medium reasonable in the circumstances” unless the offer unambiguously requires a certain mode of acceptance.

### Who May Accept?

The identity of the offeree is usually clear, even if the name is unknown. The person to whom a promise is made is ordinarily the person whom the offeror contemplates will make a return promise or perform the act requested. But this is not invariably so. A promise can be made to one person who is not expected to do anything in return. The consideration necessary to weld the offer and acceptance into a legal contract can be given by a third party. Under the common law, whoever is invited to furnish consideration to the offeror is the offeree, and only an offeree may accept an offer. A common example is sale to a minor. George promises to sell his automobile to Bartley, age seventeen, if Bartley’s father will promise to pay \$3,500 to George. Bartley is the promisee (the person to whom the promise is made) but not the offeree; Bartley cannot legally accept George’s offer. Only Bartley’s father, who is called on to pay for the car, can accept, by making the promise requested.

10. Assent to the terms of the offer.

And notice what might seem obvious: a *promise* to perform as requested in the offer is itself a binding acceptance.

### When Is Acceptance Effective?

As noted previously, an offer, a revocation of the offer, and a rejection of the offer are not effective until received. The same rule does not always apply to the acceptance.

#### Instantaneous Communication

Of course, in many instances the moment of acceptance is not in question: in face-to-face deals or transactions negotiated by telephone, the parties extend an offer and accept it instantaneously during the course of the conversation. But problems can arise in contracts negotiated through correspondence.

#### Stipulations as to Acceptance

One common situation arises when the offeror stipulates the mode of acceptance (e.g., return mail, fax, or carrier pigeon). If the offeree uses the stipulated mode, then the acceptance is deemed effective when sent. Even though the offeror has no knowledge of the acceptance at that moment, the contract has been formed. Moreover, according to the Restatement, Section 60, if the offeror says that the offer can be accepted only by the specified mode, that mode must be used. (It is said that “the offeror is the master of the offer.”)

If the offeror specifies no particular mode, then acceptance is effective when transmitted, as long as the offeree uses a reasonable method of acceptance. It is implied that the offeree can use the same means used by the offeror or a means of communication customary to the industry.

#### The “Mailbox Rule”

The use of the postal service is customary, so acceptances are considered effective when mailed, regardless of the method used to transmit the offer. Indeed, the so-called **mailbox rule**<sup>11</sup> has a lineage tracing back more than one hundred years to the English courts. *Adams v. Lindsell*, 1 Barnewall & Alderson 681 (K.B. 1818).

The mailbox rule may seem to create particular difficulties for people in business, since the acceptance is effective even though the offeror is unaware of the acceptance, and even if the letter is lost and never arrives. But the solution is the

11. Common-law rule that acceptance is effective when dropped in mail.

same as the rationale for the rule. In contracts negotiated through correspondence, there will always be a burden on one of the parties. If the rule were that the acceptance is not effective until received by the offeror, then the offeree would be on tenterhooks, rather than the other way around, as is the case with the present rule. As between the two, it seems fairer to place the burden on the offeror, since he or she alone has the power to fix the moment of effectiveness. All the offeror need do is specify in the offer that acceptance is not effective until received.

In all other cases—that is, when the offeror fails to specify the mode of acceptance and the offeree uses a mode that is not reasonable—acceptance is deemed effective only when received.

### Acceptance “Outruns” Rejection

When the offeree sends a rejection first and then later transmits a superseding acceptance, the “effective when received” rule also applies. Suppose a seller offers a buyer two cords of firewood and says the offer will remain open for a week. On the third day, the buyer writes the seller, rejecting the offer. The following evening, the buyer rethinks his firewood needs, and on the morning of the fifth day, he sends an e-mail accepting the seller’s terms. The previously mailed letter arrives the following day. Since the letter had not yet been received, the offer had not been rejected. For there to be a valid contract, the e-mailed acceptance must arrive before the mailed rejection. If the e-mail were hung up in cyberspace, although through no fault of the buyer, so that the letter arrived first, the seller would be correct in assuming the offer was terminated—even if the e-mail arrived a minute later. In short, where “the acceptance outruns the rejection” the acceptance is effective. See [Figure 9.1](#).

Figure 9.1

	When Sent	When Recieved
1. Offer		✓
2. Revocation of Offer		✓
3. Rejection		✓
4. Acceptance	If reasonable or by specified mode	If unreasonable or mode not specified or after rejection sent

*When Is Communication Effective?*

## Electronic Communications

Electronic communications have, of course, become increasingly common. Many contracts are negotiated by e-mail, accepted and “signed” electronically. Generally speaking, this does not change the rules. The **Uniform Electronic Transactions Act (UETA)**<sup>12</sup> was promulgated (i.e., disseminated for states to adopt) in 1999. It is one of a number of uniform acts, like the Uniform Commercial Code. As of June 2010, forty-seven states and the US Virgin Islands had adopted the statute. The introduction to the act provides that “the purpose of the UETA is to remove barriers to electronic commerce by validating and effectuating electronic records and signatures.” The National Conference of Commissioners on Uniform State Laws, *Uniform Electronic Transactions Act (1999)* (Denver: National Conference of Commissioners on Uniform State Laws, 1999), accessed March 29, 2011, <http://www.law.upenn.edu/bll/archives/ulc/fnact99/1990s/ueta99.pdf>. In general, the UETA provides the following:

- a. A record or signature may not be denied legal effect or enforceability solely because it is in electronic form.
- b. A contract may not be denied legal effect or enforceability solely because an electronic record was used in its formation.
- c. If a law requires a record to be in writing, an electronic record satisfies the law.
- d. If a law requires a signature, an electronic signature satisfies the law.

The UETA, though, doesn’t address all the problems with electronic contracting. Clicking on a computer screen may constitute a valid acceptance of a contractual offer, but only if the offer is clearly communicated. In *Specht v. Netscape Communications Corp.*, customers who had downloaded a free online computer program complained that it effectively invaded their privacy by inserting into their machines “cookies”; they wanted to sue, but the defendant said they were bound to arbitration. *Specht v. Netscape Communications Corp.*, 306 F.3d 17 (2d Cir. 2002). They had clicked on the Download button, but hidden below it were the licensing terms, including the arbitration clause. The federal court of appeals held that there was no valid acceptance. The court said, “We agree with the district court that a reasonably prudent Internet user in circumstances such as these would not have known or learned of the existence of the license terms before responding to defendants’ invitation to download the free software, and that defendants therefore did not provide reasonable notice of the license terms. In consequence, the plaintiffs’ bare act of downloading the software did not unambiguously manifest assent to the arbitration provision contained in the license terms.”

12. A US law generally making electronic contracting valid and the contracts enforceable.

If a faxed document is sent but for some reason not received or not noticed, the emerging law is that the mailbox rule does not apply. A court would examine the

circumstances with care to determine the reason for the nonreceipt or for the offeror's failure to notice its receipt. A person has to have fair notice that his or her offer has been accepted, and modern communication makes the old-fashioned mailbox rule—that acceptance is effective upon dispatch—problematic. See, for example, *Clow Water Systems Co. v. National Labor Relations Board*, 92 F.3d 441 (6th Cir. 1996).

## Silence as Acceptance

### General Rule: Silence Is Not Acceptance

Ordinarily, for there to be a contract, the offeree must make some positive manifestation of assent to the offeror's terms. The offeror cannot usually word his offer in such a way that the offeree's failure to respond can be construed as an acceptance.

### Exceptions

The Restatement, Section 69, gives three situations, however, in which silence can operate as an acceptance. The first occurs when the offeree avails himself of services proffered by the offeror, even though he could have rejected them and had reason to know that the offeror offered them expecting compensation. The second situation occurs when the offer states that the offeree may accept without responding and the offeree, remaining silent, intends to accept. The third situation is that of previous dealings, in which only if the offeree intends not to accept is it reasonable to expect him to say so.

As an example of the first type of acceptance by silence, assume that a carpenter happens by your house and sees a collapsing porch. He spots you in the front yard and points out the deterioration. "I'm a professional carpenter," he says, "and between jobs. I can fix that porch for you. Somebody ought to." You say nothing. He goes to work. There is an implied contract, with the work to be done for the carpenter's usual fee.

To illustrate the second situation, suppose that a friend has left her car in your garage. The friend sends you a letter in which she offers you the car for \$4,000 and adds, "If I don't hear from you, I will assume that you have accepted my offer." If you make no reply, with the intention of accepting the offer, a contract has been formed.

The third situation is illustrated by [Section 9.4.3 "Silence as Acceptance"](#), a well-known decision made by Justice Oliver Wendell Holmes Jr. when he was sitting on the Supreme Court of Massachusetts.

### KEY TAKEAWAY

Without an acceptance of an offer, no contract exists, and once an acceptance is made, a contract is formed. If the offeror stipulates how the offer should be accepted, so be it. If there is no stipulation, any reasonable means of communication is good. Offers and revocations are usually effective upon receipt, while an acceptance is effective on dispatch. The advent of electronic contracting has caused some modification of the rules: courts are likely to investigate the facts surrounding the exchange of offer and acceptance more carefully than previously. But the nuances arising because of the mailbox rule and acceptance by silence still require close attention to the facts.

### EXERCISES

1. Rudy puts this poster, with a photo of his dog, on utility poles around his neighborhood: "\$50 reward for the return of my lost dog." Carlene doesn't see the poster, but she finds the dog and, after looking at the tag on its collar, returns the dog to Rudy. As she leaves his house, her eye falls on one of the posters, but Rudy declines to pay her anything. Why is Rudy correct that Carlene has no legal right to the reward?
2. How has the UCC changed the common law's mirror image rule, and why?
3. When is an offer generally said to be effective? A rejection of an offer? A counteroffer?
4. How have modern electronic communications affected the law of offer and acceptance?
5. When is silence considered an acceptance?

## 9.4 Cases

### Objective Intention

Lucy v. Zehmer

84 S.E.2d 516 (Va. 1954)

Buchanan, J.

This suit was instituted by W. O. Lucy and J. C. Lucy, complainants, against A. H. Zehmer and Ida S. Zehmer, his wife, defendants, to have specific performance of a contract by which it was alleged the Zehmers had sold to W. O. Lucy a tract of land owned by A. H. Zehmer in Dinwiddie county containing 471.6 acres, more or less, known as the Ferguson farm, for \$50,000. J. C. Lucy, the other complainant, is a brother of W. O. Lucy, to whom W. O. Lucy transferred a half interest in his alleged purchase.

The instrument sought to be enforced was written by A. H. Zehmer on December 20, 1952, in these words: "We hereby agree to sell to W. O. Lucy the Ferguson farm complete for \$50,000.00, title satisfactory to buyer," and signed by the defendants, A. H. Zehmer and Ida S. Zehmer.

The answer of A. H. Zehmer admitted that at the time mentioned W. O. Lucy offered him \$50,000 cash for the farm, but that he, Zehmer, considered that the offer was made in jest; that so thinking, and both he and Lucy having had several drinks, he wrote out "the memorandum" quoted above and induced his wife to sign it; that he did not deliver the memorandum to Lucy, but that Lucy picked it up, read it, put it in his pocket, attempted to offer Zehmer \$5 to bind the bargain, which Zehmer refused to accept, and realizing for the first time that Lucy was serious, Zehmer assured him that he had no intention of selling the farm and that the whole matter was a joke. Lucy left the premises insisting that he had purchased the farm....

In his testimony Zehmer claimed that he "was high as a Georgia pine," and that the transaction "was just a bunch of two doggoned drunks bluffing to see who could talk the biggest and say the most." That claim is inconsistent with his attempt to testify in great detail as to what was said and what was done....



If it be assumed, contrary to what we think the evidence shows, that Zehmer was jesting about selling his farm to Lucy and that the transaction was intended by him to be a joke, nevertheless the evidence shows that Lucy did not so understand it but considered it to be a serious business transaction and the contract to be binding on the Zehmers as well as on himself. The very next day he arranged with his brother to put up half the money and take a half interest in the land. The day after that he employed an attorney to examine the title. The next night, Tuesday, he was back at Zehmer's place and there Zehmer told him for the first time, Lucy said, that he wasn't going to sell and he told Zehmer, "You know you sold that place fair and square." After receiving the report from his attorney that the title was good he wrote to Zehmer that he was ready to close the deal.

Not only did Lucy actually believe, but the evidence shows he was warranted in believing, that the contract represented a serious business transaction and a good faith sale and purchase of the farm.

In the field of contracts, as generally elsewhere, "We must look to the outward expression of a person as manifesting his intention rather than to his secret and unexpressed intention. The law imputes to a person an intention corresponding to the reasonable meaning of his words and acts."

At no time prior to the execution of the contract had Zehmer indicated to Lucy by word or act that he was not in earnest about selling the farm. They had argued about it and discussed its terms, as Zehmer admitted, for a long time. Lucy testified that if there was any jesting it was about paying \$50,000 that night. The contract and the evidence show that he was not expected to pay the money that night. Zehmer said that after the writing was signed he laid it down on the counter in front of Lucy. Lucy said Zehmer handed it to him. In any event there had been what appeared to be a good faith offer and a good faith acceptance, followed by the execution and apparent delivery of a written contract. Both said that Lucy put the writing in his pocket and then offered Zehmer \$5 to seal the bargain. Not until then, even under the defendants' evidence, was anything said or done to indicate that the matter was a joke. Both of the Zehmers testified that when Zehmer asked his wife to sign he whispered that it was a joke so Lucy wouldn't hear and that it was not intended that he should hear.

The mental assent of the parties is not requisite for the formation of a contract. If the words or other acts of one of the parties have but one reasonable meaning, his undisclosed intention is immaterial except when an unreasonable meaning which he attaches to his manifestations is known to the other party.

“\* \* \* The law, therefore, judges of an agreement between two persons exclusively from those expressions of their intentions which are communicated between them. \* \* \*.” [Citation]

An agreement or mutual assent is of course essential to a valid contract but the law imputes to a person an intention corresponding to the reasonable meaning of his words and acts. If his words and acts, judged by a reasonable standard, manifest an intention to agree, it is immaterial what may be the real but unexpressed state of his mind.

So a person cannot set up that he was merely jesting when his conduct and words would warrant a reasonable person in believing that he intended a real agreement.

Whether the writing signed by the defendants and now sought to be enforced by the complainants was the result of a serious offer by Lucy and a serious acceptance by the defendants, or was a serious offer by Lucy and an acceptance in secret jest by the defendants, in either event it constituted a binding contract of sale between the parties....

Reversed and remanded.

### CASE QUESTIONS

1. What objective evidence was there to support the defendants' contention that they were just kidding when they agreed to sell the farm?
2. Suppose the defendants really did think the whole thing was a kind of joke. Would that make any difference?
3. As a matter of public policy, why does the law use an objective standard to determine the seriousness of intention, instead of a subjective standard?
4. It's 85 degrees in July and 5:00 p.m., quitting time. The battery in Mary's car is out of juice, again. Mary says, "Arrgh! I will sell this stupid car for \$50!" Jason, walking to his car nearby, whips out his checkbook and says, "It's a deal. Leave your car here. I'll give you a ride home and pick up your car after you give me the title." Do the parties have a contract?

### Advertisements as Offers

Lefkowitz v. Great Minneapolis Surplus Store

86 N.W.2d 689 (Minn. 1957)

Murphy, Justice.

This is an appeal from an order of the Municipal Court of Minneapolis denying the motion of the defendant for amended findings of fact, or, in the alternative, for a new trial. The order for judgment awarded the plaintiff the sum of \$138.50 as damages for breach of contract.

This case grows out of the alleged refusal of the defendant to sell to the plaintiff a certain fur piece which it had offered for sale in a newspaper advertisement. It appears from the record that on April 6, 1956, the defendant published the following advertisement in a Minneapolis newspaper:

Saturday 9 A.M. Sharp

3 Brand New Fur Coats Worth to \$100.00

First Come

First Served

\$1 Each

[The \$100 coat would be worth about \$800 in 2010 dollars.] On April 13, the defendant again published an advertisement in the same newspaper as follows:

Saturday 9 A.M.

2 Brand New Pastel Mink 3-Skin Scarfs

Selling for. \$89.50

Out they go Saturday. Each...\$1.00

1 Black Lapin Stole Beautiful, worth \$139.50...\$1.00

First Come First Served

The record supports the findings of the court that on each of the Saturdays following the publication of the above-described ads the plaintiff was the first to present himself at the appropriate counter in the defendant's store and on each occasion demanded the coat and the stole so advertised and indicated his readiness to pay the sale price of \$1. On both occasions, the defendant refused to sell the merchandise to the plaintiff, stating on the first occasion that by a "house rule" the offer was intended for women only and sales would not be made to men, and on the second visit that plaintiff knew defendant's house rules.

The trial court properly disallowed plaintiff's claim for the value of the fur coats since the value of these articles was speculative and uncertain. The only evidence of value was the advertisement itself to the effect that the coats were "Worth to \$100.00," how much less being speculative especially in view of the price for which they were offered for sale. With reference to the offer of the defendant on April 13, 1956, to sell the "1 Black Lapin Stole \* \* \* worth \$139.50 \* \* \*" the trial court held that the value of this article was established and granted judgment in favor of the plaintiff for that amount less the \$1 quoted purchase price.

1. The defendant contends that a newspaper advertisement offering items of merchandise for sale at a named price is a "unilateral offer" which may be withdrawn without notice. He relies upon authorities which hold that, where an advertiser publishes in a newspaper that he has a certain quantity or quality of goods which he wants to dispose of at certain prices and on certain terms, such advertisements are not offers which become contracts as soon as any person to whose notice they may come signifies his acceptance by notifying the other that he will take a certain quantity of them. Such advertisements have been construed as an invitation for an offer of sale on the terms stated, which offer, when received, may be accepted or rejected and which therefore does not become a contract of sale until accepted by the seller; and until a contract has been so made, the seller may modify or revoke such prices or terms. [Citations]

...On the facts before us we are concerned with whether the advertisement constituted an offer, and, if so, whether the plaintiff's conduct constituted an acceptance.

There are numerous authorities which hold that a particular advertisement in a newspaper or circular letter relating to a sale of articles may be construed by the court as constituting an offer, acceptance of which would complete a contract. [Citations]

The test of whether a binding obligation may originate in advertisements addressed to the general public is “whether the facts show that some performance was promised in positive terms in return for something requested.” 1 Williston, Contracts (Rev. ed.) s 27.

The authorities above cited emphasize that, where the offer is clear, definite, and explicit, and leaves nothing open for negotiation, it constitutes an offer, acceptance of which will complete the contract....

Whether in any individual instance a newspaper advertisement is an offer rather than an invitation to make an offer depends on the legal intention of the parties and the surrounding circumstances. [Citations] We are of the view on the facts before us that the offer by the defendant of the sale of the Lapin fur was clear, definite, and explicit, and left nothing open for negotiation. The plaintiff having successfully managed to be the first one to appear at the seller’s place of business to be served, as requested by the advertisement, and having offered the stated purchase price of the article, he was entitled to performance on the part of the defendant. We think the trial court was correct in holding that there was in the conduct of the parties a sufficient mutuality of obligation to constitute a contract of sale.

2. The defendant contends that the offer was modified by a “house rule” to the effect that only women were qualified to receive the bargains advertised. The advertisement contained no such restriction. This objection may be disposed of briefly by stating that, while an advertiser has the right at any time before acceptance to modify his offer, he does not have the right, after acceptance, to impose new or arbitrary conditions not contained in the published offer. [Citations]

Affirmed.

## CASE QUESTIONS

1. If the normal rule is that display advertisements in newspapers and the like are not offers, but rather invitations to make an offer, why was this different? Why did the court hold that this was an offer?
2. What is the rationale for the rule that a display ad is usually not an offer?
3. If a newspaper display advertisement reads, “This offer is good for two weeks,” is it still only an invitation to make an offer, or is it an offer?
4. Is a listing by a private seller for the sale of a trailer on Craigslist or in the weekly classified advertisements an offer or an invitation to make an offer?

### Silence as Acceptance

Hobbs v. Massasoit Whip Co.

33 N.E. 495 (Mass. 1893)

Holmes, J.

This is an action for the price of eel skins sent by the plaintiff to the defendant, and kept by the defendant some months, until they were destroyed. It must be taken that the plaintiff received no notice that the defendant declined to accept the skins. The case comes before us on exceptions to an instruction to the jury that, whether there was any prior contract or not, if skins are sent to the defendant, and it sees fit, whether it has agreed to take them or not, to lie back, and to say nothing, having reason to suppose that the man who has sent them believes that it is taking them, since it says nothing about it, then, if it fails to notify, the jury would be warranted in finding for the plaintiff.

Standing alone, and unexplained, this proposition might seem to imply that one stranger may impose a duty upon another, and make him a purchaser, in spite of himself, by sending goods to him, unless he will take the trouble, and bear the expense, of notifying the sender that he will not buy. The case was argued for the defendant on that interpretation. But, in view of the evidence, we do not understand that to have been the meaning of the judge and we do not think that the jury can have understood that to have been his meaning. The plaintiff was not a stranger to the defendant, even if there was no contract between them. He had sent eel skins in the same way four or five times before, and they had been accepted and

paid for. On the defendant's testimony, it was fair to assume that if it had admitted the eel skins to be over 22 inches in length, and fit for its business, as the plaintiff testified and the jury found that they were, it would have accepted them; that this was understood by the plaintiff; and, indeed, that there was a standing offer to him for such skins.

In such a condition of things, the plaintiff was warranted in sending the defendant skins conforming to the requirements, and even if the offer was not such that the contract was made as soon as skins corresponding to its terms were sent, sending them did impose on the defendant a duty to act about them; and silence on its part, coupled with a retention of the skins for an unreasonable time, might be found by the jury to warrant the plaintiff in assuming that they were accepted, and thus to amount to an acceptance. [Citations] The proposition stands on the general principle that conduct which imports acceptance or assent is acceptance or assent, in the view of the law, whatever may have been the actual state of mind of the party—a principle sometimes lost sight of in the cases. [Citations]

Exceptions overruled.

#### CASE QUESTIONS

1. What is an eel, and why would anybody make a whip out of its skin?
2. Why did the court here deny the defendant's assertion that it never accepted the plaintiff's offer?
3. If it reasonably seems that silence is acceptance, does it make any difference what the offeree really intended?

## 9.5 Summary and Exercises

### Summary

Whether a legally valid contract was formed depends on a number of factors, including whether the parties reached agreement, whether consideration was present, and whether the agreement was legal. Agreement may seem like an intuitive concept, but intuition is not a sufficient guide to the existence of agreement in legal terms. The most common way of examining an agreement for legal sufficiency is by determining whether a valid offer and acceptance were made.

An offer is a manifestation of willingness to enter into a bargain such that it would be reasonable for another individual to conclude that assent to the offer would complete the bargain. Offers must be communicated and must be definite; that is, they must spell out terms to which the offeree can assent.

An important aspect of the offer is its duration. An offer can expire in any one of several ways: (1) rejection, (2) counteroffer, (3) acceptance with counteroffer, (4) lapse of time, (5) death or insanity of the offeror or destruction of an essential term, (6) illegality, and (7) revocation. No understanding of agreement is complete without a mastery of these conditions.

To constitute an agreement, an offer must be accepted.

The offeree must manifest his assent to the terms of the offer in a manner invited or required by the offer. Complications arise when an offer is accepted indirectly through correspondence. Although offers and revocations of offers are not effective until received, an acceptance is deemed accepted when sent if the offeree accepts in the manner specified by the offeror. But the nuances that arise because of the mailbox rule and acceptance by silence require close attention to the circumstances of each agreement.



## EXERCISES

1. Sarah's student apartment was unfurnished. She perused Doug's List, an online classified ad service (for nonmerchants), and saw this advertisement: "Moving. For sale: a very nice brown leather couch, almost new, \$600." There was an accompanying photo and contact information. Sarah e-mailed the contact, saying she wanted to buy the couch. Does Sarah have a contract with the seller? Explain.
2. Seller called Buyer on the telephone and offered to sell his used stereo. Buyer agreed to buy it without asking the price. The next day Buyer changed her mind and attempted to back out of the agreement. Do the parties have a contract? Explain.
3. On August 1, Ernie wrote to Elsie offering to sell Elsie his car for \$7,600, and he promised to hold the offer open for ten days. On August 4 Ernie changed his mind; he sent Elsie a letter revoking the offer. On August 5 Elsie e-mailed Ernie, accepting the offer. Ernie's letter of revocation arrived on August 6. Is there a contract? Explain.
4. On August 1 Grover visited a local electronics shop to purchase a new television. He saw one he liked but wasn't sure if he could afford the \$750. The store owner agreed to write up and sign an offer stating that it would be held open for ten days, which he did. On August 2 the owner changed his mind and sent Grover an e-mail revoking the offer, which Grover received immediately. On August 3 Grover sent a reply e-mail accepting the original offer. Is there a contract? Explain.

5. Acme Corporation sent the following letter, here set out in its entirety:

January 2, 2012

Acme Corporation

We hereby offer you 100 Acme golden widgets, size 6. This offer will be good for 10 days.

[Signed] Roberta Acme

Owner, Acme Corporation

Is this offer irrevocable for the time stated? Explain.

6. On November 26, Joe wrote to Kate offering to purchase a farm that she owned. Upon receiving the letter on November 28, Kate immediately

sent Joe a letter of acceptance. However, shortly after mailing the letter, Kate had second thoughts and called Joe to advise him that she was rejecting his offer. The call was made before Joe received the letter of acceptance. Has a contract been formed? Why?

7. On a busy day just before April 15, Albert Accountant received a call from a local car dealer. The dealer said, “Hi, Mr. Accountant. Now, while you have income from doing clients’ taxes, I have an excellent offer for you. You can buy a new Buick Century automobile completely loaded for \$36,000. Al, I know you’re busy. If I don’t hear from you by the end of the day, I’ll assume you want the car.” Albert, distracted, did not respond immediately, and the dealer hung up. Then followed an exhausting day of working with anxiety-ridden tax clients. Albert forgot about the conversation. Two days later a statement arrived from the dealer, with instructions on how Albert should pick up the car at the dealership. Is there a contract? Explain.
8. Mr. and Mrs. Mitchell, the owners of a small secondhand store, attended an auction where they bought a used safe for \$50. The safe, part of the Sumstad estate, had a locked compartment inside, a fact the auctioneer mentioned. After they bought the safe, the Mitchells had a locksmith open the interior compartment; it contained \$32,000 in cash. The locksmith called the police, who impounded the safe, and a lawsuit ensued between the Mitchells and the Sumstad estate to determine the ownership of the cash. Who should get it, and why?
9. Ivan Mestrovic, an internationally renowned artist, and his wife lived for years in a house in Indiana. Ivan died in 1982. His widow remained in the house for some years; upon her death the contents of the house were willed to her children. When the Wilkens bought the house from the estate, it was very cluttered. A bank representative (the executor of the estate) said, “You can clean it yourself and keep whatever items you want, or we—as executor of Mrs. Mestrovic’s estate—will hire a rubbish removal service to dispose of it.” The Wilkens opted to clean it up themselves, and amid the mess, behind sofas and in odd closets, were six apparently valuable paintings by Mestrovic. The estate claimed them; the Wilkens claimed them. Who gets the paintings, and why?
10. David Kidd’s dog bit Mikaila Sherrod. On June 14, 2010, the Kidds offered to settle for \$32,000. On July 12 the Sherrods sued the Kidds. On July 20 the Kidds bumped their offer up to \$34,000. The suit was subject to mandatory arbitration, which proceeded on April 28, 2011. On May 5 the arbitrator awarded the Sherrods \$25,000. On May 9 the Sherrods wrote to the Kidds and purported to accept their last offer of \$34,000, made the year before. The Sherrods’ attorney moved to enforce that purported \$34,000 “settlement agreement.” The court concluded that the offer was properly accepted because it had not been withdrawn and entered

judgment against the Kidds for \$34,000. The Kidds appealed. What result should obtain on appeal, and why? *Sherrod ex rel. Cantone v. Kidd*, 155 P.3d 976 (Wash. Ct. App., 2007).

## SELF-TEST QUESTIONS

1. In interpreting agreements for the purpose of establishing whether a valid contract exists, courts generally apply
  - a. subjective standards
  - b. objective standards
  - c. either a subjective or an objective standard
  - d. none of the above
  
2. A valid offer must be
  - a. written
  - b. written and intended
  - c. communicated by letter
  - d. communicated and definite
  
3. An offer
  - a. must specify time, place, and manner of acceptance
  - b. must be accepted immediately to be valid
  - c. need not be accepted immediately
  - d. can only be accepted by the same means it was made
  
4. An offer generally
  - a. is rejected by a counteroffer
  - b. can be revoked if the offeror changes his or her mind
  - c. can lapse after a reasonable period of time
  - d. involves all of the above
  
5. An acceptance is generally considered effective
  - a. when a letter is received by the offeror
  - b. when a letter is mailed
  - c. when the offeree is silent
  - d. only when the acceptance is transmitted in writing

**SELF-TEST ANSWERS**

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

# Chapter 10

## Real Assent

### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. Contracts require “a meeting of the minds” between competent parties, and if there is no such “meeting,” the agreement is usually voidable.
2. Parties must enter the contract voluntarily, without duress or undue influence.
3. Misrepresentation or fraud, when proven, vitiates a contract.
4. A mistake may make a contract voidable.
5. Parties to a contract must have capacity—that is, not labor under infancy, intoxication, or insanity.

We turn to the second of the four requirements for a valid contract. In addition to manifestation of assent, a party’s assent must be real; he or she must consent to the contract freely, with adequate knowledge, and must have capacity. The requirement of real assent raises the following major questions:

1. Did the parties enter into the contract of their own free will, or was one forced to agree under duress or undue influence?
2. Did the parties enter into the contract with full knowledge of the facts, or was one or both led to the agreement through fraud or mistake?
3. Did both parties have the capacity to make a contract?

## 10.1 Duress and Undue Influence

### LEARNING OBJECTIVES

1. Recognize that if a person makes an agreement under duress (being forced to enter a contract against his or her will), the agreement is void.
2. Understand what undue influence is and what the typical circumstances are when it arises to make a contract voidable.

### Duress

When a person is forced to do something against his or her will, that person is said to have been the victim of **duress**<sup>1</sup>—compulsion. There are two types of duress: physical duress and duress by improper threat. A contract induced by physical violence is void.

### Physical Duress

If a person is forced into entering a contract on threat of physical bodily harm, he or she is the victim of **physical duress**<sup>2</sup>. It is defined by the Restatement (Second) of Contracts in Section 174: “If conduct that appears to be a manifestation of assent by a party who does not intend to engage in that conduct is physically compelled by duress, the conduct is not effective as a manifestation of assent.”

Comment (a) to Section 174 provides in part, “This Section involves an application of that principle to those *relatively rare situations in which actual physical force* has been used to compel a party to appear to assent to a contract....The essence of this type of duress is that a party is compelled by physical force to do an act that he has no intention of doing. He is, it is sometimes said, ‘a mere mechanical instrument.’ The result is that there is no contract at all, or a ‘void contract’ as distinguished from a voidable one” (emphasis added).

The Restatement is undoubtedly correct that there are “relatively rare situations in which actual physical force” is used to compel assent to a contract. Extortion is a crime.

1. A threat of improper action to induce a person to make a contract.
2. The threat of physical harm that wrongfully induces a party to contract.

### Duress by Threat

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

First, the threat must be improper. Second, there must be no reasonable alternative. If, for example, a supplier threatens to hold up shipment of necessary goods unless the buyer agrees to pay more than the contract price, this would not be duress if the buyer could purchase identical supplies from someone else. Third, the test for inducement is subjective. It does not matter that the person threatened is unusually timid or that a reasonable person would not have felt threatened. The question is whether the threat in fact induced assent by the victim. Such facts as the victim's belief that the threatener had the ability to carry out the threat and the length of time between the threat and assent are relevant in determining whether the threat did prompt the assent.

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

Jack buys a car from a local used-car salesman, Mr. Olson, and the next day realizes he bought a lemon. He threatens to break windows in Olson's showroom if Olson does not buy the car back for \$2,150, the purchase price. Mr. Olson agrees. The agreement is voidable, even though the underlying deal is fair, if Olson feels he has no reasonable alternative and is frightened into agreeing. Suppose Jack knows that Olson has been tampering with his cars' odometers, a federal offense, and threatens to have Olson prosecuted if he will not repurchase the car. Even though Olson may be guilty, this threat makes the repurchase contract voidable, because it is a misuse for personal ends of a power (to go to the police) given each of us for other purposes. If these threats failed, suppose Jack then tells Olson, "I'm going to haul you into court and sue your pants off." If Jack means he will sue for his purchase price, this is not an improper threat, because everyone has the right to use the courts to gain what they think is rightfully theirs. But if Jack meant that he would fabricate damages done him by a (falsely) claimed odometer manipulation, that would be an improper threat. Although Olson could defend against the suit, his reputation would suffer in the meantime from his being accused of odometer tampering.



A threat to breach a contract that induces the victim to sign a new contract could be improper. Suppose that as part of the original purchase price, Olson agrees to make all necessary repairs and replace all failed parts for the first ninety days. At the end of one month, the transmission dies, and Jack demands a replacement. Olson refuses to repair the car unless Jack signs a contract agreeing to buy his next car from Olson. Whether this threat is improper depends on whether Jack has a reasonable alternative; if a replacement transmission is readily available and Jack has the funds to pay for it, he might have an alternative in suing Olson in small claims court for the cost. But if Jack needs the car immediately and he is impecunious, then the threat would be improper and the contract voidable. A threat to breach a contract is not necessarily improper, however. It depends on whether the new contract is fair and equitable because of unanticipated circumstances. If, for example, Olson discovers that he must purchase a replacement transmission at three times the anticipated cost, his threat to hold up work unless Jack agrees to pay for it might be reasonable.

## Undue Influence

The Restatement of Contracts (Second) characterizes **undue influence**<sup>3</sup> as “unfair persuasion.” Restatement (Second) of Contracts, Section 177. It is a milder form of duress than physical harm or threats. The unfairness does not lie in any misrepresentation; rather, it occurs when the victim is under the domination of the persuader or is one who, in view of the relationship between them, is warranted in believing that the persuader will act in a manner detrimental to the victim’s welfare if the victim fails to assent. It is the improper use of trust or power to deprive a person of free will and substitute instead another’s objective. Usually the fact pattern involves the victim being isolated from receiving advice except from the persuader. Falling within this rule are situations where, for example, a child takes advantage of an infirm parent, a doctor takes advantage of an ill patient, or a lawyer takes advantage of an unknowledgeable client. If there has been undue influence, the contract is voidable by the party who has been unfairly persuaded. Whether the relationship is one of domination and the persuasion is unfair is a factual question. The answer hinges on a host of variables, including “the unfairness of the resulting bargain, the unavailability of independent advice, and the susceptibility of the person persuaded.” Restatement (Second) of Contracts, Section 177(b). See Section 10.5.1 “Undue Influence”, *Hodge v. Shea*.

3. Improper use of power or trust in a way that deprives a person of free will and substitutes another’s objective.

### KEY TAKEAWAY

A contract induced by physical duress—threat of bodily harm—is void; a contract induced by improper threats—another type of duress—is voidable. Voidable also are contracts induced by undue influence, where a weak will is overborne by a stronger one.

### EXERCISES

1. What are the two types of duress?
2. What are the elements necessary to support a claim of undue influence?

## 10.2 Misrepresentation

### LEARNING OBJECTIVES

1. Understand the two types of misrepresentation: fraudulent and nonfraudulent.
2. Distinguish between fraudulent misrepresentation in the execution and fraudulent misrepresentation in the inducement.
3. Know the elements necessary to prove fraudulent and nonfraudulent misrepresentation.
4. Recognize the remedies for misrepresentation.

### General Description

The two types of misrepresentation are fraudulent and nonfraudulent. Within the former are fraud in the execution and fraud in the inducement. Within the latter are negligent misrepresentation and innocent misrepresentation.

**Misrepresentation**<sup>4</sup> is a statement of fact that is not consistent with the truth. If misrepresentation is intentional, it is fraudulent misrepresentation; if it is not intentional, it is nonfraudulent misrepresentation, which can be either negligent or innocent.

In further taxonomy, courts distinguish between fraud in the execution and fraud in the inducement. **Fraud in the execution**<sup>5</sup> is defined by the Restatement as follows: “If a misrepresentation as to the character or essential terms of a proposed contract induces conduct that appears to be a manifestation of assent by one who neither knows nor has reasonable opportunity to know of the character or essential terms of the proposed contract, his conduct is not effective as a manifestation of assent.” Restatement (Second) of Contracts, Section 163. For example, Alphonse and Gaston decide to sign a written contract incorporating terms to which they have agreed. It is properly drawn up, and Gaston reads it and approves it. Before he can sign it, however, Alphonse shrewdly substitutes a different version to which Gaston has not agreed. Gaston signs the substitute version. There is no contract. There has been fraud in the execution.

**Fraud in the inducement**<sup>6</sup> is more common. It involves some misrepresentation about the subject of the contract that induces assent. Alphonse tells Gaston that the

4. A false or misleading statement or impression given that induces a party to contract.

5. Causing a person to sign a legal document while that person believes he or she is signing some other type of document.

6. Deceit or trick to cause someone to contract to his or her disadvantage.

car Gaston is buying from Alphonse has just been overhauled—which pleases Gaston—but it has not been. This renders the contract voidable.

## Fraudulent Misrepresentation

Necessary to proving **fraudulent misrepresentation**<sup>7</sup> (usually just “fraud,” though technically “fraud” is the crime and “fraudulent misrepresentation” is the civil wrong) is a misstatement of fact that is intentionally made and justifiably relied upon.

### Misstatement of Fact

Again, generally, any statement not in accord with the facts (a fact is something amenable to testing as true) is a misrepresentation. Falsity does not depend on intent. A typist’s unnoticed error in a letter (inadvertently omitting the word “not,” for example, or transposing numbers) can amount to a misrepresentation on which the recipient may rely (it is not fraudulent misrepresentation). A half-truth can amount to a misrepresentation, as, for example, when the seller of a hotel says that the income is from both permanent and transient guests but fails to disclose that the bulk of the income is from single-night stopovers by seamen using the hotel as a brothel. *Ikeda v. Curtis*, 261 P.2d 684 (Wash. 1951).

### Concealment

Another type of misrepresentation is concealment. It is an act that is equivalent to a statement that the facts are to the contrary and that serves to prevent the other party from learning the true statement of affairs; it is hiding the truth. A common example is painting over defects in a building—by concealing the defects, the owner is misrepresenting the condition of the property. The act of concealment need not be direct; it may consist of sidetracking the other party from gaining necessary knowledge by, for example, convincing a third person who has knowledge of the defect not to speak. Concealment is always a misrepresentation.

### Nondisclosure

A more passive type of concealment is nondisclosure. Although generally the law imposes no obligation on anyone to speak out, nondisclosure of a fact can operate as a misrepresentation under certain circumstances. This occurs, for example, whenever the other party has erroneous information, or, as *Reed v. King* ([Section 10.5.2 "Misrepresentation by Concealment"](#)) shows, where the nondisclosure amounts to a failure to act in good faith, or where the party who conceals knows or

7. Misrepresentation with the intention to deceive.

should know that the other side cannot, with reasonable diligence, discover the truth.

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

The high court of New York ruled he could rescind the contract because the house was “haunted as a matter of law”: the defendant had promoted it as such on village tours and in *Reader’s Digest*. She had concealed it, and no reasonable buyer’s inspection would have revealed the “fact.” The dissent basically hooted, saying, “The existence of a poltergeist is no more binding upon the defendants than it is upon this court.” *Stambovsky v. Ackley*, 169 A.D.2d 254 (N.Y. 1991).

### **Statement Made False by Subsequent Events**

If a statement of fact is made false by later events, it must be disclosed as false. For example, in idle chatter one day, Alphonse tells Gaston that he owns thirty acres of land. In fact, Alphonse owns only twenty-seven, but he decided to exaggerate a little. He meant no harm by it, since the conversation had no import. A year later, Gaston offers to buy the “thirty acres” from Alphonse, who does not correct the impression that Gaston has. The failure to speak is a nondisclosure—presumably intentional, in this situation—that would allow Gaston to rescind a contract induced by his belief that he was purchasing thirty acres.

### **Statements of Opinion**

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

If Jack asks what condition the car is in that he wishes to buy, Mr. Olson’s response of “Great!” is not ordinarily a misrepresentation. As the Restatement puts it: “The

propensity of sellers and buyers to exaggerate the advantages to the other party of the bargains they promise is well recognized, and to some extent their assertions must be discounted.”Restatement (Second) of Contracts, Section 168(d). Vague statements of quality, such as that a product is “good,” ought to suggest nothing other than that such is the personal judgment of the opinion holder.

Despite this general rule, there are certain exceptions that justify reliance on opinions and effectively make them into facts. Merely because someone is less astute than the one with whom she is bargaining does not give rise to a claim of justifiable reliance on an unwarranted opinion. But if the person is inexperienced and susceptible or gullible to blandishments, the contract can be voided, as illustrated in *Vokes v. Arthur Murray, Inc.* in [Section 10.5.3 "Misrepresentation by Assertions of Opinion"](#).

### **Misstatement of Law**

Incorrect assertions of law usually do not give rise to any relief, but sometimes they do. An assertion that “the city has repealed the sales tax” or that a court has cleared title to a parcel of land is a statement of fact; if such assertions are false, they are governed by the same rules that govern misrepresentations of fact generally. An assertion of the legal consequences of a given set of facts is generally an opinion on which the recipient relies at his or her peril, especially if both parties know or assume the same facts. Thus, if there is a lien on a house, the seller’s statement that “the courts will throw it out, you won’t be bothered by it” is an opinion. A statement that “you can build a five-unit apartment on this property” is not actionable because, at common law, people are supposed to know what the local and state laws are, and nobody should rely on a layperson’s statement about the law. However, if the statement of law is made by a lawyer or real estate broker, or some other person on whom a layperson may justifiably rely, then it may be taken as a fact and, if untrue, as the basis for a claim of misrepresentation. (Assertions about foreign laws are generally held to be statements of fact, not opinion.)

### **Assertions of Intention**

Usually, assertions of intention are not considered facts. The law allows considerable leeway in the honesty of assertions of intention. The Restatement talks in terms of “a misrepresentation of intention...consistent with reasonable standards of fair dealing.”Restatement (Second) of Contracts, Section 171(1). The right to misstate intentions is useful chiefly in the acquisition of land; the cases permit buyers to misrepresent the purpose of the acquisition so as not to arouse the suspicion of the seller that the land is worth considerably more than his asking price. To be a misrepresentation that will permit rescission, an assertion of intention must be false at the time made; that is, the person asserting an intention

must not then have intended it. That later he or she does not carry out the stated intention is not proof that there was no intention at the time asserted. Moreover, to render a contract voidable, the false assertion of intention must be harmful in some way to other interests of the recipient. Thus, in the common example, the buyer of land tells the seller that he intends to build a residence on the lot, but he actually intends to put up a factory and has lied because he knows that otherwise the seller will not part with it because her own home is on an adjacent lot. The contract is voidable by the seller. So a developer says, as regards the picturesque old barn on the property, "I'll sure try to save it," but after he buys the land he realizes it would be very expensive (and in the way), so he does not try to save it. No misrepresentation.

### **Intentionally Made Misrepresentation**

The second element necessary to prove fraud is that the misrepresentation was intentionally made. A misrepresentation is intentionally made "if the maker intends his assertion to induce a party to manifest his assent and the maker (a) knows or believes that the assertion is not in accord with the facts, or (b) does not have the confidence that he states or implies in the truth of the assertion, or (c) knows that he does not have the basis that he states or implies for the assertion." Restatement (Second) of Contracts, Section 162(1).

The question of intent often has practical consequences in terms of the remedy available to the plaintiff. If the misrepresentation is fraudulent, the plaintiff may, as an alternative to avoiding the contract, recover damages. Some of this is discussed in [Section 10.2.4 "Remedies"](#) and more fully in [Chapter 16 "Remedies"](#), where we see that some states would force the plaintiff to elect one of these two remedies, whereas other states would allow the plaintiff to pursue both remedies (although only one type of recovery would eventually be allowed). If the misrepresentation is not intentional, then the common law allowed the plaintiff only the remedy of rescission. But the Uniform Commercial Code (UCC), Section 2-721, allows both remedies in contracts for the sale of goods, whether the misrepresentation is fraudulent or not, and does not require election of remedies.

### **Reliance**

The final element necessary to prove fraud is reliance by the victim. He or she must show that the misrepresentation induced assent—that is, he or she relied on it. The reliance need not be solely on the false assertion; the defendant cannot win the case by demonstrating that the plaintiff would have assented to the contract even without the misrepresentation. It is sufficient to avoid the contract if the plaintiff weighed the assertion as one of the important factors leading him to make the contract, and he believed it to be true. The person who asserts reliance to avoid a

contract must have acted in good faith and reasonably in relying on the false assertion. Thus if the victim failed to read documents given him that truly stated the facts, he cannot later complain that he relied on a contrary statement, as, for example, when the purchaser of a car dealership was told the inventory consisted of new cars, but the supporting papers, receipt of which he acknowledged, clearly stated how many miles each car had been driven. If Mr. Olson tells Jack that the car Jack is interested in is “a recognized classic,” and if Jack doesn’t care a whit about that but buys the car because he likes its tail fins, he will have no case against Mr. Olson when he finds out the car is not a classic: it didn’t matter to him, and he didn’t rely on it.

Ordinarily, the person relying on a statement need not verify it independently. However, if verification is relatively easy, or if the statement is one that concerns matters peculiarly within the person’s purview, he or she may not be held to have justifiably relied on the other party’s false assertion. Moreover, usually the rule of reliance applies to statements about past events or existing facts, not about the occurrence of events in the future.

## Nonfraudulent Misrepresentation

Nonfraudulent misrepresentation may also be grounds for some relief. There are two types: negligent misrepresentation and innocent misrepresentation.

### Negligent Misrepresentation

Where representation is caused by carelessness, it is **negligent misrepresentation**<sup>8</sup>. To prove it, a plaintiff must show a negligent misstatement of fact that is material and justifiably relied upon.

### Negligent

As an element of misrepresentation, “negligent” here means the party who makes the representation was careless. A potential buyer of rural real estate asks the broker if the neighborhood is quiet. The broker assures her it is. In fact, the neighbors down the road have a whole kennel of hunting hounds that bark a lot. The broker didn’t know that; she just assumed the neighborhood was quiet. That is negligence: failure to use appropriate care.

8. A false or misleading statement or impression made because of carelessness.



### **Misstatement of Fact**

Whether a thing is a fact may be subject to the same general analysis used in discussing fraudulent misrepresentation. (A person could negligently conceal a fact, or negligently give an opinion, as in legal malpractice.)

### **Materiality**

A material misrepresentation is one that “would be likely to induce a reasonable person to manifest his assent” or that “the maker knows...would be likely to induce the recipient to do so.” Restatement (Second) of Contracts, Section 162(2). An honestly mistaken statement that the house for sale was built in 1922 rather than 1923 would not be the basis for avoiding the contract because it is not material unless the seller knew that the buyer had sentimental or other reasons for purchasing a house built in 1922.

We did not mention materiality as an element of fraud; if the misrepresentation is fraudulent, the victim can avoid the contract, no matter the significance of the misrepresentation. So although materiality is not technically required for fraudulent misrepresentation, it is usually a crucial factor in determining whether the plaintiff did rely. Obviously, the more immaterial the false assertion, the less likely it is that the victim relied on it to his detriment. This is especially the case when the defendant knows that he does not have the basis that he states for an assertion but believes that the particular point is unimportant and therefore immaterial. And of course it is usually not worth the plaintiff's while to sue over an immaterial fraudulent misrepresentation. Consequently, for practical purposes, materiality is an important consideration in most cases. *Reed v. King* ([Section 10.5.2 "Misrepresentation by Concealment"](#)) discusses materiality (as well as nondisclosure).

### **Justifiable Reliance**

The issues here for negligent misrepresentation are the same as those set out for fraudulent misrepresentation.

Negligent misrepresentation implies culpability and is usually treated the same as fraudulent misrepresentation; if the representation is not fraudulent, however, it cannot be the basis for rescission unless it is also material.

### Innocent Misrepresentation

The elements necessary to prove **innocent misrepresentation**<sup>9</sup> are, reasonably enough, based on what we've looked at so far, as follows: an innocent misstatement of fact that is material and justifiably relied upon.

It is not necessary here to go over the elements in detail. The issues are the same as previously discussed, except now the misrepresentation is innocent. The plaintiffs purchased the defendants' eighteen-acre parcel on the defendants' representation that the land came with certain water rights for irrigation, which they believed was true. It was not true. The plaintiffs were entitled to rescission on the basis of innocent misrepresentation. *Leshner v. Strid*, 996 P.2d 988 (Or. Ct. App. 2000).

### Remedies

Remedies will be taken up in [Chapter 16 "Remedies"](#), but it is worth noting the difference between remedies for fraudulent misrepresentation and remedies for nonfraudulent misrepresentation.

Fraudulent misrepresentation has traditionally given the victim the right to rescind the contract promptly (return the parties to the before-contract status) or affirm it and bring an action for damages caused by the fraud, but not both. *Merritt v. Craig*, 753 A.2d 2 (Md. Ct. App. 2000). The UCC (Section 2-721) has rejected the "election of remedies" doctrine; it allows cumulative damages, such that the victim can both return the goods and sue for damages. And this is the modern trend for fraudulent misrepresentation: victims may first seek damages, and if that does not make them whole, they may seek rescission. *Ehrman v. Mann*, 979 So.2d 1011 (Fla. Ct. App. 2008). In egregious cases of fraud where the defendant has undertaken a pattern of such deceit, the rare civil remedy of punitive damages may be awarded against the defendant.

One further note: the burden of proof for fraudulent misrepresentation is that it must be proved not just "by a preponderance of the evidence," as in the typical civil case, but rather "by clear, cogent, and convincing evidence"; the fact finder must believe the claim of fraud is very probably true. *Kirkham v. Smith*, 23 P.3d 10 (Wash. Ct. App. 2001).

9. A misrepresentation made by one who believes it is true.

### KEY TAKEAWAY

Misrepresentation may be of two types: fraudulent (in the execution or in the inducement) and nonfraudulent (negligent or innocent). Each type has different elements that must be proved, but in general there must be a misstatement of fact by some means that is intentionally made (for fraud), material (for nonfraudulent), and justifiably relied upon.

### EXERCISES

1. Distinguish between fraudulent misrepresentation and nonfraudulent misrepresentation, between fraud in the execution and fraud in the inducement, and between negligent and innocent misrepresentation.
2. List the elements that must be shown to prove the four different types of misrepresentation noted in Exercise 1.
3. What is the difference between the traditional common-law approach to remedies for fraud and the UCC's approach?

## 10.3 Mistake

### LEARNING OBJECTIVES

1. Recognize under what circumstances a person may be relieved of a unilateral mistake.
2. Recognize when a mutual mistake will be grounds for relief, and the types of mutual mistakes.

In discussing fraud, we have considered the ways in which trickery by the other party makes a contract void or voidable. We now examine the ways in which the parties might “trick” themselves by making assumptions that lead them mistakenly to believe that they have agreed to something they have not. A mistake is “a belief about a fact that is not in accord with the truth.” Restatement (Second) of Contracts, Section 151.

### Mistake by One Party

#### Unilateral Mistake

Where one party makes a mistake, it is a **unilateral mistake**<sup>10</sup>. The rule: ordinarily, a contract is not voidable because one party has made a mistake about the subject matter (e.g., the truck is not powerful enough to haul the trailer; the dress doesn’t fit).

#### Exceptions

If one side *knows or should know* that the other has made a mistake, he or she may not take advantage of it. A person who makes the mistake of not reading a written document will usually get no relief, nor will relief be afforded to one whose mistake is caused by negligence (a contractor forgets to add in the cost of insulation) unless the negligent party would suffer unconscionable hardship if the mistake were not corrected. Courts will allow the correction of drafting errors in a contract (“reformation”) in order to make the contract reflect the parties’ intention. *Sikora v. Vanderploeg*, 212 S.W.3d 277 (Tenn. Ct. App. 2006).

#### Mutual Mistake

In the case of **mutual mistake**<sup>11</sup>—both parties are wrong about the subject of the contract—relief may be granted.

10. A mistake made by one party to a contract; relief is not usually granted.

11. Erroneous belief shared and relied on by both parties to a contract for which a court often grants relief.

The Restatement sets out three requirements for successfully arguing mutual mistake. Restatement (Second) of Contracts, Section 152. The party seeking to avoid the contract must prove that

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

*Basic assumption* is probably clear enough. In the famous “cow case,” the defendant sold the plaintiff a cow—Rose of Abalone—believed by both to be barren and thus of less value than a fertile cow (a promising young dairy cow in 2010 might sell for \$1,800). *Sherwood v. Walker*, 33 N.W. 919 (1887). Just before the plaintiff was to take Rose from the defendant’s barn, the defendant discovered she was “large with calf”; he refused to go on with the contract. The court held this was a mutual mistake of fact—“a barren cow is substantially a different creature than a breeding one”—and ruled for the defendant. That she was infertile was “a basic assumption,” but—for example—that hay would be readily available to feed her inexpensively was not, and had hay been expensive, that would not have vitiated the contract.

### **Material Effect on the Agreed-to Exchange of Performance**

“Material effect on the agreed-to exchange of performance” means that because of the mutual mistake, there is a significant difference between the value the parties thought they were exchanging compared with what they would exchange if the contract were performed, given the standing facts. Again, in the cow case, had the seller been required to go through with the deal, he would have given up a great deal more than he anticipated, and the buyer would have received an unagreed-to windfall.

### **Party Seeking Relief Does Not Bear the Risk of the Mistake**

Assume a weekend browser sees a painting sitting on the floor of an antique shop. The owner says, “That old thing? You can have it for \$100.” The browser takes it home, dusts it off, and hangs it on the wall. A year later a visitor, an expert in art history, recognizes the hanging as a famous lost El Greco worth \$1 million. The story is headlined; the antique dealer is chagrined and claims the contract for sale should be voided because both parties mistakenly thought they were dickering over an “old, worthless” painting. The contract is valid. The owner is said to bear the risk of mistake because he contracted with conscious awareness of his ignorance: he

knew he didn't know what the painting's possible value might be, but he didn't feel it worthwhile to have it appraised. He gambled it wasn't worth much, and lost.

#### KEY TAKEAWAY

A mistake may be unilateral, in which case no relief will be granted unless the other side knows of the mistake and takes advantage of it. A mistake may be mutual, in which case relief may be granted if it is about a basic assumption on which the contract was made, if the mistake has a material effect on the agreed-to exchange, and if the person adversely affected did not bear the risk of the mistake.

#### EXERCISES

1. Why is relief usually not granted for unilateral mistakes? When is relief granted for them?
2. If there is a mutual mistake, what does the party seeking relief have to show to avoid the contract?

## 10.4 Capacity

### LEARNING OBJECTIVES

1. Understand that infants may avoid their contracts, with limitations.
2. Understand that insane or intoxicated people may avoid their contracts, with limitations.
3. Understand the extent to which contracts made by mentally ill persons are voidable, void, or effectively enforceable.
4. Recognize that contracts made by intoxicated persons may be voidable.

A contract is a meeting of minds. If someone lacks mental capacity to understand what he is assenting to—or that he is assenting to anything—it is unreasonable to hold him to the consequences of his act. At common law there are various classes of people who are presumed to lack the requisite capacity. These include infants (minors), the mentally ill, and the intoxicated.

### Minors (or “Infants”)

#### The General Rule

The general rule is this: **minors**<sup>12</sup> (or more legalistically “**infants**<sup>13</sup>”) are in most states persons younger than seventeen years old; they can avoid their contracts, up to and within a reasonable time after reaching majority, subject to some exceptions and limitations. The rationale here is that infants do not stand on an equal footing with adults, and it is unfair to require them to abide by contracts made when they have immature judgment.

The words *minor* and *infant* are mostly synonymous, but not exactly, necessarily. In a state where the legal age to drink alcohol is twenty-one, a twenty-year-old would be a minor, but not an infant, because infancy is under eighteen. A seventeen-year-old may avoid contracts (usually), but an eighteen-year-old, while legally bound to his contracts, cannot legally drink alcohol. Strictly speaking, the better term for one who may avoid his contracts is *infant*, even though, of course, in normal speaking we think of an infant as a baby.

The **age of majority**<sup>14</sup> (when a person is no longer an infant or a minor) was lowered in all states except Mississippi during the 1970s (to correspond to the Twenty-Sixth Amendment, ratified in 1971, guaranteeing the right to vote at eighteen) from twenty-one to either eighteen or nineteen. Legal rights for those

12. Basically synonymous with *infant*: a young person who may avoid contracts on that account.

13. A person who has not reached the age of majority and who may (usually) avoid contracts on that account.

14. When a person is old enough to make his or her contracts unavoidable on account of age.

under twenty-one remain ambiguous, however. Although eighteen-year-olds may assent to binding contracts, not all creditors and landlords believe it, and they may require parents to cosign. For those under twenty-one, there are also legal impediments to holding certain kinds of jobs, signing certain kinds of contracts, marrying, leaving home, and drinking alcohol. There is as yet no uniform set of rules.

The exact day on which the disability of minority vanishes also varies. The old common-law rule put it on the day before the twenty-first birthday. Many states have changed this rule so that majority commences on the day of the eighteenth birthday.

An infant's contract is voidable, not void. An infant wishing to avoid the contract need do nothing positive to disaffirm. The defense of infancy to a lawsuit is sufficient; although the adult cannot enforce the contract, the infant can (which is why it is said to be voidable, not void).

### **Exceptions and Complications**

There are exceptions and complications here. We call out six of them.

#### **Necessities**

First, as an exception to the general rule, infants are generally liable for the reasonable cost of necessities (for the reason that denying them the right to contract for necessities would harm them, not protect them). At common law, a necessity was defined as food, medicine, clothing, or shelter. In recent years, however, the courts have expanded the concept, so that in many states today, necessities include property and services that will enable the infant to earn a living and to provide for those dependent on him. If the contract is executory, the infant can simply disaffirm. If the contract has been executed, however, the infant must face more onerous consequences. Although he will not be required to perform under the contract, he will be liable under a theory of "quasi-contract" for the reasonable value of the necessity. In *Gastonia Personnel Corp. v. Rogers*, an emancipated infant, nineteen years old (before the age of minority was reduced), needed employment; he contracted with a personnel company to find him a job, for which it would charge him a fee. *Gastonia Personnel Corp. v. Rogers*, 172 S.E.2d 19 (N.C. 1970). The company did find him a job, and when he attempted to disaffirm his liability for payment on the grounds of infancy, the North Carolina court ruled against him, holding that the concepts of necessities "should be enlarged to include such...services as are reasonable and necessary to enable the infant to earn the money required to provide the necessities of life for himself" and his dependents.



### **Nonvoidable Contracts**

Second, state statutes variously prohibit disaffirmation for such contracts as insurance, education or medical care, bonding agreements, stocks, or bank accounts. In addition, an infant will lose her power to avoid the contract if the rights of third parties intervene. Roberta, an infant, sells a car to Oswald; Oswald, in turn, shortly thereafter sells it to Byers, who knows nothing of Roberta. May Roberta—still an infant—recover it from Byers? No: the rights of the third party have intervened. To allow the infant seller recovery in this situation would undermine faith in commercial transactions.

### **Misrepresentation of Age**

A third exception involves misrepresentation of age. Certainly, that the adult reasonably believed the infant was an adult is of no consequence in a contract suit. In many states, an infant may misrepresent his age and disaffirm in accordance with the general rule. But it depends. If an infant affirmatively lies about his age, the trend is to deny disaffirmation. A Michigan statute, for instance, prohibits an infant from disaffirming if he has signed a “separate instrument containing only the statement of age, date of signing and the signature.” And some states estop him from claiming to be an infant even if he less expressly falsely represented himself as an adult. Estoppel is a refusal by the courts on equitable grounds to allow a person to escape liability on an otherwise valid defense; unless the infant can return the consideration, the contract will be enforced. It is a question of fact how far a nonexpress (an implied) misrepresentation will be allowed to go before it is considered so clearly misleading as to range into the prohibited area. Some states hold the infant liable for damages for the tort of misrepresentation, but others do not. As William Prosser, the noted torts scholar, said of cases paying no attention to an infant’s lying about his age, “The effect of the decisions refusing to recognize tort liability for misrepresentation is to create a privileged class of liars who are a great trouble to the business world.” William L. Prosser, *Handbook of the Law of Torts*, 4th ed. (St. Paul, MN: West, 1971), 999.

### **Ratification**

Fourth, when the infant becomes an adult, she has two choices: she may ratify the contract or disaffirm it. She may ratify explicitly; no further consideration is necessary. She may also do so by implication—for instance, by continuing to make payments or retaining goods for an unreasonable period of time. If the child has not disaffirmed the contract while still an infant, she may do so within a reasonable time after reaching majority; what is a “reasonable time” depends on the circumstances.

### **Duty to Return Consideration Received**

Fifth, in most cases of disavowal, the infant's only obligation is to return the goods (if he still has them) or repay the consideration (unless it has been dissipated); he does not have to account for what he wasted, consumed, or damaged during the contract. But since the age of majority has been lowered to eighteen or nineteen, when most young people have graduated from high school, some courts require, if appropriate to avoid injustice to the adult, that the infant account for what he got. (In *Dodson v. Shrader*, the supreme court of Tennessee held that an infant would—if the contract was fair—have to pay for the pickup truck he bought and wrecked.) *Dodson v. Shrader*, 824 S.W.2d 545 (Tenn. 1992).

### **Tort Connected with a Contract**

Sixth, the general rule is that infants are liable for their torts (e.g., assault, trespass, nuisance, negligence) unless the tort suit is only an indirect method of enforcing a contract. Henry, age seventeen, holds himself out to be a competent mechanic. He is paid \$500 to overhaul Baker's engine, but he does a careless job and the engine is seriously damaged. He offers to return the \$500 but disaffirms any further contractual liability. Can Baker sue him for his negligence, a tort? No, because such a suit would be to enforce the contract.

## **Persons Who Are Mentally Ill or Intoxicated**

### **Mentally Ill Persons**

The general rule is that a contract made by person who is mentally ill is voidable by the person when she regains her sanity, or, as appropriate, by a guardian. If, though, a guardian has been legally appointed for a person who is mentally ill, any contract made by the mentally ill person is void, but may nevertheless be ratified by the ward (the incompetent person who is under a guardianship) upon regaining sanity or by the guardian. Restatement (Second) of Contracts, Section 13.

However, if the contract was for a necessity, the other party may have a valid claim against the estate of the one who is mentally ill in order to prevent unjust enrichment. In other cases, whether a court will enforce a contract made with a person who is mentally ill depends on the circumstances. Only if the mental illness impairs the competence of the person in the particular transaction can the contract be avoided; the test is whether the person understood the nature of the business at hand. Upon avoidance, the mentally ill person must return any property in her possession. And if the contract was fair and the other party had no knowledge of the mental illness, the court has the power to order other relief.

### Intoxicated Persons

If a person is so drunk that he has no awareness of his acts, and if the other person knows this, there is no contract. The intoxicated person is obligated to refund the consideration to the other party unless he dissipated it during his drunkenness. If the other person is unaware of his intoxicated state, however, an offer or acceptance of fair terms manifesting assent is binding.

If a person is only partially inebriated and has some understanding of his actions, “avoidance depends on a showing that the other party induced the drunkenness or that the consideration was inadequate or that the transaction departed from the normal pattern of similar transactions; if the particular transaction is one which a reasonably competent person might have made, it cannot be avoided even though entirely executory.” Restatement (Second) of Contracts, Section 16(b). A person who was intoxicated at the time he made the contract may nevertheless subsequently ratify it. Thus where Mervin Hyland, several times involuntarily committed for alcoholism, executed a promissory note in an alcoholic stupor but later, while sober, paid the interest on the past-due note, he was denied the defense of intoxication; the court said he had ratified his contract. *First State Bank of Sinai v. Hyland*, 399 N.W.2d 894 (S.D. 1987). In any event, intoxicated is a disfavored defense on public policy grounds.

#### KEY TAKEAWAY

Infants may generally disaffirm their contracts up to majority and within a reasonable time afterward, but the rule is subject to some exceptions and complications: necessities, contracts made nonvoidable by statute, misrepresentation of age, extent of duty to return consideration, ratification, and a tort connected with the contract are among these exceptions.

Contracts made by insane or intoxicated people are voidable when the person regains competency. A contract made by a person under guardianship is void, but the estate will be liable for necessities. A contract made while insane or intoxicated may be ratified.

## EXERCISES

1. Ivar, an infant, bought a used car—not a necessity—for \$9,500. Seller took advantage of Ivar’s infancy: the car was really worth only \$5,500. Can Ivar keep the car but disclaim liability for the \$4,000 difference?
2. If Ivar bought the car and it was a necessity, could he disclaim liability for the \$4,000?
3. Alice Ace found her adult son’s Christmas stocking; Mrs. Ace herself had made it fifty years before. It was considerably deteriorated. Isabel, sixteen, handy with knitting, agreed to reknit it for \$100, which Mrs. Ace paid in advance. Isabel, regrettably, lost the stocking. She returned the \$100 to Mrs. Ace, who was very upset. May Mrs. Ace now sue Isabel for the loss of the stocking (conversion) and emotional distress?
4. Why is voluntary intoxication a disfavored defense?

## 10.5 Cases

### Undue Influence

Hodge v. Shea

168 S.E.2d 82 (S.C. 1969)

Brailsford, J.

In this equitable action the circuit court decreed specific performance of a contract for the sale of land, and the defendant has appealed. The plaintiff is a physician, and the contract was prepared and executed in his medical office on August 19, 1965. The defendant had been plaintiff's patient for a number of years. On the contract date, he was seventy-five years of age, was an inebriate of long standing, and was afflicted by grievous chronic illnesses, including arteriosclerosis, cirrhosis of the liver, neuritis, arthritis of the spine and hip and varicose veins of the legs. These afflictions and others required constant medication and frequent medical attention, and rendered him infirm of body and mind, although not to the point of incompetency to contract.

During the period immediately before and after August 19, 1965, George A. Shea, the defendant, was suffering a great deal of pain in his back and hip and was having difficulty in voiding. He was attended professionally by the plaintiff, Dr. Joseph Hodge, either at the Shea home, at the doctor's office or in the hospital at least once each day from August 9 through August 26, 1965, except for August 17. The contract was signed during the morning of August 19. One of Dr. Hodge's frequent house calls was made on the afternoon of that day, and Mr. Shea was admitted to the hospital on August 21, where he remained until August 25.

Mr. Shea was separated from his wife and lived alone. He was dependent upon Dr. Hodge for house calls, which were needed from time to time. His relationship with his physician, who sometimes visited him as a friend and occasionally performed non-professional services for him, was closer than ordinarily arises from that of patient and physician....

“Where a physician regularly treats a chronically ill person over a period of two years, a confidential relationship is established, raising a presumption that financial dealings between them are fraudulent.” [Citation]

A 125 acre tract of land near Mr. Shea's home, adjacent to land which was being developed as residential property, was one of his most valuable and readily salable assets. In 1962, the developer of this contiguous land had expressed to Mr. Shea an interest in it at \$1000.00 per acre. A firm offer of this amount was made in November, 1964, and was refused by Mr. Shea on the advice of his son-in-law that the property was worth at least \$1500.00 per acre. Negotiations between the developer and Mr. Ransdell commenced at that time and were in progress when Mr. Shea, at the instance of Dr. Hodge and without consulting Mr. Ransdell or anyone else, signed the contract of August 19, 1965. Under this contract Dr. Hodge claims the right to purchase twenty choice acres of the 125 acre tract for a consideration calculated by the circuit court to be the equivalent of \$361.72 per acre. The market value of the land on the contract date has been fixed by an unappealed finding of the master at \$1200.00 per acre....

The consideration was expressed in the contract between Dr. Hodge and Mr. Shea as follows:

The purchase price being (Cadillac Coupe DeVille 6600) & \$4000.00 Dollars, on the following terms: Dr. Joseph Hodge to give to Mr. George Shea a new \$6600 coupe DeVille Cadillac which is to be registered in name of Mr. George A. Shea at absolutely no cost to him. In return, Mr. Shea will give to Dr. Joe Hodge his 1964 Cadillac coupe DeVille and shall transfer title of this vehicle to Dr. Hodge. Further, Dr. Joseph Hodge will pay to Mr. George A. Shea the balance of \$4000.00 for the 20 acres of land described above subject to survey, title check, less taxes on purchase of vehicle.

Dr. Hodge was fully aware of Mr. Shea's financial troubles, the liens on his property and his son-in-law's efforts in his behalf. He was also aware of his patient's predilection for new Cadillacs. Although he was not obligated to do so until the property was cleared of liens, which was not accomplished until the following June, Dr. Hodge hastened to purchase a 1965 Cadillac Coupe DeVille and delivered it to Mr. Shea on the day after his discharge from the hospital on August 25, 1965. If he acted in haste in an effort to fortify what he must have realized was a dubious contract, he has so far succeeded....

The case at hand is attended by gross inadequacy of consideration, serious impairment of the grantor's mentality from age, intemperance and disease, and a confidential relationship between the grantee and grantor. Has the strong presumption of vitiating unfairness arising from this combination of circumstances been overcome by the evidence? We must conclude that it has not. The record is devoid of any evidence suggesting a reason, compatible with fairness, for Mr. Shea's assent to so disadvantageous a bargain. Disadvantageous not only because of the

gross disparity between consideration and value, but because of the possibility that the sale would impede the important negotiations in which Mr. Ransdell was engaged. Unless his memory failed him, Mr. Shea knew that his son-in-law expected to sell the 125 acre tract for about \$1500.00 per acre as an important step toward raising sufficient funds to satisfy the tax and judgment liens against the Shea property. These circumstances furnish strong evidence that Mr. Shea's assent to the contract, without so much as notice to Mr. Ransdell, was not the product of a deliberate Exercise of an informed judgment....

Finally, on this phase of the case, it would be naive not to recognize that the 1965 Cadillac was used to entice a highly susceptible old man into a hard trade. Mr. Shea was fatuously fond of new Cadillacs, but was apparently incapable of taking care of one. His own 1964 model (he had also had a 1963 model) had been badly abused. According to Dr. Hodge, it 'smelled like a toilet. \* \* \* had several fenders bumped, bullet holes in the top and the car was just filthy \* \* \*. It was a rather foul car.'...Knowing the condition of Mr. Shea's car, his financial predicament and the activities of his son-in-law in his behalf, Dr. Hodge used the new automobile as a means of influencing Mr. Shea to agree to sell. The means was calculated to becloud Mr. Shea's judgment, and, under the circumstances, its use was unfair....

Reversed and remanded.

### CASE QUESTIONS

1. Why is it relevant that Mr. Shea was separated from his wife and lived alone?
2. Why is it relevant that it was his doctor who convinced him to sell the real estate?
3. Why did the doctor offer the old man a Cadillac as part of the deal?
4. Generally speaking, if you agree to sell your real estate for less than its real value, that's just a unilateral mistake and the courts will grant no relief. What's different here?

### Misrepresentation by Concealment

Reed v. King

193 Cal. Rptr. 130 (Calif. Ct. App. 1983)

Blease, J.

In the sale of a house, must the seller disclose it was the site of a multiple murder? Dorris Reed purchased a house from Robert King. Neither King nor his real estate agents (the other named defendants) told Reed that a woman and her four children were murdered there ten years earlier. However, it seems “truth will come to light; murder cannot be hid long.” (Shakespeare, Merchant of Venice, Act II, Scene II.) Reed learned of the gruesome episode from a neighbor after the sale. She sues seeking rescission and damages. King and the real estate agent defendants successfully demurred to her first amended complaint for failure to state a cause of action. Reed appeals the ensuing judgment of dismissal. We will reverse the judgment.

### **Facts**

We take all issuable facts pled in Reed’s complaint as true. King and his real estate agent knew about the murders and knew the event materially affected the market value of the house when they listed it for sale. They represented to Reed the premises were in good condition and fit for an “elderly lady” living alone. They did not disclose the fact of the murders. At some point King asked a neighbor not to inform Reed of that event. Nonetheless, after Reed moved in neighbors informed her no one was interested in purchasing the house because of the stigma. Reed paid \$76,000, but the house is only worth \$65,000 because of its past....

### **Discussion**

Does Reed’s pleading state a cause of action? Concealed within this question is the nettlesome problem of the duty of disclosure of blemishes on real property which are not physical defects or legal impairments to use.

Numerous cases have found non-disclosure of physical defects and legal impediments to use of real property are material. [Citation] However, to our knowledge, no prior real estate sale case has faced an issue of non-disclosure of the kind presented here. Should this variety of ill-repute be required to be disclosed? Is this a circumstance where “non-disclosure of the fact amounts to a failure to act in good faith and in accordance with reasonable standards of fair dealing [?]” (Rest.2d Contracts, § 161, subd. (b).)

The paramount argument against an affirmative conclusion is it permits the camel’s nose of unrestrained irrationality admission to the tent. If such an “irrational” consideration is permitted as a basis of rescission the stability of all conveyances will be seriously undermined. Any fact that might disquiet the enjoyment of some segment of the buying public may be seized upon by a disgruntled purchaser to void a bargain. In our view, keeping this genie in the bottle is not as difficult a task as



these arguments assume. We do not view a decision allowing Reed to survive a demurrer in these unusual circumstances as endorsing the materiality of facts predicated peripheral, insubstantial, or fancied harms.

The murder of innocents is highly unusual in its potential for so disturbing buyers they may be unable to reside in a home where it has occurred. This fact may foreseeably deprive a buyer of the intended use of the purchase. Murder is not such a common occurrence that *buyers* should be charged with anticipating and discovering this disquieting possibility. Accordingly, the fact is not one for which a duty of inquiry and discovery can sensibly be imposed upon the buyer.

Reed alleges the fact of the murders has a quantifiable effect on the market value of the premises. We cannot say this allegation is inherently wrong and, in the pleading posture of the case, we assume it to be true. If information known or accessible only to the seller has a significant and measureable effect on market value and, as is alleged here, the seller is aware of this effect, we see no principled basis for making the duty to disclose turn upon the character of the information. Physical usefulness is not and never has been the sole criterion of valuation. Stamp collections and gold speculation would be insane activities if utilitarian considerations were the sole measure of value.

Reputation and history can have a significant effect on the value of realty. “George Washington slept here” is worth something, however physically inconsequential that consideration may be. Ill-repute or “bad will” conversely may depress the value of property. Failure to disclose such a negative fact where it will have a foreseeably depressing effect on income expected to be generated by a business is tortious. [Citation] Some cases have held that *unreasonable* fears of the potential buying public that a gas or oil pipeline may rupture may depress the market value of land and entitle the owner to incremental compensation in eminent domain.

Whether Reed will be able to prove her allegation the decade-old multiple murder has a significant effect on market value we cannot determine. If she is able to do so by competent evidence she is entitled to a favorable ruling on the issues of materiality and duty to disclose. Her demonstration of objective tangible harm would still the concern that permitting her to go forward will open the floodgates to rescission on subjective and idiosyncratic grounds....

The judgment is reversed.

## CASE QUESTIONS

1. Why is it relevant that the plaintiff was “an elderly lady living alone”?
2. How did Mrs. Reed find out about the gruesome fact here?
3. Why did the defendants conceal the facts?
4. What is the concern about opening “floodgates to rescission on subjective and idiosyncratic grounds”?
5. Why *did* George Washington sleep in so many places during the Revolutionary War?
6. Did Mrs. Reed get to rescind her contract and get out of the house as a result of this case?

### Misrepresentation by Assertions of Opinion

Vokes v. Arthur Murray, Inc.

212 S.2d. 906 (Fla. 1968)

Pierce, J.

This is an appeal by Audrey E. Vokes, plaintiff below, from a final order dismissing with prejudice, for failure to state a cause of action, her fourth amended complaint, hereinafter referred to as plaintiff’s complaint.

Defendant Arthur Murray, Inc., a corporation, authorizes the operation throughout the nation of dancing schools under the name of “Arthur Murray School of Dancing” through local franchised operators, one of whom was defendant J. P. Davenport whose dancing establishment was in Clearwater.

Plaintiff Mrs. Audrey E. Vokes, a widow of 51 years and without family, had a yen to be “an accomplished dancer” with the hopes of finding “new interest in life.” So, on February 10, 1961, a dubious fate, with the assist of a motivated acquaintance, procured her to attend a “dance party” at Davenport’s “School of Dancing” where she whiled away the pleasant hours, sometimes in a private room, absorbing his accomplished sales technique, during which her grace and poise were elaborated upon and her rosy future as “an excellent dancer” was painted for her in vivid and glowing colors. As an incident to this interlude, he sold her eight 1/2-hour dance lessons to be utilized within one calendar month therefrom, for the sum of \$14.50 cash in hand paid, obviously a baited “come-on.”

Thus she embarked upon an almost endless pursuit of the terpsichorean art during which, over a period of less than sixteen months, she was sold fourteen “dance courses” totaling in the aggregate 2302 hours of dancing lessons for a total cash outlay of \$31,090.45 [about \$220,000 in 2010 dollars] all at Davenport’s dance emporium. All of these fourteen courses were evidenced by execution of a written “Enrollment Agreement-Arthur Murray’s School of Dancing” with the addendum in heavy black print, “No one will be informed that you are taking dancing lessons. Your relations with us are held in strict confidence”, setting forth the number of “dancing lessons” and the “lessons in rhythm sessions” currently sold to her from time to time, and always of course accompanied by payment of cash of the realm.

These dance lesson contracts and the monetary consideration therefore of over \$31,000 were procured from her by means and methods of Davenport and his associates which went beyond the unsavory, yet legally permissible, perimeter of “sales puffing” and intruded well into the forbidden area of undue influence, the suggestion of falsehood, the suppression of truth, and the free Exercise of rational judgment, if what plaintiff alleged in her complaint was true. From the time of her first contact with the dancing school in February, 1961, she was influenced unwittingly by a constant and continuous barrage of flattery, false praise, excessive compliments, and panegyric encomiums, to such extent that it would be not only inequitable, but unconscionable, for a Court exercising inherent chancery power to allow such contracts to stand.

She was incessantly subjected to overreaching blandishment and cajolery. She was assured she had “grace and poise”; that she was “rapidly improving and developing in her dancing skill”; that the additional lessons would “make her a beautiful dancer, capable of dancing with the most accomplished dancers”; that she was “rapidly progressing in the development of her dancing skill and gracefulness”, etc., etc. She was given “dance aptitude tests” for the ostensible purpose of “determining” the number of remaining hours of instructions needed by her from time to time.

At one point she was sold 545 additional hours of dancing lessons to be entitled to an award of the “Bronze Medal” signifying that she had reached “the Bronze Standard”, a supposed designation of dance achievement by students of Arthur Murray, Inc....At another point, while she still had over 1,000 unused hours of instruction she was induced to buy 151 additional hours at a cost of \$2,049.00 to be eligible for a “Student Trip to Trinidad”, at her own expense as she later learned....

Finally, sandwiched in between other lesser sales promotions, she was influenced to buy an additional 481 hours of instruction at a cost of \$6,523.81 in order to “be classified as a Gold Bar Member, the ultimate achievement of the dancing studio.”

All the foregoing sales promotions, illustrative of the entire fourteen separate contracts, were procured by defendant Davenport and Arthur Murray, Inc., by false representations to her that she was improving in her dancing ability, that she had excellent potential, that she was responding to instructions in dancing grace, and that they were developing her into a beautiful dancer, whereas in truth and in fact she did not develop in her dancing ability, she had no “dance aptitude,” and in fact had difficulty in “hearing that musical beat.” The complaint alleged that such representations to her “were in fact false and known by the defendant to be false and contrary to the plaintiff’s true ability, the truth of plaintiff’s ability being fully known to the defendants, but withheld from the plaintiff for the sole and specific intent to deceive and defraud the plaintiff and to induce her in the purchasing of additional hours of dance lessons.” It was averred that the lessons were sold to her “in total disregard to the true physical, rhythm, and mental ability of the plaintiff.” In other words, while she first exulted that she was entering the “spring of her life”, she finally was awakened to the fact there was “spring” neither in her life nor in her feet.

The complaint prayed that the Court decree the dance contracts to be null and void and to be cancelled, that an accounting be had, and judgment entered against, the defendants “for that portion of the \$31,090.45 not charged against specific hours of instruction given to the plaintiff.” The Court held the complaint not to state a cause of action and dismissed it with prejudice. We disagree and reverse.

It is true that “generally a misrepresentation, to be actionable, must be one of fact rather than of opinion.” [Citations] But this rule has significant qualifications, applicable here. It does not apply where there is a fiduciary relationship between the parties, or where there has been some artifice or trick employed by the representor, or where the parties do not in general deal at “arm’s length” as we understand the phrase, or where the representee does not have equal opportunity to become apprised of the truth or falsity of the fact represented. [Citation] As stated by Judge Allen of this Court in [Citation]:

“\* \* \* A statement of a party having \* \* \* superior knowledge may be regarded as a statement of fact although it would be considered as opinion if the parties were dealing on equal terms.”...

In [Citation] it was said that “\* \* \* what is plainly injurious to good faith ought to be considered as a fraud sufficient to impeach a contract.”... [Reversed.]

## CASE QUESTIONS

1. What was the motivation of the “motivated acquaintance” in this case?
2. Why is it relevant that Mrs. Vokes was a “widow of 51 years and without family”?
3. How did the defendant J. P. Davenport entice her into spending a lot of money on dance lessons?
4. What was the defendants’ defense as to why they should not be liable for misrepresentation, and why was that defense not good?
5. Would you say the court here is rather condescending to Mrs. Vokes, all things considered?

### Mutual Mistake

Konic International Corporation v. Spokane Computer Services, Inc.,

708 P.2d 932 (Idaho 1985)

The magistrate found the following facts. David Young, an employee of Spokane Computer, was instructed by his employer to investigate the possibility of purchasing a surge protector, a device which protects computers from damaging surges of electrical current. Young’s investigation turned up several units priced from \$50 to \$200, none of which, however, were appropriate for his employer’s needs. Young then contacted Konic. After discussing Spokane Computer’s needs with a Konic engineer, Young was referred to one of Konic’s salesmen. Later, after deciding on a certain unit, Young inquired as to the price of the selected item. The salesman responded, “fifty-six twenty.” The salesman meant \$5,620. Young in turn thought \$56.20.

The salesman for Konic asked about Young’s authority to order the equipment and was told that Young would have to get approval from one of his superiors. Young in turn prepared a purchase order for \$56.20 and had it approved by the appropriate authority. Young telephoned the order and purchase order number to Konic who then shipped the equipment to Spokane Computer. However, because of internal processing procedures of both parties the discrepancy in prices was not discovered immediately. Spokane Computer received the surge protector and installed it in its office. The receipt and installation of the equipment occurred while the president of Spokane Computer was on vacation. Although the president’s father, who was also chairman of the board of Spokane Computer, knew of the installation, he only inquired as to what the item was and who had ordered it. The president came back from vacation the day after the surge protector had been installed and placed in

operation and was told of the purchase. He immediately ordered that power to the equipment be turned off because he realized that the equipment contained parts which alone were worth more than \$56 in value. Although the president then told Young to verify the price of the surge protector, Young failed to do so. Two weeks later, when Spokane Computer was processing its purchase order and Konic's invoice, the discrepancy between the amount on the invoice and the amount on the purchase order was discovered. The president of Spokane Computer then contacted Konic, told Konic that Young had no authority to order such equipment, that Spokane Computer did not want the equipment, and that Konic should remove it. Konic responded that Spokane Computer now owned the equipment and if the equipment was not paid for, Konic would sue for the price. Spokane Computer refused to pay and this litigation ensued.

Basically what is involved here is a failure of communication between the parties. A similar failure to communicate arose over 100 years ago in the celebrated case of *Raffles v. Wichelhaus*, [Citation] which has become better known as the case of the good ship "Peerless." In *Peerless*, the parties agreed on a sale of cotton which was to be delivered from Bombay by the ship "Peerless." In fact, there were two ships named "Peerless" and each party, in agreeing to the sale, was referring to a different ship. Because the sailing time of the two ships was materially different, neither party was willing to agree to shipment by the "other" Peerless. The court ruled that, because each party had a different ship in mind at the time of the contract, there was in fact no binding contract. The *Peerless* rule later was incorporated into section 71 of the Restatement of Contracts and has now evolved into section 20 of Restatement (Second) of Contracts (1981). Section 20 states in part:

(1) There is no manifestation of mutual assent to an exchange if the parties attach materially different meanings to their manifestations and

(a) neither knows or has reason to know the meaning attached by the other.

Comment (c) to Section 20 further explains that "even though the parties manifest mutual assent to the same words of agreement, there may be no contract because of a material difference of understanding as to the terms of the exchange." Another authority, Williston, discussing situations where a mistake will prevent formation of a contract, agrees that "where a phrase of contract...is reasonably capable of different interpretations...there is no contract." [Citation]

In the present case, both parties attributed different meanings to the same term, "fifty-six twenty." Thus, there was no meeting of the minds of the parties. With a hundred fold difference in the two prices, obviously price was a material term.

Because the “fifty-six twenty” designation was a material term expressed in an ambiguous form to which two meanings were obviously applied, we conclude that no contract between the parties was ever formed. Accordingly, we do not reach the issue of whether Young had authority to order the equipment.

[Affirmed.]

### CASE QUESTIONS

1. Why is it reasonable to say that no contract was made in this case?
2. A discrepancy in price of one hundred times is, of course, enormous. How could such an egregious mistake have occurred by both parties? In terms of running a sensible business, how could this kind of mistake be avoided before it resulted in expensive litigation?

## 10.6 Summary and Exercises

### Summary

No agreement is enforceable if the parties did not enter into it (1) of their own free will, (2) with adequate knowledge of the terms, and (3) with the mental capacity to appreciate the relationship.

Contracts coerced through duress will void a contract if actually induced through physical harm and will make the contract voidable if entered under the compulsion of many types of threats. The threat must be improper and leave no reasonable alternative, but the test is subjective—that is, what did the person threatened actually fear, not what a more reasonable person might have feared.

Misrepresentations may render an agreement void or voidable. Among the factors to be considered are whether the misrepresentation was deliberate and material; whether the promisee relied on the misrepresentation in good faith; whether the representation was of fact, opinion, or intention; and whether the parties had a special relationship.

Similarly, mistaken beliefs, not induced by misrepresentations, may suffice to avoid the bargain. Some mistakes on one side only make a contract voidable. More often, mutual mistakes of facts will show that there was no meeting of the minds.

Those who lack capacity are often entitled to avoid contract liability. Although it is possible to state the general rule, many exceptions exist—for example, in contracts for necessities, infants will be liable for the reasonable value of the goods purchased.



## EXERCISES

1. Eulrich, an auto body mechanic who had never operated a business, entered into a Snap-On Tools franchise agreement. For \$22,000 invested from his savings and the promise of another \$22,000 from the sale of inventory, he was provided a truck full of tools. His job was to drive around his territory and sell them. The agreement allowed termination by either party; if Eulrich terminated, he was entitled to resell to Snap-On any new tools he had remaining. When he complained that his territory was not profitable, his supervisors told him to work it harder, that anybody could make money with Snap-On's marketing system. (In fact, the evidence was the system made money for the supervisors and little for dealers; dealers quickly failed and were replaced by new recruits.) Within several months Eulrich was out of money and desperate. He tried to "check in" his truck to get money to pay his household bills and uninsured medical bills for his wife; the supervisors put him off for weeks. On the check-in day, the exhausted Eulrich's supervisors berated him for being a bad businessman, told him no check would be forthcoming until all the returned inventory was sold, and presented him with a number of papers to sign, including a "Termination Agreement" whereby he agreed to waive any claims against Snap-On; he was not aware that was what he had signed. He sued to rescind the contract and for damages. The defendants held up the waiver as a defense. Under what theory might Eulrich recover? *Eulrich v. Snap-On Tools Corp.*, 853 P.2d 1350 (Or. Ct. App. 1993).
2. Chauncey, a college student, worked part-time in a restaurant. After he had worked for several months, the owner of the restaurant discovered that Chauncey had stolen \$2,000 from the cash register. The owner called Chauncey's parents and told them that if they did not sign a note for \$2,000, he would initiate criminal proceedings against Chauncey. The parents signed and delivered the note to the owner but later refused to pay. May the owner collect on the note? Why?
3. A restaurant advertised a steak dinner that included a "juicy, great-tasting steak, a fresh crisp salad, and a warm roll." After reading the ad, Clarence visited the restaurant and ordered the steak dinner. The steak was dry, the lettuce in the salad was old and limp with brown edges, and the roll was partly frozen. May Clarence recover from the restaurant on the basis of misrepresentation? Why?
4. Bert purchased Ernie's car. Before selling the car, Ernie had stated to Bert, "This car runs well and is reliable. Last week I drove the car all the way from Seattle to San Francisco to visit my mother and back again to Seattle." In fact, Ernie was not telling the truth: he had driven the car to

San Francisco to visit his paramour, not his mother. Upon discovery of the truth, may Bert avoid the contract? Why?

5. Randolph enrolled in a business law class and purchased a new business law textbook from the local bookstore. He dropped the class during the first week and sold the book to his friend Scott. Before making the sale, Randolph told Scott that he had purchased the book new and had owned it for one week. Unknown to either Randolph or Scott, the book was in fact a used one. Scott later discovered some underlining in the middle of the book and attempted to avoid the contract. Randolph refused to refund the purchase price, claiming that he had not intentionally deceived his friend. May Scott avoid the contract? Why?
6. Langstraat was seventeen when he purchased a motorcycle. When applying for insurance, he signed a "Notice of Rejection," declining to purchase uninsured motorist coverage. He was involved in an accident with an uninsured motorist and sought to disaffirm his rejection of the uninsured motorist coverage on the basis of infancy. May he do so?
7. Waters was attracted to Midwest Supply by its advertisements for doing federal income taxes. The ads stated "guaranteed accurate tax preparation." Waters inquired about amending past returns to obtain refunds. Midwest induced him to apply for and receive improper refunds. When Waters was audited, he was required to pay more taxes, and the IRS put tax liens on his wages and bank accounts. In fact, Midwest hired people with no knowledge about taxes at all; if a customer inquired about employees' qualifications, Midwest's manual told the employees to say, "Midwest has been preparing taxes for twenty years." The manual also instructed office managers never to refer to any employee as a "specialist" or "tax expert," but never to correct any news reporters or commentators if they referred to employees as such. What cause of action has Waters, and for what remedies?
8. Mutschler Grain Company (later Jamestown Farmers Elevator) agreed to sell General Mills 30,000 bushels of barley at \$1.22 per bushel. A dispute arose: Mutschler said that transportation was to be by truck but that General Mills never ordered any trucks to pick up the grain; General Mills said the grain was to be shipped by rail (railcars were in short supply). Nine months later, after Mutschler had delivered only about one-tenth the contracted amount, the price of barley was over \$3.00 per bushel. Mutschler defaulted on, and then repudiated, the contract. Fred Mutschler then received this telephone call from General Mills: "We're General Mills, and if you don't deliver this grain to us, why we'll have a battery of lawyers in there tomorrow morning to visit you, and then we are going to the North Dakota Public Service

(Commission); we're going to the Minneapolis Grain Exchange and we're going to the people in Montana and there will be no more Mutschler Grain Company. We're going to take your license."

Mutschler then shipped 22,000 bushels of barley at the \$1.22 rate and sued General Mills for the difference between that price and the market price of over \$3.00. Summary judgment issued for General Mills. Upon what basis might Mutschler Grain appeal?

9. Duke decided to sell his car. The car's muffler had a large hole in it, and as a result, the car made a loud noise. Before showing the car to potential buyers, Duke patched the hole with muffler tape to quiet it. Perry bought the car after test-driving it. He later discovered the faulty muffler and sought to avoid the contract, claiming fraud. Duke argued that he had not committed fraud because Perry had not asked about the muffler and Duke had made no representation of fact concerning it. Is Duke correct? Decide and explain.
10. At the end of the term at college, Jose, talking in the library with his friend Leanne, said, "I'll sell you my business law notes for \$25." Leanne agreed and paid him the money. Jose then realized he'd made a mistake in that he had offered his notes when he meant to offer his book. Leanne didn't want the book; she had a book. She wanted the notes. Would Leanne have a cause of action against Jose if he refused to deliver the notes? Decide and explain.

## SELF-TEST QUESTIONS

1. Misrepresentation that does not go to the core of a contract is
  - a. fraud in the execution
  - b. fraud in the inducement
  - c. undue influence
  - d. an example of mistake
  
2. In order for a misrepresentation to make a contract voidable,
  - a. it must have been intentional
  - b. the party seeking to void must have relied on the misrepresentation
  - c. it must always be material
  - d. none of the above is required
  
3. A mistake by one party will not invalidate a contract unless
  - a. the other party knew of the mistake
  - b. the party making the mistake did not read the contract closely
  - c. the parties to the contract had never done business before
  - d. the party is mistaken about the law
  
4. Upon reaching the age of majority, a person who entered into a contract to purchase goods while a minor may
  - a. ratify the contract and keep the goods without paying for them
  - b. disaffirm the contract and keep the goods without paying for them
  - c. avoid paying for the goods by keeping them without ratifying or disaffirming the contract
  - d. none of these
  
5. Seller does not disclose to Buyer that the foundation of a house is infested with termites. Upon purchasing the house and remodeling part of the basement, Buyer discovers the termites. Has Buyer a cause of action against Seller?

- a. yes
- b. no

### SELF-TEST ANSWERS

- 1. a
- 2. d
- 3. a
- 4. e
- 5. b

# Chapter 11

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## Consideration

### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. What “consideration” is in contract law, what it is not, and what purposes it serves
2. How the sufficiency of consideration is determined
3. In what common situations an understanding of consideration is important
4. What promises are enforceable without consideration

## 11.1 General Perspectives on Consideration

### LEARNING OBJECTIVES

1. Understand what “consideration” is in contract law.
2. Recognize what purposes the doctrine serves.
3. Understand how the law determines whether consideration exists.
4. Know the elements of consideration.

### The Purpose of Consideration

This chapter continues our inquiry into whether the parties created a valid contract. In [Chapter 9 "The Agreement"](#), we saw that the first requisite of a valid contract is an agreement: offer and acceptance. In this chapter, we assume that agreement has been reached and concentrate on one of its crucial aspects: the existence of consideration. Which of the following, if any, is a contract?

1. Betty offers to give a book to Lou. Lou accepts.
2. Betty offers Lou the book in exchange for Lou’s promise to pay twenty-five dollars. Lou accepts.
3. Betty offers to give Lou the book if Lou promises to pick it up at Betty’s house. Lou agrees.

In American law, only the second situation is a binding contract, because only that contract contains **consideration**<sup>1</sup>, a set of mutual promises in which each party agrees to give up something to the benefit of the other. This chapter will explore the meaning and rationale of that statement.

The question of what constitutes a binding contract has been answered differently throughout history and in other cultures. For example, under Roman law, a contract without consideration was binding if certain formal requirements were met. And in the Anglo-American tradition, the presence of a seal—the wax impression affixed to a document—was once sufficient to make a contract binding without any other consideration. The seal is no longer a substitute for consideration, although in some states it creates a presumption of consideration; in forty-nine states, the Uniform Commercial Code (UCC) has abolished the seal on contracts for the sale of goods. (Louisiana has not adopted UCC Article 2.)

1. The surrender of any legal right (a detriment) in return for the promise of some benefit in return.

Whatever its original historical purposes, and however apparently arcane, the doctrine of consideration serves some still-useful purposes. It provides objective evidence for asserting that a contract exists; it distinguishes between enforceable and unenforceable bargains; and it is a check against rash, unconsidered action, against thoughtless promise making. Lon L. Fuller, "Consideration and Form," *Columbia Law Review* 41 (1941): 799.

### A Definition of Consideration

Consideration is said to exist when the promisor receives some benefit for his promise and the promisee gives up something in return; it is the bargained-for price you pay for what you get. That may seem simple enough. But as with much in the law, the complicating situations are never very far away. The "something" that is promised or delivered cannot be just anything, such as a feeling of pride, warmth, amusement, or friendship; it must be something known as a **legal detriment**<sup>2</sup>—an act, forbearance, or a promise of such from the promisee. The detriment need not be an actual detriment; it may in fact be a benefit to the promisee, or at least not a loss. The detriment to one side is usually a **legal benefit**<sup>3</sup> to the other, but the detriment to the promisee need not confer a tangible benefit on the promisor; the promisee can agree to forego something without that something being given to the promisor. Whether consideration is legally sufficient has nothing to do with whether it is morally or economically adequate to make the bargain a fair one. Moreover, legal consideration need not even be certain; it can be a promise contingent on an event that may never happen. Consideration is a legal concept, and it centers on the giving up of a legal right or benefit.

Consideration has two elements. The first, as just outlined, is whether the promisee has incurred a legal detriment—given up something, paid some "price," though it may be, for example, the promise to do something, like paint a house. (Some courts—although a minority—take the view that a bargained-for legal benefit to the promisor is sufficient consideration.) The second element is whether the legal detriment was bargained for: did the promisor specifically intend the act, forbearance, or promise in return for his promise? Applying this two-pronged test to the three examples given at the outset of the chapter, we can easily see why only in the second is there legally sufficient consideration. In the first, Lou incurred no legal detriment; he made no pledge to act or to forbear from acting, nor did he in fact act or forbear from acting. In the third example, what might appear to be such a promise is not really so. Betty made a promise on a condition that Lou comes to her house; the intent clearly is to make a gift.

2. The giving up by a person of that which he or she had a right to retain.

3. The receipt by one person of something legal he or she had no preexisting right to.



### KEY TAKEAWAY

Consideration is—with some exceptions—a required element of a contract. It is the bargained-for giving up of something of legal value for something in return. It serves the purposes of making formal the intention to contract and reducing rash promise making.

### EXERCISES

1. Alice promises to give her neighbor a blueberry bush; the neighbor says, “Thank you!” Subsequently, Alice changes her mind. Is she bound by her promise?
2. Why, notwithstanding its relative antiquity, does consideration still serve some useful purposes?
3. Identify the exchange of consideration in this example: A to B, “I will pay you \$800 if you paint my garage.” B to A, “Okay, I’ll paint your garage for \$800.”

## 11.2 Legal Sufficiency

### LEARNING OBJECTIVES

1. Know in general what “legal sufficiency” means when examining consideration.
2. Recognize how the concept operates in such common situations as threat of litigation, and accord and satisfaction.
3. Understand why illusory promises are unenforceable, and how courts deal with needs, outputs, and exclusive dealings contracts.

### The Concept of Legal Sufficiency

As suggested in [Section 11.1 "General Perspectives on Consideration"](#), what is required in contract is the exchange of a legal detriment and a legal benefit; if that happens, the consideration is said to have **legal sufficiency**<sup>4</sup>.

#### Actual versus Legal Detriment

Suppose Phil offers George \$500 if George will quit smoking for one year. Is Phil’s promise binding? Because George is presumably benefiting by making and sticking to the agreement—surely his health will improve if he gives up smoking—how can his act be considered a legal detriment? The answer is that there is forbearance on George’s part: George is legally entitled to smoke, and by contracting not to, he suffers a loss of his legal right to do so. This is a legal detriment; consideration does not require an actual detriment.

#### Adequacy of Consideration

Scrooge offers to buy Caspar’s motorcycle, worth \$700, for \$10 and a shiny new fountain pen (worth \$5). Caspar agrees. Is this agreement supported by adequate consideration? Yes, because both have agreed to give up something that is theirs: Scrooge, the cash and the pen; Caspar, the motorcycle. Courts are not generally concerned with the economic adequacy of the consideration but instead with whether it is present. As Judge Richard A. Posner puts it, “To ask whether there is consideration is simply to inquire whether the situation is one of exchange and a bargain has been struck. To go further and ask whether the consideration is adequate would require the court to do what...it is less well equipped to do than the parties—decide whether the price (and other essential terms) specified in the contract are reasonable.” Richard A. Posner, *Economic Analysis of Law* (New York:

4. Something of value enough to constitute consideration.

Aspen, 1973), 46. In short, “courts do not inquire into the adequacy of consideration.”

Of course, normally, parties to contracts will not make such a one-sided deal as Scrooge and Caspar’s. But there is a common class of contracts in which nominal consideration—usually one dollar—is recited in printed forms. Usually these are option contracts, in which “in consideration of one dollar in hand paid and receipt of which is hereby acknowledged” one party agrees to hold open the right of the other to make a purchase on agreed terms. The courts will enforce these contracts if the dollar is intended “to support a short-time option proposing an exchange on fair terms.” Restatement (Second) of Contracts, Section 87(b). If, however, the option is for an unreasonably long period of time and the underlying bargain is unfair (the Restatement gives as an example a ten-year option permitting the optionee to take phosphate rock from a widow’s land at a per-ton payment of only one-fourth the prevailing rate), then the courts are unlikely to hold that the nominal consideration makes the option irrevocable.

Because the consideration on such option contracts is nominal, its recital in the written instrument is usually a mere formality, and it is frequently never paid; in effect, the recital of nominal consideration is false. Nevertheless, the courts will enforce the contract—precisely because the recital has become a formality and nobody objects to the charade. Moreover, it would be easy enough to upset an option based on nominal consideration by falsifying oral testimony that the dollar was never paid or received. In a contest between oral testimonies where the incentive to lie is strong and there is a written document clearly incorporating the parties’ agreement, the courts prefer the latter. However, as [Section 11.4.1 "Consideration for an Option"](#), *Board of Control of Eastern Michigan University v. Burgess*, demonstrates, the state courts are not uniform on this point, and it is a safe practice always to deliver the consideration, no matter how nominal.

## Applications of the Legal Sufficiency Doctrine

This section discusses several common circumstances where the issue of whether the consideration proffered (offered up) is adequate.

### Threat of Litigation: Covenant Not to Sue

Because every person has the legal right to file suit if he or she feels aggrieved, a promise to refrain from going to court is sufficient consideration to support a promise of payment or performance. In *Dedeaux v. Young*, Dedeaux purchased property and promised to make certain payments to Young, the broker. *Dedeaux v. Young*, 170 So.2d 561 (1965). But Dedeaux thereafter failed to make these payments,

and Young threatened suit; had he filed papers in court, the transfer of title could have been blocked. To keep Young from suing, Dedeaux promised to pay a 5 percent commission if Young would stay out of court. Dedeaux later resisted paying on the ground that he had never made such a promise and that even if he had, it did not amount to a contract because there was no consideration from Young. The court disagreed, holding that the evidence supported Young's contention that Dedeaux had indeed made such a promise and upholding Young's claim for the commission because "a request to forbear to exercise a legal right has been generally accepted as sufficient consideration to support a contract." If Young had had no grounds to sue—for example, if he had threatened to sue a stranger, or if it could be shown that Dedeaux had no obligation to him originally—then there would have been no consideration because Young would not have been giving up a legal right. A promise to forebear suing in return for settlement of a dispute is called a **covenant not to sue**<sup>5</sup> (*covenant* is another word for agreement).

### Accord and Satisfaction Generally

Frequently, the parties to a contract will dispute the meaning of its terms and conditions, especially the amount of money actually due. When the dispute is genuine (and not the unjustified attempt of one party to avoid paying a sum clearly due), it can be settled by the parties' agreement on a fixed sum as the amount due. This second agreement, which substitutes for the disputed first agreement, is called an accord, and when the payment or other term is discharged, the completed second contract is known as an **accord and satisfaction**<sup>6</sup>. A suit brought for an alleged breach of the original contract could be defended by citing the later accord and satisfaction.

An accord is a contract and must therefore be supported by consideration. Suppose Jan owes Andy \$7,000, due November 1. On November 1, Jan pays only \$3,500 in exchange for Andy's promise to release Jan from the remainder of the debt. Has Andy (the promisor) made a binding promise? He has not, because there is no consideration for the accord. Jan has incurred no detriment; she has received something (release of the obligation to pay the remaining \$3,500), but she has given up nothing. But if Jan and Andy had agreed that Jan would pay the \$3,500 on October 25, then there would be consideration; Jan would have incurred a legal detriment by obligating herself to make a payment earlier than the original contract required her to. If Jan had paid the \$3,500 on November 11 and had given Andy something else agreed to—a pen, a keg of beer, a peppercorn—the required detriment would also be present.

5. An agreement not to pursue legal action.

6. An agreement to substitute a new contract for a disputed one; when executed, the accord is satisfied.

Let's take a look at some examples of the accord and satisfaction principle. The dispute that gives rise to the parties' agreement to settle by an accord and satisfaction may come up in several typical ways: where there is an unliquidated

debt; a disputed debt; an “in-full-payment check” for less than what the creditor claims is due; unforeseen difficulties that give rise to a contract modification, or a novation; or a composition among creditors. But no obligation ever arises—and no real legal dispute can arise—where a person promises a benefit if someone will do that which he has a preexisting obligation to, or where a person promises a benefit to someone not to do that which the promisee is already disallowed from doing, or where one makes an illusory promise.

### Settling an Unliquidated Debt

An **unliquidated debt**<sup>7</sup> is one that is uncertain in amount. Such debts frequently occur when people consult professionals in whose offices precise fees are rarely discussed, or where one party agrees, expressly or by implication, to pay the customary or reasonable fees of the other without fixing the exact amount. It is certain that a debt is owed, but it is not certain how much. (A **liquidated debt**<sup>8</sup>, on the other hand, is one that is fixed in amount, certain. A debt can be liquidated by being written down in unambiguous terms—“IOU \$100”—or by being mathematically ascertainable—\$1 per pound of ice ordered and 60 pounds delivered; hence the liquidated debt is \$60.)

Here is how the matter plays out: Assume a patient goes to the hospital for a gallbladder operation. The cost of the operation has not been discussed beforehand in detail, although the cost in the metropolitan area is normally around \$8,000. After the operation, the patient and the surgeon agree on a bill of \$6,000. The patient pays the bill; a month later the surgeon sues for another \$2,000. Who wins? The patient: he has forgone his right to challenge the reasonableness of the fee by agreeing to a fixed amount payable at a certain time. The agreement liquidating the debt is an accord and is enforceable. If, however, the patient and the surgeon had agreed on an \$8,000 fee before the operation, and if the patient arbitrarily refused to pay this liquidated debt unless the surgeon agreed to cut her fee in half, then the surgeon would be entitled to recover the other half in a lawsuit, because the patient would have given no consideration—given up nothing, “suffered no detriment”—for the surgeon’s subsequent agreement to cut the fee.

### Settling a Disputed Debt

A **disputed debt** arises where the parties *did* agree on (liquidated) the price or fee but subsequently get into a dispute about its fairness, and then settle. When this dispute is settled, the parties have given consideration to an agreement to accept a fixed sum as payment for the amount due. Assume that in the gallbladder case the patient agrees in advance to pay \$8,000. Eight months after the operation and as a result of nausea and vomiting spells, the patient undergoes a second operation; the surgeons discover a surgical sponge embedded in the patient’s intestine. The

7. A money obligation the amount of which is unknown.

8. A money obligation the value of which is known.

patient refuses to pay the full sum of the original surgeon's bill; they settle on \$6,000, which the patient pays. This is a binding agreement because subsequent facts arose to make legitimate the patient's quarrel over his obligation to pay the full bill. As long as the dispute is based in fact and is not trumped up, as long as the promisee is acting in good faith, then consideration is present when a disputed debt is settled.

### The "In-Full-Payment" Check Situation

To discharge his liquidated debt for \$8,000 to the surgeon, the patient sends a check for \$6,000 marked "payment in full." The surgeon cashes it. There is no dispute. May the surgeon sue for the remaining \$2,000? This may appear to be an accord: by cashing the check, the surgeon seems to be agreeing with the patient to accept the \$6,000 in full payment. But consideration is lacking. Because the surgeon is owed more than the face amount of the check, she causes the patient no legal detriment by accepting the check. If the rule were otherwise, debtors could easily tempt hard-pressed creditors to accept less than the amount owed by presenting immediate cash. The key to the enforceability of a "payment in full" legend is the character of the debt. If unliquidated, or if there is a dispute, then "payment in full" can serve as accord and satisfaction when written on a check that is accepted for payment by a creditor. But if the debt is liquidated and undisputed, there is no consideration when the check is for a lesser amount. (However, it is arguable that if the check is considered to be an agreement modifying a sales contract, no consideration is necessary under Uniform Commercial Code (UCC) Section 2-209.)

### Unforeseen Difficulties

An **unforeseen difficulty**<sup>9</sup> arising after a contract is made may be resolved by an accord and satisfaction, too. Difficulties that no one could foresee can sometimes serve as catalyst for a further promise that may appear to be without consideration but that the courts will enforce nevertheless. Suppose Peter contracts to build Jerry a house for \$390,000. While excavating, Peter unexpectedly discovers quicksand, the removal of which will cost an additional \$10,000. To ensure that Peter does not delay, Jerry promises to pay Peter \$10,000 more than originally agreed. But when the house is completed, Jerry reneges on his promise. Is Jerry liable? Logically perhaps not: Peter has incurred no legal detriment in exchange for the \$10,000; he had already contracted to build the house. But most courts would allow Peter to recover on the theory that the original contract was terminated, or modified, either by mutual agreement or by an implied condition that the original contract would be discharged if unforeseen difficulties developed. In short, the courts will enforce the parties' own mutual recognition that the unforeseen conditions had made the old contract unfair. The parties either have modified their original contract (which

9. Problems in executing a contract so great as to warrant the assumption that the contract is modified.

requires consideration at common law) or have given up their original contract and made a new one (called a **novation**<sup>10</sup>).

It is a question of fact whether the new circumstance is new and difficult enough to make a preexisting obligation into an unforeseen difficulty. Obviously, if Peter encounters only a small pocket of quicksand—say two gallons' worth—he would have to deal with it as part of his already-agreed-to job. If he encounters as much quicksand as would fill an Olympic-sized swimming pool, that's clearly unforeseen, and he should get extra to deal with it. Somewhere between the two quantities of quicksand there is enough of the stuff so that Peter's duty to remove it is outside the original agreement and new consideration would be needed in exchange for its removal.

### Creditors' Composition

A **creditors' composition**<sup>11</sup> may give rise to debt settlement by an accord and satisfaction. It is an agreement whereby two or more creditors of a debtor consent to the debtor's paying them pro rata shares of the debt due in full satisfaction of their claims. A composition agreement can be critically important to a business in trouble; through it, the business might manage to stave off bankruptcy. Even though the share accepted is less than the full amount due and is payable after the due date so that consideration appears to be lacking, courts routinely enforce these agreements. The promise of each creditor to accept a lesser share than that owed in return for getting something is taken as consideration to support the promises of the others. A debtor has \$3,000 on hand. He owes \$3,000 each to A, B, and C. A, B, and C agree to accept \$1,000 each and discharge the debtor. Each creditor has given up \$2,000 but in return has at least received something, the \$1,000. Without the composition, one might have received the entire amount owed her, but the others would have received nothing.

### Preexisting Duty

Not amenable to settlement by an accord and satisfaction is the situation where a party has a **preexisting duty** and he or she is offered a benefit to discharge it. When the only consideration offered the promisor is an act or promise to act to carry out a preexisting duty, there is no valid contract. As *Denney v. Reppert* ([Section 11.4.2 "Consideration: Preexisting Obligation"](#)) makes clear, the promisee suffers no legal detriment in promising to undertake that which he is already obligated to do. Where a person is promised a benefit not to do that which he is already disallowed from doing, there is no consideration. David is sixteen years old; his uncle promises him \$50 if he will refrain from smoking. The promise is not enforceable: legally, David already must refrain from smoking, so he has promised to give up nothing to which he had a legal right. As noted previously, the difficulty arises where it is

10. A new contract substituting for an old one, or a new party to a contract replacing a former party.

11. An agreement among creditors, each accepting less than full payment from a debtor so that each gets something.

unclear whether a person has a preexisting obligation or whether such unforeseen difficulties have arisen as to warrant the recognition that the parties have modified the contract or entered into a novation. What if Peter insists on additional payment for him to remove one wheelbarrow full of quicksand from the excavation? Surely that's not enough "unforeseen difficulty." How much quicksand is enough?

### Illusory Promises

Not every promise is a pledge to do something. Sometimes it is an **illusory promise**<sup>12</sup>, where the terms of the contract really bind the promisor to give up nothing, to suffer no detriment. For example, Lydia offers to pay Juliette \$10 for mowing Lydia's lawn. Juliette promises to mow the lawn if she feels like it. May Juliette enforce the contract? No, because Juliette has incurred no legal detriment; her promise is illusory, since by doing nothing she still falls within the literal wording of her promise. The doctrine that such bargains are unenforceable is sometimes referred to as the rule of mutuality of obligation: if one party to a contract has not made a binding obligation, neither is the other party bound. Thus if A contracts to hire B for a year at \$6,000 a month, reserving the right to dismiss B at any time (an "option to cancel" clause), and B agrees to work for a year, A has not really promised anything; A is not bound to the agreement, and neither is B.

The illusory promise presents a special problem in agreements for exclusive dealing, outputs, and needs contracts.

### Exclusive Dealing Agreement

In an **exclusive dealing agreement**<sup>13</sup>, one party (the franchisor) promises to deal solely with the other party (the franchisee)—for example, a franchisor-designer agrees to sell all of her specially designed clothes to a particular department store (the franchisee). In return, the store promises to pay a certain percentage of the sales price to the designer. On closer inspection, it may appear that the store's promise is illusory: it pays the designer only if it manages to sell dresses, but it may sell none. The franchisor-designer may therefore attempt to back out of the deal by arguing that because the franchisee is not obligated to do anything, there was no consideration for her promise to deal exclusively with the store.

12. The promisor actually gives up no consideration, as in "I will paint your house in June if I feel like it."

13. A contract—as between buyer and seller—where the parties agree only to deal with each other.

Courts, however, have upheld exclusive dealing contracts on the theory that the franchisee has an obligation to use reasonable efforts to promote and sell the product or services. This obligation may be spelled out in the contract or implied by its terms. In the classic statement of this concept, Judge Benjamin N. Cardozo, then on the New York Court of Appeals, in upholding such a contract, declared:



It is true that [the franchisee] does not promise in so many words that he will use reasonable efforts to place the defendant's endorsements and market her designs. We think, however, that such a promise is fairly to be implied. The law has outgrown its primitive stage of formalism when the precise word was the sovereign talisman, and every slip was fatal. It takes a broader view today. A promise may be lacking, and yet the whole writing may be "instinct with an obligation," imperfectly expressed....His promise to pay the defendant one-half of the profits and revenues resulting from the exclusive agency and to render accounts monthly was a promise to use reasonable efforts to bring profits and revenues into existence. *Otis F. Wood v. Lucy, Lady Duff-Gordon*, 118 N.E. 214 (1917).

The UCC follows the same rule. In the absence of language specifically delineating the seller's or buyer's duties, an exclusive dealing contract under Section 2-306(2) imposes "an obligation by the seller to use best efforts to supply the goods and by the buyer to use best efforts to promote their sale."

### Outputs Contracts and Needs Contracts

A similar issue arises with outputs contracts and needs contracts. In an **outputs contract**<sup>14</sup>, the seller—say a coal company—agrees to sell its entire yearly output of coal to an electric utility. Has it really agreed to produce and sell any coal at all? What if the coal-mine owner decides to shut down production to take a year's vacation—is that a violation of the agreement? Yes. The law imposes upon the seller here a duty to produce and sell a reasonable amount. Similarly, if the electric utility contracted to buy all its requirements of coal from the coal company—a **needs contract**<sup>15</sup>—could it decide to stop operation entirely and take no coal? No, it is required to take a reasonable amount.

14. An agreement to sell all of one's goods or services to a single person.

15. An agreement to buy all of one's requirements (of goods or services) from a single source.

### KEY TAKEAWAY

Courts do not inquire into the adequacy of consideration, but (with some exceptions) do require the promisor to incur a legal detriment (the surrender of any legal right he or she possesses—to give up something) in order to receive the bargained-for benefit. The surrender of the right to sue is a legal detriment, and the issue arises in analyzing various kinds of dispute settlement agreements (accord and satisfaction): the obligation to pay the full amount claimed by a creditor on a liquidated debt, an unliquidated debt, and a disputed debt. Where unforeseen difficulties arise, an obligor will be entitled to additional compensation (consideration) to resolve them either because the contract is modified or because the parties have entered into a novation, but no additional consideration is owing to one who performs a preexisting obligation or forbears from performing that which he or she is under a legal duty not to perform. If a promisor gives an illusory promise, he or she gives no consideration and no contract is formed; but exclusive dealing agreements, needs contracts, and outputs contracts are not treated as illusory.

### EXERCISES

1. What is meant by “legally sufficient” consideration?
2. Why do courts usually not “inquire into the adequacy of consideration”?
3. How can it be said there is consideration in the following instances: (a) settlement of an unliquidated debt? (b) settlement of a disputed debt? (c) a person agreeing to do more than originally contracted for because of unforeseen difficulties? (d) a creditor agreeing with other creditors for each of them to accept less than they are owed from the debtor?
4. Why is there no consideration where a person demands extra compensation for that which she is already obligated to do, or for forbearing to do that which she already is forbidden from doing?
5. What is the difference between a contract modification and a novation?
6. How do courts resolve the problem that a needs or outputs contract apparently imposes no detriment—no requirement to pass any consideration to the other side—on the promisor?

## 11.3 Promises Enforceable without Consideration

### LEARNING OBJECTIVE

1. Understand the exceptions to the requirement of consideration.

For a variety of policy reasons, courts will enforce certain types of promises even though consideration may be absent. Some of these are governed by the Uniform Commercial Code (UCC); others are part of the established common law.

### Promises Enforceable without Consideration at Common Law Past Consideration

Ordinarily, **past consideration**<sup>16</sup> is not sufficient to support a promise. By past consideration, the courts mean an act that could have served as consideration if it had been bargained for at the time but that was not the subject of a bargain. For example, Mrs. Ace's dog Fluffy escapes from her mistress's condo at dusk. Robert finds Fluffy, sees Mrs. Ace, who is herself out looking for her pet, and gives Fluffy to her. She says, "Oh, thank you for finding my dear dog. Come by my place tomorrow morning and I'll give you fifty dollars as a reward." The next day Robert stops by Mrs. Ace's condo, but she says, "Well, I don't know. Fluffy soiled the carpet again last night. I think maybe a twenty-dollar reward would be plenty." Robert cannot collect the fifty dollars. Even though Mrs. Ace might have a moral obligation to pay him and honor her promise, there was no consideration for it. Robert incurred no legal detriment; his contribution—finding the dog—was paid out before her promise, and his past consideration is invalid to support a contract. There was no bargained-for exchange.

However, a valid consideration, given in the past to support a promise, can be the basis for another, later contract under certain circumstances. These occur when a person's duty to act for one reason or another has become no longer binding. If the person then makes a new promise based on the unfulfilled past duty, the new promise is binding without further consideration. Three types of cases follow.

16. A promise subsequent to a promisee's act, not bargained for; it does not count as consideration.

17. The law stipulating how long after a cause of action arises that a person has to sue on it.

### Promise Revived after Statute of Limitations Has Passed

A **statute of limitations**<sup>17</sup> is a law requiring a lawsuit to be filed within a specified period of years. For example, in many states a contract claim must be sued on within six years; if the plaintiff waits longer than that, the claim will be dismissed,

regardless of its merits. When the time period set forth in the statute of limitations has lapsed, the statute is said to have “run.” If a debtor renews a promise to pay or acknowledges a debt after the running of a statute of limitations, then under the common law the promise is binding, although there is no consideration in the usual sense. In many states, this promise or acknowledgment must be in writing and signed by the debtor. Also, in many states, the courts will imply a promise or acknowledgment if the debtor makes a partial payment after the statute has run.

### Voidable Duties

Some promises that might otherwise serve as consideration are voidable by the promisor, for a variety of reasons, including infancy, fraud, duress, or mistake. But a voidable contract does not automatically become void, and if the promisor has not avoided the contract but instead thereafter renews his promise, it is binding. For example, Mr. Melvin sells his bicycle to Seth, age thirteen. Seth promises to pay Mr. Melvin one hundred dollars. Seth may repudiate the contract, but he does not. When he turns eighteen, he renews his promise to pay the one hundred dollars. This promise is binding. (However, a promise made up to the time he turned eighteen would not be binding, since he would still have been a minor.)

### Promissory Estoppel

We examined the meaning of this forbidding phrase in Chapter 8 "Introduction to Contract Law" (recall the English *High Trees* case). It represents another type of promise that the courts will enforce without consideration. Simply stated, **promissory estoppel**<sup>18</sup> means that the courts will stop the promisor from claiming that there was no consideration. The doctrine of promissory estoppel is invoked in the interests of justice when three conditions are met: (1) the promise is one that the promisor should reasonably expect to induce the promisee to take action or forbear from taking action of a definite and substantial character; (2) the action or forbearance is taken; and (3) injustice can be avoided only by enforcing the promise. (The complete phraseology is “promissory estoppel with detrimental reliance.”)

Timko served on the board of trustees of a school. He recommended that the school purchase a building for a substantial sum of money, and to induce the trustees to vote for the purchase, he promised to help with the purchase and to pay at the end of five years the purchase price less the down payment. At the end of four years, Timko died. The school sued his estate, which defended on the ground that there was no consideration for the promise. Timko was promised or given nothing in return, and the purchase of the building was of no direct benefit to him (which would have made the promise enforceable as a unilateral contract). The court ruled that under the three-pronged promissory estoppel test, Timko’s estate was

18. To be prohibited from denying a promise when another subsequently has relied on it.

liable. *Estate of Timko v. Oral Roberts Evangelistic Assn.*, 215 N.W.2d 750 (Mich. App. 1974).

Cases involving pledges of charitable contributions have long been troublesome to courts. Recognizing the necessity to charitable institutions of such pledges, the courts have also been mindful that a mere pledge of money to the general funds of a hospital, university, or similar institution does not usually induce substantial action but is, rather, simply a promise without consideration. When the pledge does prompt a charitable institution to act, promissory estoppel is available as a remedy. In about one-quarter of the states, another doctrine is available for cases involving simple pledges: the “mutual promises” theory, whereby the pledges of many individuals are taken as consideration for each other and are binding against each promisor. This theory was not available to the plaintiff in *Timko* because his was the only promise.

### **Moral Obligation**

The Restatement allows, under some circumstances, the enforcement of past-consideration contracts. It provides as follows in Section 86, “Promise for Benefit Received”:

A promise made in recognition of a benefit previously received by the promisor from the promisee is binding to the extent necessary to prevent injustice.

A promise is not binding under Subsection (1)

if the promisee conferred the benefit as a gift or for other reasons the promisor has not been unjustly enriched; or

to the extent that its value is disproportionate to the benefit.

### **Promises Enforceable without Consideration by Statute**

We have touched on several common-law exceptions to the consideration requirement. Some also are provided by statute.

#### **Under the UCC**

The UCC permits one party to discharge, without consideration, a claim or right arising out of an alleged breach of contract by the other party. This is accomplished

by delivering to the other party a signed written **waiver**<sup>19</sup> or **renunciation**<sup>20</sup>. Uniform Commercial Code, Section 1-107. This provision applies to any contract governed by the UCC and is not limited to the sales provisions of Article 2.

The UCC also permits a party to discharge the other side without consideration when there is no breach, and it permits parties to modify their Article 2 contract without consideration. Uniform Commercial Code, Sections 2-209(4) and 2-209(1). The official comments to the UCC section add the following: “However, modifications made thereunder must meet the test of good faith imposed by this Act. The effective use of bad faith to escape performance on the original contract terms is barred, and the extortion of a “modification” without legitimate commercial reason is ineffective as a violation of the duty of good faith.”

Seller agrees to deliver a ton of coal within seven days. Buyer needs the coal sooner and asks Seller to deliver within four days. Seller agrees. This promise is binding even though Seller received no additional consideration beyond the purchase price for the additional duty agreed to (the duty to get the coal to Buyer sooner than originally agreed). The UCC allows a merchant’s **firm offer**<sup>21</sup>, signed, in writing, to bind the merchant to keep the offer to buy or sell open without consideration. Uniform Commercial Code, Section 2-205. This is the UCC’s equivalent of a common-law option, which, as you recall, does require consideration.

Section 1-207 of the UCC allows a party a **reservation of rights**<sup>22</sup> while performing a contract. This section raises a difficult question when a debtor issues an in-full-payment check in payment of a disputed debt. As noted earlier in this chapter, because under the common law the creditor’s acceptance of an in-full-payment check in payment of a disputed debt constitutes an accord and satisfaction, the creditor cannot collect an amount beyond the check. But what if the creditor, in cashing the check, reserves the right (under Section 1-207) to sue for an amount beyond what the debtor is offering? The courts are split on the issue: regarding the sale of goods governed by the UCC, some courts allow the creditor to sue for the unpaid debt notwithstanding the check being marked “paid in full,” and others do not.

- 19. An informed choice wherein one surrenders the right to pursue some otherwise available legal remedy.
- 20. A formal rejection of something, as a contract.
- 21. A signed promise made by a merchant to hold an offer open.
- 22. A statement that one is intentionally retaining all or some legal rights, so as to warn others of those rights.

### Bankruptcy

Bankruptcy is, of course, federal statutory law. The rule here regarding a promise to pay after the obligation is discharged is similar to that governing statutes of limitations. Traditionally, a promise to repay debts after a bankruptcy court has discharged them makes the debtor liable once again. This traditional rule gives rise to potential abuse; after undergoing the rigors of bankruptcy, a debtor could be

badgered by creditors into **reaffirmation**<sup>23</sup>, putting him in a worse position than before, since he must wait six years before being allowed to avail himself of bankruptcy again.

The federal Bankruptcy Act includes certain procedural protections to ensure that the debtor knowingly enters into a reaffirmation of his debt. Among its provisions, the law requires the debtor to have reaffirmed the debt before the debtor is discharged in bankruptcy; he then has sixty days to rescind his reaffirmation. If the bankrupt party is an individual, the law also requires that a court hearing be held at which the consequences of his reaffirmation must be explained, and reaffirmation of certain consumer debts is subject to court approval if the debtor is not represented by an attorney.

### International Contracts

Contracts governed by the Convention on Contracts for the International Sale of Goods (as mentioned in [Chapter 8 "Introduction to Contract Law"](#)) do not require consideration to be binding.

#### KEY TAKEAWAY

There are some exceptions to the consideration requirement. At common law, past consideration doesn't count, but no consideration is necessary in these cases: where a promise barred by the statute of limitations is revived, where a voidable duty is reaffirmed, where there has been detrimental reliance on a promise (i.e., promissory estoppel), or where a court simply finds the promisor has a moral obligation to keep the promise.

Under statutory law, the UCC has several exceptions to the consideration requirement. No consideration is needed to revive a debt discharged in bankruptcy, and none is called for under the Convention on Contracts for the International Sale of Goods.

23. To confirm again the validity of a promise that was discharged, as in bankruptcy.

## EXERCISES

1. Melba began work for Acme Company in 1975 as a filing clerk. Thirty years later she had risen to be comptroller. At a thirty-year celebration party, her boss, Mr. Holder, said, “Melba, I hope you work here for a long time, and you can retire at any time, but if you decide to retire, on account of your years of good service, the company will pay you a monthly pension of \$2,000.” Melba continued to work for another two years, then retired. The company paid the pension for three years and then, in an economic downturn, stopped. When Melba sued, the company claimed it was not obligated to her because the pension was of past consideration. What will be the result?
2. What theories are used to enforce charitable subscriptions?
3. What are the elements necessary for the application of the doctrine of promissory estoppel?
4. Under what circumstances does the Restatement employ moral obligation as a basis for enforcing an otherwise unenforceable contract?
5. Promises unenforceable because barred by bankruptcy or by the running of the statute of limitations can be revived without further consideration. What do the two circumstances have in common?
6. Under the UCC, when is no consideration required where it would be in equivalent situations at common law?



## 11.4 Cases

### Consideration for an Option

Board of Control of Eastern Michigan University v. Burgess

206 N.W.2d 256 (Mich. 1973)

Burns, J.

On February 15, 1966, defendant signed a document which purported to grant to plaintiff a 60-day option to purchase defendant's home. That document, which was drafted by plaintiff's agent, acknowledged receipt by defendant of "One and no/100 (\$1.00) Dollar and other valuable consideration." Plaintiff concedes that neither the one dollar nor any other consideration was ever paid or even tendered to defendant. On April 14, 1966, plaintiff delivered to defendant written notice of its intention to exercise the option. On the closing date defendant rejected plaintiff's tender of the purchase price. Thereupon, plaintiff commenced this action for specific performance.

At trial defendant claimed that the purported option was void for want of consideration, that any underlying offer by defendant had been revoked prior to acceptance by plaintiff, and that the agreed purchase price was the product of fraud and mutual mistake. The trial judge concluded that no fraud was involved, and that any mutual mistake was not material. He also held that defendant's acknowledgment of receipt of consideration bars any subsequent contention to the contrary. Accordingly, the trial judge entered judgment for plaintiff.

Options for the purchase of land, if based on valid consideration, are contracts which may be specifically enforced. [Citations] Conversely, that which purports to be an option, but which is not based on valid consideration, is not a contract and will not be enforced. [Citations] One dollar is valid consideration for an option to purchase land, provided the dollar is paid or at least tendered. [Citations] In the instant case defendant received no consideration for the purported option of February 15, 1966.

A written acknowledgment of receipt of consideration merely creates a rebuttable presumption that consideration has, in fact, passed. Neither the parol evidence rule

nor the doctrine of estoppel bars the presentation of evidence to contradict any such acknowledgment. [Citation]

It is our opinion that the document signed by defendant on February 15, 1966, is not an enforceable option, and that defendant is not barred from so asserting.

The trial court premised its holding to the contrary on *Lawrence v. McCalmont*... (1844). That case is significantly distinguishable from the instant case. Mr. Justice Story held that '(t)he guarantor acknowledged the receipt of one dollar, and is now estopped to deny it.' However, in reliance upon the guaranty substantial credit had been extended to the guarantor's sons. The guarantor had received everything she bargained for, save one dollar. In the instant case defendant claims that she never received any of the consideration promised her.

That which purports to be an option for the purchase of land, but which is not based on valid consideration, is a simple offer to sell the same land. [Citation] An option is a contract collateral to an offer to sell whereby the offer is made irrevocable for a specified period. [Citation] Ordinarily, an offer is revocable at the will of the offeror. Accordingly, a failure of consideration affects only the collateral contract to keep the offer open, not the underlying offer.

A simple offer may be revoked for any reason or for no reason by the offeror at any time prior to its acceptance by the offeree. [Citation] Thus, the question in this case becomes, 'Did defendant effectively revoke her offer to sell before plaintiff accepted that offer?'...

Defendant testified that within hours of signing the purported option she telephoned plaintiff's agent and informed him that she would not abide by the option unless the purchase price was increased. Defendant also testified that when plaintiff's agent delivered to her on April 14, 1966, plaintiff's notice of its intention to exercise the purported option, she told him that 'the option was off'.

Plaintiff's agent testified that defendant did not communicate to him any dissatisfaction until sometime in July, 1966.

If defendant is telling the truth, she effectively revoked her offer several weeks before plaintiff accepted that offer, and no contract of sale was created. If plaintiff's agent is telling the truth, defendant's offer was still open when plaintiff accepted that offer, and an enforceable contract was created. The trial judge thought it unnecessary to resolve this particular dispute. In light of our holding the dispute must be resolved.

An appellate court cannot assess the credibility of witnesses. We have neither seen nor heard them testify. [Citation] Accordingly, we remand this case to the trial court for additional findings of fact based on the record already before the court....

Reversed and remanded for proceedings consistent with this opinion. Costs to defendant.

### CASE QUESTIONS

1. Why did the lower court decide the option given by the defendant was valid?
2. Why did the appeals court find the option invalid?
3. The case was remanded. On retrial, how could the plaintiff (the university) still win?
4. It was not disputed that the defendant signed the purported option. Is it right that she should get out of it merely because she didn't really get the \$1.00?

### Consideration: Preexisting Obligation

Denney v. Reppert

432 S.W.2d 647 (Ky. 1968)

R. L. Myre, Sr., Special Commissioner.

The sole question presented in this case is which of several claimants is entitled to an award for information leading to the apprehension and conviction of certain bank robbers....

On June 12th or 13th, 1963, three armed men entered the First State Bank, Eubank, Kentucky, and with a display of arms and threats robbed the bank of over \$30,000 [about \$208,000 in 2010 dollars]. Later in the day they were apprehended by State Policemen Garret Godby, Johnny Simms and Tilford Reppert, placed under arrest, and the entire loot was recovered. Later all of the prisoners were convicted and Garret Godby, Johnny Simms and Tilford Reppert appeared as witnesses at the trial.

The First State Bank of Eubank was a member of the Kentucky Bankers Association which provided and advertised a reward of \$500.00 for the arrest and conviction of

each bank robber. Hence the outstanding reward for the three bank robbers was \$1,500.00 [about \$11,000 in 2010 dollars]. Many became claimants for the reward and the Kentucky State Bankers Association being unable to determine the merits of the claims for the reward asked the circuit court to determine the merits of the various claims and to adjudge who was entitled to receive the reward or share in it. All of the claimants were made defendants in the action.

At the time of the robbery the claimants Murrell Denney, Joyce Buis, Rebecca McCollum and Jewell Snyder were employees of the First State Bank of Eubank and came out of the grueling situation with great credit and glory. Each one of them deserves approbation and an accolade. They were vigilant in disclosing to the public and the peace officers the details of the crime, and in describing the culprits, and giving all the information that they possessed that would be useful in capturing the robbers. Undoubtedly, they performed a great service. It is in the evidence that the claimant Murrell Denney was conspicuous and energetic in his efforts to make known the robbery, to acquaint the officers as to the personal appearance of the criminals, and to give other pertinent facts.

The first question for determination is whether the employees of the robbed bank are eligible to receive or share in the reward. The great weight of authority answers in the negative. [Citation] states the rule thusly:

‘To the general rule that, when a reward is offered to the general public for the performance of some specified act, such reward may be claimed by any person who performs such act, is the exception of agents, employees and public officials who are acting within the scope of their employment or official duties. \* \* \*.’...

At the time of the robbery the claimants Murrell Denney, Joyce Buis, Rebecca McCollum, and Jewell Snyder were employees of the First State Bank of Eubank. They were under duty to protect and conserve the resources and moneys of the bank, and safeguard every interest of the institution furnishing them employment. Each of these employees exhibited great courage, and cool bravery, in a time of stress and danger. The community and the county have recompensed them in commendation, admiration and high praise, and the world looks on them as heroes. But in making known the robbery and assisting in acquainting the public and the officers with details of the crime and with identification of the robbers, they performed a duty to the bank and the public, for which they cannot claim a reward.

The claims of Corbin Reynolds, Julia Reynolds, Alvie Reynolds and Gene Reynolds also must fail. According to their statements they gave valuable information to the arresting officers. However, they did not follow the procedure as set forth in the offer of reward in that they never filed a claim with the Kentucky Bankers

Association. It is well established that a claimant of a reward must comply with the terms and conditions of the offer of reward. [Citation]

State Policemen Garret Godby, Johnny Simms and Tilford Reppert made the arrest of the bank robbers and captured the stolen money. All participated in the prosecution. At the time of the arrest, it was the duty of the state policemen to apprehend the criminals. Under the law they cannot claim or share in the reward and they are interposing no claim to it.

This leaves the defendant, Tilford Reppert the sole eligible claimant. The record shows that at the time of the arrest he was a deputy sheriff in Rockcastle County, but the arrest and recovery of the stolen money took place in Pulaski County. He was out of his jurisdiction, and was thus under no legal duty to make the arrest, and is thus eligible to claim and receive the reward. In [Citation] it was said:

‘It is \* \* \* well established that a public officer with the authority of the law to make an arrest may accept an offer of reward or compensation for acts or services performed outside of his bailiwick or not within the scope of his official duties. \* \* \*’ ...

It is manifest from the record that Tilford Reppert is the only claimant qualified and eligible to receive the reward. Therefore, it is the judgment of the circuit court that he is entitled to receive payment of the \$1,500.00 reward now deposited with the Clerk of this Court.

The judgment is affirmed.

### CASE QUESTIONS

1. Why did the Bankers Association put the resolution of this matter into the court’s hands?
2. Several claimants came forward for the reward; only one person got it. What was the difference between the person who got the reward and those who did not?

### Consideration: Required for Contract Modification

Gross v. Diehl Specialties International, Inc.

776 S.W.2d 879 (Missouri Ct. App. 1989)

Smith, J.

Plaintiff appeals from a jury verdict and resultant judgment for defendant in a breach of employment contract case....

Plaintiff was employed under a fifteen year employment contract originally executed in 1977 between plaintiff and defendant. Defendant, at that time called Dairy Specialties, Inc., was a company in the business of formulating ingredients to produce non-dairy products for use by customers allergic to cow's milk. Plaintiff successfully formulated [Vitamite]...for that usage.

Thereafter, on August 24, 1977, plaintiff and defendant corporation entered into an employment contract employing plaintiff as general manager of defendant for fifteen years. Compensation was established at \$14,400 annually plus cost of living increases. In addition, when 10% of defendant's gross profits exceeded the annual salary, plaintiff would receive an additional amount of compensation equal to the difference between his compensation and 10% of the gross profits for such year. On top of that plaintiff was to receive a royalty for the use of each of his inventions and formulae of 1% of the selling price of all of the products produced by defendant using one or more of plaintiff's inventions or formulae during the term of the agreement. That amount was increased to 2% of the selling price following the term of the agreement. The contract further provided that during the term of the agreement the inventions and formulae would be owned equally by plaintiff and defendant and that following the term of the agreement the ownership would revert to plaintiff. During the term of the agreement defendant had exclusive rights to use of the inventions and formulae and after the term of agreement a non-exclusive right of use.

At the time of the execution of the contract, sales had risen from virtually nothing in 1976 to \$750,000 annually from sales of Vitamite and a chocolate flavored product formulated by plaintiff called Chocolite. [Dairy's owner] was in declining health and in 1982 desired to sell his company. At that time yearly sales were \$7,500,000. [Owner] sold the company to the Diehl family enterprises for 3 million dollars.

Prior to sale Diehl insisted that a new contract between plaintiff and defendant be executed or Diehl would substantially reduce the amount to be paid for [the company]. A new contract was executed August 24, 1982. It reduced the expressed term of the contract to 10 years, which provided the same expiration date as the

prior contract. It maintained the same base salary of \$14,400 effective September 1982, thereby eliminating any cost of living increases incurred since the original contract. The 10% of gross profit provision remained the same. The new contract provided that plaintiff's inventions and formula were exclusively owned by defendant during the term of the contract and after its termination. The 1% royalty during the term of the agreement remained the same, but no royalties were provided for after the term of the agreement. No other changes were made in the agreement. Plaintiff received no compensation for executing the new contract. He was not a party to the sale of the company by [Owner] and received nothing tangible from that sale.

After the sale plaintiff was given the title and responsibilities of president of defendant with additional duties but no additional compensation. In 1983 and 1984 the business of the company declined severely and in October 1984, plaintiff's employment with defendant was terminated by defendant. This suit followed....

We turn now to the court's holding that the 1982 agreement was the operative contract. Plaintiff contends this holding is erroneous because there existed no consideration for the 1982 agreement. We agree. A modification of a contract constitutes the making of a new contract and such new contract must be supported by consideration. [Citation] Where a contract has not been fully performed at the time of the new agreement, the substitution of a new provision, resulting in a modification of the obligations on *both* sides, for a provision in the old contract still unperformed is sufficient consideration for the new contract. While consideration may consist of either a detriment to the promisee or a benefit to the promisor, a promise to carry out an already existing contractual duty does not constitute consideration. [Citation]

Under the 1982 contract defendant assumed no detriment it did not already have. The term of the contract expired on the same date under both contracts. Defendant undertook no greater obligations than it already had. Plaintiff on the other hand received less than he had under the original contract. His base pay was reduced back to its amount in 1977 despite the provision in the 1977 contract for cost of living adjustments. He lost his equal ownership in his formulae during the term of the agreement and his exclusive ownership after the termination of the agreement. He lost all royalties after termination of the agreement and the right to use and license the formulae subject to defendant's right to non-exclusive use upon payment of royalties. In exchange for nothing, defendant acquired exclusive ownership of the formulae during and after the agreement, eliminated royalties after the agreement terminated, turned its non-exclusive use after termination into exclusive use and control, and achieved a reduction in plaintiff's base salary. Defendant did no more than promise to carry out an already existing contractual duty. There was no consideration for the 1982 agreement.

Defendant asserts that consideration flowed to plaintiff because the purchase of defendant by the Diehls might not have occurred without the agreement and the purchase provided plaintiff with continued employment and a financially viable employer. There is no evidence to support this contention. Plaintiff had continued employment with the same employer under the 1977 agreement. Nothing in the 1982 agreement provided for any additional financial protection to plaintiff. The essence of defendant's position is that [the owner] received more from his sale of the company because of the new agreement than he would have without it. We have difficulty converting [the owner's] windfall into a benefit to plaintiff.

[Remanded to determine how much plaintiff should receive.]

### CASE QUESTIONS

1. Why did the court determine that Plaintiff's postemployment benefits should revert to those in his original contract instead being limited to those in the modified contract?
2. What argument did Defendant make as to why the terms of the modified contract should be valid?



## 11.5 Summary and Exercises

### Summary

Most agreements—including contract modification at common law (but not under the Uniform Commercial Code [UCC])—are not binding contracts in the absence of what the law terms “consideration.” Consideration is usually defined as a “legal detriment”—an act, forbearance, or a promise. The act can be the payment of money, the delivery of a service, or the transfer of title to property. Consideration is a legal concept in that it centers on the giving up of a legal right or benefit.

An understanding of consideration is important in many commonplace situations, including those in which (1) a debtor and a creditor enter into an accord that is later disputed, (2) a duty is preexisting, (3) a promise is illusory, and (4) creditors agree to a composition.

Some promises are enforceable without consideration. These include certain promises under the UCC and other circumstances, including (1) contracts barred by the statute of limitations, (2) promises by a bankrupt to repay debts, and (3) situations in which justice will be served by invoking the doctrine of promissory estoppel. Determining whether an agreement should be upheld despite the lack of consideration, technically defined, calls for a diligent assessment of the factual circumstances.

## EXERCISES

1. Hornbuckle purchased equipment from Continental Gin (CG) for \$6,300. However, after some of the equipment proved defective, Hornbuckle sent CG a check for \$4,000 marked “by endorsement this check is accepted in full payment,” and CG endorsed and deposited the check. May CG force Hornbuckle to pay the remaining \$2,300? Why?
2. Joseph Hoffman alleged that Red Owl Stores promised him that it would build a store building in Chilton, Wisconsin, and stock it with merchandise for Hoffman to operate in return for Hoffman’s investment of \$18,000. The size, cost, design, and layout of the store building was not discussed, nor were the terms of the lease as to rent, maintenance, and purchase options. Nevertheless, in reliance on Red Owl’s promise, the Hoffmans sold their bakery and grocery store business, purchased the building site in Chilton, and rented a residence there for the family. The deal was never consummated: a dispute arose, Red Owl did not build the store, and it denied liability to Hoffman on the basis that its promise to him was too indefinite with respect to all details for a contract to have resulted. Is Hoffman entitled to some relief? On what theory?
3. Raquel contracted to deliver one hundred widgets to Sam on December 15, for which he would pay \$4,000. On November 25, Sam called her and asked if she could deliver the widgets on December 5. Raquel said she could, and she promised delivery on that day. Is her promise binding? Why?
4. Richard promised to have Darlene’s deck awning constructed by July 10. On June 20, Darlene called him and asked if he could get the job done by July 3, in time for Independence Day. Richard said he could, but he failed to do so, and Darlene had to rent two canopies at some expense. Darlene claims that because Richard breached his promise, he is liable for the cost of awning rental. Is she correct—was his promise binding? Why?
5. Seller agreed to deliver gasoline to Buyer at \$3.15 per gallon over a period of one year. By the sixth month, gasoline had increased in price over a dollar a gallon. Although Seller had gasoline available for sale, he told Buyer the price would have to increase by that much or he would be unable to deliver. Buyer agreed to the increase, but when billed, refused to pay the additional amount. Is Buyer bound by the promise? Explain.
6. Montbanks’s son, Charles, was seeking an account executive position with Dobbs, Smith & Fogarty, Inc., a large brokerage firm. Charles was independent and wished no interference by his well-known father. The firm, after several weeks’ deliberation, decided to hire Charles. They made him an offer on April 12, 2010, and Charles accepted. Montbanks, unaware that his son had been hired and concerned that he might not be, mailed a letter to Dobbs on April 13 in which he promised to give the

brokerage firm \$150,000 in commission business if the firm would hire his son. The letter was received by Dobbs, and the firm wishes to enforce it against Montbanks. May Dobbs enforce the promise? Why?

7. In 1869, William E. Story promised his nephew, William E. Story II (then sixteen years old), \$5,000 (about \$120,000 in today's money) if "Willie" would abstain from drinking alcohol, smoking, swearing, and playing cards or billiards for money until the nephew reached twenty-one years of age. All of these were legally permissible activities for the teenager at that time in New York State. Willie accepted his uncle's promise and did refrain from the prohibited acts until he turned twenty-one. When the young man asked for the money, his uncle wrote to him that he would honor the promise but would rather wait until Willie was older before delivering the money, interest added on. Willie agreed. Subsequently, Willie assigned the right to receive the money to one Hamer (Willie wanted the money sooner), and Story I died without making any payment. The estate, administered by Franklin Sidway, refused to pay, asserting there was no binding contract due to lack of consideration: the boy suffered no "detriment," and the uncle got no benefit. The trial court agreed with the estate, and the plaintiff appealed. Should the court on appeal affirm or reverse? Explain.
8. Harold Pearsall and Joe Alexander were friends for over twenty-five years. About twice a week, they bought what they called a package: a half-pint of vodka, orange juice, two cups, and two lottery tickets. They went to Alexander's house to watch TV, drink screwdrivers, and scratch the lottery tickets. The two had been sharing tickets and screwdrivers since the Washington, DC, lottery began. On the evening in issue, Pearsall bought the package and asked Alexander, "Are you in on it?" Alexander said yes. Pearsall asked for his half of the purchase price, but Alexander had no money. A few hours later, Alexander, having come by some funds of his own, bought another package. He handed one ticket to Pearsall, and they both scratched the tickets; Alexander's was a \$20,000 winner. When Pearsall asked for his share, Alexander refused to give him anything. Are the necessary elements of offer, acceptance, and consideration present here so as to support Pearsall's assertion the parties had a contract?
9. Defendant, Lee Taylor, had assaulted his wife, who took refuge in the house of Plaintiff, Harrington. The next day, Taylor gained access to the house and began another assault upon his wife. Mrs. Taylor knocked him down with an axe and was on the point of cutting his head open or decapitating him while he was lying on the floor when Plaintiff intervened and caught the axe as it was descending. The blow intended for Defendant fell upon Harrington's hand, mutilating it badly, but saving Defendant's life. Subsequently, Defendant orally promised to pay

Plaintiff her damages but, after paying a small sum, failed to pay anything more. Is Harrington entitled to enforce Taylor's entire promise?

10. White Sands Forest Products (Defendant) purchased logging equipment from Clark Corporation (Plaintiff) under an installment contract that gave Plaintiff the right to repossess and resell the equipment if Defendant defaulted on the contract. Defendant did default and agreed to deliver the equipment to Plaintiff if Plaintiff would then discharge Defendant from further obligation. Plaintiff accepted delivery and resold the equipment, but the sale left a deficiency (there was still money owing by Defendant). Plaintiff then sued for the deficiency, and Defendant set up as a defense the accord and satisfaction. Is the defense good?

## SELF-TEST QUESTIONS

1. Consideration
  - a. can consist of a written acknowledgment of some benefit received, even if in fact the benefit is not delivered
  - b. cannot be nominal in amount
  - c. is a bargained-for act, forbearance, or promise from the promisee
  - d. is all of the above
  
2. An example of valid consideration is a promise
  - a. by a seventeen-year-old to refrain from drinking alcohol
  - b. to refrain from going to court
  - c. to cook dinner if the promisor can get around to it
  - d. to repay a friend for the four years of free legal advice he had provided
  
3. An unliquidated debt is a debt
  - a. one is not able to pay
  - b. not yet paid
  - c. of uncertain amount
  - d. that is unenforceable debt
  
4. The rule that if one party to a contract has not made a binding obligation, the other party is not bound is called
  - a. revocation
  - b. mutuality of obligation
  - c. accord and satisfaction
  - d. estoppel
  
5. Examples of promises enforceable without consideration include
  - a. an agreement modifying a sales contract
  - b. a promise to pay a debt after the statute of limitations has run

- c. a debtor's promise to repay a debt that has been discharged in bankruptcy
- d. all of the above

#### SELF-TEST ANSWERS

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

## Chapter 12

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### Legality

#### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The types of contracts (bargains) that are deemed illegal
2. How courts deal with disputes concerning illegal contracts
3. Under what circumstances courts will enforce otherwise illegal contracts

## 12.1 General Perspectives on Illegality

### LEARNING OBJECTIVES

1. Understand why courts refuse to enforce illegal agreements.
2. Recognize the rationale behind exceptions to the rule.

We have discussed the requirements of mutual assent, real assent, and consideration. We now turn to the fourth of the five requirements for a valid contract: the legality of the underlying bargain. The basic rule is that courts will not enforce an illegal bargain. (The term *illegal bargain* is better than *illegal contract* because a contract is by definition a legal agreement, but the latter terminology prevails in common usage.) Why should this be? Why should the courts refuse to honor contracts made privately by people who presumably know what they are doing—for example, a wager on the World Series or a championship fight? Two reasons are usually given. One is that refusal to enforce helps discourage unlawful behavior; the other is that honoring such contracts would demean the judiciary. Are these reasons valid? Yes and no, in the opinion of one contracts scholar:

[D]enying relief to parties who have engaged in an illegal transaction...helps to effectuate the public policy involved by discouraging the conduct that is disapproved. Mere denial of contractual and quasi-contractual remedy [however] rarely has a substantial effect in discouraging illegal conduct. A man who is hired to perform a murder is not in the least deterred by the fact that the courts are not open to him to collect his fee. Such a man has other methods of enforcement, and they are in fact more effective than legal process. The same is true in varying degrees where less heinous forms of illegal conduct are involved. Even in the matter of usury it was found that mere denial of enforcement was of little value in the effort to eliminate the loan shark. And restraints of trade were not curbed to an appreciable extent until contracts in restraint of trade were made criminal.

In most instances, then, the protection of the good name of the judicial institution must provide the principal reason for the denial of a remedy to one who has trafficked in the forbidden. This is, moreover, a very good reason. The first duty of an institution is to preserve itself, and if the courts to any appreciable extent busied themselves with “justice among thieves,” the community...would be shocked and the courts would be brought into disrepute. Harold C. Havighurst, review of *Corbin on Contracts*, by Arthur L. Corbin, *Yale Law Journal* 61 (1952): 1143, 1144–45.



Strictly enforced, the rule prohibiting courts from ordering the parties to honor illegal contracts is harsh. It means that a promisee who has already performed under the contract can neither obtain performance of the act for which he bargained nor recover the money he paid or the value of the performance he made. The court will simply leave the parties where it finds them, meaning that one of the parties will have received an uncompensated benefit.

Not surprisingly, the severity of the rule against enforcement has led courts to seek ways to moderate its impact, chiefly by modifying it according to the principle of **restitution**<sup>1</sup>. In general, restitution requires that one who has conferred a benefit or suffered a loss should not unfairly be denied compensation.

Pursuing this notion, the courts have created several exceptions to the general rule. Thus a party who is excusably ignorant that his promise violates public policy and a party who is not equally in the wrong may recover. Likewise, when a party “would otherwise suffer a forfeiture that is disproportionate in relation to the contravention of public policy involved,” restitution will be allowed. Restatement (Second) of Contracts, Section 197(b). Other exceptions exist when the party seeking restitution withdraws from the transaction contemplated in the contract before the illegal purpose has been carried out and when “allowing the claim would put an end to a continuing situation that is contrary to the public interest.” Restatement (Second) of Contracts, Section 197(b). An example of the latter situation occurs when two bettors place money in the hands of a stakeholder. If the wager is unlawful, the loser of the bet has the right to recover his money from the stakeholder before it is paid out to the winner.

Though by and large courts enforce contracts without considering the worth or merits of the bargain they incorporate, freedom of contract can conflict with other public policies. Tensions arise between the desire to let people pursue their own ends and the belief that certain kinds of conduct should not be encouraged. Thus a patient may agree to be treated by an herbalist, but state laws prohibit medical care except by licensed physicians. Law and public policies against usury, gambling, obstructing justice, bribery, corrupt influence, perjury, restraint of trade, impairment of domestic relations, and fraud all significantly affect the authority and willingness of courts to enforce contracts.

In this chapter, we will consider two types of illegality: (1) that which results from a bargain that violates a statute and (2) that which the courts deem contrary to public policy, even though not expressly set forth in statutes.

1. The return or restoration of some specific thing to its rightful owner or status.

### KEY TAKEAWAY

Courts refuse to enforce illegal bargains notwithstanding the basic concept of freedom to contract because they do not wish to reward illegal behavior or sully themselves with adjudication of that which is forbidden to undertake. However, fairness sometimes compels courts to make exceptions.

### EXERCISES

1. Why is *illegal contract* a contradiction in terms?
2. Why do courts refuse to enforce contracts (or bargains) made by competent adults if the contracts harm no third party but are illegal?

## 12.2 Agreements in Violation of Statute

### LEARNING OBJECTIVES

1. Understand that various types of bargains may be made illegal by statute, including gambling, some service-for-fee agreements involving unlicensed practitioners, and usury.
2. Recognize that while gambling contracts are often illegal, some agreements that might appear to involve gambling are not.

### Overview

Any bargain that violates the criminal law—including statutes that govern extortion, robbery, embezzlement, forgery, some gambling, licensing, and consumer credit transactions—is illegal. Thus determining whether contracts are lawful may seem to be an easy enough task. Clearly, whenever the statute itself explicitly forbids the making of the contract or the performance agreed upon, the bargain (such as a contract to sell drugs) is unlawful. But when the statute does not expressly prohibit the making of the contract, courts examine a number of factors, as discussed in [Section 12.5.1 "Extension of Statutory Illegality Based on Public Policy"](#) involving the apparently innocent sale of a jewelry manufacturing firm whose real business was making marijuana-smoking paraphernalia.

### Types of Bargains Made Illegal by Statute

#### Gambling Contracts

All states have regulations affecting gambling (wagering) contracts because gambling tends to be an antiutilitarian activity most attractive to those who can least afford it, because gambling tends to reinforce fatalistic mind-sets fundamentally incompatible with capitalism and democracy, because gambling can be addictive, and because gambling inevitably attracts criminal elements lured by readily available money. With the spread of antitax enthusiasms over the last thirty-some years, however, some kinds of gambling have been legalized and regulated, including state-sponsored lotteries. Gambling is betting on an outcome of an event over which the bettors have no control where the purpose is to play with the risk.

But because the outcome is contingent on events that lie outside the power of the parties to control does not transform a bargain into a wager. For example, if a

gardener agrees to care for the grounds of a septuagenarian for life in return for an advance payment of \$10,000, the uncertainty of the date of the landowner's death does not make the deal a wager. The parties have struck a bargain that accurately assesses, to the satisfaction of each, the risks of the contingency in question. Likewise, the fact that an agreement is phrased in the form of a wager does not make it one. Thus a father says to his daughter, "I'll bet you can't get an A in organic chemistry. If you do, I'll give you \$50." This is a unilateral contract, the consideration to the father being the daughter's achieving a good grade, a matter over which she has complete control.

Despite the general rule against enforcing wagers, there are exceptions, most statutory but some rooted in the common law. The common law permits the sale or purchase of securities: Sally invests \$6,000 in stock in Acme Company, hoping the stock will increase in value, though she has no control over the firm's management. It is not called gambling; it is considered respectable risk taking in the capitalist system, or "entrepreneurialism." (It really is gambling, though, similar to horse-race gambling.) But because there are speculative elements to some agreements, they are subject to state and federal regulation.

Insurance contracts are also speculative, but unless one party has no insurable interest (a concern for the person or thing insured) in the insured, the contract is not a wager. Thus if you took out a life insurance contract on the life of someone whose name you picked out of the phone book, the agreement would be void because you and the insurance company would have been gambling on a contingent event. (You bet that the person would die within the term of the policy, the insurance company that she would not.) If, however, you insure your spouse, your business partner, or your home, the contingency does not make the policy a wagering agreement because you will have suffered a direct loss should it occur, and the agreement, while compensating for a possible loss, does not create a new risk just for the "game."

### **Sunday Contracts**

At common law, contracts entered into on Sundays, as well as other commercial activities, were valid and enforceable. But a separate, religious tradition that traces to the Second Commandment frowned on work performed on "the Lord's Day." In 1781 a New Haven city ordinance banning Sunday work was printed on blue paper, and since that time such laws have been known as blue laws. The first statewide blue law was enacted in the United States in 1788; it prohibited travel, work, sports and amusements, and the carrying on of any business or occupation on Sundays. The only exceptions in most states throughout most of the nineteenth century were mutual promises to marry and contracts of necessity or charity. As the Puritan fervor wore off, and citizens were, more and more, importuned to consider

themselves “consumers” in a capitalistic economic system, the laws have faded in importance and are mostly repealed, moribund, or unenforced. Washington State, up until 2008, completely prohibited hard alcohol sales on Sunday, and all liquor stores were closed, but subsequently the state—desperate for tax revenue—relaxed the prohibition.

### Usury

A usury statute is one that sets the maximum allowable interest that may be charged on a loan; **usury**<sup>2</sup> is charging illegal interest rates. Formerly, such statutes were a matter of real importance because the penalty levied on the lender—ranging from forfeiture of the interest, or of both the principal and the interest, or of some part of the principal—was significant. But usury laws, like Sunday contract laws, have been relaxed to accommodate an ever-more-frenzied consumer society. There are a number of transactions to which the laws do not apply, varying by state: small consumer loans, pawn shop loans, payday loans, and corporate loans. In *Marquette v. First Omaha Service Corp.*, the Supreme Court ruled that a national bank could charge the highest interest rate allowed in its home state to customers living anywhere in the United States, including states with restrictive interest caps. *Marquette v. First Omaha Service Corp.*, 439 US 299 (1978). Thus it was that in 1980 Citibank moved its credit card headquarters from cosmopolitan New York City to the somewhat less cosmopolitan Sioux Falls, South Dakota. South Dakota had recently abolished its usury laws, and so, as far as credit-card interest rates, the sky was the limit. That appealed to Citibank and a number of other financial institutions, and to the state: it became a major player in the US financial industry, garnering many jobs. See Thomas M. Reardon, “T. M. Reardon’s first-hand account of Citibank’s move to South Dakota,” *NorthWestern Financial Review*, September 15, 2004, accessed March 1, 2011, <http://www.highbeam.com/doc/1P3-708279811.html>. Mr. Reardon was a member of the South Dakota Bankers’ Association.

### Licensing Statutes

To practice most professions and carry on the trade of an increasing number of occupations, states require that providers of services possess licenses—hairdressers, doctors, plumbers, real estate brokers, and egg inspectors are among those on a long list. As sometimes happens, though, a person may contract for the services of one who is unlicensed either because he is unqualified and carrying on his business without a license or because for technical reasons (e.g., forgetting to mail in the license renewal application) he does not possess a license at the moment. Robin calls Paul, a plumber, to install the pipes for her new kitchen. Paul, who has no license, puts in all the pipes and asks to be paid. Having discovered that Paul is unlicensed, Robin refuses to pay. May Paul collect?

2. Charging interest in excess of the legal limit.

To answer the question, a three-step analysis is necessary. First, is a license required? Some occupations may be performed without a license (e.g., lawn mowing). Others may be performed with or without certain credentials, the difference lying in what the professional may tell the public. (For instance, an accountant need not be a certified public accountant to carry on most accounting functions.) Let us assume that the state requires everyone who does any sort of plumbing for pay to have a valid license.

The second step is to determine whether the licensing statute explicitly bars recovery by someone who has performed work while unlicensed. Some do; many others contain no specific provision on the point. Statutes that do bar recovery must of course govern the courts when they are presented with the question.

If the statute is silent, courts must, in the third step of the analysis, distinguish between “regulatory” and “revenue” licenses. A **regulatory license**<sup>3</sup> is intended to protect the public health, safety, and welfare. To obtain these licenses, the practitioner of the art must generally demonstrate his or her abilities by taking some sort of examination, like the bar exam for lawyers or the medical boards for doctors. A plumber’s or electrician’s licensing requirement might fall into this category. A revenue license generally requires no such examination and is imposed for the sake of raising revenue and to ensure that practitioners register their address so they can be found if a disgruntled client wants to serve them legal papers for a lawsuit. Some revenue licenses, in addition to requiring registration, require practitioners to demonstrate that they have insurance. A license to deliver milk, open to anyone who applies and pays the fee, would be an example of a revenue license. (In some states, plumbing licenses are for revenue purposes only.)

Generally speaking, failure to hold a regulatory license bars recovery, but the absence of a revenue or registration license does not—the person may obtain the license and then move to recover. See [Section 12.5.2 "Unlicensed Practitioner Cannot Collect Fee"](#) for an example of a situation in which the state statute demands practitioners be licensed.

3. A license to practice a trade or profession that requires no competency test to obtain but only a registration.

### KEY TAKEAWAY

Gambling, interest rates, and Sunday contracts are among the types of contracts that have, variously, been subject to legislative illegality. Laws may require certain persons to have licenses in order to practice a trade or profession. Whether an unlicensed person is barred from recovering a fee for service depends on the language of the statute and the purpose of the requirement: if it is a mere revenue-raising or registration statute, recovery will often be allowed. If the practitioner is required to prove competency, no recovery is possible for an unlicensed person.

### EXERCISES

1. List the typical kinds of contracts made illegal by statute.
2. Why are some practitioners completely prohibited from collecting a fee for service if they don't have a license, and others allowed to collect the fee after they get the license?
3. If no competency test is required, why do some statutes require the practitioner to be licensed?

## 12.3 Bargains Made Illegal by Common Law

### LEARNING OBJECTIVE

1. Understand what contracts or bargains have been declared illegal by courts.

### Overview

Public policy is expressed by courts as well as legislatures. In determining whether to enforce a contract where there is no legislative dictate, courts must ordinarily balance the interests at stake. To strike the proper balance, courts must weigh the parties' expectations, the forfeitures that would result from denial of enforcement, and the public interest favoring enforcement against these factors: the strength of the policy, whether denying enforcement will further the policy, the seriousness and deliberateness of the violation, and how direct the connection is between the misconduct and the contractual term to be enforced. Restatement (Second) of Contracts, Section 178.

### Types of Bargains Made Illegal by Common Law Common-Law Restraint of Trade

One of the oldest public policies evolved by courts is the common-law prohibition against restraint of trade. From the early days of industrialism, the courts took a dim view of ostensible competitors who agreed among themselves to fix prices or not to sell in each other's territories. Since 1890, with the enactment of the Sherman Act, the law of restraint of trade has been absorbed by federal and state antitrust statutes. But the common-law prohibition still exists. Though today it is concerned almost exclusively with promises not to compete in sales of businesses and employment contracts, it can arise in other settings. For example, George's promise to Arthur never to sell the parcel of land that Arthur is selling to him is void because it unreasonably restrains trade in the land.

The general rule is one of reason: not every restraint of trade is unlawful; only unreasonable ones are. As the Restatement puts it, "Every promise that relates to business dealings or to a professional or other gainful occupation operates as a restraint in the sense that it restricts the promisor's future activity. Such a promise is not, however, unenforceable, unless the restraint that it imposes is unreasonably detrimental to the smooth operation of a freely competitive private



economy.” Restatement (Second) of Contracts, Section 186(a). An agreement that restrains trade will be construed as unreasonable unless it is ancillary to a legitimate business interest and is no greater than necessary to protect the legitimate interest. Restraint-of-trade cases usually arise in two settings: (1) the sale of a business and an attendant agreement not to compete with the purchasers and (2) an employee’s agreement not to compete with the employer should the employee leave for any reason.

### Sale of a Business

A first common area where a restraint-of-trade issue may arise is with the sale of a business. Regina sells her lingerie store to Victoria and promises not to establish a competing store in town for one year. Since Victoria is purchasing Regina’s goodwill (the fact that customers are used to shopping at her store), as well as her building and inventory, there is clearly a property interest to be protected. And the geographical limitation (“in town”) is reasonable if that is where the store does business. But if Regina had agreed not to engage in any business in town, or to wait ten years before opening up a new store, or not to open up a new store anywhere within one hundred miles of town, she could avoid the noncompetition terms of the contract because the restraint in each case (nature, duration, and geographic area of restraint) would have been broader than necessary to protect Victoria’s interest. Whether the courts will uphold an agreement not to compete depends on all the circumstances of the particular case, as the Connecticut barber in [Section 12.5.3 "Unconscionability"](#) discovered.

### Employment Noncompete Agreements

A second common restraint-of-trade issue arises with regard to **noncompete agreements**<sup>4</sup> in employment contracts. As a condition of employment by the research division of a market research firm, Bruce, a product analyst, is required to sign an agreement in which he promises, for a period of one year after leaving the company, not to “engage, directly or indirectly, in any business competing with the company and located within fifty miles of the company’s main offices.” The principal reason recited in the agreement for this covenant not to compete is that by virtue of the employment, Bruce will come to learn a variety of internal secrets, including client lists, trade or business secrets, reports, confidential business discussions, ongoing research, publications, computer programs, and related papers. Is this agreement a lawful restraint of trade?

4. One party agrees not to pursue a similar profession or trade in competition against another party.

Here both the property interest of the employer and the extent of the restraint are issues. Certainly an employer has an important competitive interest in seeing that company information not walk out the door with former employees. Nevertheless, a promise by an employee not to compete with his or her former employer is

scrutinized carefully by the courts, and an **injunction**<sup>5</sup> (an order directing a person to stop doing what he or she should not do) will be issued cautiously, partly because the prospective employee is usually confronted with a **contract of adhesion**<sup>6</sup> (take it or leave it) and is in a weak bargaining position compared to the employer, and partly because an injunction might cause the employee's unemployment. Many courts are not enthusiastic about employment noncompete agreements. The California Business and Professions Code provides that "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void." California Business and Professions Code, Section 16600. As a result of the statute, and to promote entrepreneurial robustness, California courts typically interpret the statute broadly and refuse to enforce noncompete agreements. Other states are less stingy, and employers have attempted to avoid the strictures of no-enforcement state rulings by providing that their employment contracts will be interpreted according to the law of a state where noncompetes are favorably viewed.

If a covenant not to compete is ruled unlawful, the courts can pursue one of three courses by way of remedy. A court can refuse to enforce the entire covenant, freeing the employee to compete thenceforth. The court could delete from the agreement only that part that is unreasonable and enforce the remainder (the "blue pencil" rule). In some states, the courts have moved away from this rule and have actually taken to rewriting the objectionable clause themselves. Since the parties intended that there be some form of restriction on competition, a reasonable modification would achieve a more just result. *Raimondo v. Van Vlerah*, 325 N.E.2d 544 (Ohio 1975).

### Unconscionable Contracts

Courts may refuse to enforce **unconscionable contracts**<sup>7</sup>, those that are very one-sided, unfair, the product of unequal bargaining power, or oppressive; a court may find the contract divisible and enforce only the parts that are not unconscionable.

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

And the Uniform Commercial Code (UCC) (again, of course, a statute, not common law) provides a similar rule in Section 2-302(1): "If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the

- 5. A judicial order directing a person to stop doing that which he or she should not do.
- 6. A contract presented to the offeree to take or leave without bargaining.
- 7. A contract so unfair as to be unenforceable.

remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.”

*Unconscionable* is not defined in the Restatement or the UCC, but cases have given gloss to the meaning, as in [Section 12.5.3 "Unconscionability"](#), *Williams v. Walker-Thomas Furniture Co.*, a well-known early interpretation of the section by the DC Court of Appeals.

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

### Exculpatory Clauses

The courts have long held that public policy disfavors attempts to contract out of tort liability. **Exculpatory clauses**<sup>8</sup> that exempt one party from tort liability to the other for harm caused intentionally or recklessly are unenforceable without exception. A contract provision that exempts a party from tort liability for negligence is unenforceable under two general circumstances: (1) when it “exempts an employer from liability to an employee for injury in the course of his employment” or (2) when it exempts one charged with a duty of public service and who is receiving compensation from liability to one to whom the duty is owed. Restatement (Second) of Contracts, Section 195. Contract terms with offensive exculpatory clauses may be considered somewhat akin to unconscionability.

Put shortly, exculpatory clauses are OK if they are reasonable. Put not so shortly, exculpatory clauses will generally be held valid if (1) the agreement does not involve a business generally thought suitable for public regulation (a twenty-kilometer bicycle race, for example, is probably not one thought generally suitable for public regulation, whereas a bus line is); (2) the party seeking exculpation is not performing a business of great importance to the public or of practical necessity for some members of the public; (3) the party does not purport to be performing the service to just anybody who comes along (unlike the bus line); (4) the parties are dealing at arms’ length, able to bargain about the contract; (5) the person or property of the purchaser is not placed under control of the seller, subject to his or

8. A term in a contract by which one party relieves itself in advance of liability.

his agent's carelessness; or (6) the clause is conspicuous and clear. *Henriouille v. Marin Ventures, Inc.*, 573 P.2d 465 (Calif. 1978).

### Obstructing the Administration of Justice or Violating a Public Duty

It is well established under common law that contracts that would interfere with the administration of justice or that call upon a public official to violate a public duty are void and unenforceable. Examples of such contracts are numerous: to conceal or compound a crime, to pay for the testimony of a witness in court contingent on the court's ruling, to suppress evidence by paying a witness to leave the state, or to destroy documents. Thus, in an unedifying case in Arkansas, a gambler sued a circuit court judge to recover \$1,675 allegedly paid to the judge as protection money, and the Arkansas Supreme Court affirmed the dismissal of the suit, holding, "The law will not aid either party to the alleged illegal and void contract...but will leave them where it finds them, if they have been equally cognizant of the illegality." *Womack v. Maner*, 301 S.W.2d 438 (Ark. 1957). Also in this category are bribes, agreements to obstruct or delay justice (jury tampering, abuse of the legal process), and the like.

### Family Relations

Another broad area in which public policy intrudes on private contractual arrangements is that of undertakings between couples, either prior to or during marriage. Marriage is quintessentially a relationship defined by law, and individuals have limited ability to change its scope through legally enforceable contracts. Moreover, marriage is an institution that public policy favors, and agreements that unreasonably restrain marriage are void. Thus a father's promise to pay his twenty-one-year-old daughter \$100,000 if she refrains from marrying for ten years would be unenforceable. However, a promise in a **postnuptial (after marriage) agreement**<sup>9</sup> that if the husband predeceases the wife, he will provide his wife with a fixed income for as long as she remains unmarried is valid because the offer of support is related to the need. (Upon remarriage, the need would presumably be less pressing.) Property settlements before, during, or upon the breakup of a marriage are generally enforceable, since property is not considered to be an essential incident of marriage. But agreements in the form of property arrangements that tend to be detrimental to marriage are void—for example, a **prenuptial (premarital) contract**<sup>10</sup> in which the wife-to-be agrees on demand of the husband-to-be to leave the marriage and renounce any claims upon the husband-to-be at any time in the future in return for which he will pay her \$100,000. Separation agreements are not considered detrimental to marriage as long as they are entered after or in contemplation of immediate separation; but a separation agreement must be "fair" under the circumstances, and judges may review them upon challenge. Similarly, child custody agreements are not left to the

9. A contract made by spouses after marriage in which they agree on property division.

10. A premartial contract by which spouses agree on property division.

whim of the parents but must be consistent with the best interest of the child, and the courts retain the power to examine this question.

The types of contracts or bargains that might be found illegal are innumerable, limited only by the ingenuity of those who seek to overreach.

### KEY TAKEAWAY

Courts will not enforce contracts that are, broadly speaking, contrary to public policy. These include some noncompete agreements, exculpatory clauses, unconscionable bargains, contracts to obstruct the public process or justice, and contracts interfering with family relations.

### EXERCISES

1. Why are employment noncompete agreements viewed less favorably than sale-of-business noncompete agreements?
2. Can a person by contract exculpate herself from liability for gross negligence? For ordinary negligence?
3. A parking lot agreement says the parking lot is “not responsible for loss of contents or damage to the vehicle.” Is that acceptable? Explain.
4. A valet parking lot agreement—where the car owner gives the keys to the attendant who parks the car—has the same language as that for the lot in Exercise 3. Is that acceptable? Explain.

## 12.4 Effect of Illegality and Exceptions

### LEARNING OBJECTIVES

1. Recognize that courts will not enforce illegal bargains.
2. Know that there are exceptions to that rule.

### Effect of Illegality

The general rule is this: courts will not enforce illegal bargains. The parties are left where the court found them, and no relief is granted: it's a hands-off policy. The illegal agreement is void, and that a wrongdoer has benefited to the other's detriment does not matter.

For example, suppose a specialty contractor, statutorily required to have a license, constructs a waterslide for Plaintiff, when the contractor knew or should have known he was unlicensed. Plaintiff discovers the impropriety and refuses to pay the contractor \$80,000 remaining on the deal. The contractor will not get paid. *Pacific Custom Pools, Inc. v. Turner Construction*, 94 Cal. Rptr. 2d 756 (Calif. 2000). In another example, a man held himself out to be an architect in a jurisdiction requiring that architects pass a test to be licensed. He was paid \$80,000 to design a house costing \$900,000. The project was late and over budget, and the building violated relevant easement building-code rules. The unlicensed architect was not allowed to keep his fee. *Ransburg v. Haase*, 586 N.E. 2d 1295 (Ill. Ct. App. 1992).

### Exceptions

As always in the law, there are exceptions. Of relevance here are situations where a court might permit one party to recover: party withdrawing before performance, party protected by statute, party not equally at fault, excusable ignorance, and partial illegality.

### Party Withdrawing before Performance

Samantha and Carlene agree to bet on a soccer game and deliver their money to the stakeholder. Subsequently, but before the payout, Carlene decides she wants out; she can get her money from the stakeholder. Ralph hires Jacob for \$5,000 to arrange a bribe of a juror. Ralph has a change of heart; he can get his money from Jacob.

### **Party Protected by Statute**

An airline pilot, forbidden by federal law from working overtime, nevertheless does so; she would be entitled to payment for the overtime worked. Securities laws forbid the sale or purchase of unregistered offerings—such a contract is illegal; the statute allows the purchaser rescission (return of the money paid). An attorney (apparently unwittingly) charged his client beyond what the statute allowed for procuring for the client a government pension; the pensioner could get the excess from the attorney.

### **Party Not Equally at Fault**

One party induces another to make an illegal contract by undue influence, fraud, or duress; the victim can recover the consideration conveyed to the miscreant if possible.

### **Excusable Ignorance**

A woman agrees to marry a man not knowing that he is already married; bigamy is illegal, the marriage is void, and she may sue him for damages. A laborer is hired to move sealed crates, which contain marijuana; it is illegal to ship, sell, or use marijuana, but the laborer is allowed payment for his services.

### **Partial Illegality**

A six-page employment contract contains two paragraphs of an illegal noncompete agreement. The illegal part is thrown out, but the legal parts are enforceable.

#### **KEY TAKEAWAY**

There are a number of exceptions to the general rule that courts give no relief to either party to an illegal contract. The rule may be relaxed in cases where justice would be better served than by following the stricture of hands off.

## EXERCISES

1. When, in general, will a court allow a party relief from an illegal contract (or bargain)?
2. A and B engage in a game of high-stakes poker under circumstances making the game illegal in the jurisdiction. A owes B \$5,000 when A loses. When A does not pay, B sues. Does B get the money? What if A had paid B the \$5,000 and then sued to get it back?



## 12.5 Cases

### Extension of Statutory Illegality Based on Public Policy

Bovard v. American Horse Enterprises

247 Cal. Rptr. 340 (Calif. 1988)

[Bovard sued Ralph and American Horse Enterprises (a corporation) to recover on promissory notes that were signed when Ralph purchased the corporation, ostensibly a jewelry-making business. The trial court dismissed Bovard's complaint.]

Puglia, J.

The court found that the corporation predominantly produced paraphernalia used to smoke marijuana [roach clips and bongs] and was not engaged significantly in jewelry production, and that Bovard had recovered the corporate machinery through self-help [i.e., he had repossessed it]. The parties do not challenge these findings. The court acknowledged that the manufacture of drug paraphernalia was not itself illegal in 1978 when Bovard and Ralph contracted for the sale of American Horse Enterprises, Inc. However, the court concluded a public policy against the manufacture of drug paraphernalia was implicit in the statute making the possession, use and transfer of marijuana unlawful. The trial court held the consideration for the contract was contrary to the policy of express law, and the contract was therefore illegal and void. Finally, the court found the parties were in *pari delicto* [equally at fault] and thus with respect to their contractual dispute should be left as the court found them.

The trial court concluded the consideration for the contract was contrary to the policy of the law as expressed in the statute prohibiting the possession, use and transfer of marijuana. Whether a contract is contrary to public policy is a question of law to be determined from the circumstances of the particular case. Here, the critical facts are not in dispute. Whenever a court becomes aware that a contract is illegal, it has a duty to refrain from entertaining an action to enforce the contract. Furthermore the court will not permit the parties to maintain an action to settle or compromise a claim based on an illegal contract....

[There are several] factors to consider in analyzing whether a contract violates public policy: “Before labeling a contract as being contrary to public policy, courts must carefully inquire into the nature of the conduct, the extent of public harm which may be involved, and the moral quality of the conduct of the parties in light of the prevailing standards of the community [Citations]”

These factors are more comprehensively set out in the Restatement Second of Contracts section 178:

(1) A promise or other term of an agreement is unenforceable on grounds of public policy if legislation provides that it is unenforceable or the interest in its enforcement is clearly outweighed in the circumstances by a public policy against the enforcement of such terms.

(2) In weighing the interest in the enforcement of a term, account is taken of

(a) the parties’ justified expectations,

(b) any forfeiture that would result if enforcement were denied, and

(c) any special public interest in the enforcement of the particular term.

(3) In weighing a public policy against enforcement of a term, account is taken of

(a) the strength of that policy as manifested by legislation or judicial decisions,

(b) the likelihood that a refusal to enforce the term will further that policy,

(c) the seriousness of any misconduct involved and the extent to which it was deliberate, and

(d) the directness of the connection between that misconduct and the term.

Applying the Restatement test to the present circumstances, we conclude the interest in enforcing this contract is very tenuous. Neither party was reasonably justified in expecting the government would not eventually act to geld American Horse Enterprises, a business harnessed to the production of paraphernalia used to facilitate the use of an illegal drug. Moreover, although avoidance of the contract

imposed a forfeiture on Bovard, he did recover the corporate machinery, the only assets of the business which could be used for lawful purposes, i.e., to manufacture jewelry. Thus, the forfeiture was significantly mitigated if not negligible. Finally, there is no special public interest in the enforcement of this contract, only the general interest in preventing a party to a contract from avoiding a debt.

On the other hand, the Restatement factors favoring a public policy against enforcement of this contract are very strong. As we have explained, the public policy against manufacturing paraphernalia to facilitate the use of marijuana is strongly implied in the statutory prohibition against the possession, use, etc., of marijuana, a prohibition which dates back at least to 1929....Obviously, refusal to enforce the instant contract will further that public policy not only in the present circumstances but by serving notice on manufacturers of drug paraphernalia that they may not resort to the judicial system to protect or advance their business interests. Moreover, it is immaterial that the business conducted by American Horse Enterprises was not expressly prohibited by law when Bovard and Ralph made their agreement since both parties knew that the corporation's products would be used primarily for purposes which were expressly illegal. We conclude the trial court correctly declared the contract contrary to the policy of express law and therefore illegal and void.

### CASE QUESTIONS

1. Why did the court think it was significant that Bovard had repossessed the jewelry-making equipment?
2. What did Bovard want in this case?
3. If it was not illegal to make bongs and roach clips, why did the court determine that this contract should not be enforced?

### Unlicensed Practitioner Cannot Collect Fee

Venturi & Company v. Pacific Malibu Development Corp.

172 Cal.App.4th 1417 (Calif. Ct. App. 2009)

Rubin, J.

In June 2003, plaintiff Venturi & Company LLC and defendant Pacific Malibu Development Corp. entered into a contract involving development of a high-end resort on undeveloped property on the Bahamian island of Little Exuma. Under the

contract, plaintiff agreed to serve as a financial advisor and find financing for the Little Exuma project....[P]laintiff was entitled to some payment under the contract even if plaintiff did not secure financing for the project [called a success fee].

After signing the contract, plaintiff contacted more than 60 potential sources of financing for the project....[I]n the end, defendants did not receive financing from any source that plaintiff had identified.

Defendants terminated the contract in January 2005. Two months earlier, however, defendants had signed a [financing agreement] with the Talisker Group. Plaintiff was not involved in defendants' negotiations with the Talisker Group....Nevertheless, plaintiff claimed the contract's provision for a success fee entitled plaintiff to compensation following the [agreement]. When defendants refused to pay plaintiff's fee, plaintiff sued defendants for the fee and for the reasonable value of plaintiff's services.

Defendants moved for summary judgment. They argued plaintiff had provided the services of a real estate broker by soliciting financing for the Little Exuma project yet did not have a broker's license. Thus, defendants asserted...the Business and Professions Code barred plaintiff from receiving any compensation as an unlicensed broker....Plaintiff opposed summary judgment. It argued that one of its managing principals, Jane Venturi, had a real estate sales license and was employed by a real estate broker (whom plaintiff did not identify) when defendants had signed their term sheet with the Talisker Group, the document that triggered plaintiff's right to a fee.

The court entered summary judgment for defendants. The court found plaintiff had acted as a real estate broker when working on the Little Exuma project. The court pointed, however, to plaintiff's lack of evidence that Jane Venturi's unnamed broker had employed or authorized her to work on the project....[Summary judgment was issued in favor of defendants, denying plaintiff any recovery.] This appeal followed.

The court correctly ruled plaintiff could not receive compensation for providing real estate broker services to defendants because plaintiff was not a licensed broker. (Section 11136 [broker's license required to collect compensation for broker services].) But decisions such as *Lindenstadt* [Citation] establish that the court erred in denying plaintiff compensation to the extent plaintiff's services were not those of a real estate broker. In *Lindenstadt*, the parties entered into 25 to 30 written agreements in which the plaintiff promised to help the defendant find businesses for possible acquisition. After the plaintiff found a number of such businesses, the defendant refused to compensate the plaintiff. The defendant cited the plaintiff's performance of broker's services without a license as justifying its refusal to pay.

On appeal, the appellate court rejected the defendant's sweeping contention that the plaintiff's unlicensed services for *some* business opportunities meant the plaintiff could not receive compensation for *any* business opportunity. Rather, the appellate court directed the trial court to examine individually each business opportunity to determine whether the plaintiff acted as an unlicensed broker for that transaction or instead provided only services for which it did not need a broker's license.

Likewise here, the contract called for plaintiff to provide a range of services, some apparently requiring a broker's license, others seemingly not. Moreover, and more to the point, plaintiff denied having been involved in arranging, let alone negotiating, defendants' placement of Securities with the Talisker Group for which plaintiff claimed a "success fee" under the contract's provision awarding it a fee even if it had no role in procuring the financing. Thus, triable issues existed involving the extent to which plaintiff provided either unlicensed broker services or, alternatively, non-broker services for which it did not need a license. (Accord: [Citation] [severability allowed partial enforcement of personal manager employment contract when license required for some, but not all, services rendered under the contract].)

[T]he contract here...envisioned plaintiff directing its efforts toward many potential sources of financing. As to some of those sources, plaintiff may have crossed the line into performing broker services. But for other sources, plaintiff may have provided only financial and marketing advice for which it did not need a broker's license. (See, e.g. [Citation] [statute barring unlicensed contractor from receiving fees for some services did not prohibit recovery for work not within scope of licensing statute].) And finally, as to the Talisker Group, plaintiff may have provided even less assistance than financial and marketing advice, given that plaintiff denied involvement with the group. Whether plaintiff crossed the line into providing broker services is thus a triable issue of fact that we cannot resolve on summary judgment.

...Plaintiff...did not have a broker's license, and therefore was not entitled to compensation for broker's services. Plaintiff contends it was properly licensed because one of its managers, Jane Venturi, obtained a real estate sales license in February 2004. Thus, she, and plaintiff claims by extension itself, were licensed when defendants purportedly breached the contract by refusing to pay plaintiff months later for the Talisker Group placement. Jane Venturi's sales license was not, however, sufficient; only a licensed broker may provide broker services. A sales license does not permit its holder to represent another unless the salesperson acts under a broker's authority.

The judgment for defendants is vacated, and the trial court is directed to enter a new order denying defendants' motion for summary judgment....

### CASE QUESTIONS

1. Why did the plaintiff think it should be entitled to full recovery under the contract, including for services rendered as a real estate broker? Why did the court deny that?
2. Even if the plaintiff were not a real estate broker, why would that mean it could not recover for real estate services provided to the defendant?
3. The appeals court remanded the case; what did it suggest the plaintiff should recover on retrial?

### Unconscionability

Williams v. Walker-Thomas Furniture Co.

350 F.2d 445 (D.C. Ct. App. 1965)

Wright, J.

Appellee, Walker-Thomas Furniture Company, operates a retail furniture store in the District of Columbia. During the period from 1957 to 1962 each appellant in these cases purchased a number of household items from Walker-Thomas, for which payment was to be made in installments. The terms of each purchase were contained in a printed form contract which set forth the value of the purchased item and purported to lease the item to appellant for a stipulated monthly rent payment. The contract then provided, in substance, that title would remain in Walker-Thomas until the total of all the monthly payments made equaled the stated value of the item, at which time appellants could take title. In the event of a default in the payment of any monthly installment, Walker-Thomas could repossess the item.

The contract further provided that 'the amount of each periodical installment payment to be made by (purchaser) to the Company under this present lease shall be inclusive of and not in addition to the amount of each installment payment to be made by (purchaser) under such prior leases, bills or accounts; and all payments now and hereafter made by (purchaser) shall be credited pro rata on all outstanding leases, bills and accounts due the Company by (purchaser) at the time each such payment is made.' The effect of this rather obscure provision was to keep a balance

due on every item purchased until the balance due on all items, whenever purchased, was liquidated. As a result, the debt incurred at the time of purchase of each item was secured by the right to repossess all the items previously purchased by the same purchaser, and each new item purchased automatically became subject to a security interest arising out of the previous dealings.

On May 12, 1962, appellant Thorne purchased an item described as a daveno, three tables, and two lamps, having total stated value of \$391.11 [about \$2,800 in 2011 dollars]. Shortly thereafter, he defaulted on his monthly payments and appellee sought to replevy [repossess] all the items purchased since the first transaction in 1958. Similarly, on April 17, 1962, appellant Williams bought a stereo set of stated value of \$514.95 [about \$3,600 in 2011 dollars]. She too defaulted shortly thereafter, and appellee sought to replevy all the items purchased since December, 1957. The Court of General Sessions granted judgment for appellee. The District of Columbia Court of Appeals affirmed, and we granted appellants' motion for leave to appeal to this court.

Appellants' principal contention, rejected by both the trial and the appellate courts below, is that these contracts, or at least some of them, are unconscionable and, hence, not enforceable. [In its opinion the lower court said:]

The record reveals that prior to the last purchase appellant had reduced the balance in her account to \$164. The last purchase, a stereo set, raised the balance due to \$678. Significantly, at the time of this and the preceding purchases, appellee was aware of appellant's financial position. The reverse side of the stereo contract listed the name of appellant's social worker and her \$218 monthly stipend from the government. Nevertheless, with full knowledge that appellant had to feed, clothe and support both herself and seven children on this amount, appellee sold her a \$514 stereo set.

We cannot condemn too strongly appellee's conduct. It raises serious questions of sharp practice and irresponsible business dealings. A review of the legislation in the District of Columbia affecting retail sales and the pertinent decisions of the highest court in this jurisdiction disclose, however, no ground upon which this court can declare the contracts in question contrary to public policy. We note that were the Maryland Retail Installment Sales Act...or its equivalent, in force in the District of Columbia, we could grant appellant appropriate relief. We think Congress should consider corrective legislation to protect the public from such exploitive contracts as were utilized in the case at bar.

We do not agree that the court lacked the power to refuse enforcement to contracts found to be unconscionable. In other jurisdictions, it has been held as a matter of

common law that unconscionable contracts are not enforceable. While no decision of this court so holding has been found, the notion that an unconscionable bargain should not be given full enforcement is by no means novel....

Since we have never adopted or rejected such a rule, the question here presented is actually one of first impression....[W]e hold that where the element of unconscionability is present at the time a contract is made, the contract should not be enforced.

Unconscionability has generally been recognized to include an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party. Whether a meaningful choice is present in a particular case can only be determined by consideration of all the circumstances surrounding the transaction. In many cases the meaningfulness of the choice is negated by a gross inequality of bargaining power. The manner in which the contract was entered is also relevant to this consideration. Did each party to the contract, considering his obvious education or lack of it, have a reasonable opportunity to understand the terms of the contract, or were the important terms hidden in a maze of fine print and minimized by deceptive sales practices? Ordinarily, one who signs an agreement without full knowledge of its terms might be held to assume the risk that he has entered a one-sided bargain. But when a party of little bargaining power, and hence little real choice, signs a commercially unreasonable contract with little or no knowledge of its terms, it is hardly likely that his consent, or even an objective manifestation of his consent, was ever given to all the terms. In such a case the usual rule that the terms of the agreement are not to be questioned should be abandoned and the court should consider whether the terms of the contract are so unfair that enforcement should be withheld....

In determining reasonableness or fairness, the primary concern must be with the terms of the contract considered in light of the circumstances existing when the contract was made. The test is not simple, nor can it be mechanically applied. The terms are to be considered 'in the light of the general commercial background and the commercial needs of the particular trade or case.' Corbin suggests the test as being whether the terms are 'so extreme as to appear unconscionable according to the mores and business practices of the time and place.' We think this formulation correctly states the test to be applied in those cases where no meaningful choice was exercised upon entering the contract. So ordered.

Danaher, J. (dissenting):

[The lower] court...made no finding that there had actually been sharp practice. Rather the appellant seems to have known precisely where she stood.



There are many aspects of public policy here involved. What is a luxury to some may seem an outright necessity to others. Is public oversight to be required of the expenditures of relief funds? A washing machine, e.g., in the hands of a relief client might become a fruitful source of income. Many relief clients may well need credit, and certain business establishments will take long chances on the sale of items, expecting their pricing policies will afford a degree of protection commensurate with the risk. Perhaps a remedy when necessary will be found within the provisions of the D.C. “Loan Shark” law, [Citation].

I mention such matters only to emphasize the desirability of a cautious approach to any such problem, particularly since the law for so long has allowed parties such great latitude in making their own contracts. I dare say there must annually be thousands upon thousands of installment credit transactions in this jurisdiction, and one can only speculate as to the effect the decision in these cases will have.

#### CASE QUESTIONS

1. Did the court here say that cross-collateral contracts are necessarily unconscionable?
2. Why is it relevant that the plaintiff had seven children and was on welfare?
3. Why did the defendant have a cross-collateral clause in the contract? What would happen if no such clauses were allowed?
4. What are the elements of unconscionability that the court articulates?

## 12.6 Summary and Exercises

### Summary

In general, illegal contracts are unenforceable. The courts must grapple with two types of illegalities: (1) statutory violations and (2) violations of public policy not expressly declared unlawful by statute. The former include gambling contracts, contracts with unlicensed professionals, and Sunday contracts.

Contracts that violate public policy include many types of covenants not to compete. No general rule for determining their legality can be given, except to say that the more rigid their restrictions against working or competing, the less likely they will withstand judicial scrutiny. Other types of agreements that may violate public policy and hence are unenforceable include provisions that waive tort liability and contracts that interfere with family relationships.

The exceptions to the rule that illegal agreements will not be enforced and that courts leave the parties where they are generally involve situations where the hands-off approach would lead to an unfair result: where the parties are not equally at fault, where one is excusably ignorant or withdraws before performance, or where one is protected by a statute. A court may sometimes divide a contract, enforcing the legal part and not the illegal part.

## EXERCISES

1. Henrioulle was an unemployed widower with two children who received public assistance from the Marin County (California) Department of Social Services. There was a shortage of housing for low-income residents in Marin County. He entered into a lease agreement on a printed form by which the landlord disclaimed any liability for any injury sustained by the tenants anywhere on the property. Henrioulle fractured his wrist when he tripped on a rock on the common stairs in the apartment building. The landlord had been having a hard time keeping the area clean. Is the disclaimer valid? Explain.
2. Albert Bennett, an amateur cyclist, entered a bicycle race sponsored by the United States Cycling Federation. He signed a release exculpating the federation for liability: "I further understand that serious accidents occasionally occur during bicycle racing and that participants in bicycle racing occasionally sustain mortal or serious personal injuries, and/or property damage, as a consequence thereof. Knowing the risks of bicycle racing, nevertheless I hereby agree to assume those risks and to release and hold harmless all the persons or entities mentioned above who (through negligence or carelessness) might otherwise be liable to me (or my heirs or assigns) for damages."

During the race, Bennett was hit by an automobile that had been allowed on the otherwise blocked-off street by agents of the defendant. Bennett sued; the trial court dismissed the case on summary judgment. Bennett appealed. What was the decision on appeal?

3. Ramses owned an industrial supply business. He contracted to sell the business to Tut. Clause VI of their Agreement of Sale provided as follows: "In further consideration for the purchase, Ramses agrees that he shall not compete, either directly or indirectly, in the same business as is conducted by the corporation in its established territory."

Two months after the sale, Ramses opened a competing business across the street from the business now owned by Tut, who brought suit, asking the court to close Ramses's business on the basis of Clause VI. What should the court decide? Why?

4. After taking a business law class at State U, Elke entered into a contract to sell her business law book to a classmate, Matthew, for \$45. As part of the same contract, she agreed to prepare a will for Matthew's mother for an additional \$110. Elke prepared the will and sent the book to Matthew, but he refused to pay her. Is she entitled to any payment? Explain.
5. Elmo, a door-to-door salesman, entered into a contract to sell the Wilson family \$320 worth of household products on credit. The Wilsons later learned that Elmo had failed to purchase a city license to make door-to-door sales and refused to pay him. May Elmo collect from the Wilsons? Why?
6. Gardner purchased from Singer a sewing machine (\$700) and three vacuums (about \$250 each), one after the other, on Singer's "1 to 36 month plan." Gardner defaulted after paying a total of \$400 on account, and Singer sued to repossess all the purchases. Gardner defended by claiming the purchase plan was unconscionable and pointed to the *Williams* case ([Section 12.5.3 "Unconscionability"](#)) as controlling law (that cross-collateral contracts are unconscionable). The trial court ruled for Gardner; Singer appealed. What was the result on appeal?
7. Blubaugh leased a large farm combine from John Deere Leasing by signing an agreement printed on very lightweight paper. The back side of the form was "written in such fine, light print as to be nearly illegible....The court was required to use a magnifying glass." And the wording was "unreasonably complex," but it contained terms much in John Deere's favor. When Blubaugh defaulted, John Deere repossessed the combine, sold it for more than he had paid, and sued him for additional sums in accordance with the default clauses on the back side of the lease. Blubaugh defended by asserting the clauses were unconscionable. Is this a case of procedural, substantive, or no unconscionability? Decide.
8. Sara Hohe, a fifteen-year-old junior at Mission Bay High School in San Diego, was injured during a campus hypnotism show sponsored by the PTSA as a fund-raiser for the senior class. Hypnotism shows had been held annually since 1980, and Sara had seen the previous year's show. She was selected at random from a group of many volunteers. Her participation in the "Magic of the Mind Show" was conditioned on signing two release forms. Hohe's father signed a form entitled "Mission Bay High School PTSA Presents Dr. Karl Santo." Hohe and her father both signed a form titled "Karl Santo Hypnotist," releasing Santo and the school district from all liability. During the course of the show, while apparently hypnotized, Hohe slid from her chair and also fell to the floor about six times and was injured. She, through her father, then sued the school district. The Hohes claimed the release was contrary to public

policy; the trial court dismissed the suit on summary judgment. Was the release contrary to public policy? Decide.

9. In 1963 the Southern Railway Company was disturbed by an order issued by the Interstate Commerce Commission, a federal agency, which would adversely affect the firm's profit by some \$13 million [about \$90 million in 2011 dollars]. Southern hired a lawyer, Robert Troutman, who was a friend of President John F. Kennedy, to lobby the president that the latter might convince the attorney general, Robert Kennedy, to back Southern's position in a lawsuit against the ICC. It worked; Southern won. Southern then refused to pay Troutman's bill in the amount of \$200,000 [about \$14 million in 2011 dollars] and moved for summary judgment dismissing Troutman's claim, asserting—among other things—that contracts whereby one person is hired to use his influence with a public official are illegal bargains. Should summary judgment issue? Decide.
10. Buyer, representing himself to be experienced in timber negotiations, contracted to buy the timber on Seller's land. The first \$11,500 would go to Buyer, the next \$2,000 would go to Seller, and the rest would be divided fifty-fifty after costs of removal of the timber. Buyer said the timber would be worth \$18,000–\$20,000. When Seller discovered the timber was in fact worth more than \$50,000, he sued, claiming the contract was unconscionable. How should the court rule?

## SELF-TEST QUESTIONS

1. Gambling contracts are
  - a. always unenforceable
  - b. enforceable if written
  - c. in effect enforceable in certain situations involving the sale of securities
  - d. always enforceable when made with insurance companies
  
2. In State X, plumbers must purchase a license but do not have to pass an examination. This is an example of
  - a. a regulatory license
  - b. a revenue license
  - c. both a and b
  - d. neither a nor b
  
3. A contract to pay a lobbyist to influence a public official is generally illegal.
  - a. true
  - b. false
  
4. Exculpatory clauses are sometimes enforceable when they relieve someone from liability for
  - a. an intentional act
  - b. recklessness
  - c. negligence
  - d. all of the above
  
5. An employee's promise not to compete with the employer after leaving the company
  - a. is never enforceable because it restrains trade
  - b. is always enforceable if in writing
  - c. is always enforceable
  - d. is enforceable if related to the employer's property interests

**SELF-TEST ANSWERS**

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

## Chapter 13

### Form and Meaning

#### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. What kinds of contracts must be evidenced by some writing under the Statute of Frauds, what the exceptions to the requirements are, and what satisfies a writing requirement
2. What effect prior or contemporaneous “side” agreements have on a written contract
3. How a contract is to be interpreted if its meaning is disputed

In four chapters, we have focused on the question of whether the parties created a valid contract and have examined the requirements of (1) agreement (offer and acceptance), (2) real consent (free will, knowledge, and capacity), (3) consideration, and (4) legality. Assuming that these requirements have been met, we now turn to the form and meaning of the contract itself. Does the contract have to be in a written form, and—if there is a dispute—what does the contract mean?



## 13.1 The Statute of Frauds

### LEARNING OBJECTIVES

1. Know which contracts are required to be evidenced by some writing to be enforceable.
2. Understand the exceptions to that requirement.
3. Recognize what the writing requirement means.
4. Understand the effect of noncompliance with the Statute of Frauds.

### Overview of the Statute of Frauds

The general rule is this: a contract need not be in writing to be enforceable. An oral agreement to pay a high-fashion model \$2 million to pose for photographs is as binding as if the language of the deal were printed on vellum and signed in the presence of twenty bishops. For three centuries, however, a large exception grew up around the Statute of Frauds, first enacted in England in 1677 under the formal name “An Act for the Prevention of Frauds and Perjuries.” The **Statute of Frauds**<sup>1</sup> requires that some contracts be evidenced by a writing, signed by the party to be bound. The English statute’s two sections dealing with contracts read as follows:

[Sect. 4]...no action shall be brought

1. whereby to charge any executor or administrator upon any special promise, to answer damages out of his own estate;
2. or whereby to charge the defendant upon any special promise to answer for the debt, default or miscarriages of another person;
3. or to charge any person upon any agreement made upon consideration of marriage;
4. or upon any contract or sale of lands, tenements or hereditaments, or any interest in or concerning them;
5. or upon any agreement that is not to be performed within the space of one year from the making thereof;

unless the agreement upon which such action shall be brought, or some memorandum or note thereof, shall be in writing, and signed by the party to be charged therewith, or some other person thereunto by him lawfully authorized.

1. A rule requiring that certain contracts be evidenced by a writing, signed by the party to be bound, to be enforceable.

[Sect. 17]...no contract for the sale of any goods, wares and merchandizes, for the price of ten pounds sterling or upwards, shall be allowed to be good, except the buyer shall accept part of the goods so sold, and actually receive the same, or give something in earnest to bind the bargain or in part of payment, or that some note or memorandum in writing of the said bargain be made and signed by the parties to be charged by such contract, or their agents thereunto lawfully authorized.

As may be evident from the title of the act and its language, the general purpose of the law is to provide evidence, in areas of some complexity and importance, that a contract was actually made. To a lesser degree, the law serves to caution those about to enter a contract and “to create a climate in which parties often regard their agreements as tentative until there is a signed writing.”Restatement (Second) of Contracts, Chapter 5, statutory note. Notice, of course, that this is a *statute*; it is a legislative intrusion into the common law of contracts. The name of the act is somewhat unfortunate: insofar as it deals with fraud at all, it does not deal with fraud as we normally think of it. It tries to avoid the fraud that occurs when one person attempts to impose on another a contract that never was agreed to.

The Statute of Frauds has been enacted in form similar to the seventeenth-century act in every state but Maryland and New Mexico, where judicial decisions have given it legal effect, and Louisiana. With minor exceptions in Minnesota, Wisconsin, North Carolina, and Pennsylvania, the laws all embrace the same categories of contracts that are required to be in writing. Early in the twentieth century, Section 17 was replaced by a section of the Uniform Sales Act, and this in turn has now been replaced by provisions in the Uniform Commercial Code (UCC).

Figure 13.1 *Contracts Required to Be in Writing*

Statute of Frauds	UCC Sales of Contracts
<ol style="list-style-type: none"> <li>1. Promises to Pay Debt of Another</li> <li>2. Agreements of Executor or Administrator</li> <li>3. Marriage Promises</li> <li>4. Sale of Land</li> <li>5. Contracts Not to be Performed Within One Year</li> </ol>	<ol style="list-style-type: none"> <li>1. Sale of Goods for \$500 or More</li> <li>2. Sale of Securities</li> <li>3. Other Sales Exceedings \$5000</li> </ol>

However ancient, the Statute of Frauds is alive and well in the United States. Today it is used as a technical defense in many contract actions, often with unfair results: it can be used by a person to wriggle out of an otherwise perfectly fine oral contract

(it is said then to be used “as a sword instead of a shield”). Consequently, courts interpret the law strictly and over the years have enunciated a host of exceptions—making what appears to be simple quite complex. Indeed, after more than half a century of serious scholarly criticism, the British Parliament repealed most of the statute in 1954. As early as 1885, a British judge noted that “in the vast majority of cases [the statute’s] operation is simply to enable a man to break a promise with impunity because he did not write it down with sufficient formality.” A proponent of the repeal said on the floor of the House of Commons that “future students of law will, I hope, have their labours lightened by the passage of this measure.” In the United States, students have no such reprieve from the Statute of Frauds, to which we now turn for examination.

### Types of Contracts Required in Writing and the Exceptions Promises to Pay the Debt of Another

**The rule:** a promise to pay the debt of another person must be evidenced by some writing if it is a “**collateral promise**<sup>2</sup> of suretyship (or ‘guaranty’).” A collateral promise is one secondary or ancillary to some other promise. A **surety**<sup>3</sup> or **guarantor**<sup>4</sup> (the terms are essentially synonymous) is one who promises to perform upon the default of another. Consider this:

A and B agree to pay C.

Here, both A and B are making a direct promise to pay C. Although A is listed first, both are promising to pay C. Now consider this:

B agrees to pay C if A does not.

Here it is clear that there must be another agreement somewhere for A to pay C, but that is not contained in this promise. Rather, B is making an agreement with C that is *collateral*—on the side—to the promise A is making to C. Sometimes the other agreement somewhere for A to pay C is actually in the same document as B’s promise to pay C if A does not. That does not make B’s promise a direct promise as opposed to a collateral one.

2. A promise ancillary to an original promise, not made for the benefit of the party making it, that must be in writing to be enforceable.

3. One who promises to act or pay upon the default of another: a guarantor.

4. One who promises to pay or perform a contract obligation upon the default of another; a surety.

Suppose Lydia wishes to purchase on credit a coat at Miss Juliette’s Fine Furs. Juliette thinks Lydia’s creditworthiness is somewhat shaky. So Lydia’s friend Jessica promises Miss Juliette’s that if the store will extend Lydia credit, Jessica will pay whatever balance is due should Lydia default. Jessica is a surety for Lydia, and the agreement is subject to the Statute of Frauds; an oral promise will not be enforceable. Of course, if Jessica really *did* orally promise Miss Juliette’s to pay in

case Lydia didn't, it would be bad faith to lie about it. The proper course for Jessica is not to say, "Ha, ha, I promised, but it was only oral, so I'm not bound." Jessica should say, "I raise the Statute of Frauds as a defense." Suppose Jessica very much wants Lydia to have the coat, so she calls the store and says, "Send Lydia the fur, and I will pay for it." This agreement does not create a suretyship, because Jessica is primarily liable: she is making a direct promise to pay. To fall within the Statute of Frauds, the surety must back the debt of another person to a third-party promisee (also known as the obligee of the principal debtor). The "debt," incidentally, need not be a money obligation; it can be any contractual duty. If Lydia had promised to work as a cashier on Saturdays at Miss Juliette's in return for the coat, Jessica could become surety to that obligation by agreeing to work in Lydia's place if she failed to show up. Such a promise would need to be in writing to be enforceable.

**The exception: the main purpose doctrine**<sup>5</sup>. The main purpose doctrine is a major exception to the surety provision of the Statute of Frauds. It holds that if the promisor's principal reason for acting as surety is to secure her own economic advantage, then the agreement is not bound by the Statute of Frauds writing requirement. Suppose, in the previous example, that Jessica is really the one who wants the fur coat but cannot, for reasons of prudence, let it be known that she has bought one. So she proposes that Lydia "buy" it for her and that she will guarantee Lydia's payments. Since the main purpose of Jessica's promise is to advance her own interests, an oral agreement is binding. Normally, the main purpose rule comes into play when the surety desires a financial advantage to herself that cannot occur unless she provides some security. For example, the board chairman of a small company, who also owns all the voting stock, might guarantee a printer that if his company defaulted in paying the bill for desperately needed catalogs, he would personally pay the bill. If his main purpose in giving the guarantee was to get the catalogues printed in order to stave off bankruptcy, and thus to preserve his own interest in the company, he would be bound by an oral agreement. *Stuart Studio, Inc. v. National School of Heavy Equipment, Inc.*, 214 S.E.2d 192 (N.C. 1975). The same principle can be used to bind other creditors to oral agreements, as the bank discovered in [Section 13.4.1 "The Statute of Frauds' Main Purpose Doctrine"](#) (*Wilson Floors*).

### Agreements of Executor or Administrator

**The rule:** the promise by an executor or administrator of an estate to answer personally for the debt or other duty of the deceased is analogous to the surety provision—it must be evidenced by some writing if it is to be enforced over an objection by the would-be obligor. For an agreement to be covered by the statute, there must have been an obligation before the decedent's death. Thus if the executor arranges for a funeral and guarantees payment should the estate fail to pay the fee, an oral contract is binding, because there was no preexisting obligation.

5. A promise to pay the debt of another need not be in writing to be enforceable if the promisor was motivated by a desire for advantage or benefit.

If, however, the decedent has made his own arrangements and signed a note obligating his estate to pay, the executor's promise to guarantee payment would be binding only if written.

**The exception:** the main purpose exception to the surety provision applies to this section of the Statute of Frauds as well as to the "promises to pay the debts of another" section, noted earlier.

### The Marriage Provision

**The rule:** if any part of the marriage or the promise to marry consists also of a promise to exchange some consideration, the Statute of Frauds requires that part to be evidenced by some writing. Restatement (Second) of Contracts, Section 125. Mutual promises to marry are not within the rule. John and Sally exchange promises to marry; the promise would not be unenforceable for failure to be evidenced by some writing. (Of course courts are very unlikely to force anybody to keep a promise to marry; the point is, the Statute of Frauds doesn't apply). But if Sally understands John to say, "If you marry me, I will deed to you my property in the Catskill Mountains," the part about the property would need to be evidenced by some writing to be enforced over John's denial. The Statute of Frauds governs such promises regardless of who makes them. Suppose John's father had said, "If you marry Sally and settle down, I will give you \$1 million," and John agrees and marries Sally. The father's promise is not enforceable unless written, if he denies it.

Sometimes couples—especially rich people like movie stars—execute written property settlement agreements to satisfy the statute, stipulating how their assets will be treated upon marriage or upon divorce or death. If done before marriage, they are called **prenuptial (premarital) agreements**<sup>6</sup>; if after marriage, **postnuptial (after marriage) agreements**<sup>7</sup> ("prenupts" and "postnupts" in lawyer lingo).

**The exception:** there is no "named" exception here, but courts are free to make equitable adjustments of property of the marriage to avoid an injustice.

6. A premarital agreement between parties concerning division or ownership of their property.

7. An agreement after marriage between spouses concerning division or ownership of their property.

The factors to be considered in the division of the marital estate are set forth at [Citation], which states, inter alia [among other things], that the court shall finally and equitably apportion the property of the parties, however and whenever acquired. The statute vests wide discretion in the district court. [Citation]. The court is free to adopt any reasonable valuation of marital property which is supported by the record. *In re Marriage of Rada*, 402, 869 P.2d 254 (Mont. 1994).

### Contracts Affecting an Interest in Real Estate

**The rule:** almost all contracts involving an interest in real estate are subject to the Statute of Frauds. “An interest in land” is a broad description, including the sale, mortgaging, and leasing of real property (including homes and buildings); profits from the land; the creation of easements; and the establishment of other interests through restrictive covenants and agreements concerning use. Short-term leases, usually for a term of one year or less, are exempt from the provision.

**The exception: the part performance doctrine**<sup>8</sup>. The name here is a misnomer, because it is a doctrine of reliance, and the acts taken in reliance on the contract are not necessarily partial performances under it. As in all such cases, the rationale is that it is unjust not to give the promisee specific performance if he or she acted in reasonable reliance on the contract and the promisor has continued to manifest assent to its terms. An oral contract to sell land is not binding simply because the buyer has paid the purchase price; payment is not by itself reliance, and if the seller refuses to transfer title, the buyer may recover the purchase price. However, if the buyer has taken possession and made improvements on the property, courts will usually say the case is out of the statute, and the party claiming an oral contract can attempt to prove the existence of the oral contract.

### The One-Year Rule

**The rule:** any agreement that cannot be performed within one year from its making must be evidenced by some writing to be enforceable. The purpose of this part is perhaps more obvious than most of the statute’s provisions: memories fade regarding the terms of oral contracts made long ago; people die; disputes are not uncommon. Notice the critical time frame is not how long it will take to perform the contract, but how long from the time it is made until performance is complete. If a contract is made on January 1 for a house to be constructed starting on June 1 and to be completed on February 1 of the next year, the performance will be completed in eight months from the time it was begun, but thirteen months from the time the contract was made. It falls within the statute.

8. Equitable exception to Statute of Frauds dispensing with writing requirement when one party performed his or her part of the contract.

9. Exception to Statute of Frauds’ one-year rule: if at its making, a contract could have been performed in one year, no writing is required.

**The exception: the possibility test**<sup>9</sup>. The statute’s one-year rule has been universally interpreted to mean a contract that is impossible to be fully performed within one year; if there is even the slightest chance of carrying out the agreement completely within the year, an oral contract is enforceable. Thus an oral agreement to pay a sum of money on a date thirteen months hence is within the statute and not enforceable, but one calling for payment “within thirteen months” would be enforceable, since it is possible under the latter contract to pay in less than a year. Because in many cases strict application of the statute would dictate harsh results, the courts often strain for an interpretation that finds it possible to perform the

agreement within the year. Courts will even hold that because any person may die within the year, a contract without a fixed term may be fully performed in under a year and does not, therefore, fall within the statute.

### **Under the UCC**

**The rule:** contracts for the sale of goods in an amount greater than \$500 must be evidenced by some writing to be enforceable. Section 2-201 of the UCC requires all contracts for the sale of goods for the price of \$500 or more to be in writing, but oral agreements for the sale of goods valued at less than \$500 are fully enforceable without exception.

### **Other Writing Requirements**

In addition to these requirements, the UCC provides that agreements for the sale of securities (e.g., most stocks and bonds) usually need to be evidenced by a writing, and agreements for property not included in the sales or securities articles of the UCC that exceed \$5,000 in value need to be so evidenced. Uniform Commercial Code, Sections 8-319 and 1-206. Included here would be intangible property such as rights to royalties and to mortgage payments, and other rights created by contract. And in many states, other statutes require a writing for several different kinds of contracts. These include agreements to pay commissions to real estate brokers, to make a will, to pay debts already discharged in bankruptcy, to arbitrate rather than litigate, to make loans, and to make installment contracts.

### **Exceptions under the UCC**

There are four exceptions to the UCC's Statute of Frauds requirement that are relevant here.

#### **The Ten-Day-Reply Doctrine**

This provides that, as between merchants, if an oral agreement is reached and one party sends the other a written statement confirming it, the other party has ten days to object in writing or the agreement is enforceable. Uniform Commercial Code, Section 2-201(2).

#### **“Specially Manufactured Goods”**

This exception provides that a seller who has manufactured goods to the buyer's specifications or who has made “either a substantial beginning of their manufacture or commitments for their procurement” will not be stuck if the buyer

repudiates, assuming that the goods are unsuitable for sale to others. Uniform Commercial Code, Section 2-201(3)(a).

### **The “Admission” Exception**

This exception arises—reasonably enough—when the party against whom enforcement is sought admits in testimony or legal papers that a contract was in fact made. Uniform Commercial Code, Section 2-201(3)(b). However, the admission will not permit enforcement of all claimed terms of the contract; enforcement is limited to the quantity of goods admitted.

### **The “Payment or Delivery and Acceptance” Exception**

The UCC provides that an oral contract for goods in excess of \$500 will be upheld if payment has already been made and accepted, or if the goods have been received and accepted. Uniform Commercial Code, Section 2-201(3)(c).

## **Sufficiency of the Required Writing**

### **At Common Law**

We have been careful not to say “the contract needs to be in writing.” We have said, “a contractual intention must be evidenced by some writing, signed by the party to be bound.” A signed contract is not required. What is required in most states, following the wording of the original statute, is that there be at least some memorandum or note concerning the agreement—a logical consequence of the statute’s purpose to evidence the making of the contract. The words need not appear in a formal document; they are sufficient in any form in a will, or on a check or receipt, or in longhand on the back of an envelope—so long as the document is signed by the party to be charged (i.e., the party being sued on the contract).

Although the writing need not contain every term, it must recite the subject matter of the contract. It need not do so, however, in terms comprehensible to those who were not party to the negotiations; it is enough if it is understandable in context. A written agreement to buy a parcel of land is usually sufficiently definitive if it refers to the parcel in such a way that it could be mistaken for no other—for example, “seller’s land in Tuscaloosa,” assuming that the seller owned only one parcel there. Beyond the subject matter, the essential terms of promises to be performed must be written out; all details need not be. If an essential term is missing, it cannot be enforced, unless it can be inferred or imposed by rule of law. A written contract for the sale of land containing every term but the time for payment, which the parties orally agreed would be upon delivery of the deed, is sufficient. (A contract that omitted the selling price would not be.)



The parties must be named in the writing in a manner sufficient to identify them. Their whole names need not be given if initials or some other reference makes it inescapable that the writing does concern the actual parties. Reference to the agent of a party identifies the party. Possession of the writing may even be sufficient: if a seller gives a memorandum of an oral agreement for the sale of his land, stating all the terms, to the buyer, the latter may seek specific performance even though the writing omits to name or describe him or his agent. Restatement (Second) of Contracts, Section 207(f).

In a few states, consideration for the promise must be stated in writing, even if the consideration has already been given. Consequently, written contracts frequently contain such language as “for value received.” But in most states, failure to refer to consideration already given is unnecessary: “the prevailing view is that error or omission in the recital of past events does not affect the sufficiency of a memorandum.” Restatement (Second) of Contracts, Section 207(h). The situation is different, however, when the consideration is a return promise yet to be performed. Usually the return promise is an essential term of the agreement, and failure to state it will vitiate the writing.

### **Under the UCC**

In contracts for the sale of goods, the writing must be signed by the party to be charged, and the parties must be sufficiently identified. Uniform Commercial Code, Section 2-210(1). But consideration, including the selling price, need not be set forth for the memorandum to meet the requirements of the UCC (“a writing is not insufficient because it omits or incorrectly states a term agreed upon”), though obviously it makes sense to do so whenever possible. By contrast, UCC Sections 1-206 and 3-319 concerning intangible personal property and investment securities require “a defined or stated price.”

### **Electronic Communications**

One of the primary purposes of the Electronic Signatures in Global and National Commerce Act, S. 761, popularly referred to as ESign, is to repeal state law requirements for written instruments as they apply to electronic agreements and to make almost anything reasonably indicative of a signature good enough electronically. Electronic Signatures in Global and National Commerce Act, 15 U.S.C. § 96, 106th Congress (2000). It provides the following:

Notwithstanding any statute, regulation, or other rule of law [other than subsequent parts of this same statute], with respect to any transactions in or affecting interstate or foreign commerce—

1. a signature, contract, or other record relating to such transaction may not be denied legal effect, validity or enforceability solely because it is in electronic form; and
2. a contract relating to such transaction may not be denied legal effect, validity or enforceability solely because an electronic signature or electronic record was used in its formation....

The term “transaction” means an action or set of actions relating to the conduct of a business, consumer or commercial affairs between two or more persons, including any of the following types of conduct—

1. the sale, lease, exchange, or other disposition of [personal property and intangibles]
2. the sale, lease, exchange or other disposition of any interest in real property, or any combination thereof.

The term “electronic signature” means an electronic sound, symbol, or process, attached to or logically associated with a contract or other record and executed or adopted by a person with the intent to sign the record.

### **Effect of Noncompliance and Exceptions; Oral Rescission**

The basic rule is that contracts governed by the Statute of Frauds are unenforceable if they are not sufficiently written down. If the agreement contains several promises, the unenforceability of one will generally render the others unenforceable also.

The Statute of Frauds can work injustices. In addition to the exceptions already noted, there are some general exceptions.

#### **Full Performance**

First, certainly, if the contract has been performed fully by both sides, its unenforceability under the statute is moot. Having fulfilled its function (neither side having repudiated the contract), the agreement cannot be rescinded on the ground that it should have been, but was not, reduced to writing.

#### **Detrimental Reliance**

Second, some relief may be granted to one who has relied on an oral contract to her detriment (similar to the part performance doctrine mentioned already). For a

partially performed contract unenforceable under the Statute of Frauds, restitution may be available. Suppose George agrees orally to landscape Arthur's fifteen acres, in return for which George is to receive title to one acre at the far end of the lot. George is not entitled to the acre if Arthur defaults, but he may recover for the reasonable value of the services he has performed up to the time of repudiation. Somewhat related, if one side has reasonably and foreseeably relied upon a promise in such a way that injustice can only be avoided by enforcing it, some courts will use promissory estoppel to preclude the necessity of a writing, but the connection between the alleged oral contract and the detrimental reliance must be convincing.

### **Oral Rescission**

Third, most contracts required to be in writing may be rescinded orally. The new agreement is treated in effect as a modification of the old one, and since a complete rescission will not usually trigger any action the statute requires to be in writing, the rescission becomes effective in the absence of any signed memorandum.

Some agreements, however, may not be rescinded orally. Those that by their terms preclude oral rescission are an obvious class. Under the UCC, certain agreements for the sale of goods may not be orally rescinded, depending on the circumstances. For instance, if title has already passed to the buyer under a written agreement that satisfies the statute, the contract can be rescinded only by a writing. Contracts for the sale of land are another class of agreements that generally may not be orally rescinded. If title has already been transferred, or if there has been a material change of position in reliance on the contract, oral agreements to rescind are unenforceable. But a contract that remains wholly executory, even though enforceable because in writing, may be rescinded orally in most states.

### **Contract Modification**

Fourth, contracts governed by the Statute of Frauds may be modified orally if the resulting contract, taken as a whole, falls outside the statute. The same rule applies under the UCC. Uniform Commercial Code, Section 2-209(3). Thus a written contract for the sale of a new bicycle worth \$1,200 may be orally modified by substituting the sale of a used bicycle worth \$450, but not by substituting the sale of a used bike worth \$600. The modified contract effectively rescinds the original contract.

### KEY TAKEAWAY

The Statute of Frauds, an ancient legislative intrusion into common-law contracts, requires that certain contracts be evidenced by some writing, signed by the party to be bound, to be enforceable. Among those affected by the statute are contracts for an interest in real estate, contracts that by their terms cannot be performed within one year, contracts whereby one person agrees to pay the debt of another, contracts involving the exchange of consideration upon promise to marry (except mutual promises to marry), and, under the UCC, contracts in an amount greater than \$500. For each contract affected by the statute, there are various exceptions intended to prevent the statute from being used to avoid oral contracts when it is very likely such were in fact made.

The writing need not be a contract; anything in writing, signed by the person to be bound, showing adequate contractual intention will take the matter out of the statute and allow a party to attempt to show the existence of the oral contract.

There may be relief under restitution or promissory estoppel. Contracts affected by the statute can usually be orally rescinded. Any contract can be modified or rescinded; if the new oral contract as modified does not fall within the statute, the statute does not apply.

### EXERCISES

1. What is the purpose of the Statute of Frauds?
2. What common-law contracts are affected by it, and what are the exceptions?
3. How does the UCC deal with the Statute of Frauds?
4. How is the requirement of the statute satisfied?
5. Contracts can always be modified. How does the Statute of Frauds play with contract modification?

## 13.2 The Parol Evidence Rule

### LEARNING OBJECTIVES

1. Understand the purpose and operation of the parol evidence rule, including when it applies and when it does not.
2. Know how the Uniform Commercial Code (UCC) deals with evidence to show a contract's meaning.

### The Purpose of the Rule

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

### Parol Evidence at Common-Law

#### The Rule

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

The **parol evidence rule**<sup>10</sup> (*parol* means oral; it is related to *parliament* and *parly*—talking) is a substantive rule of law that operates to bar the introduction of evidence intended to show that the parties had agreed to something different from what they finally arrived at and wrote down. It applies to prior written as well as oral discussions that don't make it into the final written agreement. Though its many apparent exceptions make the rule seem difficult to apply, its purposes are simple: to give freedom to the parties to negotiate without fear of being held to the

10. Under this rule, where there is a written contract, extrinsic (parol) evidence cannot usually change the express terms laid down in that document.

consequences of asserting preliminary positions, and to give finality to the contract.

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

## The Exemptions and Exceptions

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

### Not an Integrated Contract

If the parties never intended the written contract to be their full understanding—if they intended it to be partly oral—then the rule does not apply. If the document is fully integrated, no extrinsic evidence will be permitted to modify the terms of the agreement, even if the modification is in addition to the existing terms, rather than a contradiction of them. If the contract is partially integrated, prior consistent additional terms may be shown. It is the duty of the party who wants to exclude the parol evidence to show the contract was intended to be integrated. That is not always an easy task. To prevent a party later from introducing extrinsic evidence to show that there were prior agreements, the contract itself can recite that there were none. Here, for example, is the final clause in the National Basketball Association Uniform Player Contract: “This agreement contains the entire agreement between the parties and there are no oral or written inducements, promises or agreements except as contained herein.” Such a clause is known as a **merger clause**<sup>11</sup>.

### Void or Voidable Contracts

Parol evidence is admissible to show the existence of grounds that would cause the contract to be void. Such grounds include illegality, fraud, duress, mistake, and lack of consideration. And parol evidence is allowed to show evidence of lack of

11. A contract term stating that the written agreement contains—merges—the parties' full understanding and intent.

contractual capacity. Evidence of infancy, incompetency, and so on would not change the terms of the contract at all but would show it was voidable or void.

### Contracts Subject to a Condition Precedent

When the parties orally agree that a written contract is contingent on the occurrence of an event or some other condition (a **condition precedent**<sup>12</sup>), the contract is not integrated and the oral agreement may be introduced. The classic case is that of an inventor who sells in a written contract an interest in his invention. Orally, the inventor and the buyer agree that the contract is to take effect only if the buyer's engineer approves the invention. (The contract was signed in advance of approval so that the parties would not need to meet again.) The engineer did not approve it, and in a suit for performance, the court permitted the evidence of the oral agreement because it showed "that in fact there never was any agreement at all." *Pym v. Campbell*, 119 Eng. Rep. 903 (Q.B. 1856). Note that the oral condition does not contradict a term of the written contract; it negates it. The parol evidence rule will not permit evidence of an oral agreement that is inconsistent with a written term, for as to that term the contract is integrated.

### Untrue Recital or Errors

The parol evidence rule does not prevent a showing that a fact stated in a contract is untrue. The rule deals with prior agreements; it cannot serve to choke off inquiry into the facts. Thus the parol evidence rule will not bar a showing that one of the parties is a minor, even if the contract recites that each party is over eighteen. Nor will it prevent a showing that a figure in the contract had a typographical error—for example, a recital that the rate charged will be the plumber's "usual rate of \$3 per hour" when both parties understood that the usual rate was in fact \$30 per hour. A court would allow **reformation**<sup>13</sup> (correction) of such errors.

### Ambiguity

To enforce a contract, its terms must be understood, so parol evidence would be allowed, but a claim of ambiguity cannot be used to alter, vary, or change the contract's meaning.

### Postcontract Modification

Ordinarily, an additional consistent oral term may be shown only if the contract was partially integrated. The parol evidence rule bars evidence of such a term if the contract was fully integrated. However, when there is additional consideration for the term orally agreed, it lies outside the scope of the **integrated contract**<sup>14</sup> and may be introduced. In effect, the law treats each separate consideration as creating

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

13. The correction of a contract containing errors.

14. A contract that encompasses the parties' full understanding.

a new contract; the integrated written document does not undercut the separate oral agreement, as long as they are consistent. Buyer purchases Seller's business on a contract; as part of the agreement, Seller agrees to stay on for three weeks to help Buyer "learn the ropes." Buyer realizes she is not yet prepared to go on her own. She and Seller then agree that Seller will stay on as a salaried employee for five more weeks. Buyer cannot use the parol evidence rule to preclude evidence of the new agreement: it is a postcontract modification supported by new consideration. Similarly, parties could choose to rescind a previously made contract, and the parol evidence rule would not bar evidence of that.

## The UCC Approach

Under Section 2-202 of the UCC, a course of dealing, a usage of trade, or a course of performance can be introduced as evidence to explain or supplement any written contract for the sale of goods. A **course of dealing**<sup>15</sup> is defined as "a sequence of previous conduct between the parties to a particular transaction which is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct." A **usage of trade**<sup>16</sup> is "any practice or method of dealing having such regularity of observance in a place, vocation or trade as to justify an expectation that it will be observed with respect to the transaction in question." A **course of performance**<sup>17</sup> is the conduct of a party in response to a contract that calls for repeated action (e.g., a purchase agreement for a factory's monthly output, or an undertaking to wash a neighbor's car weekly).

### KEY TAKEAWAY

The parol evidence rule is intended to preserve "the four corners" of the contract: it generally prohibits the introduction of contemporaneous oral or written elements of negotiation that did not get included in the written contract, subject to a number of exemptions.

The UCC allows evidence of course of dealing, course of performance, or usage of trade to give meaning to the contract.

15. A pattern of behavior between parties showing how they intend their relationship to work.
16. Customary way of doing business that may be used to inform the parties' contractual intentions.
17. Systematic and uniform conduct in which parties engage after they enter into a contract.



## EXERCISES

1. What is the purpose of the parol evidence rule?
2. How does it operate to crystallize the intention of the contracting parties?
3. To what kinds of contract issues does the rule not apply?
4. What “help” does the UCC give to fleshing out the parties’ contractual understanding?

## 13.3 Interpretation of Agreements: Practicalities versus Legalities

### LEARNING OBJECTIVES

1. Understand the purpose of contractual interpretation.
2. Know the tools courts use to interpret contracts.
3. Recognize that in everyday life, businesspeople tolerate oral contracts or poorly written ones, but a writing remains useful.

### The General Problem and the Purpose of Contractual Interpretation

#### The General Problem

As any reader knows, the meaning of words depends in part on context and in part on the skill and care of the writer. As Justice Oliver Wendell Holmes Jr. once succinctly noted, “A word is not a crystal, transparent and unchanged; it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used.” *Towne v. Eisner*, 245 US 418, 425 (1917). Words and phrases can be ambiguous, either when they stand alone or when they take on a different coloration from words and phrases near them. A writer can be careless and contradict himself without intending to; people often read hurriedly and easily miss errors that a more deliberate perusal might catch. Interpretation difficulties can arise for any of a number of reasons: a form contract might contain language that is inconsistent with provisions specifically annexed; the parties might use jargon that is unclear; they might forget to incorporate a necessary term; assumptions about prior usage or performance, unknown to outsiders like judges, might color their understanding of the words they do use. Because ambiguities do arise, courts are frequently called on to give content to the words on paper.

#### The Basic Rule of Interpretation

Courts attempt to give meaning to the parties’ understanding when they wrote the contract.

The intention of the parties governs, and if their purpose in making the contract is known or can be ascertained from all the circumstances, it will be given great weight in determining the meaning of an obscure, murky, or ambiguous provision or a pattern of conduct. A father tells the college bookstore that in consideration of its supplying his daughter, a freshman, with books for the coming year, he will

guarantee payment of up to \$350. His daughter purchases books totaling \$400 the first semester, and he pays the bill. Midway through the second semester, the bookstore presents him with a bill for an additional \$100, and he pays that. At the end of the year, he refuses to pay a third bill for \$150. A court could construe his conduct as indicating a purpose to ensure that his daughter had whatever books she needed, regardless of cost, and interpret the contract to hold him liable for the final bill.

## Tools of Interpretation

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

- More specific terms or conduct are given more weight than general terms or unremarkable conduct. Thus a clause that is separately negotiated and added to a contract will be counted as more significant than a standard term in a form contract.
- A writing is interpreted as a whole, without undue attention to one clause.
- Common words and terms are given common meaning; technical terms are given their technical meaning.
- In the range of language and conduct that helps in interpretation, the courts prefer the following items in the order listed: express terms, course of performance, course of dealing, and usage of trade.
- If an amount is given in words and figures that differ, the words control.
- Writing controls over typing; typing controls over printed forms.
- Ambiguities are construed against the party that wrote the contract.

In this chapter, we have considered a set of generally technical legal rules that spell out the consequences of contracts that are wholly or partially oral or that, if written, are ambiguous or do not contain every term agreed upon. These rules fall within three general headings: the Statute of Frauds, the parol evidence rule, and the rules of interpretation. Obviously, the more attention paid to the contract before it is formally agreed to, the fewer the unforeseen consequences. In general, the conclusion is inescapable that a written contract will avoid a host of problems. Writing down an agreement is not always sensible or practical, but it can probably be done more often than it is. Writing almost fifty years ago—and it is still true—a law professor studying business practices noted the following:

Businessmen often prefer to rely on “a man’s word” in a brief letter, a handshake or “common honesty and decency”—even when the transaction involves exposure to

serious risks. Seven lawyers from law firms with business practices were interviewed. Five thought that businessmen often entered contracts with only a minimal degree of advanced planning. They complained that businessmen desire to “keep it simple and avoid red tape” even where large amounts of money and significant risks are involved....Another said that businessmen when bargaining often talk only in pleasant generalities, think they have a contract, but fail to reach agreement on any of the hard, unpleasant questions until forced to do so by a lawyer. Stewart Macaulay, “Non-contractual Relations in Business: A Preliminary Study,” *American Sociological Review* 28, no. 1 (1963): 58–59.

Written contracts do not, to be sure, guarantee escape from disputes and litigation. Sometimes ambiguities are not seen; sometimes they are necessary if the parties are to reach an agreement at all. Rather than back out of the deal, it may be worth the risk to one or both parties deliberately to go along with an ambiguous provision and hope that it never arises to be tested in a dispute that winds up in court.

Nevertheless, it is generally true that a written contract has at least three benefits over oral ones, even those that by law are not required to be in writing. (1) The written contract usually avoids ambiguity. (2) It can serve both as a communications device and as a device for the allocation of power, especially within large companies. By alerting various divisions to its formal requirements, the contract requires the sales, design, quality-control, and financial departments to work together. By setting forth requirements that the company must meet, it can place the power to take certain actions in the hands of one division or another. (3) Finally, should a dispute later arise, the written contract can immeasurably add to proof both of the fact that a contract was agreed to and of what its terms were.

#### KEY TAKEAWAY

It is not uncommon for the meaning of a contract to be less than entirely clear. When called upon to interpret the meaning of a contract, courts try to give it the meaning the parties intended when they made it. Various tools of interpretation are used.

Businesspeople usually do not like to seem overbearing; they do not wish to appear untrusting; they often dislike unpleasantness. Therefore it is not uncommon for even big deals to be sealed with a handshake. But it's a trade-off, because a written contract has obvious benefits, too.

## EXERCISES

1. Why do courts fairly frequently have to interpret the meaning of contracts?
2. What is the purpose of contractual interpretation?
3. What tools do the courts use in interpreting contracts?
4. What is the social “cost” of insisting upon a written contract in a business setting? What are the benefits of the contract?

## 13.4 Cases

### The Statute of Frauds' Main Purpose Doctrine

Wilson Floors Co. v. Sciota Park, Ltd., and Unit, Inc.

377 N.E.2d 514 (1978)

Sweeny, J.

In December of 1971, Wilson Floors Company (hereinafter "Wilson") entered into a contract with Unit, Inc. (hereinafter "Unit"), a Texas corporation to furnish and install flooring materials for "The Cliffs" project, a development consisting of new apartments and an office building to be located in Columbus, Ohio. Unit...was the general manager for the project. The Pittsburgh National Bank (hereinafter the bank), as the construction lender for the project, held mortgages on The Cliffs property security for construction loans which the bank had made to Unit.

As the work progressed on the project Unit fell behind in making payments to Wilson for its completed work in the spring of 1973. At that time, the project was approximately two-thirds completed, the first mortgage money of seven million dollars having been fully dispersed by the bank to Unit. Appellant [Wilson] thereupon stopped work in May of 1973 and informed Unit that it would not continue until payments were forthcoming. On May 15, 1973, the bank conducted a meeting with the subcontractors in The Cliffs project, including Wilson.

At the meeting, the bank sought to determine whether it would be beneficial at that stage of the project to lend more money to Unit, foreclose on the mortgage and hire a new contractor to complete the work, or do nothing. Subcontractors were requested to furnish the bank an itemized account of what Unit owed them, and a cost estimate of future services necessary to complete their job contracts. Having reviewed the alternatives, the bank determined that it would be in its best interest to provide additional financing for the project. The bank reasoned that to foreclose on the mortgage and hire a new contractor at this stage of construction would result in higher costs.

There is conflicting testimony in regard to whether the bank made assurances to Wilson at this meeting that it would be paid for all work to be rendered on the

project. However, after the May meeting, Wilson, along with the other subcontractors, did return to work.

Payments from Unit again were not forthcoming, resulting in a second work stoppage. The bank then arranged another meeting to be conducted on June 28, 1973.

At this second meeting, there is conflicting testimony concerning the import of the statements made by the bank representative to the subcontractors. The bank representative who spoke at the meeting testified at trial that he had merely advised the subcontractors that adequate funds would be available to complete the job. However, two representatives of Wilson, also in attendance at the meeting, testified that the bank representative had assured Wilson that if it returned to work, it would be paid.

After the meeting, Wilson returned to work and continued to submit its progress billings to Unit for payment. Upon completion of its portion of The Cliffs project, Wilson submitted its final invoice of \$15,584.50 to Unit. This amount was adjusted downward to \$15,443.06 upon agreement of Unit and Wilson. However, Wilson was not paid this amount.

As a result of nonpayment, Wilson filed suit...against Unit and the bank to recover the \$15,443.06 [about \$60,700 in 2010 dollars]. On September 26, 1975, Wilson and Unit stipulated that judgment for the sum of \$15,365.84, plus interest, be entered against Unit. When Unit failed to satisfy the judgment, appellant proceeded with its action against the bank. [The trial court decided in favor of Wilson, but the intermediate appellate court reversed the trial court decision.]...[The Ohio statute of frauds provides]:

No action shall be brought whereby to charge the defendant, upon a special promise, to answer for the debt, default, or miscarriage of another person...unless the agreement...or some memorandum thereof, is in writing and signed by the party to be charged....

In paragraph one of *Crawford v. Edison* [an 1887 Ohio case], however, this court stated:

When the leading object of the promisor is, not to answer for another, but to subserve some pecuniary or business purpose of his own, involving a benefit to himself...his promise is not within the statute of frauds, although it may be in form

a promise to pay the debt of another and its performance may incidentally have the effect of extinguishing that liability....

So long as the promisor undertakes to pay the subcontractor whatever his services are worth irrespective of what he may owe the general contractor and so long as the main purpose of the promisor is to further his own business or pecuniary interest, the promise is enforceable....

The facts in the instant case reflect that the bank made its guarantee to Wilson to subserve its own business interest of reducing costs to complete the project. Clearly, the bank induced Wilson to remain on the job and rely on its credit for future payments. To apply the statute of frauds and hold that the bank had no contractual duty to Wilson despite its oral guarantees would not prevent the wrong which the statute's enactment was to prevent, but would in reality effectuate a wrong.

Therefore, this court affirms the finding of the Court of Common Pleas that the verbal agreement made by the bank is enforceable by Wilson, and reverses the judgment of the Court of Appeals.

### CASE QUESTIONS

1. The exception to the Statute of Frauds in issue here is the main purpose doctrine. How does this doctrine relate to the concept of promissory estoppel?
2. What was the main purpose behind the bank's purported promise?

### The Statute of Frauds' One-Year Rule

Iacono v. Lyons

16 S.W.3d 92 (Texas Ct. App. 2000)

O'Connor, J.

Mary Iacono, the plaintiff below and appellant here, appeals from a take-nothing summary judgment rendered in favor of Carolyn Lyons, the defendant below and appellee here. We reverse and remand.



The plaintiff [Iacono] and defendant [Lyons] had been friends for almost 35 years. In late 1996, the defendant invited the plaintiff to join her on a trip to Las Vegas, Nevada. There is no dispute that the defendant paid all the expenses for the trip, including providing money for gambling.

The plaintiff contended she was invited to Las Vegas by the defendant because the defendant thought the plaintiff was lucky. Sometime before the trip, the plaintiff had a dream about winning on a Las Vegas slot machine. The plaintiff's dream convinced her to go to Las Vegas, and she accepted the defendant's offer to split "50-50" any gambling winnings.

In February 1997, the plaintiff and defendant went to Las Vegas. They started playing the slot machines at Caesar's Palace. The plaintiff contends that, after losing \$47, the defendant wanted to leave to see a show. The plaintiff begged the defendant to stay, and the defendant agreed on the condition that she (the defendant) put the coins into the machines because doing so took the plaintiff too long. (The plaintiff, who suffers from advanced rheumatoid arthritis, was in a wheelchair.) The plaintiff agreed, and took the defendant to a dollar slot machine that looked like the machine in her dream. The machine did not pay on the first try. The plaintiff then said, "Just one more time," and the defendant looked at the plaintiff and said, "This one's for you, Puddin."

The slot machine paid \$1,908,064. The defendant refused to share the winnings with the plaintiff, and denied they had an agreement to split any winnings. The defendant told Caesar's Palace she was the sole winner and to pay her all the winnings.

The plaintiff sued the defendant for breach of contract. The defendant moved for summary judgment on the grounds that any oral agreement was unenforceable under the statute of frauds or was voidable for lack of consideration. The trial court rendered summary judgment in favor of the defendant....

[Regarding the "consideration" argument:] The defendant asserted the agreement, if any, was voidable because there was no consideration. The defendant contended the plaintiff's only contribution was the plaintiff's dream of success in Las Vegas and her "luck." The plaintiff asserted the defendant bargained with her to go to Las Vegas in return for intangibles that the defendant thought the plaintiff offered (good luck and the realization of the dream). The plaintiff said she gave up her right to remain in Houston in return for the agreement to split any winnings. The plaintiff also asserted the agreement was an exchange of promises.

...The plaintiff alleged she promised to share one-half of her winnings with the defendant in exchange for the defendant's promise to share one-half of her winnings with the plaintiff. These promises, if made, represent the respective benefits and detriments, or the bargained for exchange, necessary to satisfy the consideration requirement. *See* [Citation] (when no other consideration is shown, mutual obligations by the parties to the agreement will furnish sufficient consideration to constitute a binding contract)...[Regarding the Statute of Frauds argument:] The defendant asserted the agreement, if any, was unenforceable under the statute of frauds because it could not be performed within one year. There is no dispute that the winnings were to be paid over a period of 20 years....

[The statute] does not apply if the contract, from its terms, could possibly be performed within a year—however improbable performance within one year may be. [Citations] [It bars] only oral contracts that cannot be completed within one year. [Citation] (If the agreement, either by its terms or by the nature of the required acts, cannot be performed within one year, it falls within the statute of frauds and must be in writing).

To determine the applicability of the statute of frauds with indefinite contracts, this Court may use any reasonably clear method of ascertaining the intended length of performance. [Citation] The method is used to determine the parties' intentions at the time of contracting. The fact that the entire performance within one year is not required, or expected, will not bring an agreement within the statute. *See* [Citations].

Assuming without deciding that the parties agreed to share their gambling winnings, such an agreement possibly could have been performed within one year. For example, if the plaintiff and defendant had won \$200, they probably would have received all the money in one pay-out and could have split the winnings immediately. Therefore, the defendant was not entitled to summary judgment based on her affirmative defense of the statute of frauds.

We reverse the trial court's judgment and remand for further proceedings.

## CASE QUESTIONS

1. The defendant contended there was no consideration to support her alleged promise to split the winnings fifty-fifty. What consideration did the court find here?
2. The defendant contended that the Statute of Frauds' one-year rule prohibited the plaintiff from attempting to prove the existence of the alleged oral contract to split the winnings. What reasoning did the court give here as to why the statute did not apply?
3. After this case, the court remanded the matter to the lower court. What has to happen there before plaintiff gets her money?

### The Parol Evidence Rule: Postcontract Modification

Hampden Real Estate, Inc. v. Metropolitan Management Group, Inc.

142 Fed. Appx. 600 (Fed. Ct. App. Pa. 2005)

Cowen, J.

[The court has jurisdiction based on diversity of citizenship.]

Hampden Real Estate sold Metropolitan Management a residential property pursuant to an Agreement of Sale (the "Sale Agreement"). The Sale Agreement provided that the property would be sold for \$3.7 million, that Metropolitan would assume Hampden's mortgage on the building, and that Hampden would receive a credit in the amount of \$120,549.78—the amount being held in escrow pursuant to the mortgage (the "Escrow Account Credit").

Between the execution of the Sale Agreement and the closing, the parties negotiated certain adjustments to the purchase price to compensate for required repairs. During these negotiations, the parties reviewed a draft and final Settlement Statement (the "Settlement Statement"), prepared by the closing agent, which did not list the Escrow Account Credit among the various debits and credits. A few weeks after the closing, Hampden demanded payment of the Escrow Account Credit.

Following Metropolitan's refusal to pay the Escrow Account Credit, Hampden filed a complaint claiming breach of contract, unjust enrichment, and conversion.

Metropolitan brought counterclaims for breach of contract, unjust enrichment, and fraudulent or negligent misrepresentation. Hampden brought a partial motion for summary judgment as to the breach of contract claim, which was granted and its unjust enrichment and conversion claims were dismissed as moot....

The District Court correctly determined that the threshold issue is the role of the Settlement Statement, “based on both the intent of the parties and the custom and usage of the document.” However, the Court refused to consider extrinsic or parol evidence to determine the intent of the parties, reasoning that the parol evidence rule precluded such consideration absent ambiguity in the written contract. We find that the District Court misapplied the rule. The parol evidence rule seeks to preserve the integrity of written agreements by precluding the introduction of contemporaneous or prior declarations to alter the meaning of written agreements. [Citation] The rule does not apply, however, where a party seeks to introduce evidence of subsequent oral modifications. *See* [Citation:] a “written agreement may be modified by a subsequent written or oral agreement and this modification may be shown by writings or by words or by conduct or by all three. In such a situation the parol evidence rule is inapplicable.” Here, the parol evidence rule does not preclude testimony regarding the parties’ intention to alter the final purchase price by executing a Settlement Statement, after the execution of the Sale Agreement, which omitted the Escrow Account Credit.

The cases cited by Hampden are not to the contrary as each involved the admissibility of prior negotiations to demonstrate misrepresentations made in the inducement of the contract. As example, the court in [Citation], held that “[i]f a party contends that a writing is not an accurate expression of the agreement between the parties, and that certain provisions were omitted therefrom, the parol evidence rule does not apply.” (Permitting the introduction of parol evidence to establish that the contract omitted provisions which appellees represented would be included in the writing)....

The District Court further held that the integration clause contained in the written contract supports the conclusion that the Settlement Statement, which mentioned neither the Escrow Account Credit nor that it was amending the Sale Agreement, is not a modification of the Sale Agreement. The Court explained that the outcome might be different if the Settlement Statement mentioned “the escrow credit but provided different details, but as the [Settlement Statement] in this case simply ignored the escrow credit, and both parties agree that there were no oral discussions regarding the escrow credit, the [Settlement Statement] cannot be said to modify the escrow credit provision in the Agreement of Sale.” We disagree.

It is well-settled law in Pennsylvania that a “written contract which is not for the sale of goods may be modified orally, even when the contract provides that modifications may only be made in writing.” [Citation] “The modification may be accomplished either by words or conduct,” [Citation] demonstrating that the parties intended to waive the requirement that amendments be made in writing. [Citation] An oral modification of a written contract must be proven by “clear, precise and convincing evidence.” [Citation] Viewing the evidence in the light most favorable to Metropolitan, we find that the District Court erred in concluding that there was insufficient evidence in the record to raise a genuine issue of material fact as to whether the parties intended to orally modify the Sale Agreement. Metropolitan introduced a Settlement Statement which omitted the Escrow Account Credit, while listing all other debits and credits and submitted an affidavit from its President who “reviewed the Draft Settlement Statement and understood that the Escrow Account Credit had been omitted as part of the ongoing negotiations between the parties concerning the amount of the credit to which Metropolitan was entitled” due to the poor condition of the property.

Accordingly, the District Court erred in granting summary judgment in favor of Hampden. At a minimum, there was a triable issue of fact concerning whether the Settlement Statement was intended to modify the prior written Sale Agreement and serve as the final and binding manifestation of the purchase price. Specifically, whether the parties intended to exclude the Escrow Account Credit from the purchase price as part of the negotiations to address Hampden’s failure to maintain the property.

[Reversed and remanded.]

### CASE QUESTIONS

1. The contract had an integration clause. Why didn’t that bar admission of the subsequent oral modification to the contract?
2. What rule of law was the plaintiff relying on in support of its contention that the original agreement should stand?
3. What rule of law was the defendant relying on in support of its contention that the original agreement had been modified?
4. According to the defendant, how had the original agreement been modified, and why?

## 13.5 Summary and Exercises

### Summary

In an economic system mostly governed by contract, parties may not only make the kinds of deals they wish but may make them in any form they wish—with some significant exceptions. The most significant issue of form in contract law is whether the contract must be written or may be oral and still be enforceable. The question can be answered by paying close attention to the Statute of Frauds and court decisions interpreting it. In general, as we have seen, the following types of contracts must be in writing: interests in real property, promises to pay the debt of another, certain agreements of executors and administrators, performances that cannot be completed within one year, sale of goods for \$500 or more, and sale of securities. There are exceptions to all these rules.

Another significant rule that permeates contract law is the parol evidence rule: prior statements, agreements, or promises, whether oral or written, made during the negotiation process are often discharged by a subsequent written agreement. No matter what you were promised before you signed on the dotted line, you are stuck if you sign an integrated agreement without the promise. Again, of course, exceptions lie in wait for the unwary: Is the agreement only partially integrated? Are there grounds to invalidate the entire agreement? Is the contract subject to an oral condition? Is a fact recited in the contract untrue?

Contracts are not always clear and straightforward. Often they are murky and ambiguous. Interpreting them when the parties disagree is for the courts. To aid them in the task, the courts over the years have developed a series of guidelines such as these: Does the agreement have a plain meaning on its face? If there is an ambiguity, against whom should it be construed? Are there usages of trade or courses of dealing or performance that would help explain the terms?

## EXERCISES

1. Plaintiff's and Defendant's cars crashed. Plaintiff hired an attorney, who negotiated with Defendant's insurance adjuster. Plaintiff's attorney claimed he and the adjuster reached an oral settlement, but the insurance company refused to honor it and filed for summary judgment, raising the Statute of Frauds' suretyship provision as a defense: a promise by one person (the insurance company here) to pay the debts of another (the insured) must be evidenced by some writing, and there was no writing. Is the defense good? Explain.
2. Plaintiff Irma Kozlowski cohabited with Defendant Thaddeus Kozlowski for fifteen years without marriage. She repeatedly asked him specifically about her financial situation should he predecease her, and he assured her—she said—that he would arrange to provide for her for the rest of her life. She had provided the necessary household services and emotional support to permit him to successfully pursue his business career; she had performed housekeeping, cleaning, and shopping services and had run the household and raised the children, her own as well as his. When they separated and she was “literally forced out of the house,” she was sixty-three years old and had no means or wherewithal for survival. When she sued, he raised the Statute of Frauds' one-year rule as a defense. Is the defense good? *Kozlowski v. Kozlowski*, 395 A.2d 913 (N.J. 1978).
3. Carlson purchased a parcel of real estate that was landlocked. Carlson called his neighbor, Peterson, and asked if he could use an abandoned drive on Peterson's property to travel to his (Carlson's) property from the highway. Peterson said, “Sure, anytime.” Later the two became engaged in a dispute, and Peterson blocked the drive. May Carlson enforce Peterson's promise that he could use the drive “anytime”? Why?
4. Silverman, who was elderly and somewhat disabled, lived alone on a farm. Silverman called Burch and said, “Burch, if you will move in with me and help me take care of the farm, it will be yours when I die.” Burch did as Silverman requested and on Silverman's death two years later, claimed the farm on the basis of their oral agreement, but the estate resisted. Is Burch entitled to the farm? Why?
5. On February 12, Sally was hired to manage a company for a period of one year. She reported for work on February 26 but was fired two weeks later. She sued the owner of the company for breach of their one-year oral contract. May she recover? Why?
6. Baker entered into an oral contract to sell her car to Clyde for \$8,600. She delivered the car to Clyde; Clyde inspected it, found no problems, kept it for three days, but then refused to pay and now wants to return the car. Is the contract enforceable? Why?

7. Wayne, a building contractor, built a new house and offered it for sale. A young couple accepted the offer, and the parties entered into an oral agreement covering all the terms of sale. The couple later tried to back out of the agreement. Wayne filed suit, and during the trial, the couple admitted making the contract. Is the contract enforceable? Why?
8. Plaintiff leased commercial space from Defendant for a florist shop. After the lease was signed, Plaintiff learned that the county code allowed only one freestanding sign on the property, and one was already up, advertising Defendant's business. Plaintiff claimed Defendant breached the lease by not providing them space for a sign; Defendant pointed to the lease, paragraph 16 of which provided that "Tenant shall not erect or install any sign...without written consent of the Landlord." But Plaintiff claimed Defendant said during negotiations he could have a sign, evidence Defendant objected to based on the parol evidence rule. Defendant admitted that during negotiations he told Plaintiff that despite paragraph 16, he could have a sign (but not freestanding); that despite language in the lease requiring renovation plans to be in writing, they did not have to be. Defendant also testified that the written form lease he used was not drafted specifically for this property, and that although the lease required attachments of exhibits, there were no attachments. Is Plaintiff barred by the parol evidence rule from showing that Defendant said he could have a freestanding sign?
9. On March 1, 2010, Milton talked to Harriet and, as Harriet claimed, said, "I will hire you as sales manager for one year at a salary of \$57,000. You start next Monday, March 8." Harriet agreed. Four months later Milton discharged Harriet and she sued, claiming breach of employment contract. Is the alleged contract enforceable?
10. Al Booth's Inc. sued Boyd-Scarp (a contractor) and James Rathmann for nonpayment following delivery of various appliances to Rathmann's new home being built by Boyd-Scarp. Booth's was aware that Boyd-Scarp was having financial problems and allegedly contacted Rathmann prior to delivery, asking him to guarantee payment. Evidence was adduced that Rathmann orally promised to pay in the event the builder did not and that the goods were then delivered. Rathmann denied any such promise, raising the Statute of Frauds, and Al Booth's sued. Will Al Booth's prevail?



## SELF-TEST QUESTIONS

1. As a general rule
  - a. contracts do not have to be in writing to be enforceable
  - b. contracts that can be performed in one year must be in writing
  - c. all oral contracts are unenforceable
  - d. a suretyship agreement need not be in writing to be enforceable
  
2. An exception to the UCC Statute of Frauds provision is
  - a. the one-year rule
  - b. the reply doctrine
  - c. executor agreements
  - d. all of the above
  
3. Rules that require certain contracts to be in writing are found in
  - a. state statutory law
  - b. the UCC
  - c. the Statute of Frauds
  - d. all of the above
  
4. The parol evidence rule
  - a. applies only when contracts must be in writing
  - b. does not apply to real estate contracts
  - c. states that a written contract discharges all prior or contemporaneous promises that add to, vary, or conflict with it
  - d. is designed to hold parties to promises they made during negotiations
  
5. A merger clause
  - a. is required when goods are sold for \$500 or more
  - b. is used when two parcels of real estate are sold in the same contract

- c. invalidates a contract for the sale of securities
- d. evidences an intention that the written contract is the parties' full understanding

#### SELF-TEST ANSWERS

- 1. a
- 2. b
- 3. d
- 4. c
- 5. d

## Chapter 14

### Third-Party Rights

#### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. How an assignment of contract rights is made and how it operates
2. What a delegation of duties is and how it operates
3. Under what circumstances a person not a party to a contract can enforce it

To this point, we have focused on the rights and duties of the two parties to the contract. In this chapter, we turn our attention to contracts in which outsiders acquire rights or duties or both. Three types of outsiders merit examination:

1. Assignees (outsiders who acquire rights after the contract is made)
2. Delegates (outsiders who acquire duties after the contract is made)
3. Third-party beneficiaries (outsiders who acquire rights when the original contract is made)

## 14.1 Assignment of Contract Rights

### LEARNING OBJECTIVES

1. Understand what an assignment is and how it is made.
2. Recognize the effect of the assignment.
3. Know when assignments are not allowed.
4. Understand the concept of assignor's warranties.

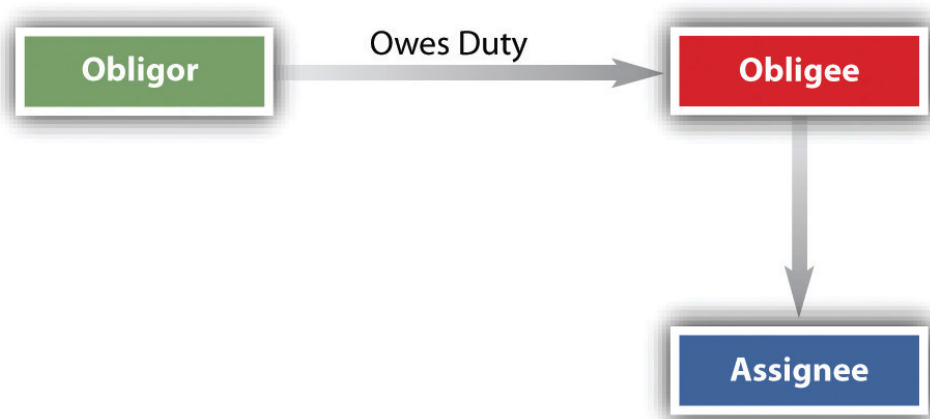
### The Concept of a Contract Assignment

Contracts create rights and duties. By an **assignment**<sup>1</sup>, an **obligee**<sup>2</sup> (one who has the right to receive a contract benefit) transfers a right to receive a contract benefit owed by the **obligor**<sup>3</sup> (the one who has a duty to perform) to a third person (**assignee**<sup>4</sup>); the obligee then becomes an **assignor**<sup>5</sup> (one who makes an assignment).

The Restatement (Second) of Contracts defines an assignment of a right as “a manifestation of the assignor’s intention to transfer it by virtue of which the assignor’s right to performance by the obligor is extinguished in whole or in part and the assignee acquires the right to such performance.” Restatement (Second) of Contracts, Section 317(1). The one who makes the assignment is both an obligee and a transferor. The assignee acquires the right to receive the contractual obligations of the promisor, who is referred to as the obligor (see [Figure 14.1 "Assignment of Rights"](#)). The assignor may assign any right unless (1) doing so would materially change the obligation of the obligor, materially burden him, increase his risk, or otherwise diminish the value to him of the original contract; (2) statute or public policy forbids the assignment; or (3) the contract itself precludes assignment. The common law of contracts and Articles 2 and 9 of the Uniform Commercial Code (UCC) govern assignments. Assignments are an important part of business financing, such as factoring. A **factor**<sup>6</sup> is one who purchases the right to receive income from another.

1. The passing or delivering by one person to another of the right to a contract benefit.
2. One to whom an obligation is owed.
3. One who owes an obligation.
4. One to whom the right to receive benefit of a contract is passed or delivered.
5. One who agrees to allow another to receive the benefit of a contract.
6. A person who pays money to receive another’s executory contractual benefits.

Figure 14.1 *Assignment of Rights*



## Method of Assignment

### Manifesting Assent

To effect an assignment, the assignor must make known his intention to transfer the rights to the third person. The assignor's intention must be that the assignment is effective without need of any further action or any further manifestation of intention to make the assignment. In other words, the assignor must intend and understand himself to be making the assignment then and there; he is not promising to make the assignment sometime in the future.

Under the UCC, any assignments of rights in excess of \$5,000 must be in writing, but otherwise, assignments can be oral and consideration is not required: the assignor could assign the right to the assignee for nothing (not likely in commercial transactions, of course). Mrs. Franklin has the right to receive \$750 a month from the sale of a house she formerly owned; she assigns the right to receive the money to her son Jason, as a gift. The assignment is good, though such a gratuitous assignment is usually revocable, which is not the case where consideration has been paid for an assignment.

### Acceptance and Revocation

For the assignment to become effective, the assignee must manifest his acceptance under most circumstances. This is done automatically when, as is usually the case, the assignee has given consideration for the assignment (i.e., there is a contract between the assignor and the assignee in which the assignment is the assignor's consideration), and then the assignment is not revocable without the assignee's consent. Problems of acceptance normally arise only when the assignor intends the

assignment as a gift. Then, for the assignment to be irrevocable, either the assignee must manifest his acceptance or the assignor must notify the assignee in writing of the assignment.

### Notice

Notice to the obligor is not required, but an obligor who renders performance to the assignor without notice of the assignment (that performance of the contract is to be rendered now to the assignee) is discharged. Obviously, the assignor cannot then keep the consideration he has received; he owes it to the assignee. But if notice is given to the obligor and she performs to the assignor anyway, the assignee can recover from either the obligor or the assignee, so the obligor could have to perform twice, as in Exercise 2 at the chapter's end, *Aldana v. Colonial Palms Plaza*. Of course, an obligor who receives notice of the assignment from the assignee will want to be sure the assignment has really occurred. After all, anybody could waltz up to the obligor and say, "I'm the assignee of your contract with the bank. From now on, pay me the \$500 a month, not the bank." The obligor is entitled to verification of the assignment.

## Effect of Assignment

### General Rule

An assignment of rights effectively makes the assignee **stand in the shoes of**<sup>7</sup> the assignor. He gains all the rights against the obligor that the assignor had, but no more. An obligor who could avoid the assignor's attempt to enforce the rights could avoid a similar attempt by the assignee. Likewise, under UCC Section 9-318(1), the assignee of an account is subject to all terms of the contract between the debtor and the creditor-assignor. Suppose Dealer sells a car to Buyer on a contract where Buyer is to pay \$300 per month and the car is warranted for 50,000 miles. If the car goes on the fritz before then and Dealer won't fix it, Buyer could fix it for, say, \$250 and deduct that \$250 from the amount owed Dealer on the next installment (called a setoff). Now, if Dealer assigns the contract to Assignee, Assignee stands in Dealer's shoes, and Buyer could likewise deduct the \$250 from payment to Assignee.

### Exceptions

The "shoe rule" does not apply to two types of assignments. First, it is inapplicable to the sale of a negotiable instrument to a holder in due course (covered in detail [Chapter 23 "Negotiation of Commercial Paper"](#)). Second, the rule may be waived: under the UCC and at common law, the obligor may agree in the original contract not to raise defenses against the assignee that could have been raised against the assignor. Uniform Commercial Code, Section 9-206. While a **waiver of defenses**<sup>8</sup> makes the assignment more marketable from the assignee's point of view, it is a

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

8. Surrender by a party of legal rights otherwise available to him or her.

situation fraught with peril to an obligor, who may sign a contract without understanding the full import of the waiver. Under the waiver rule, for example, a farmer who buys a tractor on credit and discovers later that it does not work would still be required to pay a credit company that purchased the contract; his defense that the merchandise was shoddy would be unavailing (he would, as used to be said, be “having to pay on a dead horse”).

For that reason, there are various rules that limit both the holder in due course and the waiver rule. Certain defenses, the so-called real defenses (infancy, duress, and fraud in the execution, among others), may always be asserted. Also, the waiver clause in the contract must have been presented in good faith, and if the assignee has actual notice of a defense that the buyer or lessee could raise, then the waiver is ineffective. Moreover, in consumer transactions, the UCC’s rule is subject to state laws that protect consumers (people buying things used primarily for personal, family, or household purposes), and many states, by statute or court decision, have made waivers of defenses ineffective in such **consumer transactions**<sup>9</sup>. Federal Trade Commission regulations also affect the ability of many sellers to pass on rights to assignees free of defenses that buyers could raise against them. Because of these various limitations on the holder in due course and on waivers, the “shoe rule” will not govern in consumer transactions and, if there are real defenses or the assignee does not act in good faith, in business transactions as well.

### When Assignments Are Not Allowed

The general rule—as previously noted—is that most contract rights are assignable. But there are exceptions. Five of them are noted here.

#### Material Change in Duties of the Obligor

When an assignment has the effect of materially changing the duties that the obligor must perform, it is ineffective. Changing the party to whom the obligor must make a payment is not a material change of duty that will defeat an assignment, since that, of course, is the purpose behind most assignments. Nor will a minor change in the duties the obligor must perform defeat the assignment.

Several residents in the town of Centerville sign up on an annual basis with the *Centerville Times* to receive their morning paper. A customer who is moving out of town may assign his right to receive the paper to someone else within the delivery route. As long as the assignee pays for the paper, the assignment is effective; the only relationship the obligor has to the assignee is a routine delivery in exchange for payment. Obligor can consent in the original contract, however, to a subsequent assignment of duties. Here is a clause from the World Team Tennis

9. A contract for household or domestic purposes, not commercial purposes.

League contract: “It is mutually agreed that the Club shall have the right to sell, assign, trade and transfer this contract to another Club in the League, and the Player agrees to accept and be bound by such sale, exchange, assignment or transfer and to faithfully perform and carry out his or her obligations under this contract as if it had been entered into by the Player and such other Club.” Consent is not necessary when the contract does not involve a personal relationship.

### Assignment of Personal Rights

When it matters to the obligor who receives the benefit of his duty to perform under the contract, then the receipt of the benefit is a **personal right**<sup>10</sup> that cannot be assigned. For example, a student seeking to earn pocket money during the school year signs up to do research work for a professor she admires and with whom she is friendly. The professor assigns the contract to one of his colleagues with whom the student does not get along. The assignment is ineffective because it matters to the student (the obligor) who the person of the assignee is. An insurance company provides auto insurance covering Mohammed Kareem, a sixty-five-year-old man who drives very carefully. Kareem cannot assign the contract to his seventeen-year-old grandson because it matters to the insurance company who the person of its insured is. Tenants usually cannot assign (sublet) their tenancies without the landlord’s permission because it matters to the landlord who the person of their tenant is. Section 14.4.1 "Nonassignable Rights", *Nassau Hotel Co. v. Barnett & Barse Corp.*, is an example of the nonassignability of a personal right.

### Assignment Forbidden by Statute or Public Policy

Various federal and state laws prohibit or regulate some contract assignment. The assignment of future wages is regulated by state and federal law to protect people from improvidently denying themselves future income because of immediate present financial difficulties. And even in the absence of statute, public policy might prohibit some assignments.

### Contracts That Prohibit Assignment

Assignability of contract rights is useful, and prohibitions against it are not generally favored. Many contracts contain general language that prohibits assignment of rights or of “the contract.” Both the Restatement and UCC Section 2-210(3) declare that in the absence of any contrary circumstances, a provision in the agreement that prohibits assigning “the contract” bars “only the delegation to the assignee of the assignor’s performance.” Restatement (Second) of Contracts, Section 322. In other words, unless the contract specifically prohibits assignment of any of its terms, a party is free to assign anything except his or her own duties.

10. The right or duty of a particular person to perform or receive contract duties or benefits; cannot be assigned.



Even if a contractual provision explicitly prohibits it, a right to damages for breach of the whole contract is assignable under UCC Section 2-210(2) in contracts for goods. Likewise, UCC Section 9-318(4) invalidates any contract provision that prohibits assigning sums already due or to become due. Indeed, in some states, at common law, a clause specifically prohibiting assignment will fail. For example, the buyer and the seller agree to the sale of land and to a provision barring assignment of the rights under the contract. The buyer pays the full price, but the seller refuses to convey. The buyer then assigns to her friend the right to obtain title to the land from the seller. The latter's objection that the contract precludes such an assignment will fall on deaf ears in some states; the assignment is effective, and the friend may sue for the title.

### **Future Contracts**

The law distinguishes between assigning future rights under an existing contract and assigning rights that will arise from a future contract. Rights contingent on a future event can be assigned in exactly the same manner as existing rights, as long as the contingent rights are already incorporated in a contract. Ben has a long-standing deal with his neighbor, Mrs. Robinson, to keep the latter's walk clear of snow at twenty dollars a snowfall. Ben is saving his money for a new printer, but when he is eighty dollars shy of the purchase price, he becomes impatient and cajoles a friend into loaning him the balance. In return, Ben assigns his friend the earnings from the next four snowfalls. The assignment is effective. However, a right that will arise from a future contract cannot be the subject of a present assignment.

### **Partial Assignments**

An assignor may assign part of a contractual right, but only if the obligor can perform that part of his contractual obligation separately from the remainder of his obligation. Assignment of part of a payment due is always enforceable. However, if the obligor objects, neither the assignor nor the assignee may sue him unless both are party to the suit. Mrs. Robinson owes Ben one hundred dollars. Ben assigns fifty dollars of that sum to his friend. Mrs. Robinson is perplexed by this assignment and refuses to pay until the situation is explained to her satisfaction. The friend brings suit against Mrs. Robinson. The court cannot hear the case unless Ben is also a party to the suit. This ensures all parties to the dispute are present at once and avoids multiple lawsuits.

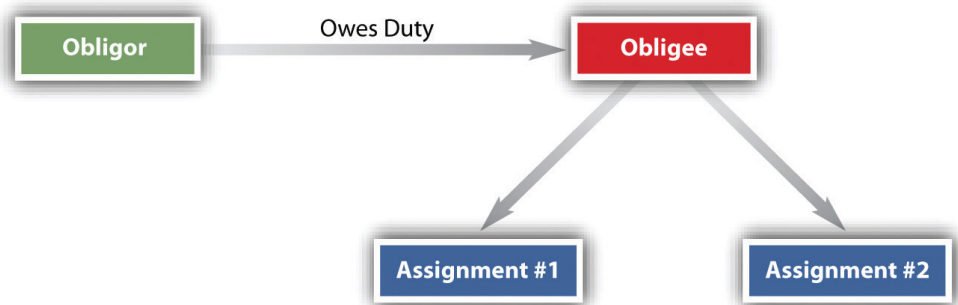
### **Successive Assignments**

It may happen that an assignor assigns the same interest twice (see [Figure 14.2 "Successive Assignments"](#)). With certain exceptions, the first assignee takes precedence over any subsequent assignee. One obvious exception is when the first

assignment is ineffective or revocable. A subsequent assignment has the effect of revoking a prior assignment that is ineffective or revocable. Another exception: if in good faith the subsequent assignee gives consideration for the assignment and has no knowledge of the prior assignment, he takes precedence whenever he obtains payment from, performance from, or a judgment against the obligor, or whenever he receives some tangible evidence from the assignor that the right has been assigned (e.g., a bank deposit book or an insurance policy).

Some states follow the different English rule: the first assignee to give notice to the obligor has priority, regardless of the order in which the assignments were made. Furthermore, if the assignment falls within the filing requirements of UCC Article 9 (see [Chapter 28 "Secured Transactions and Suretyship"](#)), the first assignee to file will prevail.

Figure 14.2 *Successive Assignments*



### Assignor’s Warranties

An assignor has legal responsibilities in making assignments. He cannot blithely assign the same interests pell-mell and escape liability. Unless the contract explicitly states to the contrary, a person who assigns a right for value makes certain **assignor’s warranties**<sup>11</sup> to the assignee: that he will not upset the assignment, that he has the right to make it, and that there are no defenses that will defeat it. However, the assignor does not guarantee payment; assignment does not by itself amount to a warranty that the obligor is solvent or will perform as agreed in the original contract. Mrs. Robinson owes Ben fifty dollars. Ben assigns this sum to his friend. Before the friend collects, Ben releases Mrs. Robinson from her obligation. The friend may sue Ben for the fifty dollars. Or again, if Ben represents to his friend that Mrs. Robinson owes him (Ben) fifty dollars and assigns his friend that amount, but in fact Mrs. Robinson does not owe Ben that much, then Ben has breached his assignor’s warranty. The assignor’s warranties may be express or implied.

11. Promises, express or implied, made by an assignor to the assignee about the merits of the assignment.

### KEY TAKEAWAY

Generally, it is OK for an obligee to assign the right to receive contractual performance from the obligor to a third party. The effect of the assignment is to make the assignee stand in the shoes of the assignor, taking all the latter's rights and all the defenses against nonperformance that the obligor might raise against the assignor. But the obligor may agree in advance to waive defenses against the assignee, unless such waiver is prohibited by law.

There are some exceptions to the rule that contract rights are assignable. Some, such as personal rights, are not circumstances where the obligor's duties would materially change, cases where assignability is forbidden by statute or public policy, or, with some limits, cases where the contract itself prohibits assignment. Partial assignments and successive assignments can happen, and rules govern the resolution of problems arising from them.

When the assignor makes the assignment, that person makes certain warranties, express or implied, to the assignee, basically to the effect that the assignment is good and the assignor knows of no reason why the assignee will not get performance from the obligor.

### EXERCISES

1. If Able makes a valid assignment to Baker of his contract to receive monthly rental payments from Tenant, how is Baker's right different from what Able's was?
2. Able made a valid assignment to Baker of his contract to receive monthly purchase payments from Carr, who bought an automobile from Able. The car had a 180-day warranty, but the car malfunctioned within that time. Able had quit the auto business entirely. May Carr withhold payments from Baker to offset the cost of needed repairs?
3. Assume in the case in Exercise 2 that Baker knew Able was selling defective cars just before his (Able's) withdrawal from the auto business. How, if at all, does that change Baker's rights?
4. Why are leases generally not assignable? Why are insurance contracts not assignable?

## 14.2 Delegation of Duties

### LEARNING OBJECTIVES

1. Know what a delegation of duty is.
2. Recognize how liability remains on the delegator following a delegation.
3. Understand what duties may not be delegated.

### Basic Rules Regarding Delegation

#### General Rule

To this point, we have been considering the assignment of the assignor's rights (usually, though not solely, to money payments). But in every contract, a right connotes a corresponding duty, and these may be delegated. A **delegation**<sup>12</sup> is the transfer to a third party of the duty to perform under a contract. The one who delegates is the **delegator**<sup>13</sup>. Because most obligees are also obligors, most assignments of rights will simultaneously carry with them the delegation of duties. Unless public policy or the contract itself bars the delegation, it is legally enforceable.

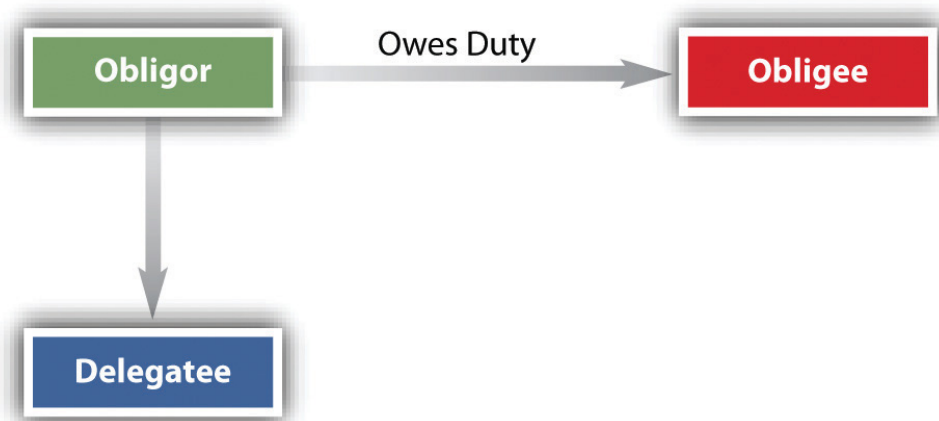
In most states, at common law, duties must be expressly delegated. Under Uniform Commercial Code (UCC) Section 2-210(4) and in a minority of states at common law (as illustrated in [Section 14.4.2 "Assignment Includes Delegation"](#), *Rose v. Vulcan Materials Co.*), an assignment of "the contract" or of "all my rights under the contract" is not only an assignment of rights but also a delegation of duties to be performed; by accepting the assignment, the **delegatee**<sup>14</sup> (one to whom the delegation is made) implies a promise to perform the duties. (See [Figure 14.3 "Delegation of Duties"](#))

12. The passing or delivering by one person to another of the duty to perform a contract.

13. One who delegates.

14. One to whom the duty to perform a contract is delegated.

Figure 14.3 Delegation of Duties



### Effect on Obligor

An obligor who delegates a duty (and becomes a delegator) does not thereby escape liability for performing the duty himself. The obligee of the duty may continue to look to the obligor for performance unless the original contract specifically provides for substitution by delegation. This is a big difference between assignment of contract rights and delegation of contract duties: in the former, the assignor is discharged (absent breach of assignor's warranties); in the latter, the delegator remains liable. The obligee (again, the one to whom the duty to perform flows) may also, in many cases, look to the delegatee, because the obligee becomes an intended beneficiary of the contract between the obligor and the delegatee, as discussed in [Section 14.3 "Third-Party Beneficiaries"](#). Of course, the obligee may subsequently agree to accept the delegatee and discharge the obligor from any further responsibility for performing the duty. A contract among three persons having this effect is called a **novation**<sup>15</sup>; it is a new contract. Fred sells his house to Lisa, who assumes his mortgage. Fred, in other words, has delegated the duty to pay the bank to Lisa. If Lisa defaults, Fred continues to be liable to the bank, unless in the original mortgage agreement a provision specifically permitted any purchaser to be substituted without recourse to Fred, or unless the bank subsequently accepts Lisa and discharges Fred.

### Nondelegable Duties

#### Personal Services

Personal services are not delegable. If the contract is such that the promisee expects the obligor personally to perform the duty, the obligor may not delegate it. Suppose the Catskill Civic Opera Association hires a famous singer to sing in its production of *Carmen* and the singer delegates the job to her understudy. The

15. A new contract substituting for an old one, or a new party to a contract replacing a former party.

delegation is ineffective, and performance by the understudy does not absolve the famous singer of liability for breach.

Many duties may be delegated, however. Indeed, if they could not be delegated, much of the world's work would not get done. If you hire a construction company and an architect to design and build your house to certain specifications, the contractor may in turn hire individual craftspeople—plumbers, electricians, and the like—to do these specialized jobs, and as long as they are performed to specification, the contract terms will have been met. If you hired an architecture firm, though, you might not be contracting for the specific services of a particular individual in that firm.

### **Public Policy**

Public policy may prohibit certain kinds of delegations. A public official, for example, may not delegate the duties of her office to private citizens, although various statutes generally permit the delegation of duties to her assistants and subordinates.

### **Delegations Barred by Contract**

As we have already noted, the contract itself may bar assignment. The law generally disfavors restricting the right to assign a benefit, but it will uphold a contract provision that prohibits delegation of a duty. Thus, as we have seen, UCC Section 2-210(3) states that in a contract for sale of goods, a provision against assigning “the contract” is to be construed only as a prohibition against delegating the duties.

#### **KEY TAKEAWAY**

The duty to perform a contractual obligation may usually be delegated to a third party. Such delegation, however, does not discharge the delegator, who remains liable on the contract absent a novation.

Some duties may not be delegated: personal services cannot be, and public policy or the contract itself may bar delegation.

## EXERCISES

1. What is the difference between an assignment and a delegation?
2. Under what circumstances is the delegator discharged from liability on the contract?

## 14.3 Third-Party Beneficiaries

### LEARNING OBJECTIVES

1. Know what a third-party beneficiary is, and what the types of such beneficiaries are.
2. Recognize the rights obtained by third-party beneficiaries.
3. Understand when the public might be a third-party beneficiary of government contracts.

The fundamental issue with third-party beneficiaries gets to this: can a person who is not a party to a contract sue to enforce its terms?

### The General Rule

The general rule is this: persons not a party to a contract cannot enforce its terms; they are said to lack **privity**<sup>16</sup>, a private, face-to-face relationship with the contracting parties. But if the persons are intended to benefit from the performance of a contract between others, then they can enforce it: they are intended beneficiaries.

### Two Types of Third-Party Beneficiaries

In the vocabulary of the Restatement, a third person whom the parties to the contract intend to benefit is an **intended beneficiary**<sup>17</sup>—that is, one who is entitled under the law of contracts to assert a right arising from a contract to which he or she is not a party. There are two types of intended beneficiaries.

#### Creditor Beneficiary

A **creditor beneficiary**<sup>18</sup> is one to whom the promisor agrees to pay a debt of the promisee. For example, a father is bound by law to support his child. If the child's uncle (the promisor) contracts with the father (the promisee) to furnish support for the child, the child is a creditor beneficiary and could sue the uncle. Or again, suppose Customer pays Ace Dealer for a new car, and Ace delegates the duty of delivery to Beta Dealer. Ace is now a debtor: he owes Customer something: a car. Customer is a creditor; she is owed something: a car. When Beta performs under his delegated contract with Ace, Beta is discharging the debt Ace owes to Customer. Customer is a creditor beneficiary of Dealers' contract and could sue either one for

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

17. A person not a party to a contract who was intended to benefit from it and who may sue to enforce its terms.

18. One whom the party paying for the other's performance intends to benefit as payment for a debt or obligation.



nondelivery. She could sue Ace because she made a contract with him, and she could sue Beta because—again—she was intended to benefit from the performance of Dealers' agreement.

### Donee Beneficiary

The second type of intended beneficiary is a **donee beneficiary**<sup>19</sup>. When the promisee is not indebted to the third person but intends for him or her to have the benefit of the promisor's performance, the third person is a donee beneficiary (and the promise is sometimes called a gift promise). For example, an insurance company (the promisor) promises to its policyholder (the promisee), in return for a premium, to pay \$100,000 to his wife on his death; this makes the wife a donee beneficiary (see [Figure 14.1 "Assignment of Rights"](#)). The wife could sue to enforce the contract although she was not a party to it. Or if Able makes a contract with Woodsman for the latter to cut the trees in Able's backyard as a Christmas gift to Able's uphill Neighbor (so that Neighbor will have a view), Neighbor could sue Woodsman for breach of the contract.

If a person is not an intended beneficiary—not a creditor or donee beneficiary—then he or she is said to be only an **incidental beneficiary**<sup>20</sup>, and that person has no rights. So if Able makes the contract with Woodsman not to benefit Neighbor but for Able's own benefit, the fact that the tree removal would benefit Neighbor does not make Neighbor an intended beneficiary.

The beneficiary's rights are always limited by the terms of the contract. A failure by the promisee to perform his part of the bargain will terminate the beneficiary's rights if the promisee's lapse terminates his own rights, absent language in the contract to the contrary. If Able makes the contract as a gift to Neighbor but doesn't make the required down payment to Woodsman, Neighbor's claim fails. In a suit by the beneficiary, the promisor may avail himself of any defense he could have asserted against the promisee. Woodsman may defend himself against Neighbor's claim that Woodsman did not do the whole job by showing that Able didn't make full payment for the work.

### Modification of the Beneficiary's Rights

Conferring rights on an intended beneficiary is relatively simple. Whether his rights can be modified or extinguished by subsequent agreement of the promisor and promisee is a more troublesome issue. The general rule is that the beneficiary's rights may be altered as long as there has been no **vesting of rights**<sup>21</sup> (the rights have not taken effect). The time at which the beneficiary's rights vest differs among jurisdictions: some say immediately, some say when the beneficiary assents to the

19. A person not a party to a contract who is intended, as a gift, to benefit from its performance.

20. A person not a party to a contract who benefits from its performance but was not intended to specifically.

21. The time at which the benefit of a contract is fixed in the beneficiary.

receipt of the contract right, some say the beneficiary's rights don't vest until she has detrimentally relied on the right. The Restatement says that unless the contract provides that its terms cannot be changed without the beneficiary's consent, the parties may change or rescind the benefit unless the beneficiary has sued on the promise, has detrimentally relied, or has assented to the promise at the request of one of the parties. Restatement (Second) of Contracts, Section 311. Some contracts provide that the benefit never vests; for example, standard insurance policies today reserve to the insured the right to substitute beneficiaries, to borrow against the policy, to assign it, and to surrender it for cash.

### Government Contracts

The general rule is that members of the public are only incidental beneficiaries of contracts made by the government with a contractor to do public works. It is not illogical to see a contract between the government and a company pledged to perform a service on behalf of the public as one creating rights in particular members of the public, but the consequences of such a view could be extremely costly because everyone has some interest in public works and government services.

A restaurant chain, hearing that the county was planning to build a bridge that would reroute commuter traffic, might decide to open a restaurant on one side of the bridge; if it let contracts for construction only to discover that the bridge was to be delayed or canceled, could it sue the county's contractor? In general, the answer is that it cannot. A promisor under contract to the government is not liable for the consequential damages to a member of the public arising from its failure to perform (or from a faulty performance) unless the agreement specifically calls for such liability or unless the promisee (the government) would itself be liable and a suit directly against the promisor would be consistent with the contract terms and public policy. When the government retains control over litigation or settlement of claims, or when it is easy for the public to insure itself against loss, or when the number and amount of claims would be excessive, the courts are less likely to declare individuals to be intended beneficiaries. But the service to be provided can be so tailored to the needs of particular persons that it makes sense to view them as intended beneficiaries—in the case, for example, of a service station licensed to perform emergency road repairs, as in [Section 14.4.3 "Third party Beneficiaries and Foreseeable Damages"](#), *Kornblut v. Chevron Oil Co.*

### KEY TAKEAWAY

Generally, a person who is not a party to a contract cannot sue to enforce its terms. The exception is if the person is an intended beneficiary, either a creditor beneficiary or a donee beneficiary. Such third parties can enforce the contract made by others but only get such rights as the contract provides, and beneficiaries are subject to defenses that could be made against their benefactor.

The general rule is that members of the public are not intended beneficiaries of contracts made by the government, but only incidental beneficiaries.

### EXERCISES

1. What are the two types of intended beneficiaries?
2. Smith contracted to deliver a truck on behalf of Truck Sales to Byers, who had purchased it from Truck Sales. Smith was entitled to payment by Byers for the delivery. The truck was defective. May Byers withhold payment from Smith to offset the repair costs?
3. Why is the public not usually considered an intended beneficiary of contracts made by the government?

## 14.4 Cases

### Nonassignable Rights

Nassau Hotel Co. v. Barnett & Barse Corporation

147 N.Y.S. 283 (1914)

McLaughlin, J.

Plaintiff owns a hotel at Long Beach, L. I., and on the 21st of November, 1912, it entered into a written agreement with the individual defendants Barnett and Barse to conduct the same for a period of years....Shortly after this agreement was signed, Barnett and Barse organized the Barnett & Barse Corporation with a capital stock of \$10,000, and then assigned the agreement to it. Immediately following the assignment, the corporation went into possession and assumed to carry out its terms. The plaintiff thereupon brought this action to cancel the agreement and to recover possession of the hotel and furniture therein, on the ground that the agreement was not assignable. [Summary judgment in favor of the plaintiff, defendant corporation appeals.]

The only question presented is whether the agreement was assignable. It provided, according to the allegations of the complaint, that the plaintiff leased the property to Barnett and Barse with all its equipment and furniture for a period of three years, with a privilege of five successive renewals of three years each. It expressly provided:

‘That said lessees...become responsible for the operation of the said hotel and for the upkeep and maintenance thereof and of all its furniture and equipment in accordance with the terms of this agreement and the said lessees shall have the exclusive possession, control and management thereof. \* \* \* The said lessees hereby covenant and agree that they will operate the said hotel at all times in a first-class business-like manner, keep the same open for at least six (6) months of each year, \* \* \*’ and ‘in lieu of rental the lessor and lessees hereby covenant and agree that the gross receipts of such operation shall be, as received, divided between the parties hereto as follows: (a) Nineteen per cent. (19%) to the lessor. \* \* \* In the event of the failure of the lessees well and truly to perform the covenants and agreements herein contained,’ they should be liable in the sum of \$50,000 as liquidated damages. That ‘in consideration and upon condition that the said lessees shall well and faithfully perform all the covenants and agreements by them to be performed

without evasion or delay the said lessor for itself and its successors, covenants and agrees that the said lessees, their legal representatives and assigns may at all times during said term and the renewals thereof peaceably have and enjoy the said demised premises.’ And that ‘this agreement shall inure to the benefit of and bind the respective parties hereto, their personal representatives, successors and assigns.’

The complaint further alleges that the agreement was entered into by plaintiff in reliance upon the financial responsibility of Barnett and Barse, their personal character, and especially the experience of Barnett in conducting hotels; that, though he at first held a controlling interest in the Barnett & Barse Corporation, he has since sold all his stock to the defendant Barse, and has no interest in the corporation and no longer devotes any time or attention to the management or operation of the hotel.

...[C]learly...the agreement in question was personal to Barnett and Barse and could not be assigned by them without the plaintiff’s consent. By its terms the plaintiff not only entrusted them with the care and management of the hotel and its furnishings—valued, according to the allegations of the complaint, at more than \$1,000,000—but agreed to accept as rental or compensation a percentage of the gross receipts. Obviously, the receipts depended to a large extent upon the management, and the care of the property upon the personal character and responsibility of the persons in possession. When the whole agreement is read, it is apparent that the plaintiff relied, in making it, upon the personal covenants of Barnett and Barse. They were financially responsible. As already said, Barnett had had a long and successful experience in managing hotels, which was undoubtedly an inducing cause for plaintiff’s making the agreement in question and for personally obligating them to carry out its terms.

It is suggested that because there is a clause in the agreement to the effect that it should ‘inure to the benefit of and bind the respective parties hereto, their personal representatives and assigns,’ that Barnett and Barse had a right to assign it to the corporation. But the intention of the parties is to be gathered, not from one clause, but from the entire instrument [Citation] and when it is thus read it clearly appears that Barnett and Barse were to personally carry out the terms of the agreement and did not have a right to assign it. This follows from the language used, which shows that a personal trust or confidence was reposed by the plaintiff in Barnett and Barse when the agreement was made.

In [Citation] it was said: “Rights arising out of contract cannot be transferred if they...involve a relation of personal confidence such that the party whose

agreement conferred those rights must have intended them to be exercised only by him in whom he actually confided.”

This rule was applied in [Citation] the court holding that the plaintiff—the assignee—was not only technically, but substantially, a different entity from its predecessor, and that the defendant was not obliged to entrust its money collected on the sale of the presses to the responsibility of an entirely different corporation from that with which it had contracted, and that the contract could not be assigned to the plaintiff without the assent of the other party to it.

The reason which underlies the basis of the rule is that a party has the right to the benefit contemplated from the character, credit, and substance of him with whom he contracts, and in such case he is not bound to recognize...an assignment of the contract.

The order appealed from, therefore, is affirmed.

### CASE QUESTIONS

1. The corporation created to operate the hotel was apparently owned and operated by the same two men the plaintiff leased the hotel to in the first place. What objection would the plaintiff have to the corporate entity—actually, of course, a legal fiction—owning and operating the hotel?
2. The defendants pointed to the clause about the contract inuring to the benefit of the parties “and assigns.” So the defendants assigned the contract. How could that not be allowed by the contract’s own terms?
3. What is the controlling rule of law upon which the outcome here depends?

### Assignment Includes Delegation

Rose v. Vulcan Materials Co.

194 S.E.2d 521 (N.C. 1973)

Huskins, J.

...Plaintiff [Rose], after leasing his quarry to J. E. Dooley and Son, Inc., promised not to engage in the rock-crushing business within an eight-mile radius of [the city of] Elkin for a period of ten years. In return for this promise, J. E. Dooley and Son, Inc., promised, among other things, to furnish plaintiff stone f.o.b. the quarry site at Cycle, North Carolina, at stipulated prices for ten years....

By a contract effective 23 April 1960, Vulcan Materials Company, a corporation..., purchased the stone quarry operations and the assets and obligations of J. E. Dooley and Son, Inc....[Vulcan sent Rose a letter, part of which read:]

Mr. Dooley brought to us this morning the contracts between you and his companies, copies of which are attached. This is to advise that Vulcan Materials Company assumes all phases of these contracts and intends to carry out the conditions of these contracts as they are stated.

In early 1961 Vulcan notified plaintiff that it would no longer sell stone to him at the prices set out in [the agreement between Rose and Dooley] and would thereafter charge plaintiff the same prices charged all of its other customers for stone. Commencing 11 May 1961, Vulcan raised stone prices to the plaintiff to a level in excess of the prices specified in [the Rose-Dooley agreement].

At the time Vulcan increased the prices of stone to amounts in excess of those specified in [the Rose-Dooley contract], plaintiff was engaged in his ready-mix cement business, using large quantities of stone, and had no other practical source of supply. Advising Vulcan that he intended to sue for breach of contract, he continued to purchase stone from Vulcan under protest....

The total of these amounts over and above the prices specified in [the Rose-Dooley contract] is \$25,231.57, [about \$152,000 in 2010 dollars] and plaintiff seeks to recover said amount in this action.

The [Rose-Dooley] agreement was an executory bilateral contract under which plaintiff's promise not to compete for ten years gained him a ten-year option to buy stone at specified prices. In most states, the assignee of an executory bilateral contract is not liable to anyone for the nonperformance of the assignor's duties thereunder unless he expressly promises his assignor or the other contracting party to perform, or 'assume,' such duties....These states refuse to imply a promise to perform the duties, but if the assignee expressly promises his assignor to perform, he is liable to the other contracting party on a third-party beneficiary theory. And, if the assignee makes such a promise directly to the other contracting party upon a consideration, of course he is liable to him thereon. [Citation]

A minority of states holds that the assignee of an executory bilateral contract under a general assignment becomes not only assignee of the rights of the assignor but also delegatee of his duties; and that, absent a showing of contrary intent, the assignee impliedly promises the assignor that he will perform the duties so delegated. This rule is expressed in Restatement, Contracts, s 164 (1932) as follows:

(1) Where a party under a bilateral contract which is at the time wholly or partially executory on both sides purports to assign the whole contract, his action is interpreted, in the absence of circumstances showing a contrary intention, as an assignment of the assignor's rights under the contract and a delegation of the performance of the assignor's duties.

(2) Acceptance by the assignee of such an assignment is interpreted, in the absence of circumstances showing a contrary intention, as both an assent to become an assignee of the assignor's rights and as **a promise to the assignor to assume the performance of the assignor's duties.**' (emphasis added)

We...adopt the Restatement rule and expressly hold that the assignee under a general assignment of an executory bilateral contract, in the absence of circumstances showing a contrary intention, becomes the delegatee of his assignor's duties and impliedly promises his assignor that he will perform such duties.

The rule we adopt and reaffirm here is regarded as the more reasonable view by legal scholars and textwriters. Professor Grismore says:

It is submitted that the acceptance of an assignment in this form does presumptively import a tacit promise on the part of the assignee to assume the burdens of the contract, and that this presumption should prevail in the absence of the clear showing of a contrary intention. The presumption seems reasonable in view of the evident expectation of the parties. The assignment on its face indicates an intent to do more than simply to transfer the benefits assured by the contract. It purports to transfer the contract as a whole, and since the contract is made up of both benefits and burdens both must be intended to be included....Grismore, *Is the Assignee of a Contract Liable for the Nonperformance of Delegated Duties?* 18 Mich.L.Rev. 284 (1920).

In addition, with respect to transactions governed by the Uniform Commercial Code, an assignment of a contract in general terms is a delegation of performance of the duties of the assignor, and its acceptance by the assignee constitutes a promise



by him to perform those duties. Our holding in this case maintains a desirable uniformity in the field of contract liability.

We further hold that the other party to the original contract may sue the assignee as a third-party beneficiary of his promise of performance which he impliedly makes to his assignor, under the rule above laid down, by accepting the general assignment. *Younce v. Lumber Co.*, [Citation] (1908), holds that where the assignee makes an express promise of performance to his assignor, the other contracting party may sue him for breach thereof. We see no reason why the same result should not obtain where the assignee breaches his promise of performance implied under the rule of Restatement s 164. 'That the assignee is liable at the suit of the third party where he expressly assumes and promises to perform delegated duties has already been decided in a few cases (citing *Younce*). If an express promise will support such an action it is difficult to see why a tacit promise should not have the same effect.' Grismore, *supra*. Parenthetically, we note that such is the rule under the Uniform Commercial Code, [2-210].

We now apply the foregoing principles to the case at hand. The contract of 23 April 1960, between defendant and J. E. Dooley and Son, Inc., under which, as stipulated by the parties, 'the defendant purchased the assets and obligations of J. E. Dooley and Son, Inc.,' was a general assignment of all the assets and obligations of J. E. Dooley and Son, Inc., including those under [the Rose-Dooley contract]. When defendant accepted such assignment it thereby became delegatee of its assignor's duties under it and impliedly promised to perform such duties.

When defendant later failed to perform such duties by refusing to continue sales of stone to plaintiff at the prices specified in [the Rose-Dooley contract], it breached its implied promise of performance and plaintiff was entitled to bring suit thereon as a third-party beneficiary.

The decision...is reversed with directions that the case be certified to the Superior Court of Forsyth County for reinstatement of the judgment of the trial court in accordance with this opinion.

## CASE QUESTIONS

1. Why did Rose need the crushed rock from the quarry he originally leased to Dooley?
2. What argument did Vulcan make as to why it should not be liable to sell crushed rock to Rose at the price set out in the Rose-Dooley contract?
3. What rule did the court here announce in deciding that Vulcan was required to sell rock at the price set out in the Rose-Dooley contract? That is, what is the controlling rule of law in this case?

### Third party Beneficiaries and Foreseeable Damages

Kornblut v. Chevron Oil Co.

62 A.D.2d 831 (N.Y. 1978)

Hopkins, J.

The plaintiff-respondent has recovered a judgment after a jury trial in the sum of \$519,855.98 [about \$1.9 million in 2010 dollars] including interest, costs and disbursements, against Chevron Oil Company (Chevron) and Lawrence Ettinger, Inc. (Ettinger) (hereafter collectively referred to as defendants) for damages arising from the death and injuries suffered by Fred Kornblut, her husband. The case went to the jury on the theory that the decedent was the third-party beneficiary of a contract between Chevron and the New York State Thruway Authority and a contract between Chevron and Ettinger.

On the afternoon of an extremely warm day in early August, 1970 the decedent was driving northward on the New York State Thruway. Near Sloatsburg, New York, at about 3:00 p.m., his automobile sustained a flat tire. At the time the decedent was accompanied by his wife and 12-year-old son. The decedent waited for assistance in the 92 degree temperature.

After about an hour a State Trooper, finding the disabled car, stopped and talked to the decedent. The trooper radioed Ettinger, which had the exclusive right to render service on the Thruway under an assignment of a contract between Chevron and the Thruway Authority. Thereafter, other State Troopers reported the disabled car and the decedent was told in each instance that he would receive assistance within 20 minutes.

Having not received any assistance by 6:00 p.m., the decedent attempted to change the tire himself. He finally succeeded, although he experienced difficulty and complained of chest pains to the point that his wife and son were compelled to lift the flat tire into the trunk of the automobile. The decedent drove the car to the next service area, where he was taken by ambulance to a hospital; his condition was later diagnosed as a myocardial infarction. He died 28 days later.

Plaintiff sued, *inter alia*, Chevron and Ettinger alleging in her complaint causes of action sounding in negligence and breach of contract. We need not consider the issue of negligence, since the Trial Judge instructed the jury only on the theory of breach of contract, and the plaintiff has recovered damages for wrongful death and the pain and suffering only on that theory.

We must look, then, to the terms of the contract sought to be enforced. Chevron agreed to provide “rapid and efficient roadside automotive service on a 24-hour basis from each gasoline service station facility for the areas...when informed by the authority or its police personnel of a disabled vehicle on the Thruway”. Chevron’s vehicles are required “to be used and operated in such a manner as will produce adequate service to the public, as determined in the authority’s sole judgment and discretion”. Chevron specifically covenanted that it would have “sufficient roadside automotive service vehicles, equipment and personnel to provide roadside automotive service to disabled vehicles within a maximum of thirty (30) minutes from the time a call is assigned to a service vehicle, subject to unavoidable delays due to extremely adverse weather conditions or traffic conditions.”...

In interpreting the contract, we must bear in mind the circumstances under which the parties bargained. The New York Thruway is a limited access toll highway, designed to move traffic at the highest legal speed, with the north and south lanes separated by green strips. Any disabled vehicle on the road impeding the flow of traffic may be a hazard and inconvenience to the other users. The income realized from tolls is generated from the expectation of the user that he will be able to travel swiftly and smoothly along the Thruway. Consequently, it is in the interest of the authority that disabled vehicles will be repaired or removed quickly to the end that any hazard and inconvenience will be minimized. Moreover, the design and purpose of the highway make difficult, if not impossible, the summoning of aid from garages not located on the Thruway. The movement of a large number of vehicles at high speed creates a risk to the operator of a vehicle who attempts to make his own repairs, as well as to the other users. These considerations clearly prompted the making of contracts with service organizations which would be located at points near in distance and time on the Thruway for the relief of distressed vehicles.

Thus, it is obvious that, although the authority had an interest in making provision for roadside calls through a contract, there was also a personal interest of the user served by the contract. Indeed, the contract provisions regulating the charges for calls and commanding refunds be paid directly to the user for overcharges, evince a protection and benefit extended to the user only. Hence, in the event of an overcharge, the user would be enabled to sue on the contract to obtain a recovery....Here the contract contemplates an individual benefit for the breach running to the user....

By choosing the theory of recovery based on contract, it became incumbent on the plaintiff to show that the injury was one which the defendants had reason to foresee as a probable result of the breach, under the ancient doctrine of *Hadley v Baxendale* [Citation], and the cases following it...in distinction to the requirement of proximate cause in tort actions....

The death of the decedent on account of his exertion in the unusual heat of the midsummer day in changing the tire cannot be said to have been within the contemplation of the contracting parties as a reasonably foreseeable result of the failure of Chevron or its assignee to comply with the contract....

The case comes down to this, then, in our view: though the decedent was the intended beneficiary to sue under certain provisions of the contract—such as the rate specified for services to be rendered—he was not the intended beneficiary to sue for consequential damages arising from personal injury because of a failure to render service promptly. Under these circumstances, the judgment must be reversed and the complaint dismissed, without costs or disbursements.

[Martuscello, J., concurred in the result but opined that the travelling public was not an intended beneficiary of the contract.]

### CASE QUESTIONS

1. Chevron made two arguments as to why it should not be liable for Mr. Kornblut's death. What were they?
2. Obviously, when Chevron made the contract with the New York State Thruway Authority, it did not know Mr. Kornblut was going to be using the highway. How could he, then, be an intended beneficiary of the contract?
3. Why was Chevron not found liable for Mr. Kornblut's death when, clearly, had it performed the contract properly, he would not have died?

## 14.5 Summary and Exercises

### Summary

The general rule that the promisee may assign any right has some exceptions—for example, when the promisor's obligation would be materially changed. Of course the contract itself may prohibit assignment, and sometimes statutes preclude it. Knowing how to make the assignment effective and what the consequences of the assignment are on others is worth mastering. When, for example, does the assignee not stand in the assignor's shoes? When may a future right be assigned?

Duties, as well as rights, may be transferred to third parties. Most rights (promises) contained in contracts have corresponding duties (also expressed as promises). Often when an entire contract is assigned, the duties go with it; the transferee is known, with respect to the duties, as the delegatee. The transferor himself does not necessarily escape the duty, however. Moreover, some duties are nondelegable, such as personal promises and those that public policy require to be carried out by a particular official. Without the ability to assign rights and duties, much of the modern economy would grind to a halt.

The parties to a contract are not necessarily the only people who acquire rights or duties under it. One major category of persons acquiring rights is third-party beneficiaries. Only intended beneficiaries acquire rights under the contract, and these are of two types: creditor and donee beneficiaries. The rules for determining whether rights have been conferred are rather straightforward; determining whether rights can subsequently be modified or extinguished is more troublesome. Generally, as long as the contract does not prohibit change and as long as the beneficiary has not relied on the promise, the change may be made.

## EXERCISES

1. The Dayton Country Club offered its members various social activities. Some members were entitled, for additional payment, to use the golf course, a coveted amenity. Golfing memberships could not be transferred except upon death or divorce, and there was a long waiting list in this special category; if a person at the top of the list declined, the next in line was eligible. Golfing membership rules were drawn up by a membership committee. Magness and Redman were golfing members. They declared bankruptcy, and the bankruptcy trustee sought, in order to increase the value of their debtors' estates, to assume and sell the golfing memberships to members on the waiting list, other club members, or the general public, provided the persons joined the club. The club asserted that under relevant state law, it was "excused from rendering performance to an entity other than the debtor"—that is, it could not be forced to accept strangers as members. Can these memberships be assigned?
2. Tenant leased premises in Landlord's shopping center, agreeing in the lease "not to assign, mortgage, pledge, or encumber this lease in whole or in part." Under the lease, Tenant was entitled to a construction allowance of up to \$11,000 after Tenant made improvements for its uses. Prior to the completion of the improvements, Tenant assigned its right to receive the first \$8,000 of the construction allowance to Assignee, who, in turn, provided Tenant \$8,000 to finance the construction. Assignee notified Landlord of the assignment, but when the construction was complete, Landlord paid Tenant anyway; when Assignee complained, Landlord pointed to the nonassignment clause. Assignee sued Landlord. Who wins? *Aldana v. Colonial Palms Plaza, Inc.*, 591 So.2d 953 (Fla. Ct. App., 1991).
3. Marian contracted to sell her restaurant to Billings for \$400,000. The contract provided that Billings would pay \$100,000 and sign a note for the remainder. Billings sold the restaurant to Alice, who agreed to assume responsibility for the balance due on the note held by Marian. But Alice had difficulties and declared bankruptcy. Is Billings still liable on the note to Marian?
4. Yellow Cab contracted with the Birmingham Board of Education to transport physically handicapped students. The contract provided, "Yellow Cab will transport the physically handicapped students of the School System...and furnish all necessary vehicles and personnel and will perform all maintenance and make all

repairs to the equipment to keep it in a safe and efficient operating condition at all times.”

Yellow Cab subcontracted with Metro Limousine to provide transportation in connection with its contract with the board. Thereafter, Metro purchased two buses from Yellow Cab to use in transporting the students. DuPont, a Metro employee, was injured when the brakes on the bus that he was driving failed, causing the bus to collide with a tree. DuPont sued Yellow Cab, alleging that under its contract with the board, Yellow Cab had a nondelegable duty to properly maintain the bus so as to keep it in a safe operating condition; that that duty flowed to him as an intended third-party beneficiary of the contract; and that Yellow Cab had breached the contract by failing to properly maintain the bus. Who wins? *DuPont v. Yellow Cab Co. of Birmingham, Inc.*, 565 So.2d 190 (Ala. 1990).

5. Joan hired Groom to attend to her herd of four horses at her summer place in the high desert. The job was too much for Groom, so he told Tony that he (Groom) would pay Tony, who claimed expertise in caring for horses, to take over the job. Tony neglected the horses in hot weather, and one of them needed veterinarian care for dehydration. Is Groom liable?
6. Rensselaer Water Company contracted with the city to provide water for business, domestic, and fire-hydrant purposes. While the contract was in effect, a building caught on fire; the fire spread to Plaintiff's (Moch Co.'s) warehouse, destroying it and its contents. The company knew of the fire but was unable to supply adequate water pressure to put it out. Is the owner of the warehouse able to maintain a claim against the company for the loss?
7. Rusty told Alice that he'd do the necessary overhaul on her classic car for \$5,000 during the month of May, and that when the job was done, she should send the money to his son, Jim, as a graduation present. He confirmed the agreement in writing and sent a copy to Jim. Subsequently, Rusty changed his mind. What right has Jim?
8. Fox Brothers agreed to convey to Clayton Canfield Lot 23 together with a one-year option to purchase Lot 24 in a subdivision known as Fox Estates. The agreement contained no prohibitions, restrictions, or limitations against assignments. Canfield paid the \$20,000 and took title to Lot 23 and the option to Lot 24. Canfield thereafter assigned his option rights in Lot 24 to the Scotts. When the Scotts wanted to exercise the option, Fox Brothers refused to convey the property to them. The Scotts then brought suit for specific performance. Who wins?

9. Rollins sold Byers, a businessperson, a flatbed truck on a contract; Rollins assigned the contract to Frost, and informed Byers of the assignment. Rollins knew the truck had problems, which he did not reveal to Byers. When the truck needed \$3,200 worth of repairs and Rollins couldn't be found, Byers wanted to deduct that amount from payments owed to Frost, but Frost insisted he had a right to payment. Upon investigation, Byers discovered that four other people in the state had experienced similar situations with Rollins and with Frost as Rollins's assignee. What recourse has Byers?
10. Merchants and resort owners in the San Juan Islands in Washington State stocked extra supplies, some perishable, in anticipation of the flood of tourists over Labor Day. They suffered inconvenience and monetary damage due to the union's Labor Day strike of the state ferry system, in violation of its collective bargaining agreement with the state and of a temporary restraining order. The owners sued the union for damages for lost profits, attorney fees, and costs, claiming the union should be liable for intentional interference with contractual relations (the owners' relations with their would-be customers). Do the owners have a cause of action?



## SELF-TEST QUESTIONS

1. A creditor beneficiary is
  - a. the same as a donee beneficiary
  - b. a third-party beneficiary
  - c. an incidental beneficiary
  - d. none of the above
  
2. Assignments are not allowed
  - a. for rights that will arise from a future contract
  - b. when they will materially change the duties that the obligor must perform
  - c. where they are forbidden by public policy
  - d. for any of the above
  
3. When an assignor assigns the same interest twice,
  - a. the subsequent assignee generally takes precedence
  - b. the first assignee generally takes precedence
  - c. the first assignee always takes precedence
  - d. the assignment violates public policy
  
4. Factoring
  - a. is an example of delegation of duties
  - b. involves using an account receivable as collateral for a loan
  - c. involves the purchase of a right to receive income from another
  - d. is all of the above
  
5. Personal promises
  - a. are always delegable
  - b. are generally not delegable
  - c. are delegable if not prohibited by public policy
  - d. are delegable if not barred by the contract

**SELF-TEST ANSWERS**

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

## Chapter 15

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### Discharge of Obligations

#### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. What is meant by discharge of contract obligations
2. How contract obligations are discharged

## 15.1 Discharge of Contract Duties

### LEARNING OBJECTIVES

1. Understand how performance, partial performance, or no performance may discharge contractual obligations.
2. Recognize what rights accrue to the nonbreaching party when the other side announces, before the time for performance, that performance will not be forthcoming—anticipatory breach.
3. Understand the concept of the right to adequate assurances, and the consequences if no such assurances are forthcoming.

A person is liable to perform agreed-to contract duties until or unless he or she is discharged. If the person fails to perform without being discharged, liability for damages arises. Here we deal with the second-to-the-last of the four broad themes of contract law: how contract duties are discharged.

### Discharge by Performance (or Nonperformance) of the Duty

A contract can be discharged by complete performance or material nonperformance of the contractual duty. Note, in passing, that the modern trend at common law (and explicit under the Uniform Commercial Code [UCC], Section 1-203) is that the parties have a **good-faith duty**<sup>1</sup> to perform to each other. There is in every contract “an implied covenant of good faith” (honesty in fact in the transaction) that the parties will deal fairly, keep their promises, and not frustrate the other party’s reasonable expectations of what was given and what received.

#### Full Performance

Full performance of the contractual obligation discharges the duty. If Ralph does a fine job of plumbing Betty’s new bathroom, she pays him. Both are discharged.

#### Nonperformance, Material Breach

If Ralph doesn’t do any work at all on Betty’s bathroom, or almost none, then Betty owes him nothing. She—the nonbreaching party—is discharged, and Ralph is liable for breach of contract.

1. The duty to act with honesty in fact in commercial transactions.

Under UCC Section 2-106(4), a party that ends a contract breached by the other party is said to have effected a **cancellation**<sup>2</sup>. The cancelling party retains the right to seek a remedy for breach of the whole contract or any unperformed obligation. The UCC distinguishes cancellation from **termination**<sup>3</sup>, which occurs when either party exercises a lawful right to end the contract other than for breach. When a contract is terminated, all executory duties are discharged on both sides, but if there has been a partial breach, the right to seek a remedy survives. Uniform Commercial Code, Section 2-106(3).

### Substantial Performance

Logically, anything less than full performance, even a slight deviation from what is owed, is sufficient to prevent the duty from being discharged and can amount to a breach of contract. So if Ralph does all the plumbing for Betty's new bathroom *except* hook up the toilet feed, he has not really "plumbed the new bathroom." He has only plumbed part of it. At classic common law, that was it: either you did the thing you promised completely or you had materially breached. But under modern theories, an ameliorative doctrine has developed, called **substantial performance**<sup>4</sup>: if one side has substantially, but not completely, performed, so that the other side has received a benefit, the nonbreaching party owes something for the value received. The Restatement (Second) of Contracts puts it this way: Restatement (Second) of Contracts, Section 237(d).

### Substantial Performance.

In an important category of disputes over failure of performance, one party asserts the right to payment on the ground that he has completed his performance, while the other party refuses to pay on the ground that there is an uncured material failure of performance....In such cases it is common to state the issue...in terms of whether there has been substantial performance....If there has been substantial although not full performance, the building contractor has a claim for the unpaid balance and the owner has a claim only for damages. If there has not been substantial performance, the building contractor has no claim for the unpaid balance, although he may have a claim in restitution.

The contest here is between the one who claims discharge by the other's material breach and the one who asserts there has been substantial performance. What constitutes substantial performance is a question of fact, as illustrated in Section 15.2.1 "Substantial Performance; Conditions Precedent", *TA Operating Corp. v. Solar Applications Engineering, Inc.* The doctrine has no applicability where the breaching party willfully failed to follow the contract, as where a plumber substitutes a

2. The termination of a contract by one party in response to its material breach by the other.

3. The lawful right to end the contract other than for breach.

4. At common law, the idea that a promisee should not be denied all payment under a contract when his or her performance was imperfect if significant benefit has been conferred on the promisor, who must pay for the value received.

different faucet for the one ordered; installation of the incorrect faucet is a breach, even if it is of equal or greater value than the one ordered.

Under the UCC, there is no such thing as substantial performance. Section 2-601 requires that the goods delivered according to the contract be the exact things ordered—that there be a **perfect tender**<sup>5</sup> (unless the parties agree otherwise).

### Anticipatory Breach and Demand for Reasonable Assurances

When a promisor announces before the time his performance is due that he will not perform, he is said to have committed an **anticipatory breach (or repudiation)**<sup>6</sup>. Of course a person cannot fail to perform a duty before performance is due, but the law allows the promisee to treat the situation as a material breach that gives rise to a claim for damages and discharges the obligee from performing duties required of him under the contract. The common-law rule was first recognized in the well-known 1853 British case *Hochster v. De La Tour*. In April, De La Tour hired Hochster as his courier, the job to commence in June. In May, De La Tour changed his mind and told Hochster not to bother to report for duty. Before June, Hochster secured an appointment as courier to Lord Ashburton, but that job was not to begin until July. Also in May, Hochster sued De La Tour, who argued that he should not have to pay Hochster because Hochster had not stood ready and willing to begin work in June, having already agreed to work for Lord Ashburton. The court ruled for the plaintiff Hochster:

[I]t is surely much more rational, and more for the benefit of both parties, that, after the renunciation of the agreement by the defendant, the plaintiff should be at liberty to consider himself absolved from any future performance of it, retaining his right to sue for any damage he has suffered from the breach of it. Thus, instead of remaining idle and laying out money in preparations which must be useless, he is at liberty to seek service under another employer, which would go in mitigation of the damages to which he would otherwise be entitled for a breach of the contract. It seems strange that the defendant, after renouncing the contract, and absolutely declaring that he will never act under it, should be permitted to object that faith is given to his assertion, and that an opportunity is not left to him of changing his mind.*Hochster v. De La Tour*, 2 Ellis & Blackburn 678 (Q.B. 1853).

5. The precise performance of a contractual obligation.

6. A communication that informs a party that the obligations of the original contract will not be fulfilled when due; gives rise to an immediate right to sue.

Another type of anticipatory breach consists of any voluntary act by a party that destroys, or seriously impairs, that party's ability to perform the promise made to the other side. If a seller of land, having agreed to sell a lot to one person at a date certain, sells it instead to a third party before that time, there is an anticipatory breach. If Carpenter announces in May that instead of building Owner's deck in July, as agreed, he is going on a trip to Europe, there is an anticipatory breach. In the

first instance, there would be no point to showing up at the lawyer's office when the date arrives to await the deed, so the law gives a right to sue when the land is sold to the other person. In the second instance, there would be no point to waiting until July, when indeed Carpenter does not do the job, so the law gives the right to sue when the future nonperformance is announced.

These same general rules prevail for contracts for the sale of goods under UCC Section 2-610.

Related to the concept of anticipatory breach is the idea that the obligee has a right to demand reasonable assurances from the obligor that contractual duties will be performed. If the obligee makes such a **demand for reasonable assurances**<sup>7</sup> and no adequate assurances are forthcoming, the obligee may assume that the obligor will commit an anticipatory breach, and consider it so. That is, after making the contract, the obligee may come upon the disquieting news that the obligor's ability to perform is shaky. A change in financial condition occurs, an unknown claimant to rights in land appears, a labor strike arises, or any of a number of situations may crop up that will interfere with the carrying out of contractual duties. Under such circumstances, the obligee has the right to a demand for reasonable assurance that the obligor will perform as contractually obligated. The general reason for such a rule is given in UCC Section 2-609(1), which states that a contract "imposes an obligation on each party that the other's expectation of receiving due performance will not be impaired." Moreover, an obligee would be foolish not to make alternative arrangements, if possible, when it becomes obvious that his original obligor will be unable to perform. The obligee must have reasonable grounds to believe that the obligor will breach. The fear must be that of a failure of performance that would amount to a total breach; a minor defect that can be cured and that at most would give rise to an offset in price for damages will not generally support a demand for assurances.

Under UCC Section 2-609(1), the demand must be in writing, but at common law the demand may be oral if it is reasonable in view of the circumstances. If the obligor fails within a reasonable time to give adequate assurance, the obligee may treat the failure to do so as an anticipatory repudiation, or she may wait to see if the obligor might change his mind and perform.

7. A demand to be reassured that contractual performance will be forthcoming when reasonable grounds for insecurity arise with respect to the performance of the other party; failure to get such is an anticipatory breach.

### KEY TAKEAWAY

Contracts can be discharged by performance: complete performance discharges both sides; material breach discharges the breaching party, who has a right to claim damages; substantial performance obligates the promisee to pay something for the benefit conferred but is a breach. A party may demand reasonable assurances of performance, which, if not forthcoming, may be treated as an anticipatory breach (or repudiation).

### EXERCISES

1. What types of performance discharge a contractual obligation?
2. Under the UCC, what is the difference between cancellation and termination of a contract?
3. What is an anticipatory breach, and under what circumstances can a party claim it?

## Discharge by Conditions

### LEARNING OBJECTIVES

1. Understand the concept of conditions in a contract.
2. Recognize that conditions can be classified on the basis of how they are created, their effect on the duty to perform, the essentialness of timely performance, or performance to someone's satisfaction.

Usually contracts consist of an exchange of promises—a pledge or commitment by each party that somebody will or will not do something. Andy's promise to cut Anne's lawn "over the weekend" in return for Anne's promise to pay twenty-five dollars is a commitment to have the lawn mowed by Sunday night or Monday morning. Andy's promise "not to tell anyone what I saw you doing Saturday night" in return for Anne's promise to pay one hundred dollars is a commitment that an event (the revealing of a secret) will not occur. These promises are known as independent or absolute or unconditional, because their performance does not depend on any outside event. Such promises, if contractually binding, create a present duty to perform (or a duty to perform at the time stated).



However, it is common that the obligation to perform a contract is conditioned (or conditional). A **condition**<sup>8</sup> is an event the happening or nonhappening of which gives rise to a duty to perform (or discharges a duty to perform). Conditions may be express or implied; they may also be precedent, concurrent, subsequent, or to the satisfaction of a party.

### Conditions Classified Based on How They Are Created

**Express conditions**<sup>9</sup> are stated in words in the contract, orally or written. Andy promises to mow Anne's lawn "provided it doesn't rain." "Provided it doesn't rain" is an express condition. If rain comes, there is no duty to cut the lawn, and Andy's failure to do so is not a breach of promise. Express conditions are usually introduced by language such as "provided that," "if," "when," "assuming that," "as soon as," "after," and the like. **Implied conditions**<sup>10</sup> are unexpressed but understood to be part of the contract. If Mr. Olson guarantees Jack's used car for ninety days, it is implied that his obligation to fix any defects doesn't arise until Jack lets him know the car is defective. If Ralph is hired to plumb Betty's new bathroom, it is implied that Betty's duty to pay is conditioned on Ralph's completion of the job.

### Conditions Classified Based on Their Effect on Duty to Perform

8. An uncertain future act or event whose occurrence or nonoccurrence determines the rights or obligations of a party under a legal instrument, especially a contract.
9. A condition in words, oral or in writing.
10. A provision not explicitly stated in an agreement but considered an important item.
11. A condition that is to be fulfilled by one party at the same time that a mutual condition is to be fulfilled by another party.
12. An event that terminates an existing duty of performance.
13. A clause asserting that any tardy performance is a material breach, discharging the nonbreaching party.

A condition precedent is a term in a contract (express or implied) that requires performance only in the event something else happens first. Jack will buy a car from Mr. Olson if Jack gets financing. "If Jack gets financing" is a condition precedent. A **concurrent condition**<sup>11</sup> arises when the duty to perform the contract is simultaneous: the promise of a landowner to transfer title to the purchaser and the purchaser to tender payment to the seller. The duty of each to perform is conditioned on the performance by the other. (As a practical matter, of course, somebody has to make the first move, proffering deed or tendering the check.) A condition that terminates an already existing duty of performance is known as a **condition subsequent**<sup>12</sup>. Ralph agrees to do preventive plumbing maintenance on Deborah Dairy's milking equipment for as long as David Dairy, Deb's husband, is stationed overseas. When David returns, Ralph's obligation to do the maintenance (and Deb's duty to pay him) terminates.

### Condition of Timeliness

If, as often occurs, it does not matter a great deal whether a contract is performed exactly on time, failure to do so is not a material breach, and the promisee has to accept the performance and deduct any losses caused by the delay. If, though, it makes a difference to the promisee whether the promisor acts on time, then it is said that "**time is of the essence**"<sup>13</sup>. Time as a condition can be made explicit in a

clause reciting that time is of the essence. If there is no express clause, the courts will read it in when the purpose of the contract was clearly to provide for performance at or by a certain time, and the promisee will gain little from late performance. But even express clauses are subject to a rule of reason, and if the promisor would suffer greatly by enforcement of the clause (and the promisee would suffer only slightly or not at all from a refusal to invoke it), the courts will generally excuse the untimely performance, as long as it was completed within a reasonable time. A builder's failure to finish a house by July 1 will not discharge the buyer's obligation to pay if the house is finished a week or even a month later, although the builder will be liable to the buyer for expenses incurred because of the lateness (storage charges for furniture, costs for housing during the interim, extra travel, and the like).

### **Condition That a Party Must Be Satisfied**

"You must be satisfied or your money back" is a common advertisement. A party to a contract can require that he need not pay or otherwise carry out his undertaking unless satisfied by the obligor's performance, or unless a third party is satisfied by the performance.

Parties may contract to perform to one side's personal satisfaction. Andy tells Anne, a prospective client, that he will cut her hair better than her regular hairdresser, and that if she is not satisfied, she need not pay him. Andy cuts her hair, but Anne frowns and says, "I don't like it." Assume that Andy's work is excellent. Whether Anne must pay depends on the standard for judging to be employed—a standard of objective or subjective satisfaction. The objective standard is that which would satisfy the reasonable purchaser. Most courts apply this standard when the contract involves the performance of a mechanical job or the sale of a machine whose performance is capable of objective measurement. So even if the obligee requires performance to his "personal satisfaction," the courts will hold that the obligor has performed if the service performed or the goods produced are in fact satisfactory. By contrast, if the goods or services contracted for involve personal judgment and taste, the duty to pay will be discharged if the obligee states personal (subjective) dissatisfaction. No reason at all need be given, but it must be for a good-faith reason, not just to escape payment.

The duty to make a contract payment may be conditioned on the satisfaction of a third party. Building contracts frequently make the purchaser's duty to pay conditional on the builder's receipt of an architect's certificate of compliance with all contractual terms; road construction contracts often require that the work be done "to the satisfaction of the County Engineer." These conditions can be onerous. The builder has already erected the structure and cannot "return" what he has done. Nevertheless, because the purchaser wants assurance that the building

(obviously a major purchase) or road meets his specifications, the courts will hold the contractor to the condition unless it is impossible to provide a certificate (e.g., architect may have died) or the architect has acted in bad faith, or the purchaser has somehow prevented the certificate from issuing. The third party's refusal to issue a certificate needs to be reasonable.

### KEY TAKEAWAY

Parties may, expressly or implicitly, condition the requirement for contractual performance on the happening or nonhappening of an event, or on timeliness. They may condition performance on satisfaction to one of the parties to the contract or to the satisfaction of a third party; in any event, dissatisfaction must be in good faith.

### EXERCISES

1. What is “conditioned” by a condition in a contract?
2. What conditions are based on how they are made?
3. What conditions are based on their effect on the duty of performance?
4. What typical situations involve performance to a party's satisfaction?

## Discharge by Agreement of the Parties

### LEARNING OBJECTIVE

1. Recognize that there are various ways the parties may agree between themselves to terminate mutual obligations under the contract.

Parties are free to agree to almost any contract they want, and they are free to agree to end the contract whenever they want. There are several ways this is done.

### Mutual Rescission

The parties may agree to give up the duties to perform, called **mutual rescission**<sup>14</sup>. This may be by a formal written **release**<sup>15</sup> saying the obligor is discharged upon delivery of the writing or upon occurrence of a condition. Or an obligation may be discharged by a contract not to sue about it.

14. The giving up by both sides of the right to demand contract performance.

15. A contractual discharge of obligation by one side to another.

The Restatement terms this an agreement of rescission. Restatement (Second) of Contracts, Section 283. An agreement to rescind will be given effect even though partial performance has been made or one or both parties have a claim for partial breach. The agreement need not be in writing or even expressed in words. By their actions, such as failure to take steps to perform or enforce, the parties may signal their mutual intent to rescind. Andy starts to mow Anne's lawn as they agreed. He begins the job, but it is unbearably hot. She sees how uncomfortable he is and readily agrees with him when he says, "Why don't we just forget the whole thing?" Andy's duty to finish mowing is discharged, as is Anne's duty to pay Andy, either for the whole job or for the part he has done.

Business executives live by contracts, but they do not necessarily die by them. A sociologist who studied business behavior under contract discovered a generation ago—and it is still valid—that in the great majority of cases in which one party wishes to "cancel an order," the other party permits it without renegotiation, even though the cancellation amounts to a repudiation of a contract. As one lawyer was quoted as saying,

Often business[people] do not feel they have "a contract"—rather they have an "order." They speak of "cancelling the order" rather than "breaching our contract." When I began practice I referred to order cancellations as breaches of contract, but my clients objected since they do not think of cancellation as wrong. Most clients, in heavy industry at least, believe that there is a right to cancel as part of the buyer-seller relationship. There is a widespread attitude that one can back out of any deal within some very vague limits. Lawyers are often surprised by this attitude. Stewart Macaulay, "Non-contractual Relations in Business: A Preliminary Study," *American Sociological Review* 28, no. 1 (1963): 55, 61.

This attitude is understandable. People who depend for their economic survival on continuing relationships will be loath to react to every change in plans with a lawsuit. The legal consequences of most of these cancellations are an agreement of rescission. Under UCC Section 2-720, the use of a word like "cancellation" or "rescission" does not by itself amount to a renunciation of the right to sue for breach of a provision that occurred before the rescission. If the parties mean to discharge each other fully from all duties owed, they must say so explicitly. Actions continue to speak more loudly than words, however, and in law, so can inactions. Legal rights under contracts may be lost by both parties if they fail to act; by abandoning their claims, they can affect rescission.

### Waiver

A second means of discharge is by **waiver**<sup>16</sup>, whereby a party voluntarily gives up a right she has under a contract but doesn't give up the entire right to performance by the other side. Tenant is supposed to pay rent on the first of the month, but because his employer pays on the tenth, Tenant pays Landlady on that day. If Landlady accepts the late payment without objection, she has waived her right to insist on payment by the first of the month, unless the lease provides that no waiver occurs from the acceptance of any late payments. See Section 15.2.2 "Waiver of Contract Rights; Nonwaiver Provisions", *Minor v. Chase Auto Finance Corporation*. A "waiver" is permission to deviate from the contract; a "release" means to let go of the whole thing.

### Substituted Agreement

Discharge by substituted agreement is a third way of mutual rescission. The parties may enter into a **novation**<sup>17</sup>, either a new contract or one whereby a new person is substituted for the original obligor, and the latter is discharged. If Mr. Olson is obligated to deliver a car to Jack, Jack and Mr. Olson may agree that Dewey Dealer should deliver the car to Jack instead of Mr. Olson; the latter is discharged by this novation. A **substituted agreement**<sup>18</sup> may also simply replace the original one between the original parties.

### Accord and Satisfaction

Discharge by **accord and satisfaction**<sup>19</sup> is a fourth way of mutual rescission. Here the parties to a contract (usually a disputed one) agree to substitute some performance different from what was originally agreed, and once this new agreement is executed, the original contract (as well as the more recent accord) is satisfied. But before then, the original agreement is only suspended: if the obligor does not satisfy the accord, the other side can sue on the original obligation or on the accord.

- 16. The surrender of a legal right.
- 17. The replacement of one obligation by another by mutual agreement of both parties; usually the replacement of one of the original parties to a contract with the consent of the remaining party.
- 18. A new agreement between original parties who have given up rights under the old agreement.
- 19. The settlement of a dispute by offering up less consideration than demanded in exchange for extinguishing the obligation. The original obligation remains viable until the accord is performed.

#### KEY TAKEAWAY

Parties to a contract may agree to give it up. This may be by mutual rescission, release, waiver, novation, substituted agreement, or accord and satisfaction.

## EXERCISES

1. How does mutual rescission discharge a common-law contract without apparent new consideration?
2. What is the difference between a substituted agreement and a novation?
3. What happens if the parties negotiate an accord and satisfaction and one side fails to perform it?
4. If an obligee accepts performance from the obligor that deviates from the contract, under what circumstances can the obligee nevertheless insist on strict compliance in the future?

## Discharge When Performance Becomes Impossible or Very Difficult

### LEARNING OBJECTIVE

1. Recognize that there are several circumstances when performance of the contract becomes variously impossible, very difficult, or useless, and that these may give rise to discharge.

There are at least five circumstances in which parties may be discharged from contractual obligations because performance is impossible, difficult, or useless.

### Overview

Every contract contains some element of risk: the buyer may run out of money before he can pay; the seller may run out of goods before he can deliver; the cost of raw materials may skyrocket, throwing off the manufacturer's fine financial calculations. Should the obligor's luck run out, he is stuck with the consequences—or, in the legal phrase, his liability is strict: he must either perform or risk paying damages for breach of contract, even if his failure is due to events beyond his control. Of course, an obligor can always limit his liability through the contract itself. Instead of obligating himself to deliver one million units, he can restrict his obligation to “one million units or factory output, whichever is less.” Instead of guaranteeing to finish a job by a certain date, he can agree to use his “best efforts” to do so. Similarly, damages in the event of breach can be limited. A party can even include a clause canceling the contract in the event of an untoward happening. But if these provisions are absent, the obligor is generally held to the terms of his bargain.

Exceptions include the concepts of impossibility, impracticability, and frustration of purpose.

### **Impossibility**

If performance is impossible, the duty is discharged. The categories here are death or incapacity of a personal services contractor, destruction of a thing necessary for performance, and performance prohibited by government order.

#### **Death or Incapacity of a Personal Services Contractor**

If Buyer makes a contract to purchase a car and dies before delivery, Buyer's estate could be held liable; it is not impossible (for the estate) to perform. The estate of a painter hired to do a portrait cannot be sued for damages because the painter died before she could complete the work.

#### **Destruction or Deterioration of a Thing Necessary for Performance**

When a specific object is necessary for the obligor's performance, its destruction or deterioration making its use impracticable (or its failure to come into existence) discharges the obligor's duty. Diane's Dyers contracts to buy the annual wool output of the Sheepish Ranch, but the sheep die of an epidemic disease before they can be shorn. Since the specific thing for which the contract was made has been destroyed, Sheepish is discharged from its duty to supply Diane's with wool, and Diane's has no claim against the Ranch. However, if the contract had called for a quantity of wool, without specifying that it was to be from Sheepish's flock, the duty would not be discharged; since wool is available on the open market, Sheepish could buy that and resell it to Diane's.

#### **Performance Prohibited by Government Regulation or Order**

When a government promulgates a rule after a contract is made, and the rule either bars performance or will make it impracticable, the obligor's duty is discharged. An obligor is not required to break the law and risk the consequences. Financier Bank contracts to sell World Mortgage Company certain collateralized loan instruments. The federal government, in a bank reform measure, prohibits such sales. The contract is discharged. If the Supreme Court later declared the prohibition unconstitutional, World Mortgage's duty to buy (or Financier Bank's to sell) would not revive.

## Impracticability

Less entirely undoable than impossibility, but still grounds for discharge, are common-law impracticability and its relative, commercial impracticability.

### Common-Law Impracticability

**Impracticability**<sup>20</sup> is said to exist when there is a radical departure from the circumstances that the parties reasonably contemplated would exist at the time they entered into the contract; on such facts, the courts might grant relief. They will do so when extraordinary circumstances (often called “acts of God” or “force majeure”) make it unjust to hold a party liable for performance. Although the justification for judicial relief could be found in an implied condition in all contracts that extraordinary events shall not occur, the Restatement eschews so obvious a bootstrap logic and adopts the language of UCC Section 2-615(a), which states that the crux of the analysis is whether the nonoccurrence of the extraordinary circumstance was “a basic assumption on which the contract was made.” Restatement (Second) of Contracts, Section 261. If it was—if, that is, the parties assumed that the circumstance would not occur—then the duty is discharged if the circumstance later does occur.

In one well-known case, *Autry v. Republic Productions*, the famous cowboy movie star Gene Autry had a contract to perform to the defendant. He was drafted into the army in 1942; it was temporarily, at least, impossible for him to perform his movie contractual obligations incurred prior to his service. When he was discharged in 1945, he sued to be relieved of the prewar obligations. The court took notice that there had been a long interruption in Autry’s career and of “the great decrease in the purchasing power of the dollar”—postwar inflation—and determined that to require him to perform under the old contract’s terms would work a “substantial hardship” on him. A world war is an extraordinary circumstance. The temporary impossibility had transformed into impracticability. *Autry v. Republic Productions*, 180 P.2d 144 (Calif. 1947).

Impracticability refers to the performance, not to the party doing it. Only if the performance is impracticable is the obligor discharged. The distinction is between “the thing cannot be done” and “I cannot do it.” The former refers to that which is **objectively impracticable**<sup>21</sup>, and the latter to that which is subjectively impracticable. That a duty is subjectively impracticable does not excuse it if the circumstances that made the duty difficult are not extraordinary. A buyer is liable for the purchase price of a house, and his inability to raise the money does not excuse him or allow him to escape from a suit for damages when the seller tenders the deed. *Christy v. Pilkinton*, 273 S.W.2d 533 (Ark. 1954). If Andy promises to transport Anne to the football stadium for ten dollars, he cannot wriggle out of his

20. An excuse for nonperformance of a duty where it has become unexpectedly difficult or expensive for the party who was to perform.

21. Impossible.



agreement because someone smashed into his car (rendering it inoperable) a half hour before he was due to pick her up. He could rent a car or take her in a taxi, even though that will cost considerably more than the sum she agreed to pay him. But if the agreement was that he would transport her in his car, then the circumstances make his performance **objectively impracticable**—the equivalent of impossible—and he is excused.

### Commercial Impracticability

This common-law concept of impracticability has been adopted by the UCC. Uniform Commercial Code, Section 2-615. When performance cannot be undertaken except with extreme difficulty or at highly unreasonable expense, it might be excused on the theory of **commercial impracticability**<sup>22</sup>. However, “impracticable” (the action is impossible) is not the same as “impractical” (the action would yield an insufficient return or would have little practical value). The courts allow a considerable degree of fluctuation in market prices, inflation, weather, and other economic and natural conditions before holding that an extraordinary circumstance has occurred. A manufacturer that based its selling price on last year’s costs for raw materials could not avoid its contracts by claiming that inflation within the historical range had made it difficult or unprofitable to meet its commitments. Examples of circumstances that could excuse might be severe limitations of supply due to war, embargo, or a natural disaster. Thus a shipowner who contracted with a purchaser to carry goods to a foreign port would be excused if an earthquake destroyed the harbor or if war broke out and the military authorities threatened to sink all vessels that entered the harbor. But if the shipowner had planned to steam through a canal that is subsequently closed when a hostile government seizes it, his duty is not discharged if another route is available, even if the route is longer and consequently more expensive.

### Frustration of Purpose

22. Relief from contract obligations may be granted when performance has been rendered excessively difficult, expensive, or harmful by an unforeseen contingency.

23. A defense to contractual nonperformance that occurs when an unforeseen event undermines a party’s principal purpose for entering into a contract, and both parties knew of this principal purpose at the time the contract was made.

If the parties made a basic assumption, express or implied, that certain circumstances would not arise, but they do arise, then a party is discharged from performing his duties if his principal purpose in making the contract has been “substantially frustrated.” This is not a rule of objective impossibility. It operates even though the parties easily might be able to carry out their contractual duties. The **frustration of purpose**<sup>23</sup> doctrine comes into play when circumstances make the value of one party’s performance virtually worthless to the other. This rule does not permit one party to escape a contract simply because he will make less money than he had planned or because one potential benefit of the contract has disappeared. The purpose that is frustrated must be the core of the contract, known and understood by both parties, and the level of frustration must be severe; that is,

the value of the contract to the party seeking to be discharged must be destroyed or nearly destroyed.

The classic illustration of frustration of purpose is the litigation that gave birth to the rule: the so-called coronation cases. In 1901, when King Edward VII was due to be crowned following the death of Queen Victoria, a parade route was announced for the coronation. Scores of people rented rooms in buildings that lined the streets of the route to watch the grand spectacle. But the king fell ill, and the procession was canceled. Many expectant viewers failed to pay, and the building owners took them to court; many lessees who had paid took the owners to court to seek refunds. The court declared that the lessees were not liable because the purpose of the contract had been frustrated by the king's illness.

Supervening government regulations (though here different from illegality), floods that destroy buildings in which an event was to take place, and business failures may all contribute to frustration of purpose. But there can be no general rule: the circumstances of each case are determinative. Suppose, for example, that a manufacturer agrees to supply a crucial circuit board to a computer maker who intends to sell his machine and software to the government for use in the international space station's ventilation systems. After the contract is made but before the circuit boards are delivered, the government decides to scrap that particular space station module. The computer manufacturer writes the circuit board maker, canceling the contract. Whether the manufacturer is discharged depends on the commercial prospects for the computer and the circuit board. If the circuit board can be used only in the particular computer, and it in turn is only of use on the space station, the duty to take the boards is discharged. But if the computer can be sold elsewhere, or the circuit boards can be used in other computers that the manufacturer makes, it is liable for breach of contract, since its principal purpose—selling computers—is not frustrated.

As before, the parties can provide in the contract that the duty is absolute and that no supervening event shall give rise to discharge by reason of frustration of purpose.

#### KEY TAKEAWAY

The obligations to perform under a contract cannot be dismissed lightly, but a person's duty to perform a contract duty may be discharged if it becomes impossible or very difficult to do it. This includes impossibility, common-law impracticability, commercial impracticability under the UCC, and frustration of purpose.

## EXERCISES

1. If it is possible to perform a contract, why might a party be excused because of frustration of purpose?
2. What is the difference between impractical and impracticable?
3. How would supervening government regulation be different from supervening illegality?

## Other Methods of Discharge

### LEARNING OBJECTIVES

1. Recognize when alteration, power of avoidance, the statute of limitations, and bankruptcy discharge parties from contracts.
2. In addition to performance (or lack of it), agreement of the parties, the happening or nonhappening of conditions, and variations on the theme of impossibility, there are several other ways contract duties may be discharged.

### Cancellation, Destruction, or Surrender

An obligee may unilaterally discharge the obligor's duty toward him by canceling, destroying, or surrendering the written document embodying the contract or other evidence of the duty. No consideration is necessary; in effect, the obligee is making a gift of the right that he possesses. No particular method of cancellation, destruction, or surrender is necessary, as long as the obligee manifests his intent that the effect of his act is to discharge the duty. The entire document can be handed over to the obligor with the words, "Here, you don't owe me anything." The obligee can tear the paper into pieces and tell the obligor that he has done so because he does not want anything more. Or he can mutilate the signatures or cross out the writing.

### Power of Avoidance

A contractual duty can be discharged if the obligor can avoid the contract. As discussed in [Chapter 10 "Real Assent"](#), a contract is either void or can be avoided if one of the parties lacked capacity (infancy, insanity); if there has been duress, undue influence, misrepresentation, or mistake; or the contract is determined to be unconscionable. Where a party has a **power of avoidance**<sup>24</sup> and exercises it, that party is discharged from further obligation.

24. A party's right to terminate performance of a contract—to avoid it (e.g., a minor has power of avoidance).

### Statute of Limitations

When an obligor has breached a contract, the obligee has the right to sue in court for a remedy. But that right does not last forever. Every state has statutes of limitations that establish time periods within which the suit must be brought (different time periods are spelled out for different types of legal wrongs: contract breach, various types of torts, and so on). The time period for contract actions under most statutes of limitations ranges between two and six years. The UCC has a four-year **statute of limitations**<sup>25</sup>. Uniform Commercial Code, Section 2-725. The period begins to run from the day on which the suit could have been filed in court—for example, from the moment of contract breach. An obligee who waits until after the statute has run—that is, does not seek legal relief within the period prescribed by the statute of limitations—is barred from going to court thereafter (unless she is under some incapacity like infancy), but the obligor is not thereby discharged. The effect is simply that the obligee has no legal remedy. If the parties have a continuing relationship, the obligee might be able to recoup—for example, by applying a payment for another debt to the one barred by the statute, or by offsetting a debt the obligee owes to the obligor.

### Bankruptcy

Under the federal bankruptcy laws as discussed in [Chapter 30 "Bankruptcy"](#), certain obligations are discharged once a court declares a debtor to be bankrupt. The law spells out the particular types of debts that are canceled upon bankruptcy.

#### KEY TAKEAWAY

Contract duties may be discharged by cancellation, destruction, or surrender of the written contract; by the running of the statute of limitations; or by bankruptcy.

25. The law stating how long people have to bring a lawsuit after the cause of action arises.

## 15.2 Cases

### Substantial Performance; Conditions Precedent

TA Operating Corp. v. Solar Applications Engineering, Inc.

191 S.W.3d 173 (Tex. Ct. App. 2005)

TA Operating Corporation, a truck stop travel center company, contracted with Solar Applications Engineering, Inc. to construct a prototype multi-use truck stop in San Antonio for a fixed price of \$3,543,233....

[When the project was near] completion, TA sent Solar a “punch list” of items that needed to be finished to complete the building. Solar disputed several items on the list and delivered a response to TA listing the items Solar would correct....Solar began work on the punch list items and filed a lien affidavit [a property that carries a lien can be forced into sale by the creditor in order to collect what is owed] against the project on October 2, 2000 in the amount of \$472,392.77. TA understood the lien affidavit to be a request for final payment.

On October 18, 2000, TA sent notice to Solar that Solar was in default for not completing the punch list items, and for failing to keep the project free of liens. TA stated in the letter that Solar was not entitled to final payment until it completed the remainder of the punch list items and provided documentation that liens filed against the project had been paid....Solar acknowledged at least two items on the punch list had not been completed, and submitted a final application for payment in the amount of \$472,148,77....TA refused to make final payment, however, contending that Solar had not complied with section 14.07 of the contract, which expressly made submission of a [lien-release] affidavit a condition precedent to final payment:...

The final Application for Payment shall be accompanied by:...complete and legally effective releases or waivers...of all lien rights arising out of or liens filed in connection with the work.

Although Solar did not comply with this condition precedent to final payment, Solar sued TA for breach of contract under the theory of substantial performance....TA [asserts that] the doctrine of substantial performance does not

excuse Solar's failure to comply with an express condition precedent to final payment....

The first issue we must resolve is whether the doctrine of substantial performance excuses the breach of an express condition precedent to final payment that is unrelated to completion of the building. TA acknowledges that Solar substantially performed its work on the project, but contends its duty to pay was not triggered until Solar pleaded or proved it provided TA with documentation of complete and legally effective releases or waivers of all liens filed against the project....TA contends that when the parties have expressly conditioned final payment on submission of [a liens-release] affidavit, the owner's duty to pay is not triggered until the contractor pleads or proves it complied with the condition precedent.

Solar contends that although it did not submit [a liens-release] affidavit in accordance with the contract, it may still recover under the contract pursuant to the substantial performance doctrine. Solar argues that to hold otherwise would bring back the common law tradition that the only way for a contractor to recover under a contract is full, literal performance of the contract's terms....

While the common law did at one time require strict compliance with the terms of a contract, this rule has been modified for building or construction contracts by the doctrine of substantial performance. "Substantial performance" was defined by the Texas [court] in [Citation]:

To constitute substantial compliance the contractor must have in good faith intended to comply with the contract, and shall have substantially done so in the sense that the defects are not pervasive, do not constitute a deviation from the general plan contemplated for the work, and are not so essential that the object of the parties in making the contract and its purpose cannot without difficulty, be accomplished by remedying them. Such performance permits only such omissions or deviation from the contract as are inadvertent and unintentional, are not due to bad faith, do not impair the structure as a whole, and are remediable without doing material damage to other parts of the building in tearing down and reconstructing.

...The doctrine of substantial performance recognizes that the contractor has not completed construction, and therefore is in breach of the contract. Under the doctrine, however, the owner cannot use the contractor's failure to complete the work as an excuse for non-payment. "By reason of this rule a contractor who has in good faith substantially performed a building contract is permitted to sue under the contract, substantial performance being regarded as full performance, so far as a condition precedent to a right to recover thereunder is concerned." [Citation]...

Solar argues that by agreeing substantial performance occurred, TA acknowledged that Solar was in “full compliance” with the contract and any express conditions to final payment did not have to be met. [Citation]: “[a] finding that a contract has been substantially completed is the legal equivalent of full compliance, less any offsets for remediable defects.” Solar argues that TA may not expressly provide for substantial performance in its contract and also insist on strict compliance with the conditions precedent to final payment. We disagree. While the substantial performance doctrine permits contractors to sue under the contract, it does not ordinarily excuse the non-occurrence of an express condition precedent:

The general acceptance of the doctrine of substantial performance does not mean that the parties may not expressly contract for literal performance of the contract terms....Stated otherwise, if the terms of an agreement make full or strict performance an express condition precedent to recovery, then substantial performance will not be sufficient to enable recovery under the contract.

15 Williston on Contracts § 44.53 (4th Ed.2000) (citing Restatement (Second) of Contracts, § 237, cmt. d (1981))....

TA, seeking protection from double liability and title problems, expressly conditioned final payment on Solar’s submission of a [liens-release] affidavit. Solar did not dispute that it was contractually obligated to submit the affidavit as a condition precedent to final payment, and it was undisputed at trial that \$246,627.82 in liens had been filed against the project. Though the doctrine of substantial performance permitted Solar to sue under the contract, Solar did not plead or prove that it complied with the express condition precedent to final payment. Had Solar done so, it would have been proper to award Solar the contract balance minus the cost of remediable defects. While we recognize the harsh results occasioned from Solar’s failure to perform this express condition precedent, we recognize that parties are free to contract as they choose and may protect themselves from liability by requesting literal performance of their conditions for final payment....

[T]he trial court erred in awarding Solar the contract balance [as] damages, and we render judgment that Solar take nothing on its breach of contract claim.

## CASE QUESTIONS

1. Why did Solar believe it was entitled to the contract balance here?
2. Why did the court determine that Solar should not have been awarded the contract damages that it claimed, even though it substantially complied?
3. How has the common law changed in regard to demanding strict compliance with a contract?

### Waiver of Contract Rights; Nonwaiver Provisions

Minor v. Chase Auto Finance Corporation

—S.W.3d—, 2010 WL 2006401 (Ark. 2010)

Sheffield, J.

We have been asked to determine whether non-waiver and no-unwritten-modifications clauses in a [contract] preclude a creditor from waiving future strict compliance with the agreement by accepting late payments....

Appellant Mose Minor (Minor) entered into a Simple Interest Motor Vehicle Contract and Security Agreement with Appellee Chase Auto Finance Corporation (Chase) to finance the purchase of a 2003 Toyota Tundra. By the terms of the agreement, Minor was to make sixty-six payments of \$456.99 on the fourteenth of each month....The agreement also included the following relevant provisions:

G. Default: If you...default in the performance of any promise you make in this contract or any other contract you have with us, including, but not limited to, failing to make any payments when due, or become insolvent, or file any proceeding under the U.S. Bankruptcy Code,...we may at our option and without notice or demand (1) declare all unpaid sums immediately due and payable subject to any right of reinstatement as required by law (2) file suit against you for all unpaid sums (3) take immediate possession of the vehicle (4) exercise any other legal or equitable remedy....Our remedies are cumulative and taking of any action shall not be a waiver or prohibit us from pursuing any other remedy. You agree that upon your default we shall be entitled to recover from you our reasonable collection costs, including, but not limited to, any attorney's fee. In addition, if we repossess the vehicle, you grant to us and our agents permission to enter upon any



premises where the vehicle is located. Any repossession will be performed peacefully....

J. Other Agreements of Buyer:...(2) You agree that if we accept moneys in sums less than those due or make extensions of due dates of payments under this contract, doing so will not be a waiver of any later right to enforce the contract terms as written....(12) All of the agreements between us and you are set forth in this contract and no modification of this contract shall be valid unless it is made in writing and signed by you and us....

K. Delay in Enforcement: We can delay or waive enforcement of any of our rights under this contract without losing them.

Minor's first payment was late, as were several subsequent payments. At times he failed to make any payment for months. Chase charged a late fee for each late payment, and sent several letters requesting payment and offering to assist Minor with his account. Chase also warned Minor that continued failure to make payments would result in Chase exercising its legal options available under the agreement, including repossession of the vehicle....At one point, Minor fell so far behind in his payments that Chase was on the verge of repossessing the vehicle. However...the parties agreed to a two-month extension of the agreement....The extension agreement indicated that all other terms and conditions of the original contract would remain the same.

On November 2, 2004, Minor filed for Chapter 7 "Introduction to Tort Law" bankruptcy [after which] Chase sent Minor a letter acknowledging that Minor's debt to Chase had been discharged in bankruptcy. The letter further stated that Chase still had a valid lien on the vehicle, and if Minor wished to keep the vehicle, he would have to continue to make payments to Chase. Otherwise, Chase would repossess the vehicle....

On September 28, 2006, a repossession agent...arrived at Minor's home some time in the afternoon to repossess the vehicle....[Notwithstanding Minor's insistence that the agent stop] the agent removed Minor's possessions from the vehicle and towed it away. Chase sold the vehicle. The amount of the purchase price was reflected on Minor's account....

On January 7, 2008, Minor filed a complaint against Chase [alleging] that, during the course of the contract, the parties had altered the provisions of the contract regarding Chase's right to repossess the vehicle and Chase had waived the right to strictly enforce the repossession clause. Minor further claimed that the

repossession agent committed trespass and repossessed the vehicle forcibly, without Minor's permission, and through trickery and deceit, in violation of [state law]. Also, Minor asserted that he was not in default on his payments, pursuant to the repayment schedule, at the time Chase authorized repossession. Therefore, according to Minor, Chase committed conversion, and breached the Arkansas Deceptive Trade Practices Act [Citation], and enhanced by Arkansas Code Annotated section 4-88-202, because Minor is an elderly person. Minor sought compensatory and punitive damages....

After hearing these arguments, the circuit court ruled that Minor had presented no evidence that the conduct of Chase or the repossession agent constituted grounds for punitive damages; that by the express terms of the contract Chase's acceptance of late payments did not effect a waiver of its rights in the future; that at the time of repossession, Minor was behind in his payments and in breach of the contract; that Chase had the right under the contract to repossess the vehicle and did not commit conversion; and that there was no evidence to support a claim that Chase had violated the Arkansas Deceptive Trade Practices Act....

[W]e affirm our previous decisions that when a contract does not contain a non-waiver and a no-unwritten-modification provision and the creditor has established a course of dealing in accepting late payments from the debtor, the creditor waives its right to insist on strict compliance with the contract and must give notice to the debtor that it will no longer accept late payments before it can declare default of the debt. However, we announce today that, if a contract includes non-waiver and no-unwritten-modification clauses, the creditor, in accepting late payments, does not waive its right under the contract to declare default of the debt, and need not give notice that it will enforce that right in the event of future late payments....

In arriving at this conclusion, we adhere to the principle that "a [contract] is effective according to its terms between the parties."...We have long held that non-waiver clauses are legal and valid. *See* [Citations] Also, [the Arkansas UCC 2-209(2)] declares that no-unwritten-modification provisions are binding.

We acknowledge that there is a difference of opinion amongst the courts in other jurisdictions over the effect of non-waiver and no-unwritten-modification clauses....

We concur with the Supreme Court of Indiana's decision in [Citation], that a rule providing that non-waiver clauses could themselves be waived by the acceptance of late payments is "illogical, since the very conduct which the [non-waiver] clause is designed to permit[,] acceptance of late payment[,] is turned around to constitute waiver of the clause permitting the conduct." We also agree that the approach of jurisdictions that require creditors who have accepted late payments in the past to

notify debtors that they expect strict compliance in the future, despite the existence of a non-waiver provision in the contract, is not “sound.” Such a rule, we recognize, “begs the question of validity of the non-waiver clause.” Finally, our holding is in line with the Indiana Supreme Court’s ruling that it would enforce the provisions of the contract, since the parties had agreed to them, and that it would not require the creditor to give notice, because the non-waiver clause placed the [creditor] in the same position as one who had never accepted a late payment. [Citations]...

Certified question answered; remanded to court of appeals.

### CASE QUESTIONS

1. What is a nonwaiver clause?
2. Why did Mose think his late payments were not grounds for repossession of his truck?
3. Why would a creditor accept late payments instead of immediately repossessing the collateral?
4. Why did Mose lose?

### Impossibility as a Defense

Parker v. Arthur Murray, Inc.

295 N.E.2d 487 (Ill. Ct. App. 1973)

Stamos, J.

The operative facts are not in dispute. In November, 1959 plaintiff went to the Arthur Murray Studio in Oak Park to redeem a certificate entitling him to three free dancing lessons. At that time he was a 37 year-old college-educated bachelor who lived alone in a one-room attic apartment in Berwyn, Illinois. During the free lessons the instructor told plaintiff he had ‘exceptional potential to be a fine and accomplished dancer’ and generally encouraged further participation. Plaintiff thereupon signed a contract for 75 hours of lessons at a cost of \$1000. At the bottom of the contract were the bold-type words, ‘NON-CANCELABLE, NEGOTIABLE CONTRACT.’ This initial encounter set the pattern for the future relationship between the parties. Plaintiff attended lessons regularly. He was praised and encouraged regularly by the instructors, despite his lack of progress. Contract extensions and new contracts for additional instructional hours were executed.

Each written extension contained the bold-type words, 'NON-CANCELABLE CONTRACT,' and each written contract contained the bold-type words, 'NON-CANCELABLE NEGOTIABLE CONTRACT.' Some of the agreements also contained the bold-type statement, 'I UNDERSTAND THAT NO REFUNDS WILL BE MADE UNDER THE TERMS OF THIS CONTRACT.'

On September 24, 1961 plaintiff was severely injured in an automobile collision, rendering him incapable of continuing his dancing lessons. At that time he had contracted for a total of 2734 hours of lessons, for which he had paid \$24,812.80 [about \$176,000 in 2010 dollars]. Despite written demand defendants refused to return any of the money, and this suit in equity ensued. At the close of plaintiff's case the trial judge dismissed the fraud count (Count II), describing the instructors' sales techniques as merely 'a matter of pumping salesmanship.' At the close of all the evidence a decree was entered under Count I in favor of plaintiff for all prepaid sums, plus interest, but minus stipulated sums attributable to completed lessons.

Plaintiff was granted rescission on the ground of impossibility of performance. The applicable legal doctrine is expressed in the Restatement of Contracts, s 459, as follows:

A duty that requires for its performance action that can be rendered only by the promisor or some other particular person is discharged by his death or by such illness as makes the necessary action by him impossible or seriously injurious to his health, unless the contract indicates a contrary intention or there is contributing fault on the part of the person subject to the duty....

Defendants do not deny that the doctrine of impossibility of performance is generally applicable to the case at bar. Rather they assert that certain contract provisions bring this case within the Restatement's limitation that the doctrine is inapplicable if 'the contract indicates a contrary intention.' It is contended that such bold type phrases as 'NON-CANCELABLE CONTRACT,' 'NON-CANCELABLE NEGOTIABLE CONTRACT' and 'I UNDERSTAND THAT NO REFUNDS WILL BE MADE UNDER THE TERMS OF THIS CONTRACT' manifested the parties' mutual intent to waive their respective rights to invoke the doctrine of impossibility. This is a construction which we find unacceptable. Courts engage in the construction and interpretation of contracts with the sole aim of determining the intention of the parties. We need rely on no construction aids to conclude that plaintiff never contemplated that by signing a contract with such terms as 'NON-CANCELABLE' and 'NO REFUNDS' he was waiving a remedy expressly recognized by Illinois courts. Were we also to refer to established tenets of contractual construction, this conclusion would be equally compelled. An ambiguous contract will be construed most strongly against the party who drafted it. [Citation] Exceptions or reservations

in a contract will, in case of doubt or ambiguity, be construed least favorably to the party claiming the benefit of the exceptions or reservations. Although neither party to a contract should be relieved from performance on the ground that good business judgment was lacking, a court will not place upon language a ridiculous construction. We conclude that plaintiff did not waive his right to assert the doctrine of impossibility.

Plaintiff's Count II, which alleged fraud and sought punitive damages, was dismissed by the trial judge at the close of plaintiff's case. It is contended on appeal that representations to plaintiff that he had 'exceptional potential to be a fine and accomplished dancer,' that he had 'exceptional potential' and that he was a 'natural born dancer' and a 'terrific dancer' fraudulently induced plaintiff to enter into the contracts for dance lessons.

Generally, a mere expression of opinion will not support an action for fraud. [Citation] In addition, misrepresentations, in order to constitute actionable fraud, must pertain to present or pre-existing facts, rather than to future or contingent events, expectations or probabilities. [Citation] Whether particular language constitutes speculation, opinion or averment of fact depends upon all the attending facts and circumstances of the case. [Citation] Mindful of these rules, and after carefully considering the representations made to plaintiff, and taking into account the business relationship of the parties as well as the educational background of plaintiff, we conclude that the instructors' representations did not constitute fraud. The trial court correctly dismissed Count II. We affirm.

Affirmed.

### CASE QUESTIONS

1. Why is it relevant that the plaintiff was "a bachelor who lived alone in a one-room attic apartment"?
2. The contract here contained a "no cancellation" clause; how did the court construe the contract to allow cancellation?
3. Plaintiff lost on his claim of fraud (unlike Mrs. Vokes in the similar case in [Chapter 10 "Real Assent"](#) against another franchisee of Arthur Murray, Inc.). What defense was successful?
4. What is the controlling rule of law here?

## 15.3 Summary and Exercises

### Summary

The law of contracts has various rules to determine whether obligations have been discharged. Of course, if both parties have fully performed the contract, duties will have terminated. But many duties are subject to conditions, including conditions precedent and subsequent, conditions requiring approval of the promisee or someone else, and clauses that recite time to be of the essence.

A contract obligation may be discharged if the promisor has not received the benefit of the promisee's obligation. In some cases, failure to carry out the duty completely will discharge the corresponding obligation (material breach); in other cases, the substantial performance doctrine will require the other party to act.

A contract may have terminated because one of the parties tells the other in advance that he will not carry out his obligations; this is called anticipatory breach. The right to adequate assurance allows one party to determine whether the contract will be breached by the other party.

There are other events, too, that may excuse performance: impracticability (including the UCC rules governing impracticability in contracts for the sale of goods), death or incapacity of the obligor, destruction of the thing necessary for the performance, government prohibition, frustration of purpose, and power of avoidance.

Finally, note that not all obligations are created by contract, and the law has rules to deal with discharge of duties in general. Thus, in the appropriate cases, the obligee may cancel or surrender a written contract, may enter into an accord, may agree to rescind the agreement, or may release the obligor. Or the obligor may show a material alteration in the contract, may become bankrupt, or may plead the statute of limitations—that is, plead that the obligee waited too long to sue. Or the parties may, by word or deed, mutually abandon the agreement. In all these ways, duties may be discharged.

## EXERCISES

1. Theresa hired Contractor to construct a large office building. Theresa's duty to pay Contractor was conditioned on receipt of a statement from her architect that the building complied with the terms of the contract. Contractor completed the building but used the wrong color fixtures in the bathrooms. The architect refused to approve the work, but under state law, Contractor was considered to have substantially performed the contract. Is he entitled to payment, less damages for the improper fixtures? Explain.
2. In early 1987, Larry McLanahan submitted a claim to Farmers Insurance for theft of his 1985 Lamborghini while it was on consignment for sale in the Los Angeles area. The car had sustained extensive damage, which McLanahan had his mechanic document. The insurance policy contained this language: "Allow us to inspect and appraise the damaged vehicle before its repair or disposal." But after considerable delay by Farmers, McLanahan sold the car to a cash buyer without notifying Farmers. He then sued Farmers for its refusal to pay for damages to his car. Upon what legal theory did Farmers get a summary judgment in its favor?
3. Plaintiff sold a tavern to Defendants. Several months later, Defendants began to experience severe problems with the septic tank system. They informed Plaintiff of the problem and demanded the return of their purchase money. Plaintiff refused. Defendants took no formal action against Plaintiff at that time, and they continued to operate the tavern and make their monthly payments under the contract. Some months later, Defendants met with state officials from the Departments of Environmental Quality, Health, and Liquor Control Commission. The officials warned Defendants that because of the health hazards posed by the septic tank problems, Defendants' licenses might not be renewed. As a result, Defendants decided to close the tavern and attempt to reopen when the septic tank was repaired. Defendants advertised a going-out-of-business sale. The purpose of the sale was to deplete the tavern's inventory before closing. Plaintiff learned about the sale and discovered that Defendants had removed certain personal property from the tavern. He sued the Defendants, claiming, among other things, that they had anticipatorily breached their contract with him, though he was receiving payments on time. Did the Defendants' actions amount to an anticipatory breach? *Crum v. Grant*, 692 P.2d 147 (Or. App., 1984).
4. Julius, a manufacturer of neckties, contracted to supply neckties to a wholesaler. When Julius's factory burned, he failed to supply any, and the wholesaler sued. Is Julius excused from performance by impossibility?

5. The Plaintiff (a development corporation) contracted to buy Defendant's property for \$1.8 million. A term in the contract read: "The sale...shall be closed at the office of Community Title Company on May 16th at 10:00 am....Time is of the essence in this contract." Defendant appeared at the office at 10:00 a.m. on the day designated, but the Plaintiff's agent was not there. Defendant waited for twenty minutes, then left. Plaintiff's agent arrived at 10:30 a.m. and announced that he would not have funds for payment until 1:30 p.m., but Defendant refused to return; she had already made other arrangements to finance her purchase of other real estate. Plaintiff sued Defendant for specific performance. Who wins, and why?
6. A contract between the Koles and Parker-Yale provided for completion of the Koles's condominium unit within 180 days. It also authorized the Koles to make written changes in the plans and specifications. Construction was not completed within the 180-day period, and the Koles, prior to completion, sent a letter to Parker-Yale rescinding the contract. Were the Koles within their rights to rescind the contract?
7. Plaintiff contracted to buy Defendant's commercial property for \$1,265,000. Under the terms of the agreement, Defendant paid \$126,000 as an earnest-money deposit, which would be retained by Plaintiff as liquidated damages if Defendant failed to close by the deadline. Tragically, Defendant's husband died four days before the closing deadline, and she was not able to close by the deadline. She was relying on her husband's business to assist her in obtaining the necessary financing to complete the purchase, and after his death, she was not able to obtain it. Plaintiff sued for the \$126,000; Defendant argued that the purpose of the contract was frustrated due to the untimely death of her husband. Is this a good argument?
8. Buyer contracted to buy Seller's house for \$290,000; the contract included a representation by Buyer "that he has sufficient cash available to complete this purchase." Buyer was a physician who practiced with his uncle. He had received assurances from his uncle of a loan of \$200,000 in order to finance the purchase. Shortly after the contract was executed, the uncle was examined by a cardiologist, who found his coronary arteries to be dangerously clogged. As a result, the uncle immediately had triple bypass surgery. After the operation, he told Buyer that his economic future was now uncertain and that therefore it was impossible for him to finance the house purchase. Meanwhile, Seller, who did not know of Buyer's problem, committed herself to buy a house in another state and accepted employment there as well. Buyer was unable to close; Seller sued. Buyer raised as a defense impossibility or impracticability of performance. Is the defense good?



9. Pursuant to a contract for the repair and renovation of a swimming pool owned by Defendant (City of Fort Lauderdale), Plaintiff commenced the work, which included resurfacing the inside of the pool, and had progressed almost to completion. Overnight, vandals damaged the work Plaintiff had done inside the pool, requiring that part of the work be redone. Plaintiff proceeded to redo the work and billed Defendant, who paid the contract price but refused to pay for the additional work required to repair the damage. Did the damage constitute destruction of subject matter discharging Plaintiff from his obligation to complete the job without getting paid extra?
10. Apache Plaza (the landlord) leased space to Midwest Savings to construct a bank building in Apache's shopping mall, based on a prototype approved by Apache. Midwest constructed the building and used it for twelve years until it was destroyed by a tornado. Midwest submitted plans for a new building to Apache, but Apache rejected the plans because the new building was larger and had less glass than the old building or the prototype. Midwest built it anyway. Its architect claimed that certain changes in the structure of the new building were required by new regulations and building codes, but he admitted that a building of the stipulated size could have been constructed in compliance with the applicable codes. Apache claimed \$210,000 in damages over the term of the lease because the new building consumed more square feet of mall space and required more parking. Midwest claimed it had substantially complied with the lease requirements. Is this a good defense? *Apache Plaza, Ltd. v. Midwest Sav. Ass'n*, 456 N.W.2d 729 (Minn. App. 1990).

## SELF-TEST QUESTIONS

1. A condition precedent
  - a. is a condition that terminates a duty
  - b. is always within the control of one of the parties
  - c. is an event giving rise to performance
  - d. is a condition that follows performance
  
2. If Al and Betty have an executory contract, and if Betty tells Al that she will not be fulfilling her side of the bargain,
  - a. Al must wait until the date of performance to see if Betty in fact performs
  - b. Al can sue immediately for full contract damages
  - c. Al can never sue because the contract was executory when Betty notified him of nonperformance
  - d. none of the above
  
3. Jack contracts with Anne to drive her to the airport Wednesday afternoon in his specially designed stretch limousine. On Wednesday morning Jack's limousine is hit by a drunken driver, and Jack is unable to drive Anne. This is an example of
  - a. impossibility of performance
  - b. frustration of purpose
  - c. discharge by merger
  - d. none of the above
  
4. Jack is ready and willing to drive Anne to the airport. But Anne's flight is cancelled, and she refuses to pay. This is an example of
  - a. impracticability of performance
  - b. frustration of purpose
  - c. discharge of merger
  - d. none of the above
  
5. Rescission is

- a. the discharge of one party to a contract through substitution of a third person
- b. an agreement to settle for substitute performance
- c. a mutual agreement between parties to a contract to discharge each other's contractual duties
- d. none of the above

#### SELF-TEST ANSWERS

- 1. c
- 2. b
- 3. a
- 4. b
- 5. c

# Chapter 16

## Remedies

### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The basic theory of contract remedies, and why courts don't just order the promisor to perform as promised
2. The interests that are protected by contract remedies
3. The types of legal remedies
4. The types of equitable remedies
5. The limitations on remedies

We come at last to the question of remedies. A valid agreement has been made, the promisor's duties have not been discharged; he or she has breached the contract. When one party has failed to perform, what are the rights of the parties? Or when the contract has been avoided because of incapacity or misrepresentation and the like, what are the rights of the parties after disaffirmance? These questions form the focus of this chapter. Remedies for breach of contracts for the sale of goods will be considered separately, in [Chapter 18 "Title and Risk of Loss"](#).

## 16.1 Theory of Contract Remedies

### LEARNING OBJECTIVES

1. Understand the basic purpose of remedies.
2. Recognize that there are two general categories of remedies: legal and equitable.
3. See that courts do not simply order obligors to keep their promise but instead allow them to breach and the nonbreaching party to have remedies for that breach.

### Purpose of Remedies

The fundamental purpose of remedies in noncriminal cases is not to punish the breaching party but—if possible—to put the nonbreaching party in the position he or she would have been in had there been no breach. Or, as is said, the purpose is to make the nonbreaching party whole.

There are two general categories of remedies—legal and equitable. In the category of legal remedies are **damages**<sup>1</sup>. Damages are money paid by one party to another; there are several types of damages. In the category of equitable remedies are these three: **specific performance**<sup>2</sup>, which means a person is ordered to deliver a unique thing (land or a unique personal property, such as a painting or an antique car); **injunction**<sup>3</sup>, a judicial order directing a person to stop doing what he or she should not do (such as competing with a former employer in violation of a noncompete agreement); and **restitution**<sup>4</sup>, which means putting the parties back into the position they were in before the contract was made.

1. Money paid by one party to another to satisfy a liability.
2. An order directing a person to deliver the unique thing contracted for by the other party.
3. A judicial order directing a person to stop doing that which he or she should not do.
4. Restoration; returning goods or money to put the nonbreaching party in the condition as if the contract had not been made.

### Parties Have the Power—but Not the Right—to Breach

In view of the importance given to the intention of the parties in forming and interpreting contracts, it may seem surprising that the remedy for every breach is not a judicial order that the obligor carry out his or her undertakings. But it is not. Of course, some duties cannot be performed after a breach, because time and circumstances will have altered their purpose and rendered many worthless. Still, there are numerous occasions on which it would be theoretically possible for courts to order the parties to carry out their contracts, yet the courts will not do it. In 1897, Justice Oliver Wendell Holmes Jr. declared in a famous line that “the duty to keep a contract at common law means a prediction that you must pay damages if

you do not keep it.” By that, he meant simply that the common law looks more toward compensating the promisee for his or her loss than toward compelling the promisor to perform. Indeed, the law of remedies often provides the parties with an incentive to break the contract. In short, the promisor has a choice: perform or pay.

The logic of this position is clear in many typical cases. The computer manufacturer orders specially designed circuit boards, then discovers before the circuits are made that a competitor has built a better machine and destroyed his market. The manufacturer cancels the order. It would make little economic sense for the circuit board maker to fabricate the boards if they could not be used elsewhere. A damage remedy to compensate the maker for out-of-pocket loss or lost profits is sensible; a judicial decree forcing the computer manufacturer to pay for and take delivery of the boards would be wasteful.

In general and if possible, the fundamental purpose of contract remedies is to put the nonbreaching party in the position it would have been in had there been no breach.

#### KEY TAKEAWAY

Remedies are intended to make the nonbreaching party whole. The two categories of remedies for breach of contract are legal and equitable. In the legal category are damages; in the equitable category are specific performance, injunctions, and restitution. The law does not force a party to perform; he or she always has the power (though not the right) to breach, and may do so if it is economically more advantageous to breach and suffer the consequence than to perform. Remedies, though, are not (usually) intended to punish the breaching party.

#### EXERCISES

1. Remedies are not supposed to punish the breaching party, generally. In what circumstances might punishment be a remedy, and what is that called?
2. What is the difference between legal and equitable remedies?
3. Why shouldn't people be forced to perform as they contracted, instead of giving them the power to breach and then be required to pay damages?

## 16.2 Promisee's Interests Protected by Contract

### LEARNING OBJECTIVE

1. Understand that the nonbreaching party to a contract has certain expectations that contract remedies seek to fulfill to make the nonbreaching party whole.

Contract remedies serve to protect three different interests: an expectation interest, a reliance interest, and a restitution interest. A promisee will have one of these and may have two or all three.

An **expectation interest**<sup>5</sup> is the benefit for which the promisee bargained, and the remedy is to put him in a position as good as that which he would have been in had the contract been performed. A **reliance interest**<sup>6</sup> is the loss suffered by relying on the contract and taking actions consistent with the expectation that the other party will abide by it; the remedy is reimbursement that restores the promisee to his position before the contract was made. A **restitution interest**<sup>7</sup> is that which restores to the promisee any benefit he conferred on the promisor. These interests do not dictate the outcome according to a rigid formula; circumstances and the nature of the contract, as usual, will play a large role. But in general, specific performance is a remedy that addresses the expectation interest, monetary damages address all three interests, and, not surprisingly, restitution addresses the restitution interest.

5. The interest of a party to a breached contract in receiving the benefit of the bargain by being put in a position as good as he or she would have been in had there been no breach.

6. Compensation for the nonbreaching party as a consequence of relying on the breaching party's promise to perform.

7. The nonbreaching party's interest in being returned to the position it would have been in had the promises never been made. Where this is not possible, then restitution disgorges any unjust enrichment.

Consider some simple examples. A landowner repudiates an executory contract with a builder to construct a garage on her property for \$100,000. The builder had anticipated a \$10,000 profit (the garage would have cost him \$90,000 to build). What can he expect to recover in a lawsuit against the owner? The court will not order the garage to be built; such an order would be wasteful, since the owner no longer wants it and may not be able to pay for it. Instead, the court will look to the builder's three possible interests. Since the builder has not yet started his work, he has given the owner nothing, and therefore has no restitution interest. Nor has he any reliance interest, since we are assuming that he has not paid out any money for supplies, hired a work crew, or advanced money to subcontractors. But he anticipated a profit, and so he has an expectation interest of \$10,000.

Now suppose that the builder had dug out the foundation and poured concrete, at a cost of \$15,000. His expectation interest has become \$25,000 (the difference

between \$100,000 and \$75,000, the money he will save by not having to finish the job). His reliance interest is \$15,000, because this is the amount he has already spent. He may also have a restitution interest, depending on how much the foundation of the house is worth to the owner. (The value could be more or less than the sum of money actually expended to produce the foundation; for example, the builder might have had to pay his subcontractors for a greater share of the job than they had completed, and those sums therefore would not be reflected in the worth of the foundation.)

Normally, the promisee will choose which of the three interests to pursue. As is to be expected, the choice hinges on the circumstances of the case, his feelings, and the amount at stake.

#### KEY TAKEAWAY

A nonbreaching party might have one or more interests that the law seeks to realize: expectation, reliance, and restitution.

#### EXERCISES

1. What is the expectation interest? The reliance interest? The restitution interest?
2. How are these concepts useful in understanding contract remedies?



## 16.3 Legal Remedies: Damages

### LEARNING OBJECTIVES

1. Understand what is meant when it is said that damages are a legal remedy (as opposed to an equitable remedy).
2. Understand the names and purposes of the six types of remedies.
3. Know when liquidated damages will be allowed.
4. Recognize the circumstances that might allow punitive damages.

### Overview

The promisee, whom we will hereafter refer to as the nonbreaching party, has the right to damages (a money award), if that is required to make her whole, whenever the other party has breached the contract, unless, of course, the contract itself or other circumstances suspend or discharge that right. **Damages** refers to money paid by one side to the other; it is a legal remedy. For historical and political reasons in the development of the English legal system, the courts of law were originally only able to grant monetary relief. If a petitioner wanted something other than money, recourse to a separate system of equity was required. The courtrooms and proceedings for each were separate. That actual separation is long gone, but the distinction is still recognized; a judge may be said to be “sitting in law” or “sitting in equity,” or a case may involve requests for both money and some action. We take up the legal remedies of damages first.

### Types of Damages

There are six different types of damages: compensatory, incidental, consequential, nominal, liquidated, and (sometimes) punitive.

### Compensatory Damages

Damages paid to directly compensate the nonbreaching party for the value of what was not done or performed are **compensatory damages**<sup>8</sup>. Sometimes calculating that value of the promisor’s performance is easy—for example, when the nonbreaching party has ascertainable costs and profits, as in the case of the builder who would have earned \$10,000 profit on a \$100,000 house. When the performance is a service, a useful measure of loss is what it would cost to substitute performance by someone else. But the calculation is frequently difficult, especially when the

8. In contract, damages paid to compensate the nonbreaching party for the direct loss suffered.

performance is a service that is not easily duplicated. If Rembrandt breached a contract to paint your portrait, the loss could not be measured simply by inquiring how much Van Gogh would charge to do the same thing. Nevertheless, in theory, whatever net value would ultimately have been conferred on the nonbreaching party is the proper measure of compensatory damages. An author whose publisher breaches its contract to publish the book and who cannot find another publisher is entitled to lost royalties (if ascertainable) plus the value that would have accrued from her enhanced reputation.

Since the nonbreaching party usually has obligations under the contract also, a breach by the other party discharges his duty to perform and may result in savings. Or he may have made substitute arrangements and realized at least a partial profit on the substitution. Or, as in the case of the builder, he may have purchased goods intended for the job that can be used elsewhere. In all these situations, the losses he has avoided—savings, profits, or value of goods—are subtracted from the losses incurred to arrive at the net damages. The nonbreaching party may recover his actual losses, not more. Suppose an employer breaches a contract with a prospective employee who was to begin work for a year at a salary of \$35,000. The employee quickly finds other, similar work at a salary of \$30,000. Aside from whatever he might have had to spend searching for the job (incidental damages), his compensatory damages are limited to \$5,000, the difference between what he would have earned and what he is earning.

**Lost volume**<sup>9</sup> can be a troublesome problem in calculating damages. This problem arises when the nonbreaching party, a supplier of goods or services, enters a second contract when the buyer repudiates. The question is whether the second contract is a substituted performance or an additional one. If it is substituted, damages may be little or nothing; if additional, the entire expectation interest may be recovered. An automobile dealer contracts to sell a car in his inventory. Shortly before the deal is closed, the buyer calls up and repudiates the contract. The dealer then sells the car to someone else. If the dealer can show that he could have sold an identical car to the second purchaser regardless of what the first purchaser did, then the second sale stands on its own and cannot be used to offset the net profit recoverable from the first purchaser. The factual inquiry in lost volume cases is whether the nonbreaching party would have engaged in the second transaction if the breach had never occurred.

9. Damages for loss of profits on an item of inventory.

10. Compensation for commercially reasonable expenses incurred as a result of the other party's breach.

### **Incidental Damages**

In addition to compensatory damages, the nonbreaching party may recover **incidental damages**<sup>10</sup>. Incidental loss includes expenditures that the nonbreaching party incurs in attempting to minimize the loss that flows from the breach. To

arrange for substitute goods or services, the nonbreaching party might have to pay a premium or special fees to locate another supplier or source of work.

### Consequential Damages

A consequential loss is addressed with **consequential damages**<sup>11</sup>. These are damages incurred by the nonbreaching party without action on his part because of the breach. For example, if Ralph does a poor job of plumbing Betty's bathroom and the toilet leaks, damaging the floor, the downstairs ceiling, and the downstairs rug, Ralph would owe for those losses in consequential damages. Or, again, lost sales stemming from a failure to fix a manufacturer's machine in time or physical and property injury due to a defective machine sold by the promisor would be addressed with consequential damages. Note, however, that one obvious, and often large, expenditure occasioned by a breach—namely, legal expenses in bringing a lawsuit to remedy the particular breach—is not an element of damages, unless the contract explicitly states that it is, and cannot be charged to the defendant. There is one situation, however, in which legal costs can be added to damages: when the breach causes the nonbreaching party to be involved in a lawsuit with someone else. Consequential damages will not be allowed if those damages are not foreseeable. This issue is taken up in [Section 16.5 "Limitations on Contract Remedies"](#).

### Nominal Damages

In the situation where there has been a breach but the nonbreaching party has really suffered no loss or cannot prove what his loss is, he is entitled to **nominal damages**<sup>12</sup>. Ricardo contracts to buy a new car from a dealer; the dealer breaches the contract. Ricardo finds and buys the same car from another dealer at the same price that the first one was to sell it for. Ricardo has suffered nominal damages: five dollars, perhaps.

### Liquidated Damages

Precisely because damages are sometimes difficult to assess, the parties themselves may specify how much should be paid in the event of a breach. Courts will enforce a **liquidated damages**<sup>13</sup> provision as long as the actual amount of damages is difficult to ascertain (in which case proof of it is simply made at trial) and the sum is reasonable in light of the expected or actual harm. If the liquidated sum is unreasonably large, the excess is termed a penalty and is said to be against public policy and unenforceable. [Section 16.6.2 "Liquidated Damages"](#), *Watson v. Ingram*, illustrates liquidated damages.

11. Those losses or injuries which are a result of a breach of contract but are not direct and immediate.
12. Damages in name only, as where actual damages are nonexistent or cannot be proved.
13. Damages agreed to in the contract that are payable in case of breach.

## Punitive Damages

**Punitive damages**<sup>14</sup> are those awarded for the purpose of punishing a defendant in a civil action, in which criminal sanctions are of course unavailable. They are proper in cases in which the defendant has acted willfully and maliciously and are thought to deter others from acting similarly. Since the purpose of contract law is compensation, not punishment, punitive damages have not traditionally been awarded, with one exception—when the breach of contract is also a tort for which punitive damages may be recovered. Punitive damages are permitted in the law of torts (in all but four states) when the behavior is malicious or willful (reckless conduct causing physical harm, deliberate defamation of one’s character, a knowingly unlawful taking of someone’s property), and some kinds of contract breach are also tortious. For example, when a creditor holding collateral as security under a contract for a loan sells the collateral to a good-faith purchaser for value even though the debtor was not in default, he has breached the contract and committed the tort of conversion; punitive damages may be awarded, assuming the behavior was willful and not merely mistaken.

Punitive damages are not fixed by law. The judge or jury may award at its discretion whatever sum is believed necessary to redress the wrong or deter like conduct in the future. This means that a richer person may be slapped with much heavier punitive damages than a poorer one in the appropriate case. But the judge in all cases may remit (reduce) some or all of a punitive damage award if he or she considers it excessive.

### KEY TAKEAWAY

As the purpose of contract remedies is, in general, to make the nonbreaching party whole, the law allows several types of damages (money paid) to reflect the losses suffered by the nonbreaching party. Compensatory damages compensate for the special loss suffered; consequential damages compensate for the foreseeable consequences of the breach; incidental damages compensate for the costs of keeping any more damages from occurring; nominal damages are awarded if the actual amount cannot be shown or there are no actual damages; liquidated damages are agreed to in advance where the actual amount is difficult to ascertain, and they are allowed if not a penalty; and punitive damages may sometimes be allowed if the breaching party’s behavior is an egregious tort, an outrage.

14. Damages to punish the breaching party.

## EXERCISES

1. What is the difference between a legal remedy and an equitable remedy?
2. What types of remedies are there, and what purpose does each serve?
3. What must be shown if liquidated damages are to be allowed?
4. Under what circumstances may punitive damages be allowed?

## 16.4 Equitable Remedies

### LEARNING OBJECTIVES

1. Know when equitable (as opposed to legal) remedies will be allowed.
2. Understand the different types of equitable remedies: specific performance, injunction, and restitution.

### Overview

Really the only explanation for the differences between law and equity is to be found in the history and politics of England dating to the twelfth century, but in practical terms, the distinctions are notable. First, juries are not used in equitable cases. Second, equity relies less on precedent and more on the sense that justice should be served. Third, and of most significance, where what is sought by the nonbreaching party is not money—that is, where there is no adequate legal remedy—equity may afford relief. In equity a person may get a judge to order the breaching party to deliver some actual property, or to stop doing something that he should not do, or to return the consideration the nonbreaching party gave so as to return the parties to the precontract status (specific performance, injunction, and restitution, respectively).

### Types of Remedies in Equity

There are three types of equitable remedies: specific performance, injunction, and restitution.

#### Specific Performance

**Specific performance** is a judicial order to the promisor that he undertake the performance to which he obligated himself in a contract. Specific performance is an alternative remedy to damages and may be issued at the discretion of the court, subject to a number of exceptions. Emily signs a contract to sell Charlotte a gold samovar, a Russian antique of great sentimental value because it once belonged to Charlotte's mother. Emily then repudiates the contract while still executory. A court may properly grant Charlotte an order of specific performance against Emily.

Once students understand the basic idea of specific performance, they often want to pounce upon it as the solution to almost any breach of contract. It seems reasonable

that the nonbreaching party could ask a court to simply require the promisor to do what she promised she would. But specific performance is a very limited remedy: it is *only* available for breach of contract to sell a unique item, that is, a unique item of personal property (the samovar), or a parcel of real estate (all real estate is unique). But if the item is not unique, so that the nonbreaching party can go out and buy another one, then the legal remedy of money damages will solve the problem. And specific performance will never be used to force a person to perform services against his will, which would be involuntary servitude. A person may be forced to stop doing that which he should not do (injunction), but not forced to do what he will not do.

### **Injunction**

An **injunction** is the second type of equitable remedy available in contract (it is also available in tort). It is a court order directing a person to stop doing that which she should not do. For example, if an employer has a valid noncompete contract with an employee, and the employee, in breach of that contract, nevertheless undertakes to compete with his former employer, a court may enjoin (issue an order of injunction), directing the former employee to stop such competition. A promise by a person not to do something—in this example, not to compete—is called a **negative covenant** (a covenant is a promise in a contract, itself a contract). Or if Seller promises to give Buyer the right of first refusal on a parcel of real estate or a unique work of art, but Seller, in breach of a written promise, offers the thing to a third party, a court may enjoin Seller from selling it to the third party. If a person violates an injunction, he may be held in contempt of court and put in jail for a while. *Madison Square Garden v. Carnera Corporation*, [Section 16.6.3 "Injunctions and Negative Covenants"](#), is a classic case involving injunctions for breach of contract.

### **Restitution**

The third type of equitable relief is **restitution**. Restitution is a remedy applicable to several different types of cases: those in which the contract was avoided because of incapacity or misrepresentation, those in which the other party breached, and those in which the party seeking restitution breached. As the word implies, *restitution* is a restoring to one party of what he gave to the other. Therefore, only to the extent that the injured party conferred a benefit on the other party may the injured party be awarded restitution. The point is, a person who breaches a contract should not suffer a punishment, and the nonbreaching party should not be unjustly enriched.

### **Total Nonperformance by Breaching Party**

The nonbreaching party is always entitled to restitution in the event of total breach by nonperformance or repudiation, unless both parties have performed all duties except for payment by the other party of a definite sum of money for the injured party's performance. Restatement (Second) of Contracts, Section 373. Calhoun, a contractor, agrees to build \$3,000 worth of fences for only \$2,000 and completes the construction. Arlene, the landowner, refuses to pay. Calhoun's only right is to get the \$2,000; he does not have a restitution right to \$2,500, the market price of his services (or \$3,000, the amount by which her property increased in value); he is entitled, instead, only to \$2,000, his contract price. Had Arlene repudiated prior to completion, however, Calhoun would then have been entitled to restitution based either on the market price of the work or on the amount by which he enhanced her property. If the one party breaches, the nonbreaching party is generally entitled to restitution of property that can be returned. Arlene gives Calhoun a valuable Ming vase in return for his promise to construct the fences. Upon Calhoun's breach, Arlene is entitled to specific restitution of the vase.

Measuring restitution interest can be problematic. The courts have considerable discretion to award either what it would have cost to hire someone else to do the work that the nonbreaching party performed (generally, the market price of the service) or the value that was added to the property of the party in breach by virtue of the claimant's performance. Calhoun, the contractor, agrees to construct ten fences around Arlene's acreage at the market price of \$25,000. After erecting three, Calhoun has performed services that would cost \$7,500, market value. Assume that he has increased the value of Arlene's grounds by \$8,000. If Arlene repudiated, there are two measures of Calhoun's restitution interest: \$8,000, the value by which the property was enhanced, or \$7,500, the amount it would have cost Arlene to hire someone else to do the work. Which measure to use depends on who repudiated the contract and for what reason. In some cases, the enhancement of property or wealth measurement could lead to an award vastly exceeding the market price for the service. In such cases, the smaller measure is used. For a doctor performing lifesaving operations on a patient, restitution would recover only the market value of the doctor's services—not the monetary value of the patient's life.

### **Part Performance and Then Breach**

A party who has substantially performed and then breached is entitled to restitution of a benefit conferred on the injured party, if the injured party has refused (even though justifiably) to complete his own performance owing to the other's breach. Since the party in breach is liable to the injured party for damages for loss, this rule comes into play only when the benefit conferred is greater than the amount the nonbreaching party has lost. Arlene agrees to sell her property to



Calhoun for \$120,000, and Calhoun makes a partial payment of \$30,000. He then repudiates. Arlene turns around and sells the property to a third party for \$110,000. Calhoun—the breaching party—can get his money back, less the damages Arlene suffered as a result of his breach. He gets \$30,000 minus the \$10,000 loss Arlene incurred. He gets \$20,000 in restitution. Otherwise Arlene would be enriched by Calhoun’s breach: she’d get \$140,000 in total for real estate worth \$120,000. But if he gets \$20,000 of his \$30,000 back, she receives \$110,000 from the third party and \$10,000 from Calhoun, so she gets \$120,000 total (plus, we hope, incidental damages, at least).

### Restitution in Other Cases

Upon repudiation of an oral contract governed by the Statute of Frauds, the nonbreaching party is not entitled to her expectation interest, but she may recover in restitution unless the purpose of the statute would be frustrated. When one party avoids a contract owing to lack of capacity, mistake, misrepresentation, duress, or the like, she is entitled to restitution for benefit conferred on the other party. Restitution is also available if a contract duty is discharged or never arises because (1) performance was impracticable, (2) the purpose of the contract was frustrated, (3) a condition did not occur, or (4) a beneficiary disclaimed his benefit.

#### KEY TAKEAWAY

Equitable remedies for breach of contract are available when legal remedies won’t make the nonbreaching party whole. The equitable remedies are specific performance (an order directing a person to deliver to the buyer the unique thing the seller contracted to sell), injunction (an order directing a person to stop doing that which he should not do), and restitution (the return by one party of the benefit conferred on him when the contract is not performed, to the extent necessary to avoid imposing a penalty on the breaching party).

## EXERCISES

1. Buyer contracts to buy a 1941 four-door Cadillac convertible from Seller for \$75,000. Seller, having found a Third Party who will pay \$85,000 for the car, refuses to sell to Buyer. What is Buyer's remedy?
2. Assume Third Party had paid the \$85,000 and Seller was ordered to sell to Buyer. What is Third Party's remedy?
3. Professor Smith contracts to teach business law at State University for the academic year. After the first term is over, she quits. Can State University get an order of specific performance or an injunction requiring Professor Smith to return for the second term?
4. Now suppose that the reason Professor Smith quit work at State University is because she got a better job at Central University, fifteen miles away. Can State University get an injunction prohibiting her from teaching at Central University?

## 16.5 Limitations on Contract Remedies

### LEARNING OBJECTIVES

1. Understand that there are various rules that limit recovery for the nonbreaching party in a contract case.
2. Know how these concepts serve to limit contract remedies: foreseeability, mitigation of damages, certainty of damages, loss of power of avoidance, election of remedies, and agreement of the parties.

### Overview

We have observed that the purpose of remedies in contract law is, where possible, to put the nonbreaching party in as good a position as he would have been in had there been no breach. There are, however, several limitations or restrictions affecting when a person can claim remedies, in both law (damages) and equity. Of course the contract itself may—if not unconscionable—limit remedies. Beyond that, the nonbreaching party must be able to articulate with some degree of certainty what her damages are; the damages must be foreseeable; the nonbreaching party must have made a reasonable effort to mitigate the damages; she must sometime elect to go with one remedy and forgo another; she cannot seek to avoid a contract if she has lost the power to do so. We turn to these points.

### Foreseeability

If the damages that flow from a breach of contract lack **foreseeability**<sup>15</sup>, they will not be recoverable. Failures to act, like acts themselves, have consequences. As the old fable has it, “For want of a nail, the kingdom was lost.” To put a nonbreaching party in the position he would have been in had the contract been carried out could mean, in some cases, providing compensation for a long chain of events. In many cases, that would be unjust, because a person who does not anticipate a particular event when making a contract will not normally take steps to protect himself (either through limiting language in the contract or through insurance). The law is not so rigid; a loss is not compensable to the nonbreaching party unless the breaching party, at the time the contract was made, understood the loss was foreseeable as a probable result of his breach.

15. In contract, the requirement that damages from a breach be proximately caused by the breach.

Of course, the loss of the contractual benefit in the event of breach is always foreseeable. A company that signs an employment contract with a prospective

employee knows full well that if it breaches, the employee will have a legitimate claim to lost salary. But it might have no reason to know that the employee's holding the job for a certain length of time was a condition of his grandfather's gift of \$1 million.

The leading case, perhaps the most studied case, in all the common law is *Hadley v. Baxendale*, decided in England in 1854. Joseph and Jonah Hadley were proprietors of a flour mill in Gloucester. In May 1853, the shaft of the milling engine broke, stopping all milling. An employee went to Pickford and Company, a common carrier, and asked that the shaft be sent as quickly as possible to a Greenwich foundry that would use the shaft as a model to construct a new one. The carrier's agent promised delivery within two days. But through an error, the shaft was shipped by canal rather than by rail and did not arrive in Greenwich for seven days. The Hadleys sued Joseph Baxendale, managing director of Pickford, for the profits they lost because of the delay. In ordering a new trial, the Court of Exchequer ruled that Baxendale was not liable because he had had no notice that the mill was stopped:

Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, i.e., according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it. *Hadley v. Baxendale* (1854), 9 Ex. 341, 354, 156 Eng.Rep. 145, 151.

Thus when the party in breach has not known and has had no reason to know that the contract entailed a special risk of loss, the burden must fall on the nonbreaching party. As we have seen, damages attributable to losses that flow from events that do not occur in the ordinary course of events are known as consequential or special damages. The exact amount of a loss need not be foreseeable; it is the nature of the event that distinguishes between claims for ordinary or consequential damages. A repair shop agrees to fix a machine that it knows is intended to be resold. Because it delays, the sale is lost. The repair shop, knowing why timeliness of performance was important, is liable for the lost profit, as long as it was reasonable. It would not be liable for an extraordinary profit that the seller could have made because of circumstances peculiar to the particular sale unless they were disclosed.

The special circumstances need not be recited in the contract. It is enough for the party in breach to have actual knowledge of the loss that would occur through his breach. Moreover, the parol evidence rule ([Chapter 13 "Form and Meaning"](#)) does

not bar introduction of evidence bearing on the party's knowledge before the contract was signed. So the lesson to a promisee is that the reason for the terms he bargains for should be explained to the promisor—although too much explanation could kill a contract. A messenger who is paid five dollars to deliver a letter across town is not likely to undertake the mission if he is told in advance that his failure for any reason to deliver the letter will cost the sender \$1 million, liability to be placed on the messenger.

Actual knowledge is not the only criterion, because the standard of foreseeability is objective, not subjective. That means that if the party had reason to know—if a reasonable person would have understood—that a particular loss was probable should he breach, then he is liable for damages. What one has reason to know obviously depends on the circumstances of the case, the parties' prior dealings, and industry custom. A supplier selling to a middleman should know that the commodity will be resold and that delay or default may reduce profits, whereas delay in sale to an end user might not. If it was foreseeable that the breach might cause the nonbreaching party to be sued, the other party is liable for legal fees and a resulting judgment or the cost of a settlement.

Even though the breaching party may have knowledge, the courts will not always award full consequential damages. In the interests of fairness, they may impose limitations if such an award would be manifestly unfair. Such cases usually crop up when the parties have dealt informally and there is a considerable disproportion between the loss caused and the benefit the nonbreaching party had agreed to confer on the party who breached. The messenger may know that a huge sum of money rides on his prompt delivery of a letter across town, but unless he explicitly contracted to bear liability for failure to deliver, it is unlikely that the courts would force him to ante up \$1 million when his fee for the service was only five dollars.

*EBWS, LLC v. Britly Corp.*, [Section 16.6.1 "Consequential Damages"](#), is a case that represents a modern application of the rule of *Hadley v. Baxendale* on the issue of foreseeability of consequential damages.

## Mitigation of Damages

Contract law encourages the nonbreaching party to avoid loss wherever possible; this is called **mitigation of damages**<sup>16</sup>. The concept is a limitation on damages in law. So there can be no recovery if the nonbreaching party had an opportunity to avoid or limit losses and failed to take advantage of it. Such an opportunity exists as long as it does not impose, in the Restatement's words, an "undue risk, burden or humiliation." Restatement (Second) of Contracts, Section 350. The effort to mitigate

16. The plaintiff's duty to take reasonable steps to minimize his or her damages or losses and to attempt to prevent further damage.

need not be successful. As long as the nonbreaching party makes a reasonable, good-faith attempt to mitigate his losses, damages are recoverable.

Mitigation crops up in many circumstances. Thus a nonbreaching party who continues to perform after notice that the promisor has breached or will breach may not recover for expenses incurred in continuing to perform. And losses from the use of defective goods delivered in breach of contract are not compensable if the nonbreaching party knew before use that they were defective. Often the nonbreaching party can make substitute arrangements—find a new job or a new employee, buy substitute goods or sell them to another buyer—and his failure to do so will limit the amount of damages he will recover from the party who breaches. Under the general rule, failure to mitigate when possible permits the promisor to deduct from damages the amount of the loss that the nonbreaching party could have avoided. When there is a readily ascertainable market price for goods, damages are equal to the difference between the contract price and the market price.

A substitute transaction is not just any possible arrangement; it must be suitable under the circumstances. Factors to be considered include the similarity, time, and place of performance, and whether the difference between the contracted-for and substitute performances can be measured and compensated. A prospective employee who cannot find substitute work within her field need not mitigate by taking a job in a wholly different one. An advertising salesperson whose employment is repudiated need not mitigate by taking a job as a taxi driver. When the only difference between the original and the substitute performances is price, the nonbreaching party must mitigate, even if the substitute performer is the original promisor.

The nonbreaching party must mitigate in timely fashion, but each case is different. If it is clear that the promisor has unconditionally repudiated before performance is due, the nonbreaching party must begin to mitigate as soon as practicable and should not wait until the day performance is due to look for an alternative.

As long as the nonbreaching party makes a reasonable effort to mitigate, the success of that effort is not an issue in assessing damages. If a film producer's original cameraman breaches the contract, and if the producer had diligently searched for a substitute cameraman, who cost \$150 extra per week and it later came to light that the producer could have hired a cameraman for \$100, the company is entitled nevertheless to damages based on the higher figure. *Shirley MacLaine v. Twentieth Century-Fox Corporation*, [Section 16.6.4 "Limitation on Damages: Mitigation of Damages"](#), is a well-known case involving mitigation of damages.

## Certainty of Damages

A party can recover only that amount of damage in law which can be proved with reasonable certainty. Especially troublesome in this regard are lost profits and loss of goodwill. Alf is convinced that next spring the American public will be receptive to polka-dotted belts with his name monogrammed in front. He arranges for a garment factory to produce 300,000 such belts, but the factory, which takes a large deposit from him in advance, misplaces the order and does not produce the belts in time for the selling season. When Alf discovers the failure, he cannot raise more money to go elsewhere, and his project fails. He cannot recover damages for lost profits because the number is entirely speculative; no one can prove how much he would have made, if anything. He can, instead, seek restitution of the monies advanced. If he had rented a warehouse to store the belts, he would also be able to recover his reliance interest.

Proof of lost profits is not always difficult: a seller can generally demonstrate the profit he would have made on the sale to the buyer who has breached. The problem is more difficult, as Alf's case demonstrates, when it is the seller who has breached. A buyer who contracts for but does not receive raw materials, supplies, and inventory cannot show definitively how much he would have netted from the use he planned to make of them. But he is permitted to prove how much money he has made in the past under similar circumstances, and he may proffer financial and market data, surveys, and expert testimony to support his claim. When proof of profits is difficult or impossible, the courts may grant a nonmonetary award, such as specific performance.

## Loss of Power of Avoidance

You will recall that there are several circumstances when a person may avoid a contract: duress, undue influence, misrepresentation (fraudulent, negligent, or innocent), or mistake. But a party may lose the right to avoid, and thus the right to any remedy, in several ways.

### Delay

If a party is the victim of fraud, she must act promptly to rescind at common law, or she will lose the right and her remedy will be limited to damages in tort. (This is discussed a bit more in [Section 16.5.7 "Election of Remedies"](#).)

### **Affirmation**

An infant who waits too long to disaffirm (again, delay) will have ratified the contract, as will one who—*notwithstanding* being the victim of duress, undue influence, mistake, or any other grounds for avoidance—continues to operate under the contract with full knowledge of his right to avoid. Of course the disability that gave rise to the power of avoidance must have passed before affirmation works.

### **Rights of Third Parties**

The intervening rights of third parties may terminate the power to avoid. For example, Michelle, a minor, sells her watch to Betty Buyer. Up to and within a reasonable time after reaching majority, Michelle could avoid—disaffirm—the contract. But if, before that time, Betty sells the watch to a third party, Michelle cannot get it back from the third party. Similarly, Salvador Seller sells his car to Bill Buyer, who pays for it with a bad check. If the check bounces, Salvador can rescind the deal—Bill’s consideration (the money represented by the check) has failed: Salvador could return the check and get his car back. But if, before the check from Bill bounces, Bill in turn sells the car to Pat Purchaser, Salvador cannot avoid the contract. Pat gets to keep the car. There are some exceptions to this rule.

### **Agreement of the Parties Limiting Remedies**

Certainly it is the general rule that parties are free to enter into any kind of a contract they want, so long as it is not illegal or unconscionable. The inclusion into the contract of a liquidated damages clause—mentioned previously—is one means by which the parties may make an agreement affecting damages. But beyond that, as we saw in [Chapter 12 "Legality"](#), it is very common for one side to limit its liability, or for one side to agree that it will pursue only limited remedies against the other in case of breach. Such agree-to limitations on the availability of remedies are generally OK provided they are conspicuous, bargained-for, and not unconscionable. In consumer transactions, courts are more likely to find a contracted-for limitation of remedies unconscionable than in commercial transactions, and under the Uniform Commercial Code (UCC) there are further restrictions on contractual remedy limitations.

For example, Juan buys ten bags of concrete to make a counter and stand for his expensive new barbecue. The bags have this wording in big print: “Attention. Our sole liability in case this product is defective will be to provide you with a like quantity of nondefective material. We will not be liable for any other damages, direct or indirect, express or implied.” That’s fine. If the concrete is defective, the concrete top breaks, and Juan’s new barbecue is damaged, he will get nothing but some new bags of good concrete. He could have shopped around to find somebody



who would deliver concrete with no limitation on liability. As it is, his remedies are limited by the agreement he entered into.

## Election of Remedies

### At Common Law

Another limitation on remedies—at common law—is the concept of **election of remedies**<sup>17</sup>. The nature of a loss resulting from a contract breach may be such as to entitle one party to a choice among two or more means to redress the grievance, where the choices are mutually exclusive.

At classic common law, a person who was defrauded had an election of remedies: she could, immediately upon discovering the fraud, rescind, or she could retain the item (real estate or personal property) and attempt to remedy the fraudulently defective performance by suing for damages, but not both. Buyer purchases real estate from Seller for \$300,000 and shortly discovers that Seller fraudulently misrepresented the availability of water. Buyer spends \$60,000 trying to drill wells. Finally he gives up and sues Seller for fraud, seeking \$360,000. Traditionally at common law, he would not get it. He should have rescinded upon discovery of the fraud. Now he can only get \$60,000 in damages in tort. *Merritt v. Craig*, 746 A.2d 923 (Md. 2000). The purpose of the election of remedies doctrine is to prevent the victim of fraud from getting a double recovery, but it has come under increasing criticism. Here is one court's observation: "A host of commentators support elimination of the election of remedies doctrine. A common theme is that the doctrine substitutes labels and formalism for inquiry into whether double recovery results in fact. The rigid doctrine goes to the other extreme, actually resulting in the under compensation of fraud victims and the protection of undeserving wrongdoers." *Head & Seemann, Inc. v. Gregg*, 311 N.W.2d 667 (Wis. App. 1981).

### Under the UCC

The doctrine of election of remedy has been rejected by the UCC, which means that the remedies are cumulative in nature. According to Section 2-703(1): "Whether the pursuit of one remedy bars another depends entirely on the facts of the individual case." UCC, Section 2-721, provides that neither demand for rescission of the contract in the case of misrepresentation or fraud, nor the return or rejection of goods, bars a claim for damages or any other remedy permitted under the UCC for nonfraudulent breach (we will examine remedies for breach of sales contracts in [Chapter 18 "Title and Risk of Loss"](#)).

17. The situation of a plaintiff in a civil lawsuit having multiple causes of action from which to choose as to how the defendant's wrong may be righted.

### **Tort versus Contract**

Frequently a contract breach may also amount to tortious conduct. A physician warrants her treatment as perfectly safe but performs the operation negligently, scarring the patient for life. The patient could sue for malpractice (tort) or for breach of warranty (contract). The choice involves at least four considerations:

1. Statute of limitations. Most statutes of limitations prescribe longer periods for contract than for tort actions.
2. Allowable damages. Punitive damages are more often permitted in tort actions, and certain kinds of injuries are compensable in tort but not in contract suits—for example, pain and suffering.
3. Expert testimony. In most cases, the use of experts would be the same in either tort or contract suits, but in certain contract cases, the expert witness could be dispensed with, as, for example, in a contract case charging that the physician abandoned the patient.
4. Insurance coverage. Most policies do not cover intentional torts, so a contract theory that avoids the element of willfulness would provide the plaintiff with a surer chance of recovering money damages.

### **Legal versus Extralegal Remedies**

A party entitled to a legal remedy is not required to pursue it. Lawsuits are disruptive not merely to the individuals involved in the particular dispute but also to the ongoing relationships that may have grown up around the parties, especially if they are corporations or other business enterprises. Buyers must usually continue to rely on their suppliers, and sellers on their buyers. Not surprisingly, therefore, many businesspeople refuse to file suits even though they could, preferring to settle their disputes privately or even to ignore claims that they might easily press. Indeed, the decision whether or not to sue is not one for the lawyer but for the client, who must analyze a number of pros and cons, many of them not legal ones at all.

## KEY TAKEAWAY

There are several limitations on the right of an aggrieved party to get contract remedies for a breach besides any limitations fairly agreed to by the parties. The damages suffered by the nonbreaching party must be reasonably foreseeable. The nonbreaching party must make a reasonable effort to mitigate damages, or the amount awarded will be reduced by the damages that could have been avoided. The party seeking damages must be able to explain within reason how much loss he has suffered as a result of the breach. If he cannot articulate with any degree of certainty—if the damages are really speculative—he will be entitled to nominal damages and that’s all. There are circumstances in which a party who could have got out of a contractual obligation—avoided it—loses the power to do so, and her remedy of avoidance is lost. Not infrequently, a person will enter into a contract for services or goods that contains a limitation on her right to damages in case the other side breaches. That’s all right unless the limitation is unconscionable. Sometimes parties are required to make an election of remedies: to choose among two or more possible bases of recovery. If the remedies are really mutually exclusive and one is chosen, the aggrieved party loses the right to pursue the others. And of course a person is always free not to pursue any remedy at all for breach of contract; that may be strategically or economically smart in some circumstances.

## EXERCISES

1. When one party to a contract breaches, what duty, if any, is then imposed on the other party?
2. A chef who has never owned her own restaurant sues a contractor who failed to finish building the chef’s first restaurant on time. She presents evidence of the profits made by similar restaurants that have been in business for some time. Is this good evidence of the damages she has suffered by the delay? To what damages is she entitled?
3. Rebecca, seventeen years and ten months old, buys a party dress for \$300. She wears it to the junior prom but determines it doesn’t look good on her. She puts it in her closet and forgets about it until six months later, when she decides to return it to the store. Is she now entitled to the remedy of rescission?
4. What is the difference between *rescission* and *restitution*?
5. Why are parties sometimes required to make an election of remedies?

## 16.6 Cases

### Consequential Damages

EBWS, LLC v. Britly Corp.

928 A.2d 497 (Vt. 2007)

Reiber, C.J.

The Ransom family owns Rock Bottom Farm in Strafford, Vermont, where Earl Ransom owns a dairy herd and operates an organic dairy farm. In 2000, the Ransoms decided to build a creamery on-site to process their milk and formed EBWS, LLC to operate the dairy-processing plant and to market the plant's products. In July 2000, Earl Ransom, on behalf of EBWS, met with Britly's president to discuss building the creamery....In January 2001, EBWS and Britly entered into a contract requiring Britly to construct a creamery building for EBWS in exchange for \$160,318....The creamery was substantially completed by April 15, 2001, and EBWS moved in soon afterward. On June 5, 2001, EBWS notified Britly of alleged defects in construction. [EBWS continued to use the creamery pending the necessity to vacate it for three weeks when repairs were commenced].

On September 12, 2001, EBWS filed suit against Britly for damages resulting from defective design and construction....

Following a three-day trial, the jury found Britly had breached the contract and its express warranty, and awarded EBWS: (1) \$38,020 in direct damages, and (2) \$35,711 in consequential damages....

...The jury's award to EBWS included compensation for both direct and consequential damages that EBWS claimed it would incur while the facility closed for repairs. Direct damages [i.e., compensatory damages] are for "losses that naturally and usually flow from the breach itself," and it is not necessary that the parties actually considered these damages. [Citation]. In comparison, special or consequential damages "must pass the tests of causation, certainty and foreseeability, and, in addition, be reasonably supposed to have been in the contemplation of both parties at the time they made the contract."

...The court ruled that EBWS could not recover for lost profits because it was not a going concern at the time the contract was entered into, and profits were too speculative. The court concluded, however, that EBWS could submit evidence of other business losses, including future payment for unused milk and staff wages....

At trial, Huyffer, the CEO of EBWS, testified that during a repairs closure the creamery would be required to purchase milk from adjacent Rock Bottom Farm, even though it could not process this milk. She admitted that such a requirement was self-imposed as there was no written output contract between EBWS and the farm to buy milk. In addition, Huyffer testified that EBWS would pay its employees during the closure even though EBWS has no written contract to pay its employees when they are not working. The trial court allowed these elements of damages to be submitted to the jury, and the jury awarded EBWS consequential damages for unused milk and staff wages.

On appeal, Britly contends that because there is no contractual or legal obligation for EBWS to purchase milk or pay its employees, these are not foreseeable damages. EBWS counters that it is common knowledge that cows continue to produce milk, even if the processing plant is not working, and thus it is foreseeable that this loss would occur. We conclude that these damages are not the foreseeable result of Britly's breach of the construction contract and reverse the award....

[W]e conclude that...it is not reasonable to expect Britly to foresee that its failure to perform under the contract would result in this type of damages. While we are sympathetic to EBWS's contention that the cows continue to produce milk, even when the plant is closed down, this fact alone is not enough to demonstrate that buying and dumping milk is a foreseeable result of Britly's breach of the construction contract. Here, the milk was produced by a separate and distinct entity, Rock Bottom Farm, which sold the milk to EBWS....

Similarly, EBWS maintained no employment agreements with its employees obligating it to pay wages during periods of closure for repairs, dips in market demand, or for any other reason. Any losses EBWS might suffer in the future because it chooses to pay its employees during a plant closure for repairs would be a voluntary expense and not in Britly's contemplation at the time it entered the construction contract. It is not reasonable to expect Britly to foresee losses incurred as a result of agreements that are informal in nature and carry no legal obligation on EBWS to perform. "[P]arties are not presumed to know the condition of each other's affairs nor to take into account contracts with a third party that is not communicated." [Citation] While it is true that EBWS may have business reasons to pay its employees even without a contractual obligation, for example, to ensure employee loyalty, no evidence was introduced at trial by EBWS to support a sound

rationale for such considerations. Under these circumstances, this business decision is beyond the scope of what Britly could have reasonably foreseen as damages for its breach of contract....

In addition, the actual costs of the wages and milk are uncertain....[T]he the milk and wages here are future expenses, for which no legal obligation was assumed by EBWS, and which are separate from the terms of the parties' contract. We note that at the time of the construction contract EBWS had not yet begun to operate as a creamery and had no history of buying milk or paying employees. See [Citation] (explaining that profits for a new business are uncertain and speculative and not recoverable). Thus, both the cost of the milk and the number and amount of wages of future employees that EBWS might pay in the event of a plant closure for repairs are uncertain.

Award for consequential damages is reversed....

### CASE QUESTIONS

1. Why, according to EBWS's CEO, would EBWS be required to purchase milk from adjacent Rock Bottom Farm, even though it could not process this milk?
2. Surely it is well known in Vermont dairy country that dairy farmers can't simply stop milking cows when no processing plant is available to take the milk—the cows will soon stop producing. Why was EBWS then not entitled to those damages which it will certainly suffer when the creamery is down for repairs?
3. Britly (the contractor) must have known EBWS had employees that would be idled when the creamery shut down for repairs. Why was it not liable for their lost wages?
4. What could EBWS have done at the time of contracting to protect itself against the damages it would incur in the event the creamery suffered downtime due to faulty construction?

### Liquidated Damages

Watson v. Ingram

881 P.2d 247 (Wash. 1994)

Johnson, J.

...In the summer of 1990, Wayne Watson offered to buy James Ingram's Bellingham home for \$355,000, with a \$15,000 [about \$24,000 in 2010 dollars] earnest money deposit....

Under the agreement, the entire amount of the purchase price was due in cash on or before December 3, 1990....The agreement required Watson to pay a \$15,000 earnest money deposit into escrow at Kelstrup Realty, and provided that "[i]n the event of default by Buyer, earnest money shall be forfeited to Seller as liquidated damages, unless Seller elects to seek actual damages or specific performance. Lastly, the agreement contained a provision entitled "BUYER'S REPRESENTATIONS," which stated, "Buyer represents that buyer has sufficient funds available to close this sale in accordance with this agreement, and is not relying on any contingent source of funds unless otherwise set forth in this agreement"....

On November 10, 1990, Watson sent a written proposal to Ingram seeking to modify the original agreement. The proposed modification would have allowed Watson to defer paying \$54,000 of the \$355,000 sale price for between 6 and 12 months after the scheduled December closing date. In exchange, Ingram would receive a second lien position on certain real estate Watson owned.

According to Ingram, the November 10 proposal was the first time he realized Watson did not have financing readily available for the purchase of the house. Ingram notified Watson on November 12, 1990, that he would not agree to modify the original agreement and intended to strictly enforce its terms. Ingram was involved in a child custody suit in California and wanted to move to that state as soon as possible....[Further efforts by Ingram to sell to third parties and by Watson to get an extension from Ingram failed.]

In September 1991, Ingram finally sold the house to a third party for \$355,000, the same price that Watson had agreed to pay in December 1990.

Ingram and Watson each sought to recover Watson's \$15,000 earnest money held in escrow. On December 4, 1990, Ingram wrote to Kelstrup Realty, indicating he was entitled to the \$15,000 earnest money in escrow because Watson had defaulted. In January 1991, Watson filed this action to recover the earnest money, alleging it amounted to a penalty and Ingram had suffered no actual damages....

The trial court found the earnest money "was clearly intended by both parties to be non-refundable" if Watson defaulted and determined \$15,000 was "a reasonable forecast by [Ingram and Watson] of damages that would be incurred by [Ingram] if [Watson] failed to complete the purchase". The court entered judgment in favor of

Ingram for the amount of the earnest money plus interest. The court also awarded Ingram his attorney fees pursuant to the parties' agreement. The Court of Appeals, Division One, affirmed. Watson now appeals to this court.

This case presents a single issue for review: whether the parties' contract provision requiring Watson to forfeit a \$15,000 nonrefundable earnest money deposit is enforceable as liquidated damages. Liquidated damages clauses are favored in Washington, and courts will uphold them if the sums involved do not amount to a penalty or are otherwise unlawful. [Citation] To determine whether liquidated damages clauses are enforceable, Washington courts have applied a 2-part test from the Restatement of Contracts....Liquidated damages clauses are upheld if the following two factors are satisfied:

First, the amount fixed must be a reasonable forecast of just compensation for the harm that is caused by the breach. Second, the harm must be such that it is incapable or very difficult of ascertainment.

The question before this court is whether this test is to be applied as of the time of contract formation (prospectively) or as of the time of trial (retrospectively). We have previously held, the "[r]easonableness of the forecast will be judged as of the time the contract was entered". [Citations]

In contrast, a prior Division One opinion relied upon by Petitioner held the reasonableness of the estimate of damages and the difficulty of ascertainment of harm should be measured as of the time of trial, and earnest money agreements should not be enforceable as liquidated damages if the nonbreaching party does not suffer actual damage. [Citations]

We...adopt the date of contract formation as the proper timeframe for evaluating the Restatement test. The prospective approach concentrates on whether the liquidated sum represents a reasonable prediction of the harm to the seller if the buyer breaches the agreement, and ignores actual damages except as evidence of the reasonableness of the estimate of potential damage.

We believe this approach better fulfills the underlying purposes of liquidated damages clauses and gives greater weight to the parties' expectations. Liquidated damages permit parties to allocate business and litigation risks. Even if the estimates of damages are not exact, parties can allocate and quantify those risks and can negotiate adjustments to the contract price in light of the allocated risks. Under the prospective approach, courts will enforce the parties' allocation of risk so long as the forecasts appear reasonable when made. [Citations]



In addition to permitting parties to allocate risks, liquidated damages provisions lend certainty to the parties' agreements and permit parties to resolve disputes efficiently in the event of a breach. Rather than litigating the amount of actual damages, the nonbreaching party must only establish the reasonableness of the agreement. The prospective approach permits parties to rely on their stipulated amounts without having to precisely establish damages at trial. In contrast, if the reasonableness of the amount is judged retrospectively, against the damage actually suffered, the "parties must fully litigate (at great expense and delay) that which they sought not to litigate." [Citation].

Petitioner argues the prospective approach treats buyers unfairly because it permits sellers to retain earnest money deposits even when the seller suffers no actual damage, and this violates the principle that contract damages should be compensatory only. He further contends that by evaluating parties' liquidated damages agreements against actual damages established at trial, courts can most effectively determine whether such agreements were reasonable and fair.

We disagree. As this court has previously explained, "[w]e are loath to interfere with the rights of parties to contract as they please between themselves [Citations] It is not the role of the court to enforce contracts so as to produce the most equitable result. The parties themselves know best what motivations and considerations influenced their bargaining, and, while, "[t]he bargain may be an unfortunate one for the delinquent party,...it is not the duty of courts of common law to relieve parties from the consequences of their own improvidence..." [Citations]

The retrospective approach fails to give proper weight to the parties' negotiations. At the time of contract formation, unpredictable market fluctuations and variations in possible breaches make it nearly impossible for contracting parties to predict "precisely or within a narrow range the amount of damages that would flow from breach." [Citations]. However, against this backdrop of uncertainty, the negotiated liquidated damages sum represents the parties' best estimate of the value of the breach and permits the parties to allocate and incorporate these risks in their negotiations. Under the prospective approach, a court will uphold the parties' agreed upon liquidated sum so long as the amount represents a reasonable attempt to compensate the nonbreaching party. On the other hand, if the reasonableness of a liquidated damages provision is evaluated under a retrospective approach, the parties cannot confidently rely on their agreement because the liquidated sum will not be enforced if, at trial, it is not a close approximation of the damage suffered or if no actual damages are proved....

Having adopted the date of contract formation as the proper timeframe for evaluating the Restatement test, the Restatement's second requirement loses independent significance. The central inquiry is whether the specified liquidated damages were reasonable at the time of contract formation....

We also agree with the Court of Appeals that in the context of real estate agreements, a requirement that damages be difficult to prove at trial would undermine the very purposes of the liquidated damage provision: "certainty, assurance that the contract will be performed, and avoidance of litigation". [Citation] It would "encourage litigation in virtually every case in which the sale did not close, regardless of whether the earnest money deposit was a reasonable estimate of the seller's damages." [Citation]

In sum, so long as the agreed upon earnest money agreement, viewed prospectively, is a reasonable prediction of potential damage suffered by the seller, the agreement should be enforced "without regard to the retrospective calculation of actual damages or the ease with which they may be proved". The prospective difficulty of estimating potential damage is a factor to be used in assessing the reasonableness of the earnest money agreement...

The decision of the Court of Appeals is affirmed.

### CASE QUESTIONS

1. What does the court here mean when it says that liquidated damages clauses allow the parties to "allocate and incorporate the risks [of the transaction] in their negotiations"?
2. Why is it relevant that the plaintiff Ingram was engaged in a child-custody dispute and wanted to move to California as soon as possible?
3. What, in plain language, is the issue here?
4. How does the court's resolution of the issue seem to the court the better analysis?
5. Why did the plaintiff get to keep the \$15,000 when he really suffered no damages?
6. Express the controlling rule of law out of this case.

## Injunctions and Negative Covenants

Madison Square Garden Corporation v. Carnera

52 F.2d 47 (2d Cir. Ct. App. 1931)

Chase, J.

On January 13, 1931, the plaintiff and defendant by their duly authorized agents entered into the following agreement in writing:

1. Carnera agrees that he will render services as a boxer in his next contest (which contest, hereinafter called the 'First Contest.'...

9. Carnera shall not, pending the holding of the First Contest, render services as a boxer in any major boxing contest, without the written permission of the Garden in each case had and obtained. A major contest is understood to be one with Sharkey, Baer, Campolo, Godfrey, or like grade heavyweights, or heavyweights who shall have beaten any of the above subsequent to the date hereof. If in any boxing contest engaged in by Carnera prior to the holding of the First Contest, he shall lose the same, the Garden shall at its option, to be exercised by a two weeks' notice to Carnera in writing, be without further liability under the terms of this agreement to Carnera. Carnera shall not render services during the continuance of the option referred to in paragraph 8 hereof for any person, firm or corporation other than the Garden. Carnera shall, however, at all times be permitted to engage in sparring exhibitions in which no decision is rendered and in which the heavy weight championship title is not at stake, and in which Carnera boxes not more than four rounds with any one opponent.'...

Thereafter the defendant, without the permission of the plaintiff, written or otherwise, made a contract to engage in a boxing contest with the Sharkey mentioned in paragraph 9 of the agreement above quoted, and by the terms thereof the contest was to take place before the first contest mentioned in the defendant's contract with the plaintiff was to be held.

The plaintiff then brought this suit to restrain the defendant from carrying out his contract to box Sharkey, and obtained the preliminary injunction order, from which this appeal was taken. Jurisdiction is based on diversity of citizenship and the required amount is involved.

The District Court has found on affidavits which adequately show it that the defendant's services are unique and extraordinary. A negative covenant in a contract for such personal services is enforceable by injunction where the damages for a breach are incapable of ascertainment. [Citations]

The defendant points to what is claimed to be lack of consideration for his negative promise, in that the contract is inequitable and contains no agreement to employ him. It is true that there is no promise in so many words to employ the defendant to box in a contest with Stribling or Schmeling, but the agreement read as a whole binds the plaintiff to do just that, provided either Stribling or Schmeling becomes the contestant as the result of the match between them and can be induced to box the defendant. The defendant has agreed to 'render services as a boxer' for the plaintiff exclusively, and the plaintiff has agreed to pay him a definite percentage of the gate receipts as his compensation for so doing. The promise to employ the defendant to enable him to earn the compensation agreed upon is implied to the same force and effect as though expressly stated. [Citations] The fact that the plaintiff's implied promise is conditioned, with respect to the contest with the winner of the Stribling-Schmeling match, upon the consent of that performer, does not show any failure of consideration for the defendant's promise, [Citation].

As we have seen, the contract is valid and enforceable. It contains a restrictive covenant which may be given effect. Whether a preliminary injunction shall be issued under such circumstances rests in the sound discretion of the court. [Citation] The District Court, in its discretion, did issue the preliminary injunction....

Order affirmed.

### CASE QUESTIONS

1. Why did the plaintiff not want the defendant to engage in any boxing matches until and except the ones arranged by the plaintiff?
2. What assertion did the defendant make as to why his promise was not enforceable? Why wasn't that argument accepted by the court?
3. If the defendant had refused to engage in a boxing match arranged by the plaintiff, would a court force him to do what he had promised?

### Limitation on Damages: Mitigation of Damages

Shirley MacLaine Parker v. Twentieth Century-Fox Film Corporation

474 P.2d 689 (Cal. 1970)

Burke, Justice.

Defendant Twentieth Century-Fox Film Corporation appeals from a summary judgment granting to plaintiff the recovery of agreed compensation under a written contract for her services as an actress in a motion picture. As will appear, we have concluded that the trial court correctly ruled in plaintiff's favor and that the judgment should be affirmed.

Plaintiff is well known as an actress....Under the contract, dated August 6, 1965, plaintiff was to play the female lead in defendant's contemplated production of a motion picture entitled "Bloomer Girl." The contract provided that defendant would pay plaintiff a minimum "guaranteed compensation" of \$53,571.42 per week for 14 weeks commencing May 23, 1966, for a total of \$750,000 [about \$5,048,000 in 2010 dollars]. Prior to May 1966 defendant decided not to produce the picture and by a letter dated April 4, 1966, it notified plaintiff of that decision and that it would not "comply with our obligations to you under" the written contract.

By the same letter and with the professed purpose "to avoid any damage to you," defendant instead offered to employ plaintiff as the leading actress in another film tentatively entitled "Big Country, Big Man" (hereinafter, "Big Country"). The compensation offered was identical, as were 31 of the 34 numbered provisions or articles of the original contract. Unlike "Bloomer Girl," however, which was to have been a musical production, "Big Country" was a dramatic "western type" movie. "Bloomer Girl" was to have been filmed in California; "Big Country" was to be produced in Australia. Also, certain terms in the proffered contract varied from those of the original. Plaintiff was given one week within which to accept; she did not and the offer lapsed. Plaintiff then commenced this action seeking recovery of the agreed guaranteed compensation.

The complaint sets forth two causes of action. The first is for money due under the contract; the second, based upon the same allegations as the first, is for damages resulting from defendant's breach of contract. Defendant in its answer admits the existence and validity of the contract, that plaintiff complied with all the conditions, covenants and promises and stood ready to complete the performance, and that defendant breached and "anticipatorily repudiated" the contract. It denies, however, that any money is due to plaintiff either under the contract or as a result of its breach, and pleads as an affirmative defense to both causes of action plaintiff's allegedly deliberate failure to mitigate damages, asserting that she unreasonably refused to accept its offer of the leading role in "Big Country."

Plaintiff moved for summary judgment...[T]he motion was granted...for \$750,000 plus interest...in plaintiff's favor. This appeal by defendant followed....

The general rule is that the measure of recovery by a wrongfully discharged employee is the amount of salary agreed upon for the period of service, less the amount which the employer affirmatively proves the employee has earned or with reasonable effort might have earned from other employment. [Citation] However, before projected earnings from other employment opportunities not sought or accepted by the discharged employee can be applied in mitigation, the employer must show that the other employment was comparable, or substantially similar, to that of which the employee has been deprived; the employee's rejection of or failure to seek other available employment of a different or inferior kind may not be resorted to in order to mitigate damages. [Citations]

In the present case defendant has raised no issue of reasonableness of efforts by plaintiff to obtain other employment; the sole issue is whether plaintiff's refusal of defendant's substitute offer of "Big Country" may be used in mitigation. Nor, if the "Big Country" offer was of employment different or inferior when compared with the original "Bloomer Girl" employment, is there an issue as to whether or not plaintiff acted reasonably in refusing the substitute offer. Despite defendant's arguments to the contrary, no case cited or which our research has discovered holds or suggests that reasonableness is an element of a wrongfully discharged employee's option to reject, or fail to seek, different or inferior employment lest the possible earnings therefrom be charged against him in mitigation of damages.

Applying the foregoing rules to the record in the present case, with all intendments in favor of the party opposing the summary judgment motion—here, defendant—it is clear that the trial court correctly ruled that plaintiff's failure to accept defendant's tendered substitute employment could not be applied in mitigation of damages because the offer of the "Big Country" lead was of employment both different and inferior, and that no factual dispute was presented on that issue. The mere circumstance that "Bloomer Girl" was to be a musical review calling upon plaintiff's talents as a dancer as well as an actress, and was to be produced in the City of Los Angeles, whereas "Big Country" was a straight dramatic role in a "Western Type" story taking place in an opal mine in Australia, demonstrates the difference in kind between the two employments; the female lead as a dramatic actress in a western style motion picture can by no stretch of imagination be considered the equivalent of or substantially similar to the lead in a song-and-dance production.

Additionally, the substitute "Big Country" offer proposed to eliminate or impair the director and screenplay approvals accorded to plaintiff under the original "Bloomer Girl" contract, and thus constituted an offer of inferior employment. No expertise or judicial notice is required in order to hold that the deprivation or infringement of an employee's rights held under an original employment contract converts the

available “other employment” relied upon by the employer to mitigate damages, into inferior employment which the employee need not seek or accept. [Citation]

In view of the determination that defendant failed to present any facts showing the existence of a factual issue with respect to its sole defense—plaintiff’s rejection of its substitute employment offer in mitigation of damages—we need not consider plaintiff’s further contention that for various reasons, including the provisions of the original contract set forth in footnote 1, Ante, plaintiff was excused from attempting to mitigate damages.

The judgment is affirmed.

### CASE QUESTIONS

1. Why did Ms. MacLaine refuse to accept the employment opportunity offered by the defendant?
2. Why did the defendant think it should not be liable for any damages as a result of its admitted breach of the original contract?
3. Who has the burden of proof on mitigation issues—who has to show that no mitigation occurred?
4. Express the controlling rule of law out of this case.

## 16.7 Summary and Exercises

### Summary

Contract remedies serve to protect three different interests: an expectation interest (the benefit bargained for), a reliance interest (loss suffered by relying on the contract), and a restitution interest (benefit conferred on the promisor). In broad terms, specific performance addresses the expectation interest, monetary damages address all three, and restitution addresses the restitution interest.

The two general categories of remedies are legal and equitable. In the former category are compensatory, consequential, incidental, nominal, liquidated, and (rarely) punitive damages. In the latter category—if legal remedies are inadequate—are specific performance, injunction, and restitution.

There are some limitations or restrictions on the availability of damages: they must pass the tests of foreseeability and certainty. They must be reasonably mitigated, if possible. And liquidated damages must be reasonable—not a penalty. In some situations, a person can lose the remedy of rescission—the power to avoid a contract—when the rights of third parties intervene. In some cases a person is required to make an election of remedies: to choose one remedy among several, and when the one is chosen, the others are not available any more.



## EXERCISES

1. Owner of an auto repair shop hires Contractor to remodel his shop but does not mention that two days after the scheduled completion date, Owner is to receive five small US Army personnel carrier trucks for service, with a three-week deadline to finish the job and turn the trucks over to the army. The contract between Owner and the army has a liquidated damages clause calling for \$300 a day for every day trucks are not operable after the deadline. Contractor is five days late in finishing the remodel. Can Owner claim the \$1,500 as damages against Contractor as a consequence of the latter's tardy completion of the contract? Explain.
2. Inventor devised an electronic billiard table that looked like a regular billiard table, but when balls dropped into the pocket, various electronic lights and scorekeeping devices activated. Inventor contracted with Contractor to manufacture ten prototypes and paid him \$50,000 in advance, on a total owing of \$100,000 (\$10,000 for each completed table). After the tables were built to accommodate electronic fittings, Inventor repudiated the contract. Contractor broke the ten tables up, salvaged \$1,000 of wood for other billiard tables, and used the rest for firewood. The ten intact tables, without electronics, could have been sold for \$500 each (\$5,000 total). Contractor then sued Inventor for the profit Contractor would have made had Inventor not breached. To what, if anything, is Contractor entitled by way of damages and why?
3. Calvin, a promising young basketball and baseball player, signed a multiyear contract with a professional basketball team after graduating from college. After playing basketball for one year, he decided he would rather play baseball and breached his contract with the basketball team. What remedy could the team seek?
4. Theresa leased a one-bedroom apartment from Landlady for one year at \$500 per month. After three months, she vacated the apartment. A family of five wanted to rent the apartment, but Landlady refused. Three months later—six months into what would have been Theresa's term—Landlady managed to rent the apartment to Tenant for \$400 per month. How much does Theresa owe, and why?
5. Plaintiff, a grocery store, contracted with Defendant, a burglar alarm company, for Defendant to send guards to Plaintiff's premises and to notify the local police if the alarm was activated. The contract had this language: "It is agreed that the Contractor is not an insurer, that the payments here are based solely on the value of the service in the maintenance of the system described,

that it is impracticable and extremely difficult to fix the actual damages, if any, which may proximately result from a failure to perform its services, and in case of failure to perform such services and a resulting loss, its liability shall be limited to \$500 as liquidated damages, and not as a penalty, and this liability shall be exclusive.”

A burglary took place and the alarm was activated, but Defendant failed to respond promptly. The burglars left with \$330,000. Is the liquidated damages clause—the limitation on Plaintiff’s right to recover—valid?

6. The decedent, father of the infant Plaintiff, was killed in a train accident. Testimony showed he was a good and reliable man. Through a representative, the decedent’s surviving child, age five, recovered judgment against the railroad (Defendant). Defendant objected to expert testimony that inflation would probably continue at a minimum annual rate of 5 percent for the next thirteen years (until the boy attained his majority), which was used to calculate the loss in support money caused by the father’s death. The calculations, Defendant said, were unreasonably speculative and uncertain, and damages must be proven with reasonable certainty. Is the testimony valid?
7. Plaintiff produced and directed a movie for Defendant, but contrary to their agreement, Plaintiff was not given screen credit in the edited film (his name was not shown). The film was screened successfully for nearly four years. Plaintiff then sued (1) for damages for loss of valuable publicity or advertising because his screen credits were omitted for the years and (2) for an injunction against future injuries. The jury awarded Plaintiff \$25,000 on the first count. On the second count, the court held Plaintiff should be able to “modify the prints in his personal possession to include his credits.” But Plaintiff appealed, claiming that Defendant still had many unmodified prints in its possession and that showing those films would cause future damages. What remedy is available to Plaintiff?*Tamarind Lithography Workshop v. Sanders*, 193 Cal. Rptr. 409 (Calif. Ct. App., 1983).
8. In 1929 Kerr Steamship Company, Inc. (Plaintiff), delivered to Defendant, the Radio Corporation of America (RCA), a fairly long telegram—in code—to be transmitted to Manila, Philippine Islands, with instructions about loading one of Kerr’s ships. By mistake, the telegraph was mislaid and not delivered. As a result of the failure to transmit it, the cargo was not loaded and the freight was lost in an amount of \$6,675.29 [about \$84,000 in 2010 dollars], profit that would have been earned if the message had been carried. Plaintiff said that because the telegram was

long and because the sender was a ship company, RCA personnel should have known it was important information dealing with shipping and therefore RCA should be liable for the consequential damages flowing from the failure to send it. Is RCA liable?

9. Defendant offered to buy a house from Plaintiff. She represented, verbally and in writing, that she had \$15,000 to \$20,000 of equity in another house and would pay this amount to Plaintiff after selling it. She knew, however, that she had no such equity. Relying on these intentionally fraudulent representations, Plaintiff accepted Defendant's offer to buy, and the parties entered into a land contract. After taking occupancy, Defendant failed to make any of the contract payments. Plaintiff's investigation then revealed the fraud. Based on the fraud, Plaintiff sought rescission, ejectment, and recovery for five months of lost use of the property and out-of-pocket expenses. Defendant claimed that under the election of remedies doctrine, Plaintiff seller could not both rescind the contract and get damages for its breach. How should the court rule?
10. Buyers contracted to purchase a house being constructed by Contractor. The contract contained this clause: "Contractor shall pay to the owners or deduct from the total contract price \$100.00 per day as liquidated damages for each day after said date that the construction is not completed and accepted by the Owners and Owners shall not arbitrarily withhold acceptance." Testimony established the rental value of the home at \$400-\$415 per month. Is the clause enforceable?

## SELF-TEST QUESTIONS

1. Contract remedies protect
  - a. a restitution interest
  - b. a reliance interest
  - c. an expectation interest
  - d. all of the above
  
2. A restitution interest is
  - a. the benefit for which the promisee bargained
  - b. the loss suffered by relying on the contract
  - c. that which restores any benefit one party conferred on the other
  - d. none of the above
  
3. When breach of contract caused no monetary loss, the plaintiff is entitled to
  - a. special damages
  - b. nominal damages
  - c. consequential damages
  - d. no damages
  
4. Damages attributable to losses that flow from events that do not occur in the ordinary course of events are
  - a. incidental damages
  - b. liquidated damages
  - c. consequential damages
  - d. punitive damages
  
5. Restitution is available
  - a. when the contract was avoided because of incapacity
  - b. when the other party breached
  - c. when the party seeking restitution breached
  - d. all of the above

**SELF-TEST ANSWERS**

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

## Chapter 17

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### Introduction to Sales and Leases

#### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. Why the law of commercial transactions is separate from the common law
2. What is meant by “commercial transactions” and how the Uniform Commercial Code (UCC) deals with them in general
3. The scope of Article 2, Article 2A, and the Convention on Contracts for the International Sale of Goods
4. What obligations similar to the common law’s are imposed on parties to a UCC contract, and what obligations different from the common law’s are imposed
5. The difference between a consumer lease and a finance lease

## 17.1 Commercial Transactions: the Uniform Commercial Code

### LEARNING OBJECTIVES

1. Understand why there is a separate body of law governing commercial transactions.
2. Be aware of the scope of the Uniform Commercial Code.
3. Have a sense of this text's presentation of the law of commercial transactions.

### History of the UCC

In [Chapter 8 "Introduction to Contract Law"](#) we introduced the Uniform Commercial Code. As we noted, the UCC has become a national law, adopted in every state—although Louisiana has not enacted Article 2, and differences in the law exist from state to state. Of all the uniform laws related to commercial transactions, the UCC is by far the most successful, and its history goes back to feudal times.

In a mostly agricultural, self-sufficient society there is little need for trade, and almost all law deals with things related to land (real estate): its sale, lease, and devising (transmission of ownership by inheritance); services performed on the land; and damages to the land or to things related to it or to its productive capacity (torts). Such trade as existed in England before the late fourteenth century was dominated by foreigners. But after the pandemic of the Black Death in 1348–49 (when something like 30 percent to 40 percent of the English population died), the self-sufficient feudal manors began to break down. There was a shortage of labor. People could move off the manors to find better work, and no longer tied immediately to the old estates, they migrated to towns. Urban centers—cities—began to develop. Urbanization inevitably reached the point where citizens' needs could not be met locally. Enterprising people recognized that some places had a surplus of a product and that other places were in need of that surplus and had a surplus of their own to exchange for it. So then, by necessity, people developed the means to transport the surpluses. Enter ships, roads, some medium of exchange, standardized weights and measures, accountants, lawyers, and rules governing merchandising. And enter merchants.

The power of merchants was expressed through franchises obtained from the government which entitled merchants to create their own rules of law and to

enforce these rules through their own courts. Franchises to hold fairs [retail exchanges] were temporary; but the franchises of the staple cities, empowered to deal in certain basic commodities [and to have mercantile courts], were permanent....Many trading towns had their own adaptations of commercial law.... The seventeenth century movement toward national governments resulted in a decline of separate mercantile franchises and their courts. The staple towns...had outlived their usefulness. When the law merchant became incorporated into a national system of laws enforced by national courts of general jurisdiction, the local codes were finally extinguished. But national systems of law necessarily depended upon the older codes for their stock of ideas and on the changing customs of merchants for new developments. Frederick G. Kempin Jr., *Historical Introduction to Anglo-American Law* (Eagan, MN: West, 1973), 217–18, 219–20, 221.

When the American colonies declared independence from Britain, they continued to use British law, including the laws related to commercial transactions. By the early twentieth century, the states had inconsistent rules, making interstate commerce difficult and problematic. Several uniform laws affecting commercial transactions were floated in the late nineteenth century, but few were widely adopted. In 1942, the American Law Institute (ALI) American Law Institute, “ALI Overview,” accessed March 1, 2011, <http://www.ali.org/index.cfm?fuseaction=about.overview>. hired staff to begin work on a rationalized, simplified, and harmonized national body of modern commercial law. The ALI’s first draft of the UCC was completed in 1951. The UCC was adopted by Pennsylvania two years later, and other states followed in the 1950s and 1960s.

In the 1980s and 1990s, the leasing of personal property became a significant factor in commercial transactions, and although the UCC had some sections that were applicable to leases, the law regarding the sale of goods was inadequate to address leases. Article 2A governing the leasing of goods was approved by the ALI in 1987. It essentially repeats Article 2 but applies to leases instead of sales. In 2001, amendments to Article 1—which applies to the entire UCC—were proposed and subsequently have been adopted by over half the states. No state has yet adopted the modernizing amendments to Article 2 and 2A that the ALI proposed in 2003.

That’s the short history of why the body of commercial transaction law is separate from the common law.

### **Scope of the UCC and This Text’s Presentation of the UCC**

The UCC embraces the law of commercial transactions, a term of some ambiguity. A commercial transaction may seem to be a series of separate transactions; it may include, for example, the making of a contract for the sale of goods, the signing of a



check, the endorsement of the check, the shipment of goods under a bill of lading, and so on. However, the UCC presupposes that each of these transactions is a facet of one single transaction: the lease or sale of, and payment for, goods. The code deals with phases of this transaction from start to finish. These phases are organized according to the following articles:

- Sales (Article 2)
- Leases (Article 2A)
- Commercial Paper (Article 3)
- Bank Deposits and Collections (Article 4)
- Funds Transfers (Article 4A)
- Letters of Credit (Article 5)
- Bulk Transfers (Article 6)
- Warehouse Receipts, Bills of Lading, and Other Documents of Title (Article 7)
- Investment Securities (Article 8)
- Secured Transactions; Sales of Accounts and Chattel Paper (Article 9)

Although the UCC comprehensively covers commercial transactions, it does not deal with every aspect of commercial law. Among the subjects not covered are the sale of real property, mortgages, insurance contracts, suretyship transactions (unless the surety is party to a negotiable instrument), and bankruptcy. Moreover, common-law principles of contract law that were examined in previous chapters continue to apply to many transactions covered in a particular way by the UCC. These principles include capacity to contract, misrepresentation, coercion, and mistake. Many federal laws supersede the UCC; these include the Bills of Lading Act, the Consumer Credit Protection Act, the warranty provisions of the Magnuson-Moss Act, and other regulatory statutes.

We follow the general outlines of the UCC in this chapter and in Chapter 18 "Title and Risk of Loss" and Chapter 19 "Performance and Remedies". In this chapter, we cover the law governing sales (Article 2) and make some reference to leases (Article 2A), though space constraints preclude an exhaustive analysis of leases. The use of documents of title to ship and store goods is closely related to sales, and so we cover documents of title (Article 7) as well as the law of bailments in Chapter 21 "Bailments and the Storage, Shipment, and Leasing of Goods".

In Chapter 22 "Nature and Form of Commercial Paper", Chapter 23 "Negotiation of Commercial Paper", Chapter 24 "Holder in Due Course and Defenses", and Chapter 25 "Liability and Discharge", we cover the giving of a check, draft, or note (commercial paper) for part or all of the purchase price and the negotiation of the commercial paper (Article 3). Related matters, such as bank deposits and collections

(Article 4), funds transfers (Article 4A), and letters of credit (Article 5), are also covered there.

In Chapter 28 "Secured Transactions and Suretyship" we turn to acceptance of security by the seller or lender for financing the balance of the payment due. Key to this area is the law of secured transactions (Article 9), but other types of security (e.g., mortgages and suretyship) not covered in the UCC will also be discussed in Chapter 29 "Mortgages and Nonconsensual Liens". Chapter 27 "Consumer Credit Transactions" covers consumer credit transactions and Chapter 30 "Bankruptcy" covers bankruptcy law; these topics are important for all creditors, even those lacking some form of security.

We now turn our attention to the sale—the first facet, and the cornerstone, of the commercial transaction.

#### KEY TAKEAWAY

In the development of the English legal system, commercial transactions were originally of such little importance that the rules governing them were left to the merchants themselves. They had their own courts and adopted their own rules based on their customary usage. By the 1700s, the separate courts had been absorbed into the English common law, but the distinct rules applicable to commercial transactions remained and have carried over to the modern UCC. The UCC treats commercial transactions in phases, and this text basically traces those phases.

#### EXERCISES

1. Why were medieval merchants compelled to develop their own rules about commercial transactions?
2. Why was the UCC developed, and when was the period of its initial adoption by states?

## 17.2 Introduction to Sales and Lease Law, and the Convention on Contracts for the International Sale of Goods

### LEARNING OBJECTIVES

1. Understand that the law of sales not only incorporates many aspects of common-law contract but also addresses some distinct issues that do not occur in contracts for the sale of real estate or services.
2. Understand the scope of Article 2 and the definitions of *sale* and *goods*.
3. Learn how courts deal with hybrid situations: mixtures of the sale of goods and of real estate, mixtures of goods and services.
4. Recognize the scope of Article 2A and the definitions of *lease*, *consumer lease*, and *finance lease*.
5. Learn about the Convention on Contracts for the International Sale of Goods and why it is relevant to our discussion of Article 2.

### Scope of Articles 2 and 2A and Definitions

In dealing with any statute, it is of course very important to understand the statute's scope or coverage.

Article 2 does not govern all commercial transactions, only sales. It does not cover all sales, only the sale of goods. Article 2A governs leases, but only of personal property (goods), not real estate. The Convention on Contracts for the International Sale of Goods (CISG)—kind of an international Article 2—“applies to contracts of sale of goods between parties whose places of business are in different States [i.e., countries]” (CISG, Article 1). So we need to consider the definitions of *sale*, *goods*, and *lease*.

### Definition of Sale

1. An arrangement whereby the lessee comes to own the leased goods after the term of the lease for little additional consideration.
2. A thing bestowed on another gratuitously as a present.
3. The rightful possession of goods by one not their owner.

A **sale**<sup>1</sup> “consists in the passing of title from the seller to the buyer for a price.” Uniform Commercial Code, Section 2-106.

Sales are distinguished from gifts, bailments, leases, and secured transactions. Article 2 sales should be distinguished from gifts, bailments, leases, and secured transactions. A **gift**<sup>2</sup> is the transfer of title without consideration, and a “contract” for a gift of goods is unenforceable under the Uniform Commercial Code (UCC) or otherwise (with some exceptions). A **bailment**<sup>3</sup> is the transfer of possession but not

title or use; parking your car in a commercial garage often creates a bailment with the garage owner. A lease (see the formal definition later in this chapter) is a fixed-term arrangement for possession and use of something—computer equipment, for example—and does not transfer title. In a **secured transaction**<sup>4</sup>, the owner-debtor gives a security interest in collateral to a creditor that allows the creditor to repossess the collateral if the owner defaults.

### Definition of Goods

Even if the transaction is considered a sale, the question still remains whether the contract concerns the sale of goods. Article 2 applies only to goods; sales of real estate and services are governed by non-UCC law. Section 2-105(1) of the UCC defines **goods**<sup>5</sup> as “all things...which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid.” Money can be considered goods subject to Article 2 if it is the object of the contract—for example, foreign currency.

In certain cases, the courts have difficulty applying this definition because the item in question can also be viewed as realty or service. Most borderline cases raise one of two general questions:

1. Is the contract for the sale of the real estate, or is it for the sale of goods?
2. Is the contract for the sale of goods, or is it for services?

### Real Estate versus Goods

The dilemma is this: A landowner enters into a contract to sell crops, timber, minerals, oil, or gas. If the items have already been detached from the land—for example, timber has been cut and the seller agrees to sell logs—they are goods, and the UCC governs the sale. But what if, at the time the contract is made, the items are still part of the land? Is a contract for the sale of uncut timber governed by the UCC or by real estate law?

The UCC governs under either of two circumstances: (1) if the contract calls for the seller to sever the items or (2) if the contract calls for the buyer to sever the items and if the goods can be severed without material harm to the real estate. Uniform Commercial Code, Section 2-107. The second provision specifically includes growing crops and timber. By contrast, the law of real property governs if the buyer’s severance of the items will materially harm the real estate; for example, the removal of minerals, oil, gas, and structures by the buyer will cause the law of real property to govern. (See [Figure 17.1 "Governing Law"](#).)

4. A mortgage on personal property so that the creditor may repossess it in case the debtor-owner defaults.

5. Under the UCC, all things movable at the time of the contract.

Figure 17.1 Governing Law

UCC	Real Estate Law
1. Severed by buyer without material harm (for example, removal of crops and timber) 2. Severed by seller	Severed by buyer, causes material harm (for example, removal of minerals and structures)

### Goods versus Services

Distinguishing goods from services is the other major difficulty that arises in determining the nature of the object of a sales contract. The problem: how can goods and services be separated in contracts calling for the seller to deliver a combination of goods and services? That issue is examined in [Section 17.5.1 "Mixed Goods and Services Contracts: The “Predominant Factor” Test”](#) (*Pittsley v. Houser*), where the court applied the common “predominant factor” (also sometimes “predominate purpose” or “predominant thrust”) test—that is, it asked whether the transaction was predominantly a contract for goods or for services. However, the results of this analysis are not always consistent. Compare *Epstein v. Giannattasio*, in which the court held that no sale of goods had been made because the plaintiff received a treatment in which the cosmetics were only incidentally used, with *Newmark v. Gimble’s, Inc.*, in which the court said “[i]f the permanent wave lotion were sold...for home consumption...unquestionably an implied warranty of fitness for that purpose would have been an integral incident of the sale.” *Epstein v. Giannattasio* 197 A.2d 342 (Conn. 1963); *Newmark v. Gimble’s, Inc.*, 258 A.2d 697 (N.J. 1969). The New Jersey court rejected the defendant’s argument that by actually applying the lotion to the patron’s head, the salon lessened the liability it otherwise would have had if it had simply sold her the lotion.

In two areas, state legislatures have taken the goods-versus-services issue out of the courts’ hands and resolved the issue through legislation. Food sold in restaurants is a sale of goods, whether it is to be consumed on or off the premises. Blood transfusions (really the sale of blood) in hospitals have been legislatively declared a service, not a sale of goods, in more than forty states, thus relieving the suppliers and hospitals of an onerous burden for liability from selling blood tainted with the undetectable hepatitis virus.

### Definition of Lease

Section 2A-103(j) of the UCC defines a **lease**<sup>6</sup> as “a transfer of the right to possession and use of goods for a term in return for consideration.” The **lessor**<sup>7</sup> is the one who transfers the right to possession to the **lessee**<sup>8</sup>. If Alice rents a party canopy from Equipment Supply, Equipment Supply is the lessor and Alice is the lessee.

### Two Types of Leases

The UCC recognizes two kinds of leases: consumer leases and finance leases. A **consumer lease**<sup>9</sup> is used when a lessor leases goods to “an individual...primarily for personal, family, or household purposes,” where total lease payments are less than \$25,000. Uniform Commercial Code, Section 2A-103(e). The UCC grants some special protections to consumer lessees. A **finance lease**<sup>10</sup> is used when a lessor “acquires the goods or the right to [them]” and leases them to the lessee. Uniform Commercial Code, Section 2A-103(g). The person from whom the lessor acquires the goods is a supplier, and the lessor is simply financing the deal. Jack wants to lease a boom lift (personnel aerial lift, also known as a cherry picker) for a commercial roof renovation. First Bank agrees to buy (or itself lease) the machine from Equipment Supply and in turn lease it to Jack. First Bank is the lessor, Jack is the lessee, and Equipment Supply is the supplier.

### International Sales of Goods

The UCC is, of course, American law, adopted by the states of the United States. The reason it has been adopted is because of the inconvenience of doing interstate business when each state had a different law for the sale of goods. The same problem presents itself in international transactions. As a result, the United Nations Commission on International Trade Law developed an international equivalent of the UCC, the Convention on Contracts for the International Sale of Goods (CISG), first mentioned in **Chapter 8 "Introduction to Contract Law"**. It was promulgated in Vienna in 1980. As of July 2010, the convention (a type of treaty) has been adopted by seventy-six countries, including the United States and all its major trading partners except the United Kingdom. One commentator opined on why the United Kingdom is an odd country out: it is “perhaps because of pride in its longstanding common law legal imperialism or in its long-treasured feeling of the superiority of English law to anything else that could even challenge it.” A. F. M. Maniruzzaman, quoted by Albert H. Kritzer, Pace Law School Institute of International Commercial Law, *CISG: Table of Contracting States*, accessed March 1, 2011, <http://www.cisg.law.pace.edu/cisg/countries/cntries.html>.

The CISG is interesting for two reasons. First, assuming globalization continues, the CISG will become increasingly important around the world as the law governing

6. The transfer of right of possession and use for a price.

7. One who gives possession of leased goods to another for a price.

8. One who takes possession of and uses leased goods for a price.

9. A lease of goods by a lessor to a lessee for household uses.

10. A lease by a lessor who buys or obtains the goods from a supplier for the purpose of leasing them to a commercial lessee.

international sale contracts. Its preamble states, “The adoption of uniform rules which govern contracts for the international sale of goods and take into account the different social, economic and legal systems [will] contribute to the removal of legal barriers in international trade and promote the development of international trade.” Second, it is interesting to compare the legal culture informing the common law to that informing the CISG, which is not of the English common-law tradition. Throughout our discussion of Article 2, we will make reference to the CISG, the complete text of which is available online. Pace Law School, “United Nations Convention on Contracts for the International Sale of Goods (1980) [CISG]” *CISG Database*, accessed March 1, 2011, <http://www.cisg.law.pace.edu/cisg/text/treaty.html>. References to the CISG are in bold.

**As to the CISG’s scope, CISG Article 1 provides that it “applies to contracts of sale of goods between parties whose places of business are in different States [i.e., countries]; it “governs only the formation of the contract of sale and the rights and obligations of the seller and the buyer arising from such a contract,” and has nothing to do “with the validity of the contract or of any of its provisions or of any usage” (Article 4). It excludes sales (a) of goods bought for personal, family or household use, unless the seller, at any time before or at the conclusion of the contract, neither knew nor ought to have known that the goods were bought for any such use; (b) by auction; (c) on execution or otherwise by authority of law; (d) of stocks, shares, investment securities, negotiable instruments or money; (e) of ships, vessels, hovercraft or aircraft; (f) of electricity (Article 2).**

**Parties are free to exclude the application of the Convention or, with a limited exception, vary the effect of any of its provisions (Article 6).**

#### KEY TAKEAWAY

Article 2 of the UCC deals with the sale of goods. *Sale* and *goods* have defined meanings. Article 2A of the UCC deals with the leasing of goods. *Lease* has a defined meaning, and the UCC recognizes two types of leases: consumer leases and finance leases. Similar in purpose to the UCC of the United States is the Convention on Contracts for the International Sale of Goods, which has been widely adopted around the world.

## EXERCISES

1. Why is there a separate body of statutory law governing contracts for the sale of goods as opposed to the common law, which governs contracts affecting real estate and services?
2. What is a consumer lease? A finance lease?
3. What is the Convention on Contracts for the International Sale of Goods?



## 17.3 Sales Law Compared with Common-Law Contracts and the CISG

### LEARNING OBJECTIVE

1. Recognize the differences and similarities among the Uniform Commercial Code (UCC), common-law contracts, and the CISG as related to the following contract issues:
  - Offer and acceptance
  - Revocability
  - Consideration
  - The requirement of a writing and contractual interpretation (form and meaning)

Sales law deals with the sale of goods. Sales law is a special type of contract law, but the common law informs much of Article 2 of the UCC—with some differences, however. Some of the similarities and differences were discussed in previous chapters that covered common-law contracts, but a review here is appropriate, and we can refer briefly to the CISG’s treatment of similar issues.

### Mutual Assent: Offer and Acceptance Definiteness of the Offer

The common law requires more definiteness than the UCC. Under the UCC, a contractual obligation may arise even if the agreement has **open terms**<sup>11</sup>. Under Section 2-204(3), such an agreement for sale is not voidable for indefiniteness, as in the common law, if the parties have intended to make a contract and the court can find a reasonably certain basis for giving an appropriate remedy. Perhaps the most important example is the open price term.

The open price term is covered in detail in Section 2-305. At common law, a contract that fails to specify price or a means of accurately ascertaining price will almost always fail. This is not so under the UCC provision regarding open price terms. If the contract says nothing about price, or if it permits the parties to agree on price but they fail to agree, or if it delegates the power to fix price to a third person who fails to do so, then Section 2-305(1) “plugs” the open term and decrees that the price to be awarded is a “reasonable price at the time for delivery.” When one party is permitted to fix the price, Section 2-305(2) requires that it be fixed in

11. Under the UCC, a term that has not been expressed in the contract.

good faith. However, if the parties *intend* not to be bound unless the price is first fixed or agreed on, and it is not fixed or agreed on, then no contract results. Uniform Commercial Code, Section 2-305(4).

Another illustration of the open term is in regard to particulars of performance. Section 2-311(1) provides that a contract for sale of goods is not invalid just because it leaves to one of the parties the power to specify a particular means of performing. However, “any such specification must be made in good faith and within limits set by commercial reasonableness.” (Performance will be covered in greater detail in [Chapter 18 "Title and Risk of Loss"](#).)

The CISG (Article 14) provides the following: **“A proposal for concluding a contract addressed to one or more specific persons constitutes an offer if it is sufficiently definite and indicates the intention of the offeror to be bound in case of acceptance. A proposal is sufficiently definite if it indicates the goods and expressly or implicitly fixes or makes provision for determining the quantity and the price.”**

### **Acceptance Varying from Offer: Battle of the Forms**

The concepts of offer and acceptance are basic to any agreement, but the UCC makes a change from the common law in its treatment of an acceptance that varies from the offer (this was discussed in [Chapter 8 "Introduction to Contract Law"](#)). At common law, where the “mirror image rule” reigns, if the acceptance differs from the offer, no contract results. If that were the rule for sales contracts, with the pervasive use of form contracts—where each side’s form tends to favor that side—it would be very problematic.

Section 2-207 of the UCC attempts to resolve this “battle of the forms” by providing that additional terms or conditions in an acceptance operate as such unless the acceptance is conditioned on the offeror’s consent to the new or different terms. The new terms are construed as offers but are automatically incorporated in any contract between merchants for the sale of goods unless “(a) the offer expressly limits acceptance to the terms of the offer; (b) [the terms] materially alter it; or (c) notification of objection to them has already been given or is given within a reasonable time after notice of them is received.” In any case, Section 2-207 goes on like this: “Conduct by both parties which recognizes the existence of a contract is sufficient to establish a contract for sale although the writings of the parties do not otherwise establish a contract. In such case the terms of the particular contract consist of those terms on which the writings of the parties agree, together with any supplementary terms incorporated under any other provisions of this Act.” This section of the UCC is one of the most confusing and fiercely litigated sections;

Professor Grant Gilmore once called it a “miserable, bungled, patched-up job” and “arguably the greatest statutory mess of all time.” Mark E. Roszkowski, “Symposium on Revised Article 2 of the Uniform Commercial Code—Section-by-Section Analysis,” *SMU Law Review* 54 (Spring 2001): 927, 932, quoting Professor Grant Gilmore to Professor Robert Summers, Cornell University School of Law, September 10, 1980, in *Teaching Materials on Commercial and Consumer Law*, ed. Richard E. Speidel, Robert S Summers, and James J White, 3rd ed. (St. Paul, MN: West, 1981), pp. 54–55. In 2003 the UCC revisioners presented an amendment to this section in an attempt to fix Section 2-207, but no state has adopted this section’s revision. See Commercial Law, “UCC Legislative Update,” March 2, 2010, accessed March 1, 2011, <http://ucclaw.blogspot.com/2010/03/ucc-legislative-update.html>.

**As to international contracts, the CISG says this about an acceptance that varies from the offer (Article 19), and it’s pretty much the same as the UCC:**

**(1) A reply to an offer which purports to be an acceptance but contains additions, limitations or other modifications is a rejection of the offer and constitutes a counter-offer.**

**(2) However, a reply to an offer which purports to be an acceptance but contains additional or different terms which do not materially alter the terms of the offer constitutes an acceptance, unless the offeror, without undue delay, objects orally to the discrepancy or dispatches a notice to that effect. If he does not so object, the terms of the contract are the terms of the offer with the modifications contained in the acceptance.**

**(3) Additional or different terms relating, among other things, to the price, payment, quality and quantity of the goods, place and time of delivery, extent of one party’s liability to the other or the settlement of disputes are considered to alter the terms of the offer materially.**

### **Revocation of Offer**

Under both common law and the UCC, an offer can be revoked at any time prior to acceptance unless the offeror has given the offeree an option (supported by consideration); under the UCC, an offer can be revoked at any time prior to acceptance unless a merchant gives a “**firm offer**”<sup>12</sup> (for which no consideration is needed). The CISG (Article 17) provides that an offer is revocable before it is accepted unless, however, “it indicates...that it is irrevocable” or if the offeree reasonably relied on its irrevocability.

12. A promise by a merchant to buy or sell goods in a signed (or “authenticated”) writing that is not revocable during the time stated or for a reasonable time not to exceed six months (UCC 2-205).

## Reality of Consent

There is no particular difference between the common law and the UCC on issues of duress, misrepresentation, undue influence, or mistake. As for international sales contracts, the CISG provides (Article 4(a)) that it “governs only the formation of the contract of sale and the rights and obligations of the seller and the buyer arising from such a contract and is not concerned with the validity of the contract or of any of its provisions.”

## Consideration

### The UCC

The UCC requires no consideration for modification of a sales contract made in good faith; at common law, consideration is required to modify a contract. Uniform Commercial Code, Section 2-209(1). The UCC requires no consideration if one party wants to forgive another’s breach by written waiver or renunciation signed and delivered by the aggrieved party; under common law, consideration is required to discharge a breaching party. Uniform Commercial Code, Section 1-107. The UCC requires no consideration for a “firm offer”—a writing signed by a merchant promising to hold an offer open for some period of time; at common law an option requires consideration. (Note, however, the person can give an option under either common law or the code.)

**Under the CISG (Article 29), “A contract may be modified or terminated by the mere agreement of the parties.” No consideration is needed.**

## Form and Meaning

### Requirement of a Writing

The common law has a Statute of Frauds, and so does the UCC. It requires a writing to enforce a contract for the sale of goods worth \$500 or more, with some exceptions, as discussed in [Chapter 13 "Form and Meaning"](#). Proposed amendments by UCC revisioners presented in 2003 would have raised the amount of money—to take into account inflation since the mid-fifties—to \$5,000, but no state has yet adopted this amendment; Uniform Commercial Code, Section 2-201.

**The CISG provides (Article 11), “A contract of sale need not be concluded in or evidenced by writing and is not subject to any other requirement as to form. It may be proved by any means, including witnesses.” But Article 29 provides, “A contract in writing which contains a provision requiring any modification or termination by agreement to be in writing may not be otherwise modified or terminated by agreement.”**

### Parol Evidence

Section 2-202 of the UCC provides pretty much the same as the common law: if the parties have a writing intended to be their final agreement, it “may not be contradicted by evidence of any prior agreement or of a contemporaneous oral agreement.” However, it may be explained by “course of dealing or usage of trade or by course of performance” and “by evidence of consistent additional terms.”

The CISG provides (Article 8) the following: “In determining the intent of a party or the understanding a reasonable person would have had, due consideration is to be given to all relevant circumstances of the case including the negotiations, any practices which the parties have established between themselves, usages and any subsequent conduct of the parties.”

#### KEY TAKEAWAY

The UCC modernizes and simplifies some common-law strictures. Under the UCC, the mirror image rule is abolished: an acceptance may sometimes differ from the offer, and the UCC can “plug” open terms in many cases. No consideration is required under the UCC to modify or terminate a contract or for a merchant’s “firm offer,” which makes the offer irrevocable according to its terms. The UCC has a Statute of Frauds analogous to the common law, and its parol evidence rule is similar as well. The CISG compares fairly closely to the UCC.

#### EXERCISES

1. Why does the UCC change the common-law mirror image rule, and how?
2. What is meant by “open terms,” and how does the UCC handle them?
3. The requirement for consideration is relaxed under the UCC compared with common law. In what circumstances is no consideration necessary under the UCC?
4. On issues so far discussed, is the CISG more aligned with the common law or with the UCC? Explain your answer.

## 17.4 General Obligations under UCC Article 2

### LEARNING OBJECTIVES

1. Know that the Uniform Commercial Code (UCC) imposes a general obligation to act in good faith and that it makes unconscionable contracts or parts of a contract unenforceable.
2. Recognize that though the UCC applies to all sales contracts, merchants have special obligations.
3. See that the UCC is the “default position”—that within limits, parties are free to put anything they want to in their contract.

Article 2 of the UCC of course has rules governing the obligations of parties specifically as to the offer, acceptance, performance of sales contracts, and so on. But it also imposes some general obligations on the parties. Two are called out here: one deals with unfair contract terms, and the second with obligations imposed on merchants.

### **Obligation of Good-Faith Dealings in General Under the UCC**

Section 1-203 of the UCC provides, “Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.” *Good faith* is defined at Section 2-103(j) as “honesty in fact and the observance of reasonable commercial standards of fair dealing.” This is pretty much the same as what is held by common law, which “imposes a duty of good faith and fair dealing upon the parties in performing and enforcing the contract.” Restatement (Second) of Contracts, Section 205.

The UCC’s good faith in “performance or enforcement” of the contract is one thing, but what if the terms of the contract itself are unfair? Under Section 2-302(1), the courts may tinker with a contract if they determine that it is particularly unfair. The provision reads as follows: “If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.”

The court thus has considerable flexibility. It may refuse to enforce the entire contract, strike a particular clause or set of clauses, or limit the application of a particular clause or set of clauses.

And what does “unconscionable” mean? The UCC provides little guidance on this crucial question. According to Section 2-302(1), the test is “whether, in the light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract....The principle is one of the prevention of oppression and unfair surprise and not of disturbance of allocation of risks because of superior bargaining power.”

The definition is somewhat circular. For the most part, judges have had to develop the concept with little help from the statutory language. Unconscionability is much like US Supreme Court Justice Potter Stewart’s famous statement about obscenity: “I can’t define it, but I know it when I see it.” In the leading case, *Williams v. Walker-Thomas Furniture Co.* (Section 12.5.3 “Unconscionability”, set out in Chapter 12 “Legality”), Judge J. Skelly Wright attempted to develop a framework for analysis. He refined the meaning of unconscionability by focusing on “absence of meaningful choice” (often referred to as **procedural unconscionability**<sup>13</sup>) and on terms that are “unreasonably favorable” (commonly referred to as **substantive unconscionability**<sup>14</sup>). An example of procedural unconscionability is the salesperson who says, “Don’t worry about all that little type on the back of this form.” Substantive unconscionability is the harsh term—the provision that permits the “taking of a pound of flesh” if the contract is not honored.

Despite its fuzziness, the concept of unconscionability has had a dramatic impact on American law. In many cases, in fact, the traditional notion of *caveat emptor* (Latin for “buyer beware”) has changed to *caveat venditor* (“let the seller beware”). So important is this provision that courts in recent years have applied the doctrine in cases not involving the sale of goods.

**Under the CISG, Article 7: “Regard is to be had...to the observance of good faith in international trade.”**

- 13. Unfairness in the process of contract making, as when the contract is in such fine print it cannot be read.
- 14. Contract terms so harsh and one-sided as to be unacceptably unfair.

### **Obligations Owed by Merchants “Merchant” Sellers**

Although the UCC applies to all sales of goods (even when you sell your used car to your neighbor), merchants often have special obligations or are governed by special rules.

### As between Merchants

The UCC assumes that merchants should be held to particular standards because they are more experienced and have or should have special knowledge. Rules applicable to professionals ought not apply to the casual or inexperienced buyer or seller. For example, we noted previously that the UCC relaxes the mirror image rule and provides that as “between merchants” additional terms in an acceptance become part of the contract, and we have discussed the “ten-day-reply doctrine” that says that, again “as between merchants,” a writing signed and sent to the other binds the recipient as an exception to the Statute of Frauds. Uniform Commercial Code, Sections 2-205 and 2A-205. There are other sections of the UCC applicable “as between merchants,” too.

**Article 1 of the CISG abolishes any distinction between merchants and nonmerchants: “Neither the nationality of the parties nor the civil or commercial character of the parties or of the contract is to be taken into consideration in determining the application of this Convention.”**

### Merchant to Nonmerchant

In addition to duties imposed between merchants, the UCC imposes certain duties on a merchant when she sells to a nonmerchant. A merchant who sells her merchandise makes an important **implied warranty of merchantability**<sup>15</sup>. That is, she promises that goods sold will be fit for the purpose for which such goods are normally intended. A nonmerchant makes no such promise, nor does a merchant who is not selling merchandise—for example, a supermarket selling a display case is not a “merchant” in display cases.

In *Sheeskin v. Giant Foods, Inc.*, the problem of whether a merchant made an implied warranty of merchantability was nicely presented. Mr. Seigel, the plaintiff, was carrying a six-pack carton of Coca-Cola from a display bin to his shopping cart when one or more of the bottles exploded. He lost his footing and was injured. When he sued the supermarket and the bottler for breach of the implied warranty of fitness, the defendants denied there had been a sale: he never paid for the soda pop, thus no sale by a merchant and thus no warranty. The court said that Mr. Seigel’s act of reaching for the soda to put it in his cart was a “reasonable manner of acceptance” (quoting UCC, Section 2-206(1)). *Sheeskin v. Giant Food, Inc.*, 318 A.2d 874 (Md. Ct. App. 1974).

15. An unexpressed promise that goods bought from a merchant are suitable for the purposes for which such goods are normally intended.



### Who Is a Merchant?

Section 2-104(1) of the UCC defines a merchant as one “who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction.” A phrase that recurs throughout Article 2—“between merchants”—refers to any transaction in which both parties are chargeable with the knowledge or skill of merchants. Uniform Commercial Code, Section 2-104(3). Not every businessperson is a merchant with respect to every possible transaction. But a person or institution normally not considered a merchant can be one under Article 2 if he employs an agent or broker who holds himself out as having such knowledge or skill. (Thus a university with a purchasing office can be a merchant with respect to transactions handled by that department.)

Determining whether a particular person operating a business is a merchant under Article 2-104 is a common problem for the courts. *Goldkist, Inc. v. Brownlee*, [Section 17.5.2 “Merchants” under the UCC](#), shows that making the determination is difficult and contentious, with significant public policy implications.

### Obligations May Be Determined by Parties Under the UCC

Under the UCC, the parties to a contract are free to put into their contract pretty much anything they want. Article 1-102 states that “the effect of provisions of this Act may be varied by agreement...except that the obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement but the parties may by agreement determine the standards by which the performance of such obligations is to be measure if such standards are not manifestly unreasonable.” Thus the UCC is the “default” position: if the parties want the contract to operate in a specific way, they can provide for that. If they don’t put anything in their agreement about some aspect of their contract’s operation, the UCC applies. For example, if they do not state where “delivery” will occur, the UCC provides that term. (Section 2-308 says it would be at the “seller’s place of business or if he has none, his residence.”)

**Article 6 of the CISG similarly gives the parties freedom to contract. It provides, “The parties may exclude the application of this Convention or...vary the effect of any of its provisions.”**

### KEY TAKEAWAY

The UCC imposes some general obligations on parties to a sales contract. They must act in good faith, and unconscionable contracts or terms thereof will not be enforced. The UCC applies to any sale of goods, but sometimes special obligations are imposed on merchants. While the UCC imposes various general (and more specific) obligations on the parties, they are free, within limits, to make up their own contract terms and obligations; if they do not, the UCC applies. The CISG tends to follow the basic thrust of the UCC.

### EXERCISES

1. What does the UCC say about the standard duty parties to a contract owe each other?
2. Why are merchants treated specially by the UCC in some circumstances?
3. Give an example of a merchant-to-merchant duty imposed by the UCC and of a merchant-to-nonmerchant duty.
4. What does it mean to say the UCC is the “default” contract term?

## 17.5 Cases

### **Mixed Goods and Services Contracts: The “Predominant Factor” Test**

Pittsley v. Houser

875 P.2d 232 (Idaho App. 1994)

Swanstrom, J.

In September of 1988, Jane Pittsley contracted with Hilton Contract Carpet Co. (Hilton) for the installation of carpet in her home. The total contract price was \$4,402 [about \$7,900 in 2010 dollars]. Hilton paid the installers \$700 to put the carpet in Pittsley’s home. Following installation, Pittsley complained to Hilton that some seams were visible, that gaps appeared, that the carpet did not lay flat in all areas, and that it failed to reach the wall in certain locations. Although Hilton made various attempts to fix the installation, by attempting to stretch the carpet and other methods, Pittsley was not satisfied with the work. Eventually, Pittsley refused any further efforts to fix the carpet. Pittsley initially paid Hilton \$3,500 on the contract, but refused to pay the remaining balance of \$902.

Pittsley later filed suit, seeking rescission of the contract, return of the \$3,500 and incidental damages. Hilton answered and counterclaimed for the balance remaining on the contract. The matter was heard by a magistrate sitting without a jury. The magistrate found that there were defects in the installation and that the carpet had been installed in an unworkmanlike manner. The magistrate also found that there was a lack of evidence on damages. The trial was continued to allow the parties to procure evidence on the amount of damages incurred by Pittsley. Following this continuance, Pittsley did not introduce any further evidence of damages, though witnesses for Hilton estimated repair costs at \$250.

Although Pittsley had asked for rescission of the contract and a refund of her money, the magistrate determined that rescission, as an equitable remedy, was only available when one party committed a breach so material that it destroyed the entire purpose of the contract. Because the only estimate of damages was for \$250, the magistrate ruled rescission would not be a proper remedy. Instead, the magistrate awarded Pittsley \$250 damages plus \$150 she expended in moving furniture prior to Hilton’s attempt to repair the carpet. On the counterclaim, the magistrate awarded Hilton the \$902 remaining on the contract. Additionally, both

parties had requested attorney fees in the action. The magistrate determined that both parties had prevailed and therefore awarded both parties their attorney fees.

Following this decision, Pittsley appealed to the district court, claiming that the transaction involved was governed by the Idaho Uniform Commercial Code (UCC), [Citation]. Pittsley argued that if the UCC had been properly applied, a different result would have been reached. The district court agreed with Pittsley's argument, reversing and remanding the case to the magistrate to make additional findings of fact and to apply the UCC to the transaction....

Hilton now appeals the decision of the district court. Hilton claims that Pittsley failed to allege or argue the UCC in either her pleadings or at trial. Even if application of the UCC was properly raised, Hilton argues that there were no defects in the goods that were the subject of the transaction, only in the installation, making application of the UCC inappropriate....

The single question upon which this appeal depends is whether the UCC is applicable to the subject transaction. If the underlying transaction involved the sale of "goods," then the UCC would apply. If the transaction did not involve goods, but rather was for services, then application of the UCC would be erroneous.

Idaho Code § 28-2-105(1) defines "goods" as "all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale...." Although there is little dispute that carpets are "goods," the transaction in this case also involved installation, a service. Such hybrid transactions, involving both goods and services, raise difficult questions about the applicability of the UCC. Two lines of authority have emerged to deal with such situations.

The first line of authority, and the majority position, utilizes the "predominant factor" test. The Ninth Circuit, applying the Idaho Uniform Commercial Code to the subject transaction, restated the predominant factor test as:

The test for inclusion or exclusion is not whether they are mixed, but, granting that they are mixed, whether their predominant factor, their thrust, their purpose, reasonably stated, is the rendition of service, with goods incidentally involved (e.g., contract with artist for painting) or is a transaction of sale, with labor incidentally involved (e.g., installation of a water heater in a bathroom).

[Citations]. This test essentially involves consideration of the contract in its entirety, applying the UCC to the entire contract or not at all.

The second line of authority, which Hilton urges us to adopt, allows the contract to be severed into different parts, applying the UCC to the goods involved in the contract, but not to the non-goods involved, including services as well as other non-goods assets and property. Thus, an action focusing on defects or problems with the goods themselves would be covered by the UCC, while a suit based on the service provided or some other non-goods aspect would not be covered by the UCC....

We believe the predominant factor test is the more prudent rule. Severing contracts into various parts, attempting to label each as goods or non-goods and applying different law to each separate part clearly contravenes the UCC's declared purpose "to simplify, clarify and modernize the law governing commercial transactions." I.C. § 28-1-102(2)(a). As the Supreme Court of Tennessee suggested in [Citation], such a rule would, in many contexts, present "difficult and in some instances insurmountable problems of proof in segregating assets and determining their respective values at the time of the original contract and at the time of resale, in order to apply two different measures of damages."

Applying the predominant factor test to the case before us, we conclude that the UCC was applicable to the subject transaction. The record indicates that the contract between the parties called for "175 yds Masterpiece # 2122-Installed" for a price of \$4319.50. There was an additional charge for removing the existing carpet. The record indicates that Hilton paid the installers \$700 for the work done in laying Pittsley's carpet. It appears that Pittsley entered into this contract for the purpose of obtaining carpet of a certain quality and color. It does not appear that the installation, either who would provide it or the nature of the work, was a factor in inducing Pittsley to choose Hilton as the carpet supplier. On these facts, we conclude that the sale of the carpet was the predominant factor in the contract, with the installation being merely incidental to the purchase. Therefore, in failing to consider the UCC, the magistrate did not apply the correct legal principles to the facts as found. We must therefore vacate the judgment and remand for further findings of fact and application of the UCC to the subject transaction.

## CASE QUESTIONS

1. You may recall in [Chapter 15 "Discharge of Obligations"](#) the discussion of the “substantial performance” doctrine. It says that if a common-law contract is not completely, but still “substantially,” performed, the nonbreaching party still owes something on the contract. And it was noted there that under the UCC, there is no such doctrine. Instead, the “perfect tender” rule applies: the goods delivered by the seller must be exactly right. Does the distinction between the substantial performance doctrine and the perfect tender rule shed light on what difference applying the common law or the UCC would make in this case?
2. If Pittsley won on remand, what would she get?
3. In discussing the predominant factor test, the court here quotes from the Ninth Circuit, a *federal* court of appeals. What is a federal court doing making rules for a state court?

### “Merchants” under the UCC

Goldkist, Inc. v. Brownlee

355 S.E.2d 773 (Ga. App. 1987)

Beasley, J.

The question is whether the two defendant farmers, who as a partnership both grew and sold their crops, were established by the undisputed facts as not being “merchants” as a matter of law, according to the definition in [Georgia UCC 2-104(1)]....

Appellees admit that their crops are “goods” as defined in [2-105]. The record establishes the following facts. The partnership had been operating the row crop farming business for 14 years, producing peanuts, soybeans, corn, milo, and wheat on 1,350 acres, and selling the crops.

It is also established without dispute that Barney Brownlee, whose deposition was taken, was familiar with the marketing procedure of “booking” crops, which sometimes occurred over the phone between the farmer and the buyer, rather than in person, and a written contract would be signed later. He periodically called plaintiff’s agent to check the price, which fluctuated. If the price met his approval, he sold soybeans. At this time the partnership still had some of its 1982 crop in

storage, and the price was rising slowly. Mr. Brownlee received a written confirmation in the mail concerning a sale of soybeans and did not contact plaintiff to contest it but simply did nothing. In addition to the agricultural business, Brownlee operated a gasoline service station....

In dispute are the facts with respect to whether or not an oral contract was made between Barney Brownlee for the partnership and agent Harrell for the buyer in a July 22 telephone conversation. The plaintiff's evidence was that it occurred and that it was discussed soon thereafter with Brownlee at the service station on two different occasions, when he acknowledged it, albeit reluctantly, because the market price of soybeans had risen. Mr. Brownlee denies booking the soybeans and denies the nature of the conversations at his service station with Harrell and the buyer's manager....

Whether or not the farmers in this case are “merchants” as a matter of law, which is not before us, the evidence does not demand a conclusion that they are outside of that category which is excepted from the requirement of a signed writing to bind a buyer and seller of goods....To allow a farmer who deals in crops of the kind at issue, or who otherwise comes within the definition of “merchant” in [UCC] 2-104(1), to renege on a confirmed oral booking for the sale of crops, would result in a fraud on the buyer. The farmer could abide by the booking if the price thereafter declined but reject it if the price rose; the buyer, on the other hand, would be forced to sell the crop following the booking at its peril, or wait until the farmer decides whether to honor the booking or not.

Defendants' narrow construction of “merchant” would, given the booking procedure used for the sale of farm products, thus guarantee to the farmers the best of both possible worlds (fulfill booking if price goes down after booking and reject it if price improves) and to the buyers the worst of both possible worlds. On the other hand, construing “merchants” in [UCC] 2-104(1) as not excluding as a matter of law farmers such as the ones in this case, protects them equally as well as the buyer. If the market price declines after the booking, they are assured of the higher booking price; the buyer cannot renege, as [UCC]2-201(2) would apply.

In giving this construction to the statute, we are persuaded by [Citation], supra, and the analyses provided in the following cases from other states: [Citations]. By the same token, we reject the narrow construction given in other states' cases: [Citations]. We believe this is the proper construction to give the two statutes, [UCC 2-104(1) and 2-201(2)], as taken together they are thus further branches stemming from the centuries-old simple legal idea *pacta servanda sunt*—agreements are to be kept. So construed, they evince the legislative intent to enforce the accepted practices of the marketplace among those who frequent it.

Judgment reversed. [Four justices concurred with Justice Beasley].

Benham, J., dissenting.

Because I cannot agree with the majority's conclusion that appellees are merchants, I must respectfully dissent.

...The validity of [plaintiff's] argument, that sending a confirmation within a reasonable time makes enforceable a contract even though the statute of frauds has not been satisfied, rests upon a showing that the contract was "[b]etween merchants." "Between merchants" is statutorily defined in the Uniform Commercial Code as meaning "any transaction with respect to which both parties are chargeable with the knowledge or skill of merchants" [2-104(3)]. "Merchant" means a person [1] who deals in goods of the kind or [2] otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction or [3] to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill" [Citation]. Whether [plaintiff] is a merchant is not questioned here; the question is whether, under the facts in the record, [defendant]/farmers are merchants....

The Official Comment to § 2-104 of the U.C.C. (codified in Georgia)...states: "This Article assumes that transactions between professionals in a given field require special and clear rules which may not apply to a casual or inexperienced seller or buyer...This section lays the foundation of this policy by defining those who are to be regarded as professionals or 'merchants' and by stating when a transaction is deemed to be 'between merchants.' The term 'merchant' as defined here roots in the 'law merchant' concept of a professional in business." As noted by the Supreme Court of Kansas in [Citation] (1976): "The concept of professionalism is heavy in determining who is a merchant under the statute. The writers of the official UCC comment virtually equate professionals with merchants—the casual or inexperienced buyer or seller is not to be held to the standard set for the professional in business. The defined term 'between merchants,' used in the exception proviso to the statute of frauds, contemplates the knowledge and skill of professionals on each side of the transaction." The Supreme Court of Iowa [concur in cases cited]. Where, as here, the undisputed evidence is that the farmer's sole experience in the marketplace consists of selling the crops he has grown, the courts of several of our sister states have concluded that the farmer is not a merchant. [Citations]. Just because appellee Barney Brownlee kept "conversant with the current price of [soybeans] and planned to market it to his advantage does not necessarily make him a 'merchant.' It is but natural for anyone who desires to sell anything he owns to negotiate and get the best price obtainable. If this would make



one a 'merchant,' then practically anyone who sold anything would be deemed a merchant, hence would be an exception under the statute[,] and the need for a contract in writing could be eliminated in most any kind of a sale." [Citation].

It is also my opinion that the record does not reflect that appellees "dealt" in soybeans, or that through their occupation, they held themselves out as having knowledge or skill peculiar to the practices or goods involved in the transaction. See [UCC] 2-104(1). "[A]lthough a farmer may well possess special knowledge or skill with respect to the production of a crop, the term 'merchant,' as used in the Uniform Commercial Code, contemplates special knowledge and skill associated with the marketplace. As to the area of farm crops, this special skill or knowledge means, for instance, special skill or knowledge associated with the operation of the commodities market. It is inconceivable that the drafters of the Uniform Commercial Code intended to place the average farmer, who merely grows his yearly crop and sells it to the local elevator, etc., on equal footing with the professional commodities dealer whose sole business is the buying and selling of farm commodities" [Citations]. If one who buys or sells something on an annual basis is a merchant, then the annual purchaser of a new automobile is a merchant who need not sign a contract for the purchase in order for the contract to be enforceable....

If these farmers are not merchants, a contract signed by both parties is necessary for enforcement. If the farmer signs a contract, he is liable for breach of contract if he fails to live up to its terms. If he does not sign the contract, he cannot seek enforcement of the terms of the purchaser's offer to buy....

Because I find no evidence in the record that appellees meet the statutory qualifications as merchants, I would affirm the decision of the trial court. I am authorized to state that [three other justices] join in this dissent.

## CASE QUESTIONS

1. How is the UCC's ten-day-reply doctrine in issue here?
2. Five justices thought the farmers here should be classified as "merchants," and four of them thought otherwise. What argument did the majority have against calling the farmers "merchants"? What argument did the dissent have as to why they should not be called merchants?
3. Each side marshaled persuasive precedent from other jurisdictions to support its contention. As a matter of public policy, is one argument better than another?
4. What does the court mean when it says the defendants are not excluded from the definition of merchants "as a matter of law"?

### Unconscionability in Finance Lease Contracts

Info. Leasing Corp. v. GDR Investments, Inc.

787 N.E.2d 652 (Ohio App. 2003)

Gorman, J.

The plaintiff-appellant, Information Leasing Corporation ("ILC"), appeals from the order of the trial court rendering judgment in favor of the defendants-appellees...GDR Investments, Inc. [defendant Arora's corporation], Pinnacle Exxon, and Avtar S. Arora, in an action to recover \$15,877.37 on a five-year commercial lease of an Automated Teller Machine ("ATM")....

This is one of many cases involving ILC that have been recently before this court. ILC is an Ohio corporation wholly owned by the Provident Bank. ILC is in the business of leasing ATMs through a third party, or vendor. In all of these cases, the vendor has been...Credit Card Center ("CCC"). CCC was in the business of finding lessees for the machines and then providing the services necessary to operate them, offering the lessees attractive commissions. Essentially, CCC would find a customer, usually a small business interested in having an ATM available on its premises, arrange for its customer to sign a lease with ILC, and then agree to service the machine, keeping it stocked with cash and paying the customer a certain monthly commission. Usually, as in the case of [defendants], the owner of the business was required to sign as a personal guarantor of the lease. The twist in this story is that CCC soon went bankrupt, leaving its customers stuck with ATMs under the terms of

leases with ILC but with no service provider. Rather than seeking to find another company to service the ATMs, many of CCC's former customers, like [defendants], simply decided that they no longer wanted the ATMs and were no longer going to make lease payments to ILC. The terms of each lease, however, prohibited cancellation. The pertinent section read,

LEASE NON-CANCELABLE AND NO WARRANTY. THIS LEASE CANNOT BE CANCELED BY YOU FOR ANY REASON, INCLUDING EQUIPMENT FAILURE, LOSS OR DAMAGE. YOU MAY NOT REVOKE ACCEPTANCE OF THE EQUIPMENT. YOU, NOT WE, SELECTED THE EQUIPMENT AND THE VENDOR. WE ARE NOT RESPONSIBLE FOR EQUIPMENT FAILURE OR THE VENDOR'S ACTS. YOU ARE LEASING THE EQUIPMENT 'AS IS', [sic] AND WE DISCLAIM ALL WARRANTIES, EXPRESS OR IMPLIED. WE ARE NOT RESPONSIBLE FOR SERVICE OR REPAIRS.

Either out of a sense of fair play or a further desire to make enforcement of the lease ironclad, ILC put a notice on the top of the lease that stated,

NOTICE: THIS IS A NON-CANCELABLE, BINDING CONTRACT. THIS CONTRACT WAS WRITTEN IN PLAIN LANGUAGE FOR YOUR BENEFIT. IT CONTAINS IMPORTANT TERMS AND CONDITIONS AND HAS LEGAL AND FINANCIAL CONSEQUENCES TO YOU. PLEASE READ IT CAREFULLY; FEEL FREE TO ASK QUESTIONS BEFORE SIGNING BY CALLING THE LEASING COMPANY AT 1-513-421-9191.

Arora, the owner of [defendant corporation], was a resident alien with degrees in commerce and economics from the University of Delhi, India. Arora wished to have an ATM on the premises of his Exxon station in the hope of increasing business. He made the mistake of arranging acquisition of the ATM through CCC. According to his testimony, a representative of CCC showed up at the station one day and gave him "formality papers" to sign before the ATM could be delivered. Arora stated that he was busy with other customers when the CCC representative asked him to sign the papers. He testified that when he informed the CCC representative that he needed time to read the documents before signing them, he was told not to worry and...that the papers did not need his attention and that his signature was a mere formality. Arora signed the ILC lease, having never read it.

Within days, CCC went into bankruptcy. Arora found himself with an ATM that he no longer wanted....According to his testimony, he tried unsuccessfully to contact ILC to take back the ATM. Soon Arora suffered a mild heart attack, the gas station went out of business, and the ATM, which had been in place for approximately eighteen days, was left sitting in the garage, no longer in use until ILC came and removed it several months later.

Unfortunately for Arora, the lease also had an acceleration clause that read,

DEFAULT. If you fail to pay us or perform as agreed, we will have the right to (i) terminate this lease, (ii) sue you for all past due payment AND ALL FUTURE PAYMENTS UNDER THIS LEASE, plus the Residual Value we have placed on the equipment and other charges you owe us, (iii) repossess the equipment at your expense and (iv) exercise any other right or remedy which may be available under applicable law or proceed by court act.

The trial court listened to the evidence in this case, which was awkwardly presented due in large part to Arora's decision to act as his own trial counsel. Obviously impressed with Arora's honesty and sympathetic to his situation, the trial court found that Arora owed ILC nothing. In so ruling, the court stated that ILC "ha[d] not complied with any of its contractual obligations and that [Arora] appropriately canceled any obligations by him, if there really were any." The court also found that ILC, "if they did have a contract, failed to mitigate any damages by timely picking up the machine after [Arora] gave them notice to pick up the machine."...

ILC contends, and we do not disagree, that the lease in question satisfied the definition of a "finance lease" under [UCC 2A-407]. A finance lease is considerably different from an ordinary lease in that it adds a third party, the equipment supplier or manufacturer (in this case, the now defunct CCC). As noted by White and Summers, "In effect, the finance lessee \* \* \* is relying upon the manufacturer \* \* \* to provide the promised goods and stand by its promises and warranties; the [lessee] does not look to the [lessor] for these. The [lessor] is only a finance lessor and deals largely in paper, rather than goods." [Citation].

One notorious feature of a finance lease is its typically noncancelable nature, which is specifically authorized by statute [UCC 2A-407]. [UCC 2A-407(1)] provides in the case of a finance lease that is not a consumer lease, "[T]he lessee's promises under the lease contract become irrevocable and independent upon the lessee's acceptance of the goods." The same statutory section also makes clear that the finance lease is "not subject to cancellation, termination, modification, repudiation, excuse, or substitution without the consent of the party to whom it runs." [Citation]

Because of their noncancelable nature, finance leases enjoy somewhat of a reputation. The titles of law review articles written about them reveal more than a little cynicism regarding their fairness: [Citations].

...As described by Professors White and Summers, “The parties can draft a lease agreement that carefully excludes warranty and promissory liability of the finance lessor to the lessee, and that sets out what is known in the trade as a ‘hell or high water clause,’ namely, a clause that requires the lessee to continue to make rent payments to the finance lessor even though the [equipment] is unsuitable, defective, or destroyed.”...“The lessor’s responsibility is merely to provide the money, not to instruct the lessee like a wayward child concerning a suitable purchase \* \* \*. Absent contrary agreement, even if [, for example, a finance-leased] Boeing 747 explodes into small pieces in flight and is completely uninsured, lessee’s obligation to pay continues.”

...Some people complain about being stuck with the bill; Arora’s complaint was that he was stuck with the ATM....

To begin the proper legal analysis, we note first that this was not a “consumer lease” expressly excepted from [UCC 2A-407]. A “consumer lease” is defined in [UCC 2A-103(e)] as one in which the lessee is “an individual and who takes under the lease primarily for a personal, family, or household purpose.” This would definitely not apply here, where the ATM was placed on the business premises of the Exxon station, and where the lessee was [Arora’s corporation] and not Arora individually. (Arora was liable individually as the personal guarantor of [his corporation]’s obligations under the lease.)...

Certain defenses do remain, however. First, the UCC expressly allows for the application of the doctrine of unconscionability to finance leases, both consumer and commercial. [Citation] authorizes the trial court to find “any clause of a lease contract to have been unconscionable at the time it was made \* \* \*.” If it so finds, the court is given the power to “refuse to enforce the lease contract, \* \* \* enforce the remainder of the lease contract without the unconscionable clause, or \* \* \* limit the application of the unconscionable clause as to avoid any unconscionable result.” [Citation]

In this case, the trial court made no findings as to whether the finance lease was unconscionable. The primary purpose of the doctrine of unconscionability is to prevent oppression and unfair surprise. [Citation] “Oppression” refers to substantive unconscionability and arises from overly burdensome or punitive terms of a contract, whereas “unfair surprise” refers to procedural unconscionability and is implicated in the formation of a contract, when one of the parties is either overborne by a lack of equal bargaining power or otherwise unfairly or unjustly drawn into a contract. [Citation]

It should be pointed that, although harsh, many characteristics of a finance lease are not inherently unconscionable and, as we have discussed, are specifically authorized by statute. Simply because a finance lease has a “hell or high water clause” does not make it unconscionable. As noted, a finance lease is a separate animal—it is supposed to secure minimal risk to the lessor. At least one court has rejected the argument that an acceleration clause in a commercial finance lease is punitive and unconscionable in the context of parties of relatively equal bargaining power. See [Citation]

At the heart of Arora’s defense in this case was his claim that he was misled into signing the finance lease by the CCC representative and was unfairly surprised to find himself the unwitting signatory of an oppressive lease. This is clearly an argument that implicated procedural unconscionability. His claim of being an unwitting signatory, however, must be carefully balanced against the law in Ohio that places upon a person a duty to read any contract before signing it, a duty that is not excused simply because a person willingly gives into the encouragement to “just go ahead and sign.” See [Citation]

Moreover, we note that courts have also recognized that the lessor may give, through word or conduct, the lessee consent to cancel an otherwise noncancelable lease. [UCC 2A-40792)(b)] makes a finance lease “not subject to cancellation, termination, modification, repudiation, excuse, or substitution *without the consent of the party to whom it runs.*” (Emphasis supplied.) As noted by the court in *Colonial Court* [Citation], the UCC does not say anything with respect to the form or content of the consent. The *Colonial Pacific* court concluded, therefore, “that the consent may be oral and may be established by conduct that reasonably manifests an intent. \* \* \* Any manifestations that the obligation of the lessee will not be enforced independently of the obligation that runs to the consenting party is sufficient.” The question whether consent has been given to a cancellation is a question of fact for the trier of fact.

We raise this point because the evidence indicates that there was some communication between Arora and ILC before ILC retrieved the ATM. It is unclear whether ILC removed the ATM at Arora’s request, or whether the company was forcibly repossessing the equipment pursuant to the default provision of the lease. In view of the murkiness of the testimony, it is unclear when the ATM was taken back and when the final lease payment was made. One interesting question that arises from ILC’s retrieval of the ATM, not addressed in the record, is what ILC did with the equipment afterward. Did ILC warehouse the equipment for the next four and one-half years (conduct that would appear unprofitable and therefore unlikely) or did the company then turn around and lease the ATM to someone else? If there was another lease, was ILC actually seeking a double recovery on the ATM’s rental value? In this regard, we note that the trial court ruled that ILC had failed to

mitigate its damages, a finding that is not supported by the current record, but may well prove to be true upon further trial of the matter.

In sum, this is a case that requires a much more elaborate presentation of evidence by the parties, and much more detailed findings of fact and conclusions of law than those actually made by the trial court. We sustain ILC's assignment of error upon the basis that the trial court did not apply the correct legal analysis, and that the evidence of record did not mandate a judgment in Arora's favor. Because of the number of outstanding issues and unresolved factual questions, we reverse the trial court's judgment and remand this case for a new trial consistent with the law set forth in this opinion.

Judgment reversed and cause remanded.

### CASE QUESTIONS

1. Why would a finance lease have such an iron-clad, "hell or high water" noncancellation clause as is apparently common and demonstrated here?
2. On what basis did the lower court rule in the defendant's favor?
3. What is an acceleration clause?
4. What was Mr. Arora's main defense? What concern did the court have with it?
5. The appeals court helpfully suggested several arguments the defendant might make on remand to be relieved of his contract obligations. What were they?

## 17.6 Summary and Exercises

### Summary

Sales law is a special type of contract law, governed by Article 2 of the Uniform Commercial Code (UCC), adopted in every state but Louisiana. Article 2 governs the sale of goods only, defined as things movable at the time of identification to the contract for sale. Article 2A, a more recent offering, deals with the leasing of goods, including finance leases and consumer leases. The Convention on Contracts for the International Sale of Goods (CISG) is an international equivalent of Article 2.

Difficult questions sometimes arise when the subject of the contract is a hybrid of goods and real estate or goods and services. If the seller is called on to sever crops, timber, or minerals from the land, or the buyer is required to sever and can do so without material harm to the land, then the items are goods subject to Article 2. When the goods are “sold” incidental to a service, the “predominant factor” test is used, but with inconsistent results. For two categories of goods, legislation specifically answers the question: foodstuffs served by a restaurant are goods; blood supplied for transfusions is not.

Although they are kin, in some areas Article 2 differs from the common law. As regards mutual assent, the UCC abolishes the mirror image rule; it allows for more indefiniteness and open terms. The UCC does away with some requirements for consideration. It sometimes imposes special obligations on merchants (though defining a merchant is problematic), those who deal in goods of the kind, or who by their occupations hold themselves out as experts in the use of the goods as between other merchants and in selling to nonmerchants. Article 2 gives courts greater leeway than under the common law to modify contracts at the request of a party, if a clause is found to have been unconscionable at the time made.



## EXERCISES

1. Ben owns fifty acres of timberland. He enters into a contract with Bunyan under which Bunyan is to cut and remove the timber from Ben's land. Bunyan enters into a contract to sell the logs to Log Cabin, Inc., a homebuilder. Are these two contracts governed by the UCC? Why?
2. Clarence agreed to sell his farm to Jud in exchange for five antique cars owned by Jud. Is this contract governed by the UCC? Why?
3. Professor Byte enters into a contract to purchase a laptop computer from Ultra-Intelligence Inc. He also enters into a contract with a graduate student, who is to write programs that will be run on the computer. Are these two contracts governed by the UCC? Why?
4. Pat had a skin problem and went to Dr. Pore, a dermatologist, for treatment. Dr. Pore applied a salve obtained from a pharmaceutical supplier, which made the problem worse. Is Dr. Pore liable under Article 2 of the UCC? Why?
5. Zanae visited the Bonita Burrito restaurant and became seriously ill after eating tainted food. She was rushed to a local hospital, where she was given a blood transfusion. Zanae developed hepatitis as a result of the transfusion. When she sued the restaurant and the hospital, claiming remedies under the UCC, both defended the suit by arguing that they were providing services, not goods. Are they correct? Why?
6. Bill, the owner of Bill's Used Books, decided to go out of business. He sold two of his bookcases to Ned. Ned later discovered that the bookcases were defective and sued Bill on the theory that, as a merchant, he warranted that the bookcases were of fair, average quality. Will Ned prevail on this theory? Why?
7. Rufus visited a supermarket to purchase groceries. As he moved past a display of soda pop and perhaps lightly brushed it, a bottle exploded. Rufus sustained injury and sued the supermarket, claiming breach of warranty under the UCC. Will Rufus win? Why?
8. Carpet Mart bought carpet from Collins & Aikman (Defendant) represented to be 100 percent polyester fiber. When Carpet Mart discovered in fact the carpet purchased was composed of cheaper, inferior fiber, it sued for compensatory and punitive damages. Defendant moved for a stay pending arbitration, pointing to the language of its acceptance form: "The acceptance of your order is subject to all the terms and conditions on the face and reverse side hereof, including arbitration, all of which are accepted by buyer; it supersedes buyer's order form."

The small print on the reverse side of the form provided, among other things, that all claims arising out of the contract would be submitted to arbitration in New York City. The lower court held that Carpet Mart was not bound by the arbitration agreement appearing on the back of Collins & Aikman's acknowledgment form, and Defendant appealed. How should the appeals court rule?

9. Plaintiff shipped to Defendant—Pizza Pride Inc. of Jamestown, North Carolina—an order of mozzarella cheese totaling \$11,000. That same day, Plaintiff mailed Defendant an invoice for the order, based on Plaintiff's understanding that an oral contract existed between the parties whereby Defendant had agreed to pay for the cheese. Defendant was engaged in the real estate business at this time and had earlier been approached by Pizza Pride Inc. to discuss that company's real estate investment potential. Defendant denied ever guaranteeing payment for the cheese and raised the UCC's Statute of Frauds, Section 2-201, as an affirmative defense. The Plaintiff contended that because Defendant was in the business of buying and selling real estate, she possessed knowledge or skill peculiar to the practices involved in the transaction here. After hearing the evidence, the court concluded as a matter of law that Defendant did agree to pay for the cheese and was liable to Plaintiff in the amount of \$11,000. Defendant appealed. How should the appeals court rule?
10. Seller offered to sell to Buyer goods at an agreed price "to be shipped to Buyer by UPS." Buyer accepted on a form that included this term: "goods to be shipped FedEx, Buyer to pay freight." Seller then determined not to carry on with the contract as the price of the goods had increased, and Seller asserted that because the acceptance was different from the offer, there was no contract. Is this correct?

## SELF-TEST QUESTIONS

1. Among subjects the UCC does not cover are
  - a. letters of credit
  - b. service contracts
  - c. sale of goods
  - d. bank collections
  
2. When a contract is unconscionable, a court may
  - a. refuse to enforce the contract
  - b. strike the unconscionable clause
  - c. limit the application of the unconscionable clause
  - d. take any of the above approaches
  
3. Under the UCC, the definition of *merchant* is limited to
  - a. manufacturers
  - b. retailers
  - c. wholesalers
  - d. none of the above
  
4. For the purpose of sales law, *goods*
  - a. always include items sold incidental to a service
  - b. include things movable at the time of identification to the contract
  - c. include blood supplied for transfusions
  - d. include all of the above
  
5. Article 2 differs from the common law of contracts
  - a. in no substantial way
  - b. by disallowing parties to create agreements with open terms
  - c. by obligating courts to respect all terms of the contract
  - d. by imposing special obligations on merchants

**SELF-TEST ANSWERS**

1. a
2. d
3. d
4. b
5. d

## Chapter 18

### Title and Risk of Loss

#### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. Why title is important and at what point in the contracting relationship the buyer acquires title
2. Why risk of loss is important, when risk of loss passes to the buyer, and when the buyer acquires an insurable interest
3. Under what circumstances the buyer can obtain title when a nonowner sells the goods

Parties to a sales contract will usually agree on the obvious details of a sales transaction—the nature of goods, the price, and the delivery time, as discussed in the next chapter. But there are two other issues of importance lurking in the background of every sale:

1. When does the title pass to the buyer? This question arises more in cases involving third parties, such as creditors and tax collectors. For instance, a creditor of the seller will not be allowed to take possession of goods in the seller's warehouse if the title has already passed to the buyer.
2. If goods are damaged or destroyed, who must bear the loss? The answer has obvious financial significance to both parties. If the seller must bear the loss, then in most cases he must pay damages or send the buyer another shipment of goods. A buyer who bears the loss must pay for the goods even though they are unusable. In the absence of a prior agreement, loss can trigger litigation between the parties.

## 18.1 Transfer of Title

### LEARNING OBJECTIVES

1. Understand why it is important to know who has title in a sales transaction.
2. Be able to explain when title shifts.
3. Understand when a person who has no title can nevertheless pass good title on to a buyer.

### Why It Is Important When Title Shifts

There are three reasons why it is important when title shifts from seller to buyer—that is, when the buyer gets title.

#### It Affects Whether a Sale Has Occurred

First, a sale cannot occur without a shift in title. You will recall that a sale is defined by the Uniform Commercial Code (UCC) as a “transfer of title from seller to buyer for a price.” Thus if there is no shift of title, there is no sale. And there are several consequences to there being no sale, one of which is—concerning a merchant-seller—that no implied warranty of merchantability arises. (Again, as discussed in the previous chapter, an implied warranty provides that when a merchant-seller sells goods, the goods are suitable for the ordinary purpose for which such goods are used.) In a lease, of course, title remains with the lessor.

#### Creditors’ Rights

Second, title is important because it determines whether creditors may take the goods. If a creditor has a right to seize a debtor’s goods to satisfy a judgment or because the parties have a security agreement (giving the creditor the right to repossess the debtor’s goods), obviously it won’t do at all for the creditor to seize goods when the debtor doesn’t have title to them—they are somebody else’s goods, and seizing them would be conversion, a tort (the civil equivalent of a theft offense).

#### Insurable Interest

Third, title is related to who has an **insurable interest**. A buyer cannot legally obtain insurance unless he has an insurable interest in the goods. Without an

insurable interest, the insurance contract would be an illegal gambling contract. For example, if you attempt to take out insurance on a ship with which you have no connection, hoping to recover a large sum if it sinks, the courts will construe the contract as a wager you have made with the insurance company that the ship is not seaworthy, and they will refuse to enforce it if the ship should sink and you try to collect. Thus this question arises: under the UCC, at what point does the buyer acquire an insurable interest in the goods? Certainly a person has insurable interest if she has title, but the UCC allows a person to have insurable interest with less than full title. The argument here is often between two insurance companies, each *denying* that its insured had insurable interest as to make it liable.

## Goods Identified to the Contract

### The Identification Issue

The UCC at Section 2-401 provides that “title to goods cannot pass under a contract for sale prior to their identification to the contract.” (In a lease, of course, title to the leased goods does not pass at all, only the right to possession and use for some time in return for consideration. Uniform Commercial Code, Section 2A-103(1)(j).) So identification to the contract has to happen before title can shift. **Identification to the contract**<sup>1</sup> here means that the seller in one way or another picks the goods to be sold out of the mass of inventory so that they can be delivered or held for the buyer.

**Article 67 of the CISG says the same thing: “[T]he risk does not pass to the buyer until the goods are clearly identified to the contract, whether by markings on the goods, by shipping documents, by notice given to the buyer or otherwise.”**

When are goods “identified”? There are two possibilities as to when identification happens.

### Parties May Agree

Section 2-501(1) of the UCC says “identification can be made at any time and in any manner explicated agreed to by the parties.”

### UCC Default Position

If the parties do not agree on when identification happens, the UCC default kicks in. Section 2-501(1) of the UCC says identification occurs

1. Segregating specific goods from the mass as the ones for the immediate contract.

- a. when the contract is made if it is for the sale of goods already existing and identified;
- b. if the contract is for the sale of future goods other than those described in paragraph c., when goods are shipped, marked, or otherwise identified by the seller as goods to which the contract refers;
- c. when crops are planted or otherwise become growing crops or the young are conceived if the contract is for the sale of unborn young to be born within twelve months after contract or for the sale of corps to be harvested within twelve months or the next normal harvest seasons after contracting, whichever is longer.

Thus if Very Fast Food Inc.'s purchasing agent looks at a new type of industrial sponge on Delta Sponge Makers' store shelf for restaurant supplies, points to it, and says, "I'll take it," identification happens then, when the contract is made. But if the purchasing agent wants to purchase sponges for her fast-food restaurants, sees a sample on the shelf, and says, "I want a gross of those"—they come in boxes of one hundred each—identification won't happen until one or the other of them chooses the gross of boxes of sponges out of the warehouse inventory.

## **When Title Shifts**

### **Parties May Agree**

Assuming identification is done, when does title shift? The law begins with the premise that the agreement of the parties governs. Section 2-401(1) of the UCC says that, in general, "title to goods passes from the seller to the buyer in any manner and on any conditions explicitly agreed on by the parties." Many companies specify in their written agreements at what moment the title will pass; here, for example, is a clause that appears in sales contracts of Dow Chemical Company: "Title and risk of loss in all goods sold hereunder shall pass to Buyer upon Seller's delivery to carrier at shipping point." Thus Dow retains title to its goods only until it takes them to the carrier for transportation to the buyer.

Because the UCC's default position (further discussed later in this chapter) is that title shifts when the seller has completed delivery obligations, and because the parties may agree on delivery terms, they also may, by choosing those terms, effectively agree when title shifts (again, they also can agree using any other language they want). So it is appropriate to examine some delivery terms at this juncture. There are three possibilities: shipment contracts, destination contracts, and contracts where the goods are not to be moved.



## Shipment Contracts

In a **shipment contract**<sup>2</sup>, the seller's obligation is to send the goods to the buyer, but not to a particular destination. The typical choices are set out in the UCC at Section 2-319:

- **F.O.B. [place of shipment]**<sup>3</sup> (the place from which the goods are to be shipped goes in the brackets, as in "F.O.B. Seattle"). F.O.B. means "free on board"; the seller's obligation, according to Section 2-504 of the UCC, is to put the goods into the possession of a carrier and make a reasonable contract for their transportation, to deliver any necessary documents so the buyer can take possession, and promptly notify the buyer of the shipment.
- **F.A.S. [named port]**<sup>4</sup> (the name of the seaport from which the ship is carrying the goods goes in the brackets, as in "F.A.S. Long Beach"). F.A.S. means "free alongside ship"; the seller's obligation is to at his "expense and risk deliver the goods alongside the vessel in the manner usual in that port" and to provide the buyer with pickup instructions. Uniform Commercial Code, Section 2-319(2).
- **C.I.F.**<sup>5</sup> and **C. & F.**<sup>6</sup> These are actually not abbreviations for delivery terms, but rather they describe who pays insurance and freight. "C.I.F." means "cost, insurance, and freight"—if this term is used, it means that the contract price "includes in a lump sum the cost of the goods and the insurance and freight to the named destination." Uniform Commercial Code, Section 2-320. "C. & F." means that "the price so includes cost and freight to the named destination." Uniform Commercial Code, Section 2-320.

2. Seller must see goods are on board vehicle of transportation.
3. Seller must see goods are on board vehicle of transportation at place of shipment.
4. Seller must see goods are on dock for loading on ship at named port.
5. Cost of goods includes insurance and freight.
6. Cost of goods includes freight only.
7. Seller's obligation is to get goods to a specific destination.
8. Seller's obligation is to get goods to specific destination.
9. Seller's obligation is to get goods off-loaded from the ship.

## Destination Contracts

In a **destination contract**<sup>7</sup>, the seller's obligation is to see to it that the goods actually arrive at the destination. Here again, the parties may employ the use of abbreviations that indicate the seller's duties. See the following from the UCC, Section 2-319:

- **F.O.B. [destination]**<sup>8</sup> means the seller's obligation is to "at his own expense and risk transport the goods to that place and there tender delivery of them" with appropriate pickup instructions to the buyer.
- **Ex-ship**<sup>9</sup> "is the reverse of the F.A.S. term." Uniform Commercial Code, Section 2-322. It means "from the carrying vessel"—the seller's obligation is to make sure the freight bills are paid and that "the goods leave the ship's tackle or are otherwise properly unloaded."

- **No arrival, no sale**<sup>10</sup> means the “seller must properly ship conforming goods and if they arrive by any means he must tender them on arrival but he assumes no obligation that the goods will arrive unless he has caused the non-arrival.” Uniform Commercial Code, Section 2-324. If the goods don’t arrive, or if they are damaged or deteriorated through no fault of the seller, the buyer can either treat the contract as avoided, or pay a reduced amount for the damaged goods, with no further recourse against the seller. Uniform Commercial Code, Section 2-613.

### Goods Not to Be Moved

It is not uncommon for contracting parties to sell and buy goods stored in a grain elevator or warehouse without physical movement of the goods. There are two possibilities:

1. Goods with documents of title. A first possibility is that the ownership of the goods is manifested by a **document of title**<sup>11</sup>—“bill of lading, dock warrant, dock receipt, warehouse receipt or order for the delivery of goods, and also any other document which in the regular course of business or financing is treated as adequately evidencing that the person in possession of it is entitled to receive, hold and dispose of the document and the goods it covers.” Uniform Commercial Code, Section 1-201(15). In that case, the UCC, Section 2-401(3)(a), says that title passes “at the time when and the place where” the documents are delivered to the buyer.
2. Goods without documents of title. If there is no physical transfer of the goods and no documents to exchange, then UCC, Section 2-401(3)(b), provides that “title passes at the time and place of contracting.”

Here are examples showing how these concepts work.

Suppose the contract calls for Delta Sponge Makers to “ship the entire lot of industrial grade Sponge No. 2 by truck or rail” and that is all that the contract says about shipment. That’s a “shipment contract,” and the UCC, Section 2-401(2)(a), says that title passes to Very Fast Foods at the “time and place of shipment.” At the moment that Delta turns over the 144 cartons of 1,000 sponges each to a trucker—perhaps Easy Rider Trucking comes to pick them up at Delta’s own factory—title has passed to Very Fast Foods.

Suppose the contract calls for Delta to “deliver the sponges on June 10 at the Maple Street warehouse of Very Fast Foods Inc.” This is a destination contract, and the

10. Seller must ship conforming goods but assumes no obligation that they arrive.

11. Paper representing ownership interest in goods.

seller “completes his performance with respect to the physical delivery of the goods” when it pulls up to the door of the warehouse and tenders the cartons. Uniform Commercial Code, Section 2-401(2)(b). “Tender” means that the party—here Delta Sponge Makers—is ready, able, and willing to perform and has notified its obligor of its readiness. When the driver of the delivery truck knocks on the warehouse door, announces that the gross of industrial grade Sponge No. 2 is ready for unloading, and asks where the warehouse foreman wants it, Delta has tendered delivery, and title passes to Very Fast Foods.

Suppose Very Fast Foods fears that the price of industrial sponges is about to soar; it wishes to acquire a large quantity long before it can use them all or even store them all. Delta does not store all of its sponges in its own plant, keeping some of them instead at Central Warehousing. Central is a **bailee**<sup>12</sup>, one who has rightful possession but not title. (A parking garage often is a bailee of its customers’ cars; so is a carrier carrying a customer’s goods.) Now assume that Central has issued a **warehouse receipt**<sup>13</sup> (a document of title that provides proof of ownership of goods stored in a warehouse) to Delta and that Delta’s contract with Very Fast Foods calls for Delta to deliver “document of title at the office of First Bank” on a particular day. When the goods are not to be physically moved, that title passes to Very Fast Foods “at the time when and the place where” Delta delivers the document.

Suppose the contract did not specify physical transfer or exchange of documents for the purchase price. Instead, it said, “Seller agrees to sell all sponges stored on the north wall of its Orange Street warehouse, namely, the gross of industrial Sponge No. 2, in cartons marked B300–B444, to Buyer for a total purchase price of \$14,000, payable in twelve equal monthly installments, beginning on the first of the month beginning after the signing of this agreement.” Then title passes at the time and place of contracting—that is, when Delta Sponge Makers and Very Fast Foods sign the contract.

So, as always under the UCC, the parties may agree on the terms they want when title shifts. They can do that directly by just saying when—as in the Dow Chemical example—or they can indirectly agree when title shifts by stipulating delivery terms: shipment, destination, goods not to be moved. If they don’t stipulate, the UCC default kicks in.

#### UCC Default Provision

If the parties do not stipulate by any means when title shifts, Section 2-401(2) of the UCC provides that “title passes to the buyer at the time and place at which seller completes his performance with reference to the physical delivery of the goods.” And if the parties have no term in their contract about delivery, the UCC’s default

12. One rightfully possessing goods not hers.

13. A written document for items warehoused, serving as evidence of title to the stored goods.

delivery term controls. It says “the place for delivery is the seller’s place of business or if he has none his residence,” and delivery is accomplished at the place when the seller “put[s] and hold[s] conforming goods at the buyer’s disposition and give[s] the buyer any notification reasonably necessary to enable him to take delivery.” Uniform Commercial Code, Sections 2-308 and 2-503.

### KEY TAKEAWAY

Title is important for three reasons: it determines whether a sale has occurred, it determines rights of creditors, and it affects who has an insurable interest. Parties may explicitly agree when title shifts, or they may agree indirectly by settling on delivery terms (because absent explicit agreement, delivery controls title passage). Delivery terms to choose from include shipment contracts, destination contracts, and delivery without the goods being moved (with or without documents of title). If nothing is said about when title shifts, and the parties have not indirectly agreed by choosing a delivery term, then title shifts when delivery obligations under the contract are complete, and if there are no delivery terms, delivery happens when the seller makes the goods available at seller’s place of business (or if seller has no place of business, goods will be made available at seller’s residence)—that’s when title shifts.

### EXERCISES

1. Why does it matter who has title?
2. If the parties do not otherwise agree, when does title shift from seller to buyer?
3. Why does the question of delivery terms arise in examining when title shifts?
4. When does title shift for goods stored in a warehouse that are not to be moved?

## 18.2 Title from Nonowners

### LEARNING OBJECTIVE

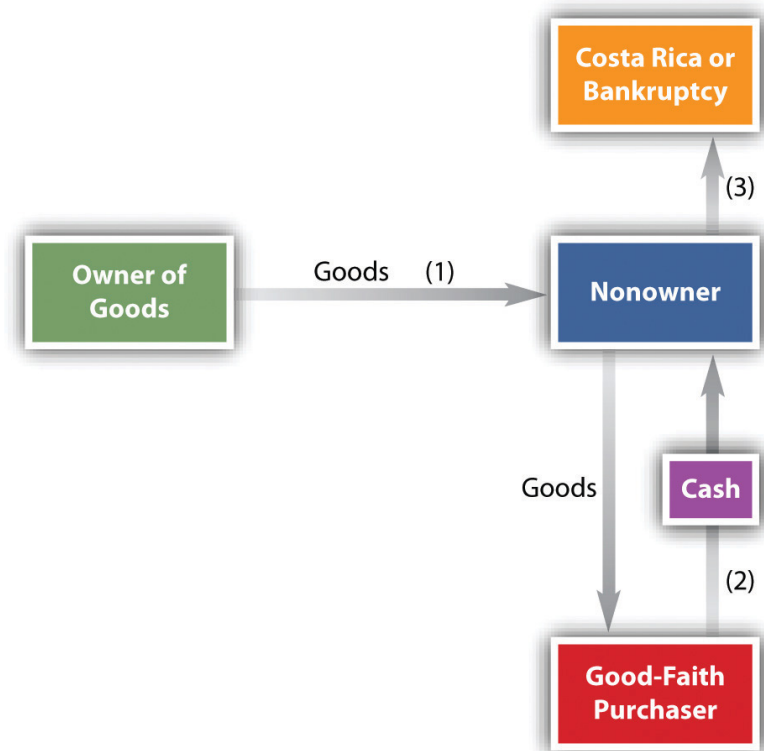
1. Understand when and why a nonowner can nevertheless pass title on to a purchaser.

### The Problem of Title from Nonowners

We have examined when title transfers from buyer to seller, and here the assumption is, of course, that seller had good title in the first place. But what title does a purchaser acquire when the seller has no title or has at best only a voidable title? This question has often been difficult for courts to resolve. It typically involves a type of eternal triangle with a three-step sequence of events, as follows (see [Figure 18.1 "Sales by Nonowners"](#)): (1) The nonowner obtains possession, for example, by loan or theft; (2) the nonowner sells the goods to an innocent purchaser for cash; and (3) the nonowner then takes the money and disappears, goes into bankruptcy, or ends up in jail. The result is that two innocent parties battle over the goods, the owner usually claiming that the purchaser is guilty of **conversion**<sup>14</sup> (i.e., the unlawful assumption of ownership of property belonging to another) and claiming damages or the right to recover the goods.

14. The civil wrong of taking property without its owner's consent.

Figure 18.1 Sales by Nonowners



## The Response to the Problem of Title from Nonowners

### The Basic Rule

To resolve this dilemma, we begin with a basic policy of jurisprudence: a person cannot transfer better title than he or she had. (The Uniform Commercial Code [UCC] notes this policy in Sections 2-403, 2A-304, and 2A-305.) This policy would apply in a sale-of-goods case in which the nonowner had a void title or no title at all. For example, if a nonowner stole the goods from the owner and then sold them to an innocent purchaser, the owner would be entitled to the goods or to damages. Because the thief had no title, he had no title to transfer to the purchaser. A person cannot get good title to goods from a thief, nor does a person have to retain physical possession of her goods at all times to retain their ownership—people are expected to leave their cars with a mechanic for repair or to leave their clothing with a dry cleaner.

If thieves could pass on good title to stolen goods, there would be a hugely increased traffic in stolen property; that would be unacceptable. In such a case, the owner can get her property back from whomever the thief sold it to in an action called **replevin**<sup>15</sup> (an action to recover personal property unlawfully taken). On the

15. An action to recover possession of goods wrongfully held.

other hand, when a buyer in good faith buys goods from an apparently reputable seller, she reasonably expects to get good title, and that expectation cannot be dashed with impunity without faith in the market being undermined. Therefore, as between two innocent parties, sometimes the original owner does lose, on the theory that (1) that person is better able to avoid the problem than the downstream buyer, who had absolutely no control over the situation, and (2) faith in commercial transactions would be undermined by allowing original owners to claw back their property under all circumstances.

So the basic legal policy that a person cannot pass on better title than he had is subject to a number of exceptions. In [Chapter 24 "Holder in Due Course and Defenses"](#), for instance, we discuss how certain purchasers of commercial paper (“holders in due course”) will obtain greater rights than the sellers possessed. And in [Chapter 28 "Secured Transactions and Suretyship"](#), we examine how a buyer in the ordinary course of business is allowed to purchase goods free of security interests that the seller has given to creditors. Likewise, the law governing the sale of goods contains exceptions to the basic legal policy. These usually fall within one of two categories: sellers with voidable title and entrustment.

### **The Exceptions**

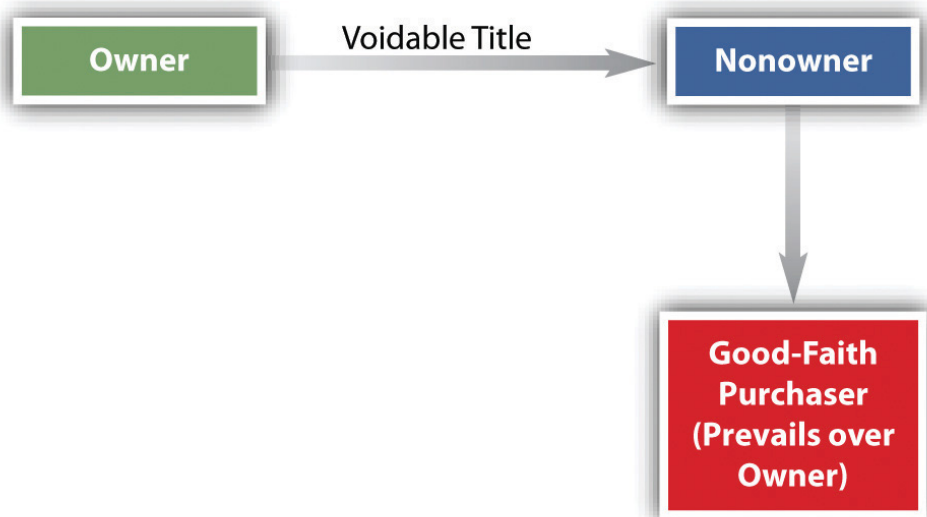
As noted, there are exceptions to the law governing the sale of goods.

#### **Sellers with a Voidable Title**

Under the UCC, a person with a voidable title has the power to transfer title to a good-faith purchaser for value (see [Figure 18.2 "Voidable Title"](#)). The UCC defines *good faith* as “honesty in fact in the conduct or transaction concerned.” Uniform Commercial Code, Section 1-201(19). A “purchaser” is not restricted to one who pays cash; any taking that creates an interest in property, whether by mortgage, pledge, lien, or even gift, is a purchase for purposes of the UCC. And “value” is not limited to cash or goods; a person gives value if he gives any consideration sufficient to support a simple contract, including a binding commitment to extend credit and security for a preexisting claim. Recall from [Chapter 9 "The Agreement"](#) that a “voidable” title is one that, for policy reasons, the courts will cancel on application of one who is aggrieved. These reasons include fraud, undue influence, mistake, and lack of capacity to contract. When a person has a voidable title, title can be taken away from her, but if it is not, she can transfer better title than she has to a good-faith purchaser for value. (See [Section 18.4.2 "Defrauding Buyer Sells to Good-Faith Purchaser for Value"](#) at the end of this chapter.)

Rita, sixteen years old, sells a video game to her neighbor Annie, who plans to give the game to her nephew. Since Rita is a minor, she could rescind the contract; that is, the title that Annie gets is voidable: it is subject to be avoided by Rita’s rescission. But Rita does not rescind. Then Annie discovers that her nephew already has that video game, so she sells it instead to an office colleague, Donald. He has had no notice that Annie bought the game from a minor and has only a voidable title. He pays cash. Should Rita—the minor—subsequently decide she wants the game back, it would be too late: Annie has transferred good title to Donald even though Annie’s title was voidable.

Figure 18.2 *Voidable Title*



Suppose Rita was an adult and Annie paid her with a check that later bounced, but Annie sold the game to Donald before the check bounced. Does Donald still have good title? The UCC says he does, and it identifies three other situations in which the good-faith purchaser is protected: (1) when the original transferor was deceived about the identity of the purchaser to whom he sold the goods, who then transfers to a good-faith purchaser; (2) when the original transferor was supposed to but did not receive cash from the intermediate purchaser; and (3) when “the delivery was procured through fraud punishable as larcenous under the criminal law.” Uniform Commercial Code, Sections 2-403(1), 2-403(1), 2A-304, and 2A-305.

This last situation may be illustrated as follows: Dimension LLC leased a Volkswagen to DK Inc. The agreement specified that DK could use the Volkswagen solely for business and commercial purposes and could not sell it. Six months later, the owner of DK, Darrell Kempf, representing that the Volkswagen was part of DK’s used-car



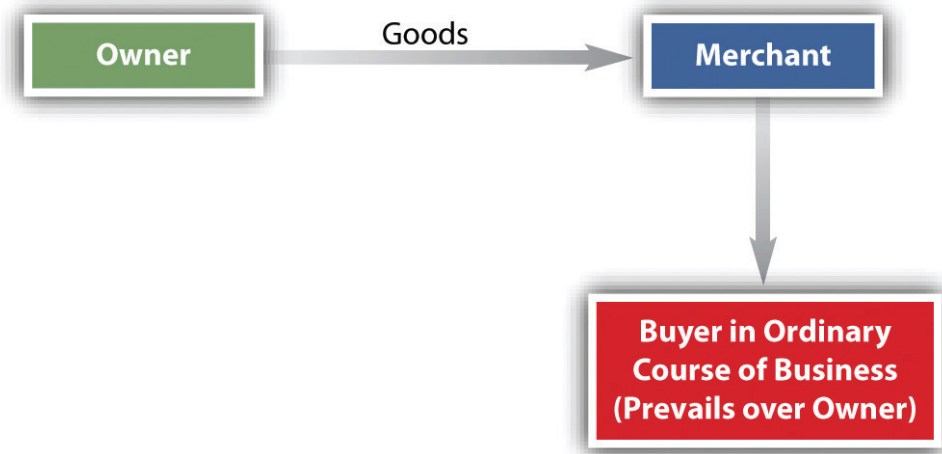
inventory, sold it to Edward Seabold. Kempf embezzled the proceeds from the sale of the car and disappeared. When DK defaulted on its payments for the Volkswagen, Dimension attempted to repossess it. Dimension discovered that Kempf had executed a release of interest on the car's title by forging the signature of Dimension's manager. The Washington Court of Appeals, applying the UCC, held that Mr. Seabold should keep the car. The car was not stolen from Dimension; instead, by leasing the vehicle to DK, Dimension transferred possession of the car to DK voluntarily, and because Seabold was a good-faith purchaser, he won. *Dimension Funding, L.L.C. v. D.K. Associates, Inc.*, 191 P.3d 923 (Wash. App. 2008).

### Entrustment

A merchant who deals in particular goods has the power to transfer all rights of one who entrusts to him goods of the kind to a “buyer in the ordinary course of business” (see [Figure 18.3 "Entrustment"](#)). Uniform Commercial Code, Sections 2-403(2), 2A-304(2), and 2A-305(2). The UCC defines such a buyer as a person who buys goods in an ordinary transaction from a person in the business of selling that type of goods, as long as the buyer purchases in “good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party in the goods.” Uniform Commercial Code, Section 1-201(9). Bess takes a pearl necklace, a family heirloom, to Wellborn's Jewelers for cleaning; as the **entrustor**<sup>16</sup>, she has entrusted the necklace to an **entrustee**<sup>17</sup>. The owner of Wellborn's—perhaps by mistake—sells it to Clara, a buyer, in the ordinary course of business. Bess cannot take the necklace back from Clara, although she has a cause of action against Wellborn's for conversion. As between the two innocent parties, Bess and Clara (owner and purchaser), the latter prevails. Notice that the UCC only says that the entrustee can pass *whatever title the entrustor had* to a good-faith purchaser, not necessarily good title. If Bess's cleaning woman borrowed the necklace, soiled it, and took it to Wellborn's, which then sold it to Clara, Bess could get it back because the cleaning woman had no title to transfer to the entrustee, Wellborn's.

16. One who puts something into another's possession for its care.

17. One to whom something is put for its care.

Figure 18.3 *Entrustment*

Entrustment is based on the general principle of estoppel: “A rightful owner may be estopped by his own acts from asserting his title. If he has invested another with the usual evidence of title, or an apparent authority to dispose of it, he will not be allowed to make claim against an innocent purchaser dealing on the faith of such apparent ownership.” *Zendman v. Harry Winston, Inc.*, 111 N.E. 2d 871 (N.Y. 1953).

#### KEY TAKEAWAY

The general rule—for obvious reasons—is that nobody can pass on better title to goods than he or she has: a thief cannot pass on good title to stolen goods to anybody. But in balancing that policy against the reasonable expectations of good-faith buyers that they will get title, the UCC has made some exceptions. A person with voidable title can pass on good title to a good-faith purchaser, and a merchant who has been entrusted with goods can pass on title of the entrustor to a good-faith purchaser.

#### EXERCISES

1. Why is it the universal rule that good title to goods cannot be had from a thief?
2. What is the “voidable title” exception to the universal rule? Why is the exception made?
3. What is the “entrusting” exception to the general rule?

## 18.3 Risk of Loss

### LEARNING OBJECTIVES

1. Understand why who has the risk of loss is important.
2. Know how parties may agree on when the risk of loss shifts.
3. Know when the risk of loss shifts if there is no breach, and if there is a breach.
4. Recognize what “insurable interest” is, why it is important, and how it attaches.

### Why Risk of Loss Is Important

“Risk of loss” means who has to pay—who bears the risk—if the goods are lost or destroyed *without the fault of either party*. It is obvious why this issue is important: Buyer contracts to purchase a new car for \$35,000. While the car is in transit to Buyer, it is destroyed in a landslide. Who takes the \$35,000 hit?

**The CISG, Article 66, provides as follows: “Loss of or damage to the goods after the risk has passed to the buyer does not discharge him from his obligation to pay the price, unless the loss or damage is due to an act or omission of the seller.”**

### When Risk of Loss Passes

#### The Parties May Agree

Just as title passes in accordance with the parties’ agreement, so too can the parties fix the risk of loss on one or the other. They may even devise a formula to divide the risk between themselves. Uniform Commercial Code, Section 2-303.

Common terms by which parties set out their delivery obligations that then affect when title shifts (F.O.B., F.A.S., ex-ship, and so on) were discussed earlier in this chapter. Similarly, parties may use common terms to set out which party has the risk of loss; these situations arise with trial sales. That is, sometimes the seller will permit the buyer to return the goods even though the seller had conformed to the contract. When the goods are intended primarily for the buyer’s use, the transaction is said to be “sale on approval.” When they are intended primarily for resale, the transaction is said to be “sale or return.” When the “buyer” is really only a sales agent for the “seller,” it is a consignment sale.

### Sale on Approval

Under a **sale-on-approval contract**<sup>18</sup>, risk of loss (and title) remains with the seller until the buyer accepts, and the buyer's trial use of the goods does not in itself constitute acceptance. If the buyer decides to return the goods, the seller bears the risk and expense of return, but a merchant buyer must follow any reasonable instructions from the seller. Very Fast Foods asks Delta for some sample sponges to test on approval; Delta sends a box of one hundred sponges. Very Fast plans to try them for a week, but before that, through no fault of Very Fast, the sponges are destroyed in a fire. Delta bears the loss. Uniform Commercial Code, Section 2-327(1)(a).

### Sale or Return

The buyer might take the goods with the expectation of reselling them—as would a women's wear shop buy new spring fashions, expecting to sell them. But if the shop doesn't sell them before summer wear is in vogue, it could arrange with the seller to return them for credit. In contrast to sale-on-approval contracts, **sale-or-return contracts**<sup>19</sup> have risk of loss (and title too) passing to the buyer, and the buyer bears the risk and expense of returning the goods.

Occasionally the question arises whether the buyer's other creditors may claim the goods when the sales contract lets the buyer retain some rights to return the goods. The answer seems straightforward: in a sale-on-approval contract, where title remains with the seller until acceptance, the buyer does not own the goods—hence they cannot be seized by his creditors—unless he accepts them, whereas they are the buyer's goods (subject to his right to return them) in a sale-or-return contract and may be taken by creditors if they are in his possession.

### Consignment Sales

18. An agreement whereby a buyer receives goods for examination. Risk of loss and title remains with the seller until the buyer indicates his or her approval of the goods (or after a reasonable time).

19. An agreement whereby the buyer (usually a retailer) accepts goods from a seller for resale. Risk of loss and title transfer to the buyer them, but if the goods do not sell, they may be returned to the seller, at the buyer's risk and expense.

In a consignment situation, the seller is a bailee and an agent for the owner who sells the goods for the owner and takes a commission. Under the Uniform Commercial Code (UCC), this is considered a sale or return, thus the consignee (at whose place the goods are displayed for sale to customers) is considered a buyer and has the risk of loss and title. Uniform Commercial Code, Section 2-326(3). The consignee's creditors can take the goods; that is, unless the parties comply "with an applicable law providing for a consignor's interest or the like to be evidenced by a sign, or where it is established that the person conducting the business is generally known by his creditors to be substantially engaged in selling the goods of others" (or complies with secured transactions requirements under Article 9, discussed in a later chapter). Uniform Commercial Code, Section 2-326.

### The UCC Default Position

If the parties fail to specify how the risk of loss is to be allocated or apportioned, the UCC again supplies the answers. A generally applicable rule, though not explicitly stated, is that risk of loss passes when the seller has completed obligations under the contract. Notice this is *not* the same as when title passes: title passes when seller has completed *delivery* obligations under the contract, risk of loss passes when *all* obligations are completed. (Thus a buyer could get good title to nonconforming goods, which might be better for the buyer than not getting title to them: if the seller goes bankrupt, at least the buyer has something of value.)

### Risk of Loss in Absence of a Breach

If the goods are *conforming*, then risk of loss would indeed pass when delivery obligations are complete, just as with title. And the analysis here would be the same as we looked at in examining shift of title.

**A shipment contract.** The contract requires Delta to ship the sponges by carrier but does not require it to deliver them to a particular destination. In this situation, risk of loss passes to Very Fast Foods when the goods are delivered to the carrier.

The CISG—pretty much like the UCC—provides as follows (Article 67):

**If the contract of sale involves carriage of the goods and the seller is not bound to hand them over at a particular place, the risk passes to the buyer when the goods are handed over to the first carrier for transmission to the buyer in accordance with the contract of sale. If the seller is bound to hand the goods over to a carrier at a particular place, the risk does not pass to the buyer until the goods are handed over to the carrier at that place.**

**A destination contract.** If the destination contract agreement calls for Delta to deliver the sponges by carrier to a particular location, Very Fast Foods assumes the risk of loss only when Delta's carrier tenders them at the specified place.

The CISG provides for basically the same thing (Article 69): “If the contract is for something other than shipment, the risk passes to the buyer when he takes over the goods or, if he does not do so in due time, from the time when the goods are placed at his disposal and he commits a breach of contract by failing to take delivery.”

**Goods not to be moved.** If Delta sells sponges that are stored at Central Warehousing to Very Fast Foods, and the sponges are not to be moved, Section 2-509(2) of the UCC sets forth three possibilities for transfer of the risk of loss:

1. The buyer receives a negotiable document of title covering the goods. A document of title is negotiable if by its terms goods are to be delivered to the bearer of the document or to the order of a named person.
2. The bailee acknowledges the buyer's right to take possession of the goods. Delta signs the contract for the sale of sponges and calls Central to inform it that a buyer has purchased 144 cartons and to ask it to set aside all cartons on the north wall for that purpose. Central does so, sending notice to Very Fast Foods that the goods are available. Very Fast Foods assumes risk of loss upon receipt of the notice.
3. When the seller gives the buyer a nonnegotiable document of title or a written direction to the bailee to deliver the goods and the buyer has had a reasonable time to present the document or direction.

**All other cases.** In any case that does not fit within the rules just described, the risk of loss passes to the buyer only when the buyer actually receives the goods. Cases that come within this section generally involve a buyer who is taking physical delivery from the seller's premises. A merchant who sells on those terms can be expected to insure his interest in any goods that remain under his control. The buyer is unlikely to insure goods not in his possession. The *Ramos* case ([Section 18.4.3 "Risk of Loss, Seller a Merchant"](#) in this chapter) demonstrates how this risk-of-loss provision applies when a customer pays for merchandise but never actually receives his purchase because of a mishap.

### **Risk of Loss Where Breach Occurs**

The general rule for risk of loss was set out as this: risk of loss shifts when seller has completed obligations under the contract. We said if the goods are conforming, the only obligation left is delivery, so then risk of loss would shift upon delivery. But if the goods are nonconforming, then the rule would say the risk doesn't shift. And that's correct, though it's subject to one wrinkle having to do with insurance. Let's examine the two possible circumstances: breach by seller and breach by buyer.

First, suppose the *seller* breaches the contract by proffering nonconforming goods, and the buyer *rejects* them—never takes them at all. Then the goods are lost or damaged. Under Section 2-510(1) of the UCC, the loss falls on seller and remains there until seller cures the breach or until buyer accepts despite the breach. Suppose Delta is obligated to deliver a gross of industrial No. 2 sponges; instead it

tenders only one hundred cartons or delivers a gross of industrial No. 3 sponges. The risk of loss falls on Delta because Delta has not completed its obligation under the contract and Very Fast Foods doesn't have possession of the goods. Or suppose Delta has breached the contract by tendering to Very Fast Foods a defective document of title. Delta cures the defect and gives the new document of title to Very Fast Foods, but before it does so the sponges are stolen. Delta is responsible for the loss.

Now suppose that a seller breaches the contract by proffering nonconforming goods and that the buyer, not having discovered the nonconformity, *accepts* them—the nonconforming goods are in the buyer's hands. The buyer has a right to revoke acceptance, but before the defective goods are returned to the seller, they are destroyed while in the buyer's possession. The seller breached, but here's the wrinkle: the UCC says that the seller bears the loss only to the extent of any deficiency in the buyer's insurance coverage. Uniform Commercial Code, Section 2-510(2). Very Fast Foods had taken delivery of the sponges and only a few days later discovered that the sponges did not conform to the contract. Very Fast has the right to revoke and announces its intention to do so. A day later its warehouse burns down and the sponges are destroyed. It then discovers that its insurance was not adequate to cover all the sponges. Who stands the loss? The seller does, again, to the extent of any deficiency in the buyer's insurance coverage.

Second, what if the *buyer* breaches the contract? Here's the scenario: Suppose Very Fast Foods calls two days before the sponges identified to the contract are to be delivered by Delta and says, "Don't bother; we no longer have a need for them." Subsequently, while the lawyers are arguing, Delta's warehouse burns down and the sponges are destroyed. Under the rules, risk of loss does not pass to the buyer until the seller has delivered, which has not occurred in this case. Nevertheless, responsibility for the loss here has passed to Very Fast Foods, to the extent that the seller's insurance does not cover it. Section 2-510(3) of the UCC permits the seller to treat the risk of loss as resting on the buyer for a "commercially reasonable time" when the buyer repudiates the contract before risk of loss has passed to him. This transfer of the risk can take place only when the goods are identified to the contract. The theory is that if the buyer had taken the goods as per the contract, the goods would not have been in the warehouse and thus would not have been burned up.

## **Insurable Interest**

### **Why It Matters**

We noted at the start of this chapter that who has title is important for several reasons, one of which is because it affects who has an insurable interest. (You can't take out insurance in something you have no interest in: if you have no title, you

may not have an insurable interest.) And it was noted that the rules on risk of loss are affected by insurance. (The theory is that a businessperson is likely to have insurance, which is a cost of business, and if she has insurance and also has possession of goods—even nonconforming ones—it is reasonable to charge her insurance with loss of the goods; thus she will have cause to take care of them in her possession, else her insurance rates increase.) So in commercial transactions insurance is important, and when goods are lost or destroyed, the frequent argument is between the buyer's and the seller's insurance companies, neither of which wants to be responsible. They want to deny that their insured had an insurable interest. Thus it becomes important who has an insurable interest.

### **Insurable Interest of the Buyer**

It is not necessary for the buyer to go all the way to having title in order for him to have an insurable interest. The buyer obtains a “special property and insurable interest in goods by identification of existing goods as goods to which the contract refers.” Uniform Commercial Code, Section 2-501(1). We already discussed how “identification” of the goods can occur. The parties can do it by branding, marking, tagging, or segregating them—and they can do it at any time. We also set out the rules for when goods will be considered identified to the contract under the UCC if the parties don't do it themselves (Section 18.1.2 "Goods Identified to the Contract").

### **Insurable Interest of the Seller**

As long as the seller retains title to or any security interest in the goods, he has an insurable interest.

### **Other Rights of the Buyer**

The buyer's “special property” interest that arises upon identification of goods gives the buyer rights other than that to insure the goods. For example, under Section 2-502 of the UCC, the buyer who has paid for unshipped goods may take them from a seller who becomes insolvent within ten days after receipt of the whole payment or the first installment payment. Similarly, a buyer who has not yet taken delivery may sue a third party who has in some manner damaged the property.



## KEY TAKEAWAY

Knowing who has the risk of loss in a contract for the sale of goods is important for obvious reasons: it is not uncommon for goods to be lost or stolen between the time they leave the seller's possession and before the buyer gets them. The parties are certainly free to agree on when the risk of loss shifts; if they do not, the UCC says it shifts when the seller has completed obligations under the contract. Thus if there is no breach, the risk of loss shifts upon delivery. If there is a breach, the UCC places the risk of loss on the breaching party, with this caveat: where the nonbreaching party is in control of the goods, the UCC places the risk of loss on that party to the extent of her insurance coverage. So if there is a breach by the seller (delivery of nonconforming goods), the risk of loss never shifts except if the buyer has taken possession of the nonconforming goods; in that case, the buyer does have the risk of loss insofar as her insurance covers the loss. If the buyer breaches by repudiating before the risk of loss passes to him (by the goods' delivery), the UCC permits the seller to treat the risk of loss as resting on the buyer for a commercially reasonable time as to goods identified to the contract.

Insurable interest becomes important when goods suffer a casualty loss because—among other reasons—often neither the seller's nor the buyer's insurance company wants *its* insured to have an interest in the goods: each side denies it. The seller retains an insurable interest if he has title to or any security interest in the goods, and the buyer obtains an insurable interest by identification of existing goods as goods to which the contract refers. A person has an insurable interest in any property owned or in the person's possession.

## EXERCISES

1. Which is more important in determining who has the risk of loss, the agreement of the parties or the UCC's default provisions?
2. When does the risk of loss shift to the buyer if the parties have no agreement on the issue?
3. Why does the UCC impose the risk of loss to the extent of his insurance on a nonbreaching party if that party has control of the goods?
4. Why can a person not take out insurance for goods in which the person has no interest? How does a seller retain an insurable interest? When does the buyer get an insurable interest?

## 18.4 Cases

### Transfer of Title: Destination Contracts

Sam and Mac, Inc. v. Treat

783 N.E.2d 760 (Ind. App. 2003)

Anthony L. Gruda and Sharon R. Gruda (the “Grudas”) owned and operated Gruda Enterprises, Inc. (Gruda Enterprises), which in turn operated The Kitchen Works, a kitchen supply business. On March 5, 1998, Gruda Enterprises contracted to sell a set of kitchen cabinets to Sam and Mac, Inc. [SMI], a commercial construction and contracting corporation. Gruda Enterprises was also to deliver and install the cabinets. Because it did not have the cabinets in stock, Gruda Enterprises ordered them from a manufacturer. On March 14, 1998, nine days after placing the order, SMI pre-paid Gruda Enterprises for the cabinet order.

On May 14, 1998, prior to delivery and installation of the cabinets, the Grudas ceased operation of Gruda Enterprises and filed for personal bankruptcy. Gruda Enterprises did not file for bankruptcy and was not dissolved. Instead, the Grudas’ stock in Gruda Enterprises became part of their bankruptcy estate....When no cabinets were delivered or installed, and the Grudas ceased operation of Gruda Enterprises, SMI asked Treat, who was the landlord of Gruda Enterprises, to open the business premises and permit SMI to remove cabinets from the property. Treat declined, stating that he feared he would incur liability to Gruda Enterprises if he started giving away its inventory. Treat and other secured creditors sued Gruda Enterprises, which owed them money. [Summary judgment was for Treat, SMI appeals.]

SMI contends that there was a completed sale between SMI, as the buyer, and Gruda Enterprises, as the seller. Specifically, SMI maintains that title to the cabinets under [UCC] 2-401(3)(b) passed to SMI when the contract for sale was [made]....Therefore, SMI argues that the trial court improperly granted summary judgment in favor of Treat because [SMI] held title and, thus, a possessory interest in the cabinets....

[T]he contract is governed by the...Indiana Uniform Commercial Code (UCC). 2-401 establishes the point in time at which title passes from seller to buyer. Specifically, 2-401(2) provides, in pertinent part, that unless explicitly agreed, title passes to the buyer at the time and place at which the seller completes his performance with respect to the physical delivery of goods....

Moreover, the record indicates that SMI and Gruda Enterprises did not have an explicit agreement to pass title at any other time, or at any time prior to actual delivery of the cabinets. SMI argues that title passed to it under 2-401(3)(b) [“where delivery is to be made without moving the goods,...if the goods are at the time of contacting already identified and no documents are to be delivered, title passes at the time and place of contacting.”]....However, the record reflects that SMI admitted that the terms of the contract required Gruda Enterprises to not only order the cabinets, but to deliver and install them at the location specified by SMI, i.e. the house that SMI was building. 2-403(3) applies to purchases of goods where delivery is to be made without moving the goods. SMI argues that since the cabinets were identified at the time of contracting and no documents needed delivery, title passed at the time and place of contracting....

[T]itle to goods cannot pass under a contract for sale prior to their identification in the contract. *See* 2-401(1). This does not mean that title passes when the goods are identified. It only means that identification is merely the earliest possible opportunity for title to pass....[I]dentification does not, in and of itself, confer either ownership or possessory rights in the goods. [UCC] 2-401(2)(b) states that “[i]f the contract requires delivery at destination, title passes on tender there.” In the present case, tender did not occur when Gruda Enterprises called SMI to notify it that the cabinets were in and ready to be delivered and installed. SMI requested that the cabinets remain at the warehouse until the house it was building was ready for the cabinets to be installed....[W]e find that SMI and Gruda Enterprises agreed to a destination point, *i.e.* the house that SMI was building. Accordingly, we find that 2-401(2)(b) is also applicable. The title to the cabinets did not pass to SMI because the cabinets were not delivered and installed at the agreed upon destination. Therefore, we conclude that SMI does not have a possessory interest in the cabinets.

Based on the foregoing, we conclude that the trial court properly granted summary judgment in favor of Treat....Affirmed.

## CASE QUESTIONS

1. One argument made by the plaintiff was that because the plaintiff had paid for the goods and they had been identified to the contract, title passed to the plaintiff. Why did the court disagree with this contention?
2. When would title to the cabinets have shifted to the plaintiff?
3. This is footnote 2 (it was not included in the parts of the case set out above): “We note that Treat owned Kitchen Wholesalers, Inc., from approximately 1987 to approximately June 20, 1996. On or about June 20, 1996, Kitchen Wholesalers, Inc. sold its assets, inventory, equipment, and business to Gruda Enterprises. The Grudas executed an Agreement for Sale of Assets, Lease, and Security Agreement, as well as a Promissory Note in which they agreed to pay \$45,000 for the assets, inventory, equipment, and business, and to pay monthly rent of \$1,500 for the premises where the business was located, and secured their obligations with inventory, equipment, and proceeds therefrom, of the business which they were purchasing. Treat filed and perfected a security interest in the accounts receivable, inventory, and equipment of The Kitchen Works on August 28, 1998. The Grudas currently owe Treat \$61,794.99.”

This means that when the Grudas failed to pay Treat, he had a right to repossess all assets *belonging to them*, including the cabinets—Treat was a creditor of the Grudas. SMI, of course, contended it had title to the cabinets. Based on the court’s analysis, who is going to get the cabinets?

### Defrauding Buyer Sells to Good-Faith Purchaser for Value

Marlow v. Conley

787 N.E.2d 490, (Ind. App. 2003)

Donald E. Marlow appeals the trial court’s judgment in favor of Robert L. Medley and Linda L. Medley (collectively, the “Medleys”) on Marlow’s complaint for replevin. Marlow raises [this issue],...whether the Medleys obtained good title to a truck pursuant to Indiana UCC 2-403(1). We affirm.

The relevant facts follow. On May 21, 2000, Robert Medley attended a car show in Indianapolis. Henderson Conley attended the same car show and was trying to sell a 1932 Ford Truck (“Truck”). Conley told Robert that he operated a “buy here, pay here car lot,” and Robert saw that the Truck had a dealer license plate. Robert purchased the Truck for \$7,500.00 as a gift for Linda. Conley gave Robert the Truck’s certificate of title, which listed the owner as Donald Marlow. When Robert questioned Conley about the owner of the Truck, Conley responded that Marlow had signed the title as part of a deal Conley had made with him. After purchasing the Truck, Robert applied to the Bureau of Motor Vehicles for a certificate of title in Linda’s name.

On December 18, 2000, Marlow filed a complaint against Conley and the Medleys....At the bench trial, Marlow testified that he had met Conley at a car show in Indianapolis on May 19, 2000, and Conley had told him that Conley owed a “car lot” on the west side of Indianapolis. Marlow also testified that Conley came to his house that night, but he “didn’t let him in.” Rather, Marlow testified that Conley “[came] over [his] fence...a big high fence.” According to Marlow, Conley asked him to invest in Conley’s business that night. Marlow gave Conley \$500.00. Marlow testified that Conley came back the next day and Marlow gave him an additional \$4,000.00. Marlow then testified that Conley stole the certificate of title for the Truck from Marlow’s house and stole the Truck from his garage. According to Marlow, he told Conley later in the day to bring his Truck back and Conley told him that it had caught on fire. Marlow testified that he then called the police. However, in the May 30, 2000 police report, which was admitted into evidence at trial, the police officer noted the following:

The deal was [Conley] gets \$4500.00, plus an orange ’32 Ford truck. In return, [Marlow] would get a ’94 Ford flatbed dump truck and an ’89 Ford Bronco. [Marlow] stated that he has not received the vehicles and that [Conley] keeps delaying getting the vehicles for him. [Conley] gave [Marlow] several titles of vehicles which are believed to be junk. [Conley] told [Marlow] that he has a car lot at 16th and Lafayette Road.

[The trial court determined that Marlow bought the truck from Conley, paying Conley \$4500 plus a Ford flatbed truck and Ford Bronco.]

...

The issue is whether the Medleys obtained good title to the Truck pursuant to Indiana UCC 2-403(1) [voidable title passed on to good-faith purchaser]. We first note that UCC 2-401(2) provides that “[u]nless otherwise explicitly agreed, title passes to the buyer at the time and place at which the seller completes his

performance with reference to the physical delivery of the goods....” Further, 2-403(1) provides as follows: “A purchaser of goods acquires all title which his transferor had or had power to transfer....A person with voidable title has power to transfer a good title to a good faith purchaser for value. When goods have been delivered under a transaction of purchase, the purchaser has such power even though:...(d) the delivery was procured through fraud punishable as theft under the criminal law.”

Thus, Conley, as purchaser of the goods, acquired all title to the Truck that Marlow, as transferor, had or had power to transfer. Additionally, even if Conley had “voidable title,” he had the power to transfer good title to the Medleys if they were “good faith purchasers for value.” Consequently, we must determine whether Conley had voidable title and, if so, whether the Medleys were good faith purchasers for value.

#### **A. Voidable Title**

We first determine whether Conley had voidable title to the Truck....[T]he UCC does not define “voidable title.” However, we have held that Indiana’s UCC 2-403 is consistent with Indiana’s common law, which provided that “legal title passes to a defrauding buyer. This title is not void; it is voidable, which means that when title gets into the hands of a bona fide purchaser for value then he will prevail over the defrauded seller.” [Citation] Thus, a “defrauding buyer” obtains voidable title. However, a thief obtains void title. See, e.g., [Citation] holding that a renter who stole a motor home had void title, not voidable title, and could not convey good title)....

Here, Marlow argues that Conley stole the Truck and forged his name on the certificate of title. However, the trial court was presented with conflicting evidence regarding whether Conley stole the Truck and the certificate of title or whether Conley and Marlow had a business deal and Conley failed to comply with the agreement. The trial court found that:

Evidence presented concerning [Marlow’s] complaint to the Indianapolis Police Department on May 30, 2000 casts doubt on the credibility of [Marlow’s] trial testimony as the report states the truck and title were obtained by Conley in exchange for a 1994 Ford Flatbed Dump Truck and a 1989 Ford Bronco plus the payment of \$4500.00 by [Marlow]. Apparently, [Marlow] was complaining to the police concerning Conley’s failure to deliver the two Ford vehicles.

...The trial court did not find Marlow’s testimony regarding the theft of the Truck and the certificate of title to be credible....[B]ased upon the trial court’s findings of

fact, we must assume that the police report accurately describes the circumstances under which Conley obtained possession of the Truck and its signed certificate of title. Consequently, we assume that Marlow gave Conley \$4,500.00 and the Truck in exchange for two other vehicles. Although Conley gave Marlow the certificates of title for the two vehicles, he never delivered the vehicles.

Conley's title is voidable if "the delivery was procured through fraud punishable as theft under the criminal law" under 2-403(1)(d)...Assuming that Conley knew that he would not deliver the two vehicles to Marlow, the delivery of the Truck to Conley was procured through fraud punishable as theft. Consequently, Marlow was defrauded, and Conley obtained voidable title to the Truck....

### **B. Good Faith Purchasers for Value**

Having determined that Conley obtained voidable title to the Truck, we must now determine whether the Medleys were good faith purchasers for value. Marlow does not dispute that the Medleys were purchasers for value. Rather, Marlow questions their "good faith" because they purchased the Truck from someone other than the person listed on the Truck's certificate of title. [UCC 1-2019] defines good faith as "honesty in fact in the conduct or transaction concerned." Marlow argues that Robert did not purchase the Truck in good faith because, although Robert purchased the vehicle from Conley, he was aware that the certificate of title was signed by Marlow.

...Here, the sole evidence presented by Marlow regarding the Medleys' lack of good faith is the fact that the certificate of title provided by Conley was signed by Marlow. Robert testified that he thought Conley was a licensed dealer and operated a "buy here, pay here" car lot. The Truck had a dealer license plate. Robert questioned Conley about the certificate of title. Conley explained that Marlow had signed the title as part of a deal Conley had made with him. Robert also testified that he had previously purchased vehicles at car shows and had previously purchased a vehicle from a dealer where the certificate of title had the previous owner's name on it....

The Medleys' failure to demand a certificate of title complying with [the Indiana licensing statute] does not affect their status as good faith purchasers in this case....The statute does not void transactions that violate the statute. [Citations] Although the failure to comply with [the licensing statute] may, combined with other suspicious circumstances, raise questions about a purchaser's good faith, we find no such circumstances here. Consequently, the Medleys were good faith purchasers for value....

Lastly, Marlow also argues that the Medleys violated [licensing statutes] by providing false information to the Bureau of Motor Vehicles because the Medleys allegedly listed the seller of the Truck as Marlow rather than Conley. We noted above that legal title to a vehicle is governed by the sales provisions of the UCC rather than the Indiana Certificate of Title Act. Thus, although false statements to the Bureau of Motor Vehicles under Ind.Code § 9-18-2-2 could result in prosecution for perjury, such false statements do not affect legal title to the vehicle.

In summary, we conclude that, as a defrauding buyer, Conley possessed voidable title and transferred good title to the Medleys as good faith purchasers for value....Thus, legal title to the Truck passed to the Medleys at the time Conley delivered the Truck to them. See UCC 2-401(2) (“[T]itle passes to the buyer at the time and place at which the seller completes his performance with reference to the physical delivery of the goods....”). This result is consistent with the policy behind 2-403.

Section 2-403 was intended to determine the priorities between the two innocent parties: (1) the original owner who parts with his goods through fraudulent conduct of another and (2) an innocent third party who gives value for the goods to the perpetrator of the fraud without knowledge of the fraud. By favoring the innocent third party, the Uniform Commercial Code endeavors to promote the flow of commerce by placing the burden of ascertaining and preventing fraudulent transactions on the one in the best position to prevent them, the original seller. The policy behind the UCC is to favor the Medleys because, as between the Medleys and Marlow, Marlow was in the best position to prevent the fraudulent transaction.

For the foregoing reasons, we affirm the trial court’s judgment for the Medleys. Affirmed.

### CASE QUESTIONS

1. The court determined Marlow was defrauded by Conley. How did Conley defraud Marlow?
2. What is the rationale, here expressed, for the UCC’s provision that a defrauding purchaser (Conley) can pass on title to a good-faith purchaser for value?
3. Why did Marlow think the Medleys should not be considered good-faith purchasers?
4. Why would the UCC prevail over the state’s certificate of title act?



## Risk of Loss, Seller a Merchant

Ramos v. Wheel Sports Center

409 N.Y.S.2d 505 (N.Y. Civ. Ct. 1978)

Mercorella, J.

In this non-jury action plaintiff/purchaser is seeking to recover from defendant/vendor the sum of \$893 [about \$3,200 in 2010 dollars] representing the payment made by plaintiff for a motorcycle.

The parties entered into a sales contract wherein defendant agreed to deliver a motorcycle to plaintiff by June 30, 1978, for the agreed price of \$893. The motorcycle was subsequently stolen by looters during the infamous power blackout of July 11, 1977.

It is uncontroverted that plaintiff paid for the motorcycle in full; was given the papers necessary for registration and insurance and did in fact register the cycle and secure liability insurance prior to the loss although license plates were never affixed to the vehicle. It is also conceded that the loss occurred without any negligence on defendant's part.

Plaintiff testified that defendant's salesman was informed that plaintiff was leaving on vacation and plaintiff would come for the cycle when he returned. He further testified that he never saw or rode the vehicle. From the evidence adduced at trial it is apparent that plaintiff never exercised dominion or control over the vehicle.

Defendant's president testified that he had no knowledge of what transpired between his salesman and plaintiff nor why the cycle was not taken prior to its loss.

The sole issue presented to the Court is which party, under the facts disclosed, bears the risk of loss?

It is the opinion of this Court that defendant must bear the risk of loss under the provisions of Section 2-509(3) of the Uniform Commercial Code.

This section provides that "...the risk of loss passes to the buyer on his receipt of the goods if the seller is a merchant...." Section 2-103(1)(c) states that receipt of goods

means taking physical possession of them. [Authors' note: UCC revisions have changed the rule so that risk of loss passes to the buyer on his receipt of the goods *irrespective* of whether the seller is a merchant or not. It is still 2-509(3), however.]

The provision tends more strongly to hold risk of loss on the seller than did the former Uniform Sales Act. Whether the contract involves delivery at the seller's place of business or at the situs of the goods, a merchant seller cannot transfer risk of loss and it remains on him until actual receipt by the buyer, even though full payment has been made and the buyer notified that the goods are at his disposal. The underlying theory is that a merchant who is to make physical delivery at his own place continues meanwhile to control the goods and can be expected to insure his interest in them.

The Court is also of the opinion that no bailee/bailor relationship, constructive or otherwise, existed between the parties.

Accordingly, let judgment be entered in favor of plaintiff for the sum of \$893, together with interest, costs and disbursements.

### CASE QUESTIONS

1. What caused the loss here, through no fault of either party?
2. What is the rationale for holding the merchant-seller liable in this circumstance?
3. Suppose instead that Ramos had purchased the motorcycle at a garage sale from an acquaintance and the same loss occurred. Who would bear the risk then?

## **18.5 Summary and Exercises**

## Summary

Two significant questions lurk in the background of any sale: (1) when does title pass? and (2) who must bear the risk of loss if the goods are destroyed or damaged through no fault of either party?

In general, title passes when the buyer and the seller agree that it passes. If the buyer and the seller fail to specify the time at which title passes, Article 2 lays down four rules: (1) under a shipment contract, title passes when the seller places the goods with the carrier; (2) under a destination contract, title passes when the goods are tendered at the place of delivery; (3) under a contract calling for delivery of documents of title, title passes when the seller tenders documents of title, even if the goods are not physically moved; and (4) when no physical delivery or exchange of documents is called for, title passes when the contract is signed.

The buyer and the seller may also specify who must bear the risk of loss. But if they do not, Article 2 sets out these four rules: (1) when the seller must ship by carrier but not to any particular destination, risk passes to the buyer when the seller delivers the goods to the carrier; (2) when the goods must be transported to a particular destination, risk passes when the carrier tenders them at that destination; (3) if the goods are held by a bailee who has issued a negotiable document of title, risk passes when the buyer receives the document; (4) in other cases, risk of loss turns on whether the seller is a merchant. If he is a merchant, risk passes when the buyer receives the goods; if he is not a merchant, risk passes when the seller tenders the goods. These rules are modified when either of the parties breaches the contract. In general, unless the breach is cured, the risk of uninsured losses lies on the party who breached.

Either party may insure the goods if it has an insurable interest in them. The buyer has an insurable interest in goods identified to the contract—for example, by marking them in some manner. The seller has an insurable interest as long as he retains title or a security interest.

In fixing passage of title and risk of loss, the parties often use shorthand terminology whose meaning must be mastered to make sense of the contract. These terms include F.O.B.; F.A.S.; ex-ship; C.I.F.; C.F.; no arrival, no sale; sale on approval; and sale or return. Use of these terms in a contract can have a significant effect on title and risk of loss.

Sometimes goods are sold by nonowners. A person with voidable title has the power to transfer title to a good-faith purchaser for value. A merchant who deals in particular goods has the power to transfer all rights of one who entrusts to him goods of the kind. And a rightful owner may be estopped by his own acts from asserting title against an innocent purchaser.

## EXERCISES

1. Betty from Baltimore contracts to purchase one hundred purple llama figurines from Sam of Syracuse. Sam is to send the goods by carrier and is not required to deliver them to Betty's Boutique, their destination. He ships them by train, which unfortunately crashes in Delaware. All the figurines are destroyed. Whose loss is it? Why?
2. In Exercise 1, assume that the train did not crash but that Sam's creditors attempted to seize the goods before their arrival. May the creditors do so? Why?
3. Hattie's Head Shop signed a written agreement with the Tangerine Computer Company to supply a Marilyn, a supercomputer with bubble memory, to total up its orders and pay its foreign agents. The contract provided that the computer was to be specially built and that Tangerine would deliver it by carrier to Hattie's ready to install no later than June 1. Tangerine engineers worked feverishly to comply with the contract terms. On May 25, the computer stood gleaming in Tangerine's shipping department. That night, before the trucks could depart, a tornado struck the factory and destroyed the computer intended for Hattie's. Whose loss is it? Why?
4. In Exercise 3, assume that the tornado did not strike but that Tangerine's creditors attempted to seize the computer. May they? Why?
5. On February 18, Clancy, who was in debt, took his stereo to Lucy's repair shop. Because Lucy and Clancy were old friends, Lucy didn't give him a receipt. On February 19, hounded by creditors, Clancy sold the stereo on credit to Grover, who was to pick it up on February 21 at Lucy's, pay Lucy the repair bill, and pay the balance of the purchase price to Clancy. Who is entitled to the radio if, on February 20, Clancy's creditor appears with the sheriff to seize the stereo from Lucy? Why?
6. Assume in Exercise 5 that, instead of the attempted seizure of the stereo by the creditor, Lucy's shop and the stereo are destroyed by fire on February 20. Must Grover still pay Clancy for the stereo? Why?
7. Cleo's Close-Outs, a wholesaler of discounted merchandise, offered Randy's Retailers a chance to buy all the contents of a shipment of bathtub toys just received. Cleo estimated that she had between five hundred and six hundred rubber ducks and wrote on October 21 offering them to Randy for only one dollar each if Randy would pick them up at Cleo's. Randy received the letter in the mail the next day and mailed his acceptance immediately. In the wee hours of the following morning, October 23, a fire consumed Cleo's warehouse, melting the ducks into an uneven soup. Assuming that Cleo was a merchant, who bears the loss? Why?

8. Plaintiff, a manufacturer of men's clothing in Los Angeles, contracted to sell a variety of clothing items to Defendant, Harrison's clothing store in Westport, Connecticut, "F.O.B. Los Angeles." Plaintiff delivered the goods to Trucking Company and received a bill of lading. When the goods arrived at Defendant's store about two weeks later, Mrs. Harrison, Defendant's wife, who was in charge of the store at the time, requested the truck driver to deliver the goods inside the door of the shop. The driver refused and ultimately drove away. The goods were lost. Defendant refused to pay for the goods and raised as a defense that "the Plaintiff refused to deliver the merchandise into the Defendant's place of business." Who wins and why? *Ninth Street East, Ltd. v. Harrison*, 259 A.2d 772 (Conn. 1968).
9. Jackson owned a number of guns and asked his friend Willard, who ran a country store, if Willard would let Jackson display the guns in the store for sale on consignment. Willard would get some compensation for his trouble. Willard agreed. Subsequently Willard's creditors seized assets of the store, including the guns. Jackson protested that they were his guns, not Willard's, and that the latter's creditors should keep their hands off them. Given no other facts, who wins?
10. Plaintiff advertised his car for sale. Roberts stopped by to look at it. He took it for a short test drive, returned to Plaintiff's house, and said, "I like it, but my wife needs to look at it before I buy it. I'll be back in less than half an hour." Roberts took the car and never returned. Plaintiff called the police, who later found the car in a neighboring state. Defendant had bought it from Roberts, who had presented him with forged registration papers. Plaintiff then sued Defendant to get the car back. Who wins?

## SELF-TEST QUESTIONS

1. In a sale-on-approval contract
  - a. the goods are intended primarily for the buyer's use
  - b. the goods are intended primarily for resale
  - c. the risk of loss is on the buyer
  - d. the buyer obtains title upon receipt of the goods
  
2. As a general rule
  - a. goods cannot be sold by persons with voidable title
  - b. a rightful owner cannot be estopped from asserting title against an innocent purchaser
  - c. a merchant cannot transfer the rights of a person who entrusts goods to him
  - d. a person with voidable title has the power to transfer title to a good-faith purchaser for value
  
3. In general, title passes
  - a. to a buyer when the contract is signed
  - b. when the buyer and the seller agree that it passes
  - c. to a buyer when the seller receives payment for goods
  - d. under none of the above conditions
  
4. When a destination contract does not specify when title is to pass, it passes
  - a. when the goods are shipped
  - b. when the contract is signed
  - c. when the buyer pays for the goods
  - d. when the seller tenders delivery
  
5. In a C.I.F. contract
  - a. the seller must obtain insurance
  - b. the buyer must obtain insurance
  - c. the seller has fewer duties than with a C.F. contract
  - d. title passes to the buyer when the seller tenders delivery

**SELF-TEST ANSWERS**

1. a
2. d
3. b
4. d
5. a



# Chapter 19

## Performance and Remedies

### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. What performance is expected of the seller in a sales contract
2. What performance is expected of the buyer in a sales contract
3. What rights and duties the buyer has if there is a nonconforming delivery
4. How, in general, the UCC approaches remedies
5. What the seller's remedies are for breach by the buyer
6. What the buyer's remedies are for breach by the seller
7. What excuses the UCC provides for nonperformance

In Part II, we examined contract performance and remedies under common law. In this chapter, we examine performance and remedies under Article 2, the law of sales, of the Uniform Commercial Code (UCC). In the next chapter, we cover special remedies for those damaged or injured by defective products.

The parties often set out in their contracts the details of performance. These include price terms and terms of delivery—where the goods are to be delivered, when, and how. If the parties fail to list these terms, the rules studied in this chapter will determine the parties' obligations: the parties may agree; if they do not, the UCC rules kick in as the default. In any event, the parties have an obligation to act in good faith.

## 19.1 Performance by the Seller

### LEARNING OBJECTIVE

1. Understand what is meant when it is said the seller has a duty to “make a timely delivery of conforming goods.”

### The Seller’s Duty in General

The general duty of the seller is this: to make a timely delivery of conforming goods. Uniform Commercial Code, Sections 2-301 and 2-309.

**The CISG, Article 30, says, “The seller must deliver the goods, hand over any documents relating to them and transfer the property in the goods, as required by the contract and this Convention.”**

### Analysis of the Seller’s Duty

#### Timing

By agreement or stipulation, the parties may fix the time when delivery is to be made by including statements in contracts such as “Delivery is due on or before July 8” or “The first of 12 installments is due on or before July 8.” Both statements are clear.

If the parties do not stipulate in their contract when delivery is to occur, the UCC fills the gap. Section 2-309 of the UCC says, “The time for shipment or any other action under a contract if not provided for in this Article or agreed upon shall be a reasonable time.” And what is a “reasonable time” is addressed by comment 1 to this section:

It thus turns on the criteria as to “reasonable time” and on good faith and commercial standards set forth in Sections 1-202, 1-203 and 2-103. It...depends on what constitutes acceptable commercial conduct in view of the nature, purposes and circumstances of the action to be taken.

**The CISG (Article 33) provides as follows:**

**The seller must deliver the goods**

**(a) if a date is fixed by or determinable from the contract, on that date;**

**(b) if a period of time is fixed by or determinable from the contract, at any time within that period unless circumstances indicate that the buyer is to choose a date; or**

**(c) in any other case, within a reasonable time after the conclusion of the contract.**

**Delivery**

The parties may agree as to how delivery shall be accomplished; if they do not, the UCC fills the gap.

**The CISG (Article 31) says this:**

**If the seller is not bound to deliver the goods at any other particular place, his obligation to deliver consists**

**(a) if the contract of sale involves carriage of the goods—in handing the goods over to the first carrier for transmission to the buyer;**

**(b) if, in cases not within the preceding subparagraph...in placing the goods at the buyer's disposal at that place [where the goods are];**

**(c) in other cases—in placing the goods at the buyer's disposal at the place where the seller had his place of business at the time of the conclusion of the contract.**

**By Agreement**

The parties may use any language they want to agree on delivery terms.

**If There Is No Agreement**

If the parties do not stipulate delivery terms or if their agreement is incomplete or merely formulaic, the UCC describes the seller's obligations or gives meaning to the

formulaic language. (Because form contracts are prevalent, formulaic language is customary.) You recall the discussion in [Chapter 18 "Title and Risk of Loss"](#) about when title shifts: we said title shifts when the seller has completed delivery obligations under the contract, and we ran through how those obligations are usually expressed. A quick review here is appropriate.

The contract may be either a *shipment* contract, a *destination* contract, or a contract where the *goods are not to be moved* (being held by a bailee). In any case, unless otherwise agreed, the delivery must be at a reasonable time and the **tender**<sup>1</sup> (the offer to make delivery) must be kept open for a reasonable time; the buyer must furnish facilities “reasonably suited to the receipt of the goods.” Uniform Commercial Code, Section 2-503.

In a shipment contract, the seller has four duties: (1) to deliver the goods to a carrier; (2) to deliver the goods with a reasonable contract for their transportation; (3) to deliver them with proper documentation for the buyer; and (4) to promptly notify the buyer of the shipment (UCC, Section 2-504). The contract may set out the seller’s duties using customary abbreviations, and the UCC interprets those: “F.O.B. [insert place where goods are to be shipped from]” means “free on board”—the seller must see to it that the goods are loaded on the vehicle of conveyance at the place of shipment. “F.A.S. [port of shipment inserted here]” means the seller must see to it that the goods are placed along the ship on the dock ready to be loaded (Section 2-319). Price terms include “C.I.F.,” which means the sale price includes the cost of the goods, insurance, and freight charges, and “C. & F.,” which means the sales price includes the cost of the goods at a cheaper unit price and freight but not insurance. Uniform Commercial Code, Section 2-320. If it is clear from the contract that the seller is supposed to ship the goods (i.e., the buyer is not going to the seller’s place to get them) but not clear whether it is a shipment or a destination contract, the UCC presumes it is a shipment contract. Uniform Commercial Code, Section 2-503(5).

If it is a destination contract, the seller has two duties: to get the goods to the destination at the buyer’s disposal and to provide appropriate documents of delivery. Uniform Commercial Code, Section 2-503. The contract language could be “F.O.B. [place of destination inserted here],” which obligates the seller to deliver to that specific location; “ex-ship,” which obligates the seller to unload the goods from the vehicle of transportation at the agreed location (e.g., load the goods onto the dock); or it could be “no arrival, no sale,” where the seller is not liable for failure of the goods to arrive, unless she caused it. Uniform Commercial Code, Sections 2-319, 2-322, and 2-324.

1. Offer of money or performance to satisfy a debt.

If the goods are in the possession of a bailee and are not to be moved—and the parties don't stipulate otherwise—the UCC, Section 2-503 says delivery is accomplished when the seller gives the buyer a negotiable document of title, or if none, when the bailee acknowledges the buyer's right to take the goods.

If nothing at all is said about delivery, the place for delivery is the seller's place of business or his residence if he has no place of business. Uniform Commercial Code, Section 2-308.

### Conforming Goods

As always, the parties may put into the contract whatever they want about the goods as delivered. If they don't, the UCC fills the gaps.

### By Agreement

The parties may agree on what "conforming goods" means. An order will specify "large grade A eggs," and that means something in the trade. Or an order might specify "20 gross 100-count boxes No. 8 × 3/8 × 32 Phillips flathead machine screws." That is a screw with a designated diameter, length, number of threads per inch, and with a unique, cruciform head insert to take a particular kind of driver. The buyer might, for example, agree to purchase "seconds," which are goods with some flaw, such as clothes with seams not sewed quite straight or foodstuffs past their pull date. The parties may also agree in the contract what happens if nonconforming goods are delivered, as we'll see later in this chapter.

### If There Is No Agreement

If nothing is said in the contract about what quality of goods conform to the contract, then the UCC default rule kicks in. The seller is to make a **perfect tender**<sup>2</sup>: what is delivered must in every respect conform to the contract. Uniform Commercial Code, Section 2-601. And if what is delivered doesn't conform to the contract, the buyer is not obligated to accept the goods.

**The CISG has no perfect tender rule. Article 46 provides this:**

**If the goods do not conform with the contract, the buyer may require delivery of substitute goods only if the lack of conformity constitutes a fundamental breach of contract and a request for substitute goods is made either in conjunction with notice given under article 39 or within a reasonable time thereafter. If the goods do not conform with the contract, the buyer may require the seller to remedy the lack of conformity by repair, unless this is**

2. The UCC's requirement that the seller tender exactly what was contracted for.

**unreasonable having regard to all the circumstances. A request for repair must be made either in conjunction with notice given under article 39 or within a reasonable time thereafter.**

### **Installment Contracts**

Unless otherwise agreed, all goods should be delivered at one time, and no payment is due until tender. But where circumstances permit either party to make or demand delivery in lots, Section 2-307 of the UCC permits the seller to demand payment for each lot if it is feasible to apportion the price. What if the contract calls for delivery in installment, and one installment is defective—is that a material breach of the whole contract? No. Section 2-612 of the UCC says this:

(2) The buyer may reject any installment which is non-conforming if the non-conformity substantially impairs the value of that installment and cannot be cured or if the non-conformity is a defect in the required documents; but if the non-conformity does not fall within subsection (3) and the seller gives adequate assurance of its cure the buyer must accept that installment.

(3) Whenever non-conformity or default with respect to one or more installments substantially impairs the value of the whole contract there is a breach of the whole.

### **Cure for Improper Delivery**

Failure to make a perfect tender, unless otherwise agreed, is a material breach of the sales contract. However, before the defaulting seller is in complete default, she has a right to cure. Here's what the UCC says in Section 2-508:

(1) Where any tender or delivery by the seller is rejected because non-conforming and the time for performance has not yet expired, the seller may seasonably notify the buyer of his intention to cure and may then within the contract time make a conforming delivery.

(2) Where the buyer rejects a non-conforming tender which the seller had reasonable grounds to believe would be acceptable with or without money allowance the seller may if he seasonably notifies the buyer have a further reasonable time to substitute a conforming tender.

Buyer orders Santa Claus candles deliverable November 5; on October 25 the goods are delivered, but they're not right: they're Christmas *angel* candles instead. But the seller still has eleven days to cure, and the buyer must allow that. Buyer places an

order exactly the same as the first order, and the order arrives on November 5 in the original manufacturer's packaging, but they're not right. "Well," says the seller, "I thought they'd be OK right out of the package. I'll get the correct ones to you right away." And the buyer would have a duty to allow that, if "right away" is a "further reasonable time."

**Article 48 of the CISG says this:**

**The seller may, even after the date for delivery, remedy at his own expense any failure to perform his obligations, if he can do so without unreasonable delay and without causing the buyer unreasonable inconvenience or uncertainty of reimbursement by the seller of expenses advanced by the buyer. However, the buyer retains any right to claim damages as provided for in this Convention. If the seller requests the buyer to make known whether he will accept performance and the buyer does not comply with the request within a reasonable time, the seller may perform within the time indicated in his request. The buyer may not, during that period of time, resort to any remedy which is inconsistent with performance by the seller.**

So, again, the seller's duty is to make a timely delivery of conforming goods. Let's take a look now at the buyer's duties.

#### KEY TAKEAWAY

The seller's obligation under the UCC is to make a timely delivery of conforming goods. For each element of the duty—timely, delivery, conforming goods—the parties may agree in their contract. If they do not, the UCC fills in default rules.

#### EXERCISES

1. If the parties do not specify a time for delivery, what is the UCC's default position?
2. What are the seller's obligations in an F.O.B. shipment contract? In an F.O.B. destination contract?
3. Compare the UCC's perfect tender rule to the common-law substantial performance doctrine.

## 19.2 Performance by Buyer

### LEARNING OBJECTIVES

1. Understand what the general duties of the buyer are.
2. Recognize what rights the buyer has if the seller tenders a nonconforming delivery.

### General Duties of Buyer

The general duty of the buyer is this: inspection, acceptance, and payment. Uniform Commercial Code, Sections 2-301 and 2-513. But the buyer's duty does not arise unless the seller tenders delivery.

### Inspection

Under Sections 2-513(1) and (2) of the Uniform Commercial Code (UCC), the buyer has a qualified right to inspect goods. That means the buyer must be given the chance to look over the goods to determine whether they conform to the contract. If they do not, he may properly reject the goods and refuse to pay. The right to inspect is subject to three exceptions:

1. The buyer waives the right. If the parties agree that payment must be made before inspection, then the buyer must pay (unless the nonconformity is obvious without inspection). Payment under these circumstances does not constitute acceptance, and the buyer does not lose the right to inspect and reject later.
2. The delivery is to be made C.O.D. (cash on delivery).
3. Payment is to be made against documents of title.

If the buyer fails to inspect, or fails to discover a defect that an inspection would have revealed, he cannot later revoke his acceptance, subject to some exceptions.

### Acceptance

Acceptance is clear enough: it means the buyer takes the goods. But the buyer's options on improper delivery need to be examined, because that's often a problem area.



The buyer may accept goods by words, silence, or action. Section 2-606(1) of the UCC defines acceptance as occurring in any one of three circumstances:

1. **Words.** The buyer, after a reasonable opportunity to inspect, tells the seller either that the goods conform or that he will keep them despite any nonconformity.
2. **Silence.** The buyer fails to reject, after a reasonable opportunity to inspect.
3. **Action.** The buyer does anything that is inconsistent with the seller's ownership, such as using the goods (with some exceptions) or selling the goods to someone else.

Once the buyer accepts, she is obligated to pay at the contract rate and loses the right to reject the goods. Uniform Commercial Code, Section 2-607. She is stuck, subject to some exceptions.

### **Payment**

The parties may specify in their contract what *payment* means and when it is to be made. If they don't, the UCC controls the transaction. Uniform Commercial Code, Sections 2-511 and 2-512.

### **A Buyer's Right on Nonconforming Delivery**

Obviously if the delivery is defective, the disappointed buyer does not have to accept the goods: the buyer may (a) reject the whole, (b) accept the whole, or (c) accept any commercial unit and reject the rest (2-601, 2A-509), or (d)—in two situations—revoke an acceptance already made.

### **Rejection and a Buyer's Duties after Rejection**

Under UCC, Section 2-601(a), rejection is allowed if the seller fails to make a perfect tender. The rejection must be made within a reasonable time after delivery or tender. Once it is made, the buyer may not act as the owner of the goods. If he has taken possession of the goods before he rejects them, he must hold them with reasonable care to permit the seller to remove them. If the buyer is a merchant, then the buyer has a special duty to follow reasonable instructions from the seller for disposing of the rejected goods; if no instructions are forthcoming and the goods are perishable, then he must try to sell the goods for the seller's account and is entitled to a commission for his efforts. Whether or not he is a merchant, a buyer may store the goods, reship them to the seller, or resell them—and charge the seller for his services—if the seller fails to send instructions on the goods' disposition.

Such storage, reshipping, and reselling are not acceptance or conversion by the buyer.

### Acceptance of a Nonconforming Delivery

The buyer need not reject a nonconforming delivery. She may accept it with or without allowance for the nonconformity.

### Acceptance of Part of a Nonconforming Delivery

The buyer may accept any commercial unit and reject the rest if she wants to. A **commercial unit**<sup>3</sup> means “such a unit of goods as by commercial usage is a single whole for purposes of sale and division of which materially impairs its character or value on the market or in use. A commercial unit may be a single article (as a machine), a set of articles (as a suite of furniture or an assortment of sizes), a quantity (as a bale, gross, or carload), or any other unit treated in use or in the relevant market as a single whole.” Uniform Commercial Code, Sections 2-105 and 2A103(1).

### Installment Sales

A contract for an installment sale complicates the answer to the question, “What right does the buyer have to accept or reject when the seller fails to deliver properly?” (An **installment contract**<sup>4</sup> is one calling for delivery of goods in separate lots with separate acceptance for each delivery.) The general answer is found in the UCC at Section 2-612, which permits the buyer to reject any nonconforming installment if the nonconformity cannot be cured if it substantially impairs the value of that particular installment. However, the seller may avoid rejection by giving the buyer adequate assurances that he will cure the defect, unless the particular defect substantially impairs the value of the whole contract.

Suppose the Corner Gas Station contracts to buy 12,000 gallons of regular gasoline from Gasoline Seller, deliverable in twelve monthly installments of 1,000 gallons on the first of each month, with a set price payable three days after delivery. In the third month, Seller is short and can deliver only 500 gallons immediately and will not have the second 500 gallons until midmonth. May Corner Gas reject this tender? The answer depends on the circumstances. The nonconformity clearly cannot be cured, since the contract calls for the full 1,000 on a particular day. But the failure to make full delivery does not necessarily impair the value of that installment; for example, Corner Gas may know that it will not use up the 500 gallons until midmonth. However, if the failure will leave Corner Gas short before midmonth and unable to buy from another supplier unless it agrees to take a full 1,000 (more than

3. A unit of goods as by usage is a single whole for sale and division.

4. A contract where payment or performance is in discrete units.

it could hold at once if it also took Seller's 500 gallons), then Corner Gas is entitled to reject Seller's tender.

Is Corner Gas entitled to reject the entire contract on the grounds that the failure to deliver impairs the value of the contract as a whole? Again, the answer depends on whether the impairment was substantial. Suppose other suppliers are willing to sell only if Corner Gas agrees to buy for a year. If Corner Gas needed the extra gasoline right away, the contract would have been breached as whole, and Corner Gas would be justified in rejecting all further attempted tenders of delivery from Seller.

Likewise, if the spot price of gasoline were rising so that month-to-month purchases from other suppliers might cost it more than the original agreed price with Seller, Corner Gas would be justified in rejecting further deliveries from Seller and fixing its costs with a supply contract from someone else. Of course, Corner Gas would have a claim against Seller for the difference between the original contract price and what it had to pay another supplier in a rising market (as you'll see later in this chapter).

### Revocation

A **revocation**<sup>5</sup> of acceptance means that although the buyer has accepted and exercised ownership of the goods, he can return the goods and get his money back. There are two circumstances in which the buyer can revoke an acceptance if the nonconformity "substantially impairs its value to him": Uniform Commercial Code, Section 2-608.

- a. if the buyer reasonably thought the nonconformity would be cured and it is not within a reasonable time; or
- b. if the acceptance was due to a latent defect that could not reasonably have been discovered before acceptance.

Consider two examples illustrated in the next paragraph. The first deals with point a (buyer thought nonconformity would be cured and it was not within a reasonable time), and the second gets to point b (latent defect).

In August 1983, the Borsages purchased a furnished mobile home on the salesperson's assertion that it was "the Cadillac of mobile homes." But when they moved in, the Borsages discovered defects: water leaks, loose moldings, a warped dishwasher door, a warped bathroom door, holes in walls, defective heating and cooling systems, cabinets with chips and holes, furniture that fell apart, mold and mildew in some rooms, a closet that leaked rainwater, and defective doors and windows. They had not seen these defects at the time of purchase because they looked at the mobile home at night and there were no lights on in it. The Borsages

5. The withdrawal of an offer by the offeror.

immediately complained. Repairmen came by but left, only promising to return again. Others did an inadequate repair job by cutting a hole in the bottom of the home and taping up the hole with masking tape that soon failed, causing the underside of the home to pooch out. Yet more repairmen came by but made things worse by inadvertently poking a hole in the septic line and failing to fix it, resulting in a permanent stench. More repairmen came by, but they simply left a new dishwasher door and countertop at the home, saying they didn't have time to make the repairs. In June 1984, the Borsages provided the seller a long list of uncorrected problems; in October they stopped making payments. Nothing happened. In March 1986—thirty-one months after buying the mobile home—they told the seller to pick up the mobile home: they revoked their acceptance and sued for the purchase price. The defendant seller argued that the Borsages' failure to move out of the house for so long constituted acceptance. But they were repeatedly assured the problems would be fixed, and moreover they had no place else to live, and no property to put another mobile home on if they abandoned the one they had. The court had no problem validating the Borsages' revocation of acceptance, under the section noted earlier, if they ever had accepted it. The seller might have a right to some rental value, though. *North River Homes, Inc., v. Borsage, Mississippi* (1992).

In April 1976, Clarence Miller ordered a new 1976 Dodge Royal Monaco station wagon from plaintiff Colonial Dodge. The car included a heavy-duty trailer package with wide tires. The evening of the day the Millers picked up the new car, Mrs. Miller noticed that there was no spare tire. The following morning, the defendant notified the plaintiff that he insisted on a spare tire, but when he was told there were no spare tires available (because of a labor strike), Mr. Miller told the plaintiff's salesman that he would stop payment on the check he'd given them and that the car could be picked up in front of his house. He parked it there, where it remained until the temporary registration sticker expired and it was towed by the police to an impound yard. Plaintiff sued for the purchase price, asserting that the missing spare tire did not "substantially impair the value of the goods to the buyer." On appeal to the Michigan Supreme Court, the plaintiff lost. "In this case the defendant's concern with safety is evidenced by the fact that he ordered the special package which included spare tires. The defendant's occupation demanded that he travel extensively, sometimes in excess of 150 miles per day on Detroit freeways, often in the early morning hours....He was afraid of a tire going flat...at 3 a.m. Without a spare, he would be helpless until morning business hours. The dangers attendant upon a stranded motorist are common knowledge, and Mr. Miller's fears are not unreasonable." The court observed that although he had accepted the car before he discovered the nonconformity, that did not preclude revocation: the spare was under a fastened panel, concealed from view. *Colonial Dodge v. Miller*, 362 N.W.2d 704 (Mich. 1984).

### KEY TAKEAWAY

The duty of the buyer in a sales contract is to inspect, accept, and pay. Failure to discover a defect that an inspection would have revealed is a waiver of right to complain. Normally the goods are conforming and the buyer accepts them, but upon discovery of a defect the buyer may reject the whole nonconforming delivery, part of it (the buyer has some duties if she has possession of the rejected goods), or in some cases reject one installment of an installment sale or, if one defective installment is serious enough to vitiate the whole contract, the buyer may consider the contract terminated. If goods have been accepted because the seller promised to fix defects or because the defects were latent, then the buyer may revoke the acceptance where the nonconformity substantially impairs the value of the contract to the buyer.

### EXERCISES

1. If a buyer takes possession of goods and shortly thereafter discovers they are nonconforming, what duty does the nonmerchant buyer have with respect to the goods? What duty does the merchant buyer have with respect to the goods?
2. What is the difference between rejection and revocation?
3. Under what circumstances will a defective installment allow the buyer to reject that installment? Under what circumstances would a defective installment allow the buyer to terminate the contract?

## 19.3 Remedies

### LEARNING OBJECTIVES

1. Understand what purpose remedies serve under the UCC.
2. Be able to see when the parties' agreements as to limited remedies fail under the UCC.
3. Recognize what the seller's remedies are.
4. Recognize what the buyer's remedies are.

### Remedies in General

#### General Policy

The general policy of the Uniform Commercial Code (UCC) is to put the aggrieved party in a good position as if the other party had fully performed—as if there had been a timely delivery of conforming goods. The UCC provisions are to be read liberally to achieve that result if possible. Thus the seller has a number of potential remedies when the buyer breaches, and likewise the buyer has a number of remedies when the seller breaches.

#### The CISG provides, at Article 74:

**Damages for breach of contract by one party consist of a sum equal to the loss, including loss of profit, suffered by the other party as a consequence of the breach. Such damages may not exceed the loss which the party in breach foresaw or ought to have foreseen at the time of the conclusion of the contract, in the light of the facts and matters of which he then knew or ought to have known, as a possible consequence of the breach of contract.**

#### Specifying Remedies

We have emphasized how the UCC allows people to make almost any contract they want (as long as it's not unconscionable). Just as the parties may specify details of performance in the contract, so they may provide for and limit remedies in the event of breach. Uniform Commercial Code, Sections 2-719(1) and 2A-503(1). The following would be a typical limitation of remedy: "Seller's sole obligation in the event goods are deemed defective by the seller is to replace a like quantity of nondefective goods." A remedy is optional unless it is expressly agreed that it is the exclusive remedy. Uniform Commercial Code, Sections 2-719(1)(b) and 2A-503(2).

But the parties are not free to eliminate all remedies. As the UCC comment to this provision puts it, “If the parties intend to conclude a contract for sale within this Article they must accept the legal consequence that there be at least a fair quantum of remedy for breach of the obligations or duties outlined in the contract.” In particular, the UCC lists three exemptions from the general rule that the parties are free to make their contract up any way they want as regards remedies:

1. When the circumstances cause the agreed-to remedy to fail or be ineffective, the default UCC remedy regime works instead. Uniform Commercial Code, Sections 2-719(2) and 2A-503(2).
2. Consequential damages may be limited or excluded unless the limitation or exclusion is unconscionable. Limitation of consequential damages for injury to the person in the case of consumer goods is prima facie unconscionable, but limitation of damages where the loss is commercial is not. Uniform Commercial Code, Sections 2-719(3) and 2A-503(2).
3. The parties may agree to liquidated damages: “Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.” Uniform Commercial Code, Section 2-718. The Code’s equivalent position on *leases* is interestingly slightly different. UCC 2A-504(1) says damages may be liquidated “but only at an amount or by a formula that is reasonable in light of the then anticipated harm caused” by the breach. It leaves out anything about difficulties of proof or inconvenience of obtaining another adequate remedy.

### **Statute of Limitations**

The UCC statute of limitations for breach of any sales contract is four years. The parties may “reduce the period of limitation to not less than one year but may not extend it.” Uniform Commercial Code, Section 2-725. Article 2A-506(1) is similar, but omits the prohibition against extending the limitation. Article 2-725(2) goes on: “A cause of action accrues when the breach occurs, regardless of the aggrieved party’s lack of knowledge of the breach. A breach of warranty occurs when tender of delivery is made, except that where a warranty explicitly extends to future performance of the goods and discovery of the breach must await the time of such performance the cause of action accrues when the breach is or should have been discovered.”

Article 2A-506(2) is similar to 2-725(2).

## **Seller's Remedies**

### **Article 2 in General**

Article 2-703 of the UCC lists the four things the buyer can do by way of default, and it lists—here slightly paraphrased—the seller's remedies (2A-523(1) is similar for leases):

Where the buyer wrongfully rejects or revokes acceptance of goods or fails to make a payment due on or before delivery or repudiates with respect to a part or the whole, then with respect to any goods directly affected and, if the breach is of the whole contract, then also with respect to the whole undelivered balance, the aggrieved seller may:

- (1) withhold delivery of such goods;
- (2) stop delivery by any bailee;
- (3) identify to the contract conforming goods not already identified;
- (4) reclaim the goods on the buyer's insolvency;
- (5) resell and recover damages;
- (6) recover damages for non-acceptance or repudiation;
- (7) or in a proper case recover the price;
- (8) cancel.

Items (1)–(4) address the seller's rights to deal with the goods; items (5)–(7) deal with the seller's rights as regards the price, and item (8) deals with the continued existence of the contract.

**The CISG's take is similar. Article 61 and following state,**

**If the buyer fails to perform any of his obligations under the contract or this Convention, the seller may:...(a) require the buyer to pay the price. (b) Fix an additional period of time of reasonable length for performance by the buyer of**



**his obligations; unless the seller has received notice from the buyer that he will not perform within the period so fixed, the seller may not, during that period, resort to any remedy for breach of contract. (c) Declare the contract avoided if the failure by the buyer to perform any of his obligations under the contract or this Convention amounts to a fundamental breach of contract or if the buyer does not, within the additional period of time fixed by the seller [above], perform his obligation to pay the price or take delivery of the goods, or if he declares that he will not do so within the period so fixed. (d) The seller also has the right to damages.**

To illustrate the UCC's remedy provision, in this and the following section, we assume these facts: Howard, of Los Angeles, enters into a contract to sell and ship one hundred prints of a Pieter Bruegel painting, plus the original, to Bunker in Dallas. Twenty-five prints have already been delivered to Bunker, another twenty-five are en route (having been shipped by common carrier), another twenty-five are finished but haven't yet been shipped, and the final twenty-five are still in production. The original is hanging on the wall in Howard's living room. We will take up the seller's remedies if the buyer breaches and if the buyer is insolvent.

### **Remedies on Breach**

Bunker, the buyer, breaches the contract. He sends Howard an e-mail stating that he won't buy and will reject the goods if delivery is attempted. Howard has the following cumulative remedies; election is not required.

#### **Withhold Further Delivery**

Howard may refuse to send the third batch of twenty-five prints that are awaiting shipment.

#### **Stop Delivery**

Howard may also stop the shipment. If Bunker is insolvent, and Howard discovers it, Howard would be permitted to stop any shipment in the possession of a carrier or bailee. If Bunker is not insolvent, the UCC permits Howard to stop delivery only of carload, truckload, planeload, or larger shipment. The reason for limiting the right to bulk shipments in the case of noninsolvency is that stopping delivery burdens the carrier and requiring a truck, say, to stop and the driver to find a small part of the contents could pose a sizeable burden.

### **Identify to the Contract Goods in Possession**

Howard could “identify to the contract” the twenty-five prints in his possession. Section 2-704(1) of the UCC permits the seller to denote conforming goods that were not originally specified as the exact objects of the contract, if they are under his control or in his possession at the time of the breach. Assume that Howard had five hundred prints of the Bruegel painting. The contract did not state which one hundred of those prints he was obligated to sell, but once Bunker breached, Howard could declare that those particular prints were the ones contemplated by the contract. He has this right whether or not the identified goods could be resold. Moreover, Howard may complete production of the twenty-five unfinished prints and identify them to the contract, too, if in his “reasonable commercial judgment” he could better avoid loss—for example, by reselling them. If continued production would be expensive and the chances of resale slight, the seller should cease manufacture and resell for scrap or salvage value.

### **Resell**

Howard could resell the seventy-five prints still in his possession as well as the original. As long as he proceeds in good faith and in a commercially reasonable manner, per Section 2-706(2) and Section 2A-527(3), he is entitled to recover the difference between the resale price and the contract price, plus incidental damages (but less any expenses saved, like shipping expenses). “Incidental damages” include any reasonable charges or expenses incurred because, for example, delivery had to be stopped, new transportation arranged, storage provided for, and resale commissions agreed on.

The seller may resell the goods in virtually any way he desires as long as he acts reasonably. He may resell them through a public or private sale. If the resale is public—at auction—only identified goods can be sold, unless there is a market for a public sale of futures in the goods (as there is in agricultural commodities, for example). In a public resale, the seller must give the buyer notice unless the goods are perishable or threaten to decline in value speedily. The goods must be available for inspection before the resale, and the buyer must be allowed to bid or buy.

The seller may sell the goods item by item or as a unit. Although the goods must relate to the contract, it is not necessary for any or all of them to have existed or to have been identified at the time of breach.

The seller does not owe the buyer anything if resale or re-lease results in a profit for the buyer. Uniform Commercial Code, Sections 2-706 and 2A-527.

### Recover Damages

The seller may recover damages equal to the difference between the market price (measured at the time and place for tender of delivery) and the unpaid contract price, plus incidental damages, but less any expenses saved because of the buyer's breach. Suppose Howard's contract price was \$100 per print plus \$10,000 for the original and that the market price on the day Howard was to deliver the seventy-five prints was \$75 (plus \$8,000 for the original). Suppose too that the shipping costs (including insurance) that Howard saved when Bunker repudiated were \$2,000 and that to resell them Howard would have to spend another \$750. His damages, then, would be calculated as follows: original contract price (\$17,500) less market price (\$13,625) = \$3,875 less \$2,000 in saved expenses = \$1,875 plus \$750 in additional expenses = \$2,625 net damages recoverable by Howard, the seller.

**The CISG puts it similarly in Article 75: “If the contract is avoided and if, in a reasonable manner and within a reasonable time after avoidance, the buyer has bought goods in replacement or the seller has resold the goods, the party claiming damages may recover the difference between the contract price and the price in the substitute transaction as well as any further damages recoverable.”**

If the formula would not put the seller in as good a position as performance under the contract, then the measure of damages is lost profits—that is, the profit that Howard would have made had Bunker taken the original painting and prints at the contract price (again, deducting expenses saved and adding additional expenses incurred, as well as giving credit for proceeds of any resale). Uniform Commercial Code, Section 2-708(2); Section 2A-528(2) is similar. This provision becomes especially important for so-called lost volume sellers. Howard may be able to sell the remaining seventy-five prints easily and at the same price that Bunker had agreed to pay. Then why isn't Howard whole? The reason is that the second buyer was not a *substitute* buyer but an *additional* one; that is, Howard would have made that sale even if Bunker had not reneged on the contract. So Howard is still short a sale and is out a profit that he would have made had Bunker honored the contract.

### Recover the Price

Howard—the seller—could recover from Bunker for the price of the twenty-five prints that Bunker holds. Or suppose they had agreed to a shipment contract, so that the risk of loss passed to Bunker when Howard placed the other prints with the trucker and that the truck crashed en route and the cargo destroyed. Howard could recover the price. Or suppose there were no market for the remaining seventy-five prints and the original. Howard could identify these prints to the contract and recover the contract price. If Howard did resell some prints, the proceeds of the sale

would have to be credited to Bunker's account and deducted from any judgment. Unless sold, the prints must be held for Bunker and given to him upon his payment of the judgment.

### **Cancel the Contract**

When Bunker repudiated, Howard could declare the contract cancelled. This would also apply if a buyer fails to make a payment due on or before delivery. Cancellation entitles the nonbreaching party to any remedies for the breach of the whole contract or for any unperformed balance. That is what happens when Howard recovers damages, lost profits, or the price. Uniform Commercial Code, Sections 2-703(f) and 2A-524(1)(a).

**Again, the CISG is similar. Article 64 provides that the seller may declare the contract avoided “if the failure by the buyer to perform any of his obligations under the contract or this Convention amounts to a fundamental breach of contract; or if the buyer does not, within the additional period of time fixed by the seller perform his obligation to pay the price or take delivery of the goods, or if he declares that he will not do so within the period so fixed.”**

Note again that these UCC remedies are cumulative. That is, Howard could withhold future delivery *and* stop delivery en route, *and* identify to the contract goods in his possession, *and* resell, *and* recover damages, *and* cancel.

### **Remedies on Insolvency**

The remedies apply when the buyer *breaches* the contract. In addition to those remedies, the seller has remedies when he learns that the buyer is insolvent, even if the buyer has not breached. Insolvency results, for example, when the buyer has “ceased to pay his debts in the ordinary course of business,” or the buyer “cannot pay his debts as they become due.” Uniform Commercial Code, Section 1-201(23).

Upon learning of Bunker's insolvency, Howard could refuse to deliver the remaining prints, unless Bunker pays cash not only for the remaining prints but for those already delivered. If Howard learned of Bunker's insolvency within ten days of delivering the first twenty-five prints, he could make a demand to reclaim them. If within three months prior to delivery, Bunker had falsely represented that he was solvent, the ten-day limitation would not cut off Howard's right to reclaim. If he does seek to reclaim, Howard will lose the right to any other remedy with respect to those particular items. However, Howard cannot reclaim goods already purchased from Bunker by a customer in the ordinary course of business. The customer does

not risk losing her print purchased several weeks before Bunker has become insolvent. Uniform Commercial Code, Section 2-702 (3).

In the lease situation, of course, the goods belong to the lessor—the lessor has title to them—so the lessor can repossess them if the lessee defaults. Uniform Commercial Code, Section 2A-525(2).

## **Buyer's Remedies**

In this section, let us assume that Howard, rather than Bunker, breaches, and all other circumstances are the same. That is, Howard had delivered twenty-five prints, twenty-five more were en route, the original painting hung in Howard's living room, another twenty-five prints were in Howard's factory, and the final twenty-five prints were in production.

### **In General**

The buyer can do the following three things by way of defaulting: repudiate the contract, fail to deliver the goods, or deliver or tender nonconforming goods. Section 2-711 of the UCC provides the following remedies for the buyer:

Where the seller fails to make delivery or repudiates, or the buyer rightfully rejects or justifiably revokes, then with respect to any goods involved, and with respect to the whole if the breach goes to the whole contract, the buyer may

- (1) cancel the contract, and
- (2) recover as much of the price as has been paid; and
- (3) “cover” and get damages; and
- (4) recover damages for nondelivery.

Where the seller fails to deliver or repudiates, the buyer may also:

- (5) if the goods have been identified recover them; or
- (6) in a proper case obtain specific performance or

(7) replevy the goods.

On rightful rejection or justifiable revocation of acceptance, a buyer:

(8) has a security interest in goods in his possession or control for any payments made on their price and any expenses reasonably incurred in their inspection, receipt, transportation, care and custody and may hold such goods and resell them in like manner as an aggrieved seller.

If the buyer has accepted non-conforming goods and notified seller of the non-conformity, buyer can

(9) recover damages for the breach; Uniform Commercial Code, Section 2-714.

and in addition the buyer may

(10) recover incidental damages and

(11) recover consequential damages. Uniform Commercial Code, Section 2-715.

Thus the buyer's remedies can be divided into two general categories: (1) remedies for goods that the buyer does not receive or accept, when he has justifiably revoked acceptance or when the seller repudiates, and (2) remedies for goods accepted.

**The CISG provides similar remedies at Articles 45–51:**

**If the seller fails to perform any of his obligations under the contract, buyer may (1) declare the contract avoided if the seller's breach is fundamental; or (2) require performance by the seller of his obligations unless the buyer has resorted to a remedy which is inconsistent with this requirement; (3) require delivery of substitute goods if the non-conformity constitutes a fundamental breach of contract; (4) may require the seller to remedy the lack of conformity by repair, unless this is unreasonable having regard to all the circumstances; (5) may fix an additional period of time of reasonable length for performance by the seller of his obligations and unless the buyer has received notice from the seller that he will not perform within the period so fixed, the buyer may not, during that period, resort to any remedy for breach of contract; (6) in case of non-conforming delivery, reduce the price in the same proportion as**

**the value that the goods actually delivered had at the time of the delivery bears to the value that conforming goods would have had at that time.**

### **Goods Not Received**

The UCC sets out buyer's remedies if goods are not received or if they are rightfully rejected or acceptance is rightfully revoked.

### **Cancel**

If the buyer has not yet received or accepted the goods (or has justifiably rejected or revoked acceptance because of their nonconformity), he may cancel the contract and—after giving notice of his cancellation—he is excused from further performance. Uniform Commercial Code, Sections 2-711(1), 2-106, 2A-508(1)(a), and 2A-505(1).

### **Recover the Price**

Whether or not the buyer cancels, he is entitled to recover the price paid above the value of what was accepted.

### **Cover**

In the example case, Bunker—the buyer—may “cover” and have damages: he may make a good-faith, reasonable purchase of substitute goods. He may then recover damages from the seller for the difference between the cost of cover and the contract price. This is the buyer's equivalent of the seller's right to resell. Thus Bunker could try to purchase seventy-five additional prints of the Bruegel from some other manufacturer. But his failure or inability to do so does not bar him from any other remedy open to him.

### **Sue for Damages for Nondelivery**

Bunker could sue for damages for nondelivery. Under Section 2-713 of the UCC, the measure of damages is the difference between the market price at the time when the buyer learned of the breach and the contract price (plus incidental damages, less expenses saved). Suppose Bunker could have bought seventy-five prints for \$125 on the day Howard called to say he would not be sending the rest of the order. Bunker would be entitled to \$1,875—the market price (\$9,375) less the contract price (\$7,500). This remedy is available even if he did not in fact purchase the substitute prints. Suppose that at the time of breach, the original painting was worth \$15,000 (Howard having just sold it to someone else at that price). Bunker

would be entitled to an additional \$5,000, which would be the difference between his contract price and the market price.

For leases, the UCC, Section 2A-519(1), provides the following: “the measure of damages for non-delivery or repudiation by the lessor or for rejection or revocation of acceptance by the lessee is the present value, as of the date of the default, of the then market rent minus the present value as of the same date of the original rent, computed for the remaining lease term of the original lease agreement, together with incidental and consequential damages, less expenses saved in consequence of the lessor’s default.”

### Recover the Goods

If the goods are unique—as in the case of the original Bruegel—Bunker is entitled to specific performance—that is, recovery of the painting. This section is designed to give the buyer rights comparable to the seller’s right to the price and modifies the old common-law requirement that courts will not order specific performance except for unique goods. It permits specific performance “in other proper circumstances,” and these might include particular goods contemplated under output or requirements contracts or those peculiarly available from one market source. Uniform Commercial Code, Sections 2-716(1) and 2A-521(1).

Even if the goods are not unique, the buyer is entitled to *replevy* them if they are identified to the contract and after good-faith effort he cannot recover them. **Replevin**<sup>6</sup> is the name of an ancient common-law action for recovering goods that have been unlawfully taken; in effect it is not different from specific performance, and the UCC makes no particular distinction between them in Section 2-716. Section 2A-521 holds the same for leases. In our case, Bunker could replevy the twenty-five prints identified and held by Howard.

Bunker also has the right to recover the goods should it turn out that Howard is insolvent. Under UCC, Section 2-502, if Howard were to become insolvent within ten days of the day on which Bunker pays the first installment of the price due, Bunker would be entitled to recover the original and the prints, as long as he tendered any unpaid portion of the price.

For security interest in goods rightfully rejected, if the buyer rightly rejects nonconforming goods or revokes acceptance, he is entitled to a security interest in any goods in his possession. In other words, Bunker need not return the twenty-five prints he has already received unless Howard reimburses him for any payments made and for any expenses reasonably incurred in their inspection, receipt, transportation, care, and custody. If Howard refuses to reimburse him, Bunker may

6. An action to recover possession of goods wrongfully held.



resell the goods and take from the proceeds the amount to which he is entitled. Uniform Commercial Code, Sections 2-711(3), 2-706, 2A-508(5), and 2A-527(5).

### **Goods Accepted**

The buyer does not have to reject nonconforming goods. She may accept them anyway or may effectively accept them because the time for revocation has expired. In such a case, the buyer is entitled to remedies as long as she notifies the seller of the breach within a reasonable time. Uniform Commercial Code, Sections 2-714(1) and 2A-519(3). In our example, Bunker can receive three types of damages, all of which are outlined here.

### **Compensatory Damages**

Bunker may recover damages for any losses that in the ordinary course of events stem from the seller's breach. Suppose Howard had used inferior paper that was difficult to detect, and within several weeks of acceptance the prints deteriorated. Bunker is entitled to be reimbursed for the price he paid.

### **Consequential Damages**

Bunker is also entitled to consequential damages. Uniform Commercial Code, Sections 2-714(3), 2-715, and 2A-519(3). These are losses resulting from general or particular requirements of the buyer's needs, which the seller had reason to know and which the buyer could not reasonably prevent by cover or otherwise. Suppose Bunker is about to make a deal to resell the twenty-five prints that he has accepted, only to discover that Howard used inferior ink that faded quickly. Howard knew that Bunker was in the business of retailing prints and therefore he knew or should have known that one requirement of the goods was that they be printed in long-lasting ink. Because Bunker will lose the resale, he is entitled to the profits he would have made. (If Howard had not wished to take the risk of paying for consequential damages, he could have negotiated a provision limiting or excluding this remedy.) The buyer has the burden of proving consequential damages, but the UCC does not require mathematical precision. Suppose customers come to Bunker's gallery and sneer at the faded colors. If he can show that he would have sold the prints were it not for the fading ink (perhaps by showing that he had sold Bruegels in the past), he would be entitled to recover a reasonable estimate of his lost profits.

In *De La Hoya v. Slim's Gun Shop* the plaintiff purchased a handgun from the defendant, a properly licensed dealer. While the plaintiff was using it for target shooting, he was questioned by a police officer, who traced the serial number of the

weapon and determined that—unknown to either the plaintiff or the defendant—it had been stolen. The plaintiff was arrested for possession of stolen property and incurred, in 2010 dollars, \$3,000 in attorney fees to extricate himself from the criminal charges. He sued the defendant for breach of the implied warranty of title and was awarded the amount of the attorney fees as consequential damages. On appeal the California court held it foreseeable that the plaintiff would get arrested for possessing a stolen gun, and “once the foreseeability of the arrest is established, a natural and usual consequence is that the [plaintiff] would incur attorney’s fee.” *De La Hoya v. Slim’s Gun Shop*, 146 Cal. Rptr. 68 (Super. 1978). Compare with *In re Stem* in the exercises later in this chapter.

### **Incidental Damages**

Section 2-715 of the UCC allows incidental damages, which are “damages resulting from the seller’s breach including expenses reasonably incurred in inspection, receipt, transportation and care and custody of goods rightfully rejected, any commercially reasonable charges, expenses or commissions in connection with effecting cover and any other reasonable expense incident to the delay or other breach.” Section 2A-520(1) of the UCC is similar for leases.

### KEY TAKEAWAY

Parties to a contract for the sale of goods may specify what the remedies will be in case of breach. They may limit or exclude remedies, but the UCC insists that there be some remedies; if the parties agree to liquidated damages, the amount set cannot be a penalty.

If the parties do not agree to different remedies for the seller in case the buyer defaults, the UCC sets out remedies. As to the seller's obligation, he may cancel the contract. As to the goods, he may withhold or stop delivery, identify conforming goods to the contract, or reclaim goods upon the buyer's insolvency. As to money, he may resell and recover damages or lost profits and recover the price. Unless they are inconsistent, these remedies are cumulative. The point of the range of remedies is, as much as possible, to put the nonbreaching seller in the position she would have been in had there been no breach. The aggrieved lessor is entitled to similar remedies as the seller.

The UCC also provides a full panoply of remedies available to a buyer if the seller fails to deliver goods or if the buyer rightfully rejects them or revokes her acceptance. As to the buyer's obligations, she may cancel the contract. As to the goods, she may claim a security interest in those rightfully rejected, recover goods identified if the seller is insolvent, or replevy or seek specific performance to get goods wrongfully withheld. As to money, she may recover payments made or cover and recover damages for nondelivery. If the buyer accepts nonconforming goods, she is entitled to damages for breach of warranty. These remedies are cumulative, so the aggrieved buyer may pursue any of them, unless the remedies are mutually exclusive. The Article on leases provides basically the same remedies for the aggrieved lessee (UCC 2A 520–523).

## EXERCISES

1. What are the four things a breaching seller could do to cause the buyer grief, commercially speaking?
2. If the buyer breaches, what rights does the seller have in regard to the goods?
3. In regard to the money owed to her?
4. In regard to the continued existence of the contract?
5. What are the four things a breaching buyer could do to cause the seller grief, commercially speaking?
6. If the seller breaches, what rights does the buyer have in regard to the goods?
7. In regard to the money owed to him?
8. In regard to the continued existence of the contract?

## 19.4 Excuses for Nonperformance

### LEARNING OBJECTIVES

1. Recognize how parties are discharged if the goods are destroyed.
2. Determine what defenses are valid when it becomes very difficult or impossible to perform.
3. Understand the UCC's position on the right to adequate assurances and anticipatory repudiation.

In contracts for the sale of goods, as in common law, things can go wrong. What then?

### Casualty to Identified Goods

As always, the parties may agree what happens if the goods are destroyed before delivery. The default is Sections 2-613 and 2A-221(a) of the Uniform Commercial Code (UCC). The UCC says that “where the contract requires for its performance goods identified when the contract is made, and the goods suffer casualty without fault of either party before the risk of loss passes to the buyer,...then (a) if the loss is total the contract is avoided; and (b) if the loss is partial the buyer may nevertheless accept them with due allowance for the goods' defects.” Thus if Howard ships the original Bruegel to Bunker but the painting is destroyed, through no fault of either party, before delivery occurs, the parties are discharged. If the frame is damaged, Bunker could, if he wants, take the painting anyway, but at a discount.

### The UCC's Take on Issues Affecting “Impossibility”

Although this matter was touched on in [Chapter 15 "Discharge of Obligations"](#), it is appropriate to mention briefly again the UCC's treatment of variations on the theme of “impossibility.”

### Impracticability

Sections 2-614(1) and 2A-404(1) of the UCC require reasonable substitution for berthing, loading, and unloading facilities that become unavailable. They also require reasonable substitution for transportation and delivery systems that become “commercially impracticable”; if a practical alternative exists, “performance must be tendered and accepted.” If Howard agreed to send the prints

by rail, but a critical railroad bridge is unusable and no trains can run, delivery by truck would be required.

Section 2-615 of the UCC says that the failure to deliver goods is not a breach of the seller's duty "if performance as agreed has become impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made or by compliance in good faith with any applicable foreign or domestic government regulation or order whether or not it later proves to be invalid." Section 2A-405(b) of the UCC is similar for leases.

**The CISG provides something similar at Article 79: "A party is not liable for a failure to perform any of his obligations if he proves that the failure was due to an impediment beyond his control and that he could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences."**

### **Right to Adequate Assurances of Performance**

Section 2-609, Comment 1, of the UCC observes that "the essential purpose of a contract...is actual performance [but] a continuing sense of reliance and security that the promised performance will be forthcoming when due is an important feature of the bargain." Thus the UCC says that if one party has "reasonable grounds for insecurity arise...either party may in writing demand adequate assurance and until he receives such assurance may if commercially reasonable suspend [his own] performance[.]"

**The CISG has a similar take at Article 71: "A party may suspend the performance of his obligations if, after the conclusion of the contract, it becomes apparent that the other party will not perform a substantial part of his obligations. A party suspending performance, whether before or after dispatch of the goods, must immediately give notice of the suspension to the other party and must continue with performance if the other party provides adequate assurance of his performance."**

### **Anticipatory Repudiation**

Obviously if a person repudiates the contract it's clear she will not perform, but what if she repudiates before time for performance is due? Does the other side have to wait until nonperformance actually happens, or can he sue in anticipation of the other's default? Sections 2-610 and 2A-402 of the UCC say the aggrieved party can do either: wait for performance or "resort to any remedy for breach." Under the

UCC, Sections 2-611 and 2A-403, the one who has anticipatorily repudiated can “retract his repudiation unless the aggrieved party has since the repudiation cancelled or materially changed his position[.]”

Suppose that Howard has cause to suspect that if he does deliver the goods, Bunker won't pay. Howard may write to Bunker and demand—not request—assurances of adequate performance. If such assurances are not adequately forthcoming, Howard may assume that Bunker has repudiated the contract and have remedies.

**Article 72 of the CISG is pretty much the same: “If prior to the date for performance of the contract it is clear that one of the parties will commit a fundamental breach of contract, the other party may declare the contract avoided.”**

#### KEY TAKEAWAY

If, through no fault of either party, the goods are destroyed before the risk of loss has passed from the seller to the buyer, the parties are both discharged. If the expected means of performance is impossible, but an alternative is available, the alternative must be utilized. If performance becomes impracticable because of an unexpected contingency, failure to deliver the goods is excused. But a party who has concerns whether the other side will perform is entitled to adequate assurances of performance; if they are not forthcoming, the worried party may suspend performance. Where a party repudiates a contract before performance is due, the other side may sue immediately (anticipatory repudiation) or may wait until the time performance comes due and then sue.

## EXERCISES

1. Suppose Plaintiff sues Defendant for breach of contract, and Defendant successfully raises an excuse for nonperformance. What liability does Defendant have now?
2. The contract read that the goods would be “shipped F.O.B. Seattle, by Burlington Northern Rail to the buyer in Vancouver, B.C.” Due to heavy rain and mudslides, the rail line between Seattle and points north was impassable. Buyer insists Seller is obligated to send the goods by motor truck; Seller insists her performance has become impossible or at least that shipment must await the rail-line clearance. Who is correct? Explain.
3. Buyer manufactured ceramic insulators and ordered the dies into which the liquid ceramic would be poured for hardening and finishing from Seller, to be delivered April 15. The first test batch of a dozen dies arrived on February 15; these dies were defective. Buyer wrote inquiring whether the defects could be remedied in time for the final delivery. Seller responded, “We are working to address the problems here.” Buyer again inquired; Seller responded, “As I said, we are working on the problems.” Buyer fretted that the deadline—two months in the future—would not be met. What remedy, if any, does Buyer have now?



## 19.5 Cases

### Limitations of Remedy Results in No Remedy

Hartzell v. Justus Co., Inc.

693 F.2d 770 (8th Cir. S.D. 1982)

Arnold, J.

This is a diversity case arising out of the purchase by Dr. Allan Hartzell of Sioux Falls, South Dakota, of a log home construction kit manufactured by the defendant Justus Homes. Dr. Hartzell purchased the package in 1977 for \$38,622 [about \$135,000 in 2010 dollars] from Del Carter, who was Justus Homes' dealer for the Sioux Falls area. He also hired Carter's construction company, Natural Wood Homes, to build the house. Hartzell, who testified that the home eventually cost about \$150,000, was dissatisfied with the house in many respects. His chief complaints were that knotholes in the walls and ceiling leaked rain profusely, and that the home was not weather tight because flashings were not included in the roofing materials and because the timbers were not kiln-dried and therefore shrank. He also complained that an undersized support beam, which eventually cracked, was included in the package. This latter defect was alleged to have resulted in cracks in the floor and inside doors that would not close. Hartzell further alleged that these structural defects were only partially remediable, and that the fair market value of the house was reduced even after all practicable repairs had been made. Alleging breach of implied and express warranties and negligence, he sought damages for this loss in value and for the cost of repairs. After a two-day trial, the jury returned a plaintiff's verdict for \$34,794.67.

Justus Homes contends the District Court erred in failing to instruct the jury on a limitation-of-remedies clause contained in its contract with the plaintiff. The defendants rely on Clause 10c of the contract, which says Justus *will repair or replace defective materials*, and Clause 10d, which states that *this limited repair or replacement clause is the exclusive remedy available against Justus* [emphasis added]. These agreements, Justus asserts, are valid under the Uniform Commercial Code 2-719(1). Section 2-719(1) states:

(1) Subject to the provisions of subsections (2) and (3) of this section and of § 57A-2-718 on liquidation and limitation of damages,

(a) The agreement may provide for remedies in addition to or in substitution for those provided in this chapter and may limit or alter the measure of damages recoverable under this chapter, as by limiting the buyer's remedies to return of the goods and repayment of the price or to repair and replacement of nonconforming goods or parts; and

(b) Resort to a remedy as provided is optional unless the remedy is expressly agreed to be exclusive, in which case it is the sole remedy.

Subsection (1) of section 2-719 is qualified by subsection (2): "Where circumstances cause an exclusive or limited remedy to fail of its essential purpose, remedy may be had as provided in this title."...

The jury's verdict for the plaintiff in an amount almost exactly equal to the plaintiff's evidence of cost of repairs plus diminution in market value means it must have found that the structural defects were not entirely remediable. Such a finding necessarily means that the limited warranty failed of its essential purpose.

Two of our recent cases support this conclusion. In *Soo Line R.R. v. Fruehauf Corp.*, 547 F.2d 1365 (8th Cir.1977), the defendant claimed, relying on a limitation-of-remedies clause similar to the one involved here, that the plaintiff's damages should be limited to the reasonable cost of repairing the railroad cars that plaintiff had bought from defendant. The jury verdict included, among other things, an award for the difference between the value of the cars as actually manufactured, and what they would have been worth if they had measured up to the defendant's representations. This Court affirmed the verdict for the larger amount. We held, construing the Minnesota U.C.C., which is identical to § 2-719 as adopted in South Dakota, that the limitation-of-remedies clause was ineffective because the remedy as thus limited failed of its essential purpose. The defendant, though called upon to make the necessary repairs, had refused to do so, and the repairs as performed by the plaintiff itself "did not fully restore the cars to totally acceptable operating conditions."

Here, Justus Homes attempted to help with the necessary repairs, which is more than Fruehauf did in the *Soo Line* case, but after the repairs had been completed the house was still, according to the jury verdict, not what Justus had promised it would be. The purpose of a remedy is to give to a buyer what the seller promised him—that is, a house that did not leak. If repairs alone do not achieve that end, then to limit the buyer's remedy to repair would cause that remedy to fail of its essential purpose....

An analogous case is *Select Pork, Inc. v. Babcock Swine, Inc.* [Citation], applying § 2-719 as adopted in Iowa. The defendant had promised to deliver to plaintiff certain extraordinary pigs known as Midwestern Gilts and Meatline Boars. Instead, only ordinary pigs were delivered. Plaintiff sued for breach of warranty, and defendant claimed that its damages, if any, should be limited to a return of the purchase price by an express clause to that effect in the contract. The District Court held that the clause was unenforceable because it was unconscionable, see § 2-719(3), and because it failed of its essential purpose. We affirmed,...“Having failed to deliver the highly-touted special pigs, defendants may not now assert a favorable clause to limit their liability.” So here, where the house sold was found by the jury to fall short of the seller’s promises, and where repairs could not make it right, defendant’s liability cannot be limited to the cost of repairs. If the repairs had been adequate to restore the house to its promised condition, and if Dr. Hartzell had claimed additional consequential damages, for example, water damage to a rug from the leaky roof, the limitation-of-remedies clause would have been effective. But that is not this case.

There was no double recovery here: the verdict was not for cost of repair plus the entire decrease in market value, but rather for cost of repair plus the decrease in market value that still existed after all the repairs had been completed.

[T]he evidence in the record all demonstrate[s] that the repair or replacement clause was a failure under the circumstances of this case. Some of the house’s many problems simply could not be remedied by repair or replacement. The clause having failed of its essential purpose, that is, effective enjoyment of implied and express warranties, the plaintiff was entitled, under UCC § 2-719(2), to any of the buyer’s remedies provided by the Code. Among these remedies are consequential damages as provided in §§ 2-714 and 2-715(2)....

The judgment is affirmed.

## CASE QUESTIONS

1. What did the seller here limit itself to do in case of defects? What was the limitation of remedy?
2. Did Justus Homes disclaim implied and expressed warranties with its contract language regarding limitation of remedies?
3. Was the essential purpose of the limitation of remedy to protect the party benefiting from it—here, the seller of the log home kit—or was the essential purpose of the limitation of remedy, as the court said, “effective enjoyment of implied and expressed warranties”?
4. In a part of the opinion excised, the court wrote, “A finding of unconscionability is, as a matter of logic, simply unnecessary in cases where § 2-719(2) applies.” Would it be easier simply to say that the limitation of liability here was unconscionable?

### Cure for Improper Delivery

Wilson v. Scampoli

228 A.2d 848 (D.C. App. 1967)

Myers, J.

This is an appeal from an order of the trial court granting rescission of a sales contract for a color television set and directing the return of the purchase price plus interest and costs.

Appellee [Mrs. Kolley’s father] purchased the set in question on November 4, 1965, paying the total purchase price in cash. The transaction was evidenced by a sales ticket showing the price paid and guaranteeing ninety days’ free service and replacement of any defective tube and parts for a period of one year. Two days after purchase the set was delivered and uncrated, the antennae adjusted and the set plugged into an electrical outlet to “cook out.” When the set was turned on however, it did not function properly, the picture having a reddish tinge. Appellant’s delivery man advised the buyer’s daughter, Mrs. Kolley, that it was not his duty to tune in or adjust the color but that a service representative would shortly call at her house for that purpose. After the departure of the delivery men, Mrs. Kolley unplugged the set and did not use it.

On November 8, 1965, a service representative arrived, and after spending an hour in an effort to eliminate the red cast from the picture advised Mrs. Kolley that he would have to remove the chassis from the cabinet and take it to the shop as he could not determine the cause of the difficulty from his examination at the house. He also made a written memorandum of his service call, noting that the television “Needs Shop Work (Red Screen).” Mrs. Kolley refused to allow the chassis to be removed, asserting she did not want a ‘repaired’ set but another ‘brand new’ set. Later she demanded the return of the purchase price, although retaining the set. Appellant refused to refund the purchase price, but renewed his offer to adjust, repair, or, if the set could not be made to function properly, to replace it. Ultimately, appellee instituted this suit against appellant seeking a refund of the purchase price. After a trial, the court ruled that “under the facts and circumstances the complaint is justified. Under the equity powers of the Court I will order the parties put back in their original status, let the \$675 [about \$4500 in 2010 dollars] be returned, and the set returned to the defendant.”

Appellant does not contest the jurisdiction of the trial court to order rescission in a proper case, but contends the trial judge erred in holding that rescission here was appropriate. He argues that he was always willing to comply with the terms of the sale either by correcting the malfunction by minor repairs or, in the event the set could not be made thereby properly operative, by replacement; that as he was denied the opportunity to try to correct the difficulty, he did not breach the contract of sale or any warranty thereunder, expressed or implied.

[The District of Columbia UCC 2-508] provides:

(1) Where any tender or delivery by the seller is rejected because non-conforming and the time for performance has not yet expired, the seller may seasonably notify the buyer of his intention to cure and may then within the contract time make a conforming delivery.

(2) Where the buyer rejects a nonconforming tender which the seller had reasonable grounds to believe would be acceptable with or without money allowance the seller may if he seasonably notifies the buyer have a further reasonable time to substitute a conforming tender.

...

Removal of a television chassis for a short period of time in order to determine the cause of color malfunction and ascertain the extent of adjustment or correction needed to effect full operational efficiency presents no great inconvenience to the

buyer. In the instant case, appellant's expert witness testified that this was not infrequently necessary with new televisions. Should the set be defective in workmanship or parts, the loss would be upon the manufacturer who warranted it free from mechanical defect. Here the adamant refusal of Mrs. Kolley, acting on behalf of appellee, to allow inspection essential to the determination of the cause of the excessive red tinge to the picture defeated any effort by the seller to provide timely repair or even replacement of the set if the difficulty could not be corrected. The cause of the defect might have been minor and easily adjusted or it may have been substantial and required replacement by another new set—but the seller was never given an adequate opportunity to make a determination.

We do not hold that appellant has no liability to appellee, but as he was denied access and a reasonable opportunity to repair, appellee has not shown a breach of warranty entitling him either to a brand new set or to rescission. We therefore reverse the judgment of the trial court granting rescission and directing the return of the purchase price of the set.

Reversed.

#### CASE QUESTIONS

1. Why did the seller “have reasonable grounds to believe [the television] would be acceptable”?
2. What did Mrs. Kolley want?
3. Does this case require a buyer to accept patchwork goods or substantially repaired articles in lieu of flawless merchandise?

### Seller's Remedies When Buyer Defaults

Santos v. DeBellis

901 N.Y.S.2d 457 (N.Y. Sup.App. 2010)

Molia, J.

On March 1, 2008 and March 11, 2008, plaintiff made payments to defendant of \$3,000 each, in connection with the purchase of a mobile home located in Fort Pierce, Florida. Thereafter, on March 13, 2008, plaintiff and defendant signed an agreement which had been prepared by defendant. The agreement described the

subject property by its location, recorded the fact that plaintiff had paid defendant deposits totaling \$6,000, set forth a closing date of March 25, 2008, and specified that “the remaining \$27,000.00” was payable at closing to defendant by a guaranteed financial instrument. Plaintiff never paid the outstanding balance and brought this action to recover the \$6,000 deposit she paid to defendant. Following a nonjury trial, judgment was awarded in favor of defendant dismissing the complaint.

Because the sale of a mobile home constitutes a contract for the sale of goods rather than of real property [Citations], the parties’ agreement was governed by the Uniform Commercial Code. The agreement, which was made after plaintiff had made the two \$3,000 “deposit” payments, constituted a memorandum in confirmation of an oral agreement and, even though it omitted some terms, was sufficient to satisfy the statute of frauds [Citations].

Section 2-718 of the Uniform Commercial Code specifies that in the absence of a contractual provision with respect to the liquidation or limitation of damages and the return of deposits,

(2) Where the seller justifiably withholds delivery of goods because of the buyer’s breach, the buyer is entitled to restitution of any amount by which the sum of his payments exceeds...

(b) [in the absence of contractually fixed terms] twenty per cent of the value of the total performance for which the buyer is obligated under the contract or \$500, whichever is smaller.

(3) The buyer’s right to restitution under subsection (2) is subject to offset to the extent that the seller establishes

(a) a right to recover damages under the provisions of this Article other than subsection (1), and

(b) the amount or value of any benefits received by the buyer directly or indirectly by reason of the contract.

Here, notwithstanding the fact that plaintiff, as buyer, had breached the contract, defendant failed to demonstrate any damages resulting therefrom; nor did defendant establish that plaintiff had received any benefits directly or indirectly by

reason of the parties' agreement (*see* UCC 2-718[3]). Therefore, pursuant to UCC 2-718(2), plaintiff was entitled to the return of all but \$500 of her deposit.

The order of the District Court dismissing the complaint is accordingly reversed, and judgment is awarded to plaintiff in the principal sum of \$5,500.

### CASE QUESTIONS

1. If the plaintiff had been a dealer in mobile homes and the unit here had been part of his inventory, he would be entitled to claim lost profits on the sale of one unit. Here, apparently, the plaintiff seller was a private party. Why was he not entitled to any damages greater than \$500?
2. New York adopted the UCC in 1964. Five hundred dollars in 1964 would be worth about \$3,500 in 2010. Why isn't the change in the dollar's value recognized here?

### Buyer's Remedies When Seller Breaches

[Note: this case is slightly edited by the authors.]

Furlong v. Alpha Chi Omega Sorority

657 N.E.2d 866 (Ohio Mun. 1993)

Bachman, J.

In late September through mid-October 1992, plaintiff Johnathan James Furlong ("Furlong") contacted defendant Alpha Chi Omega Sorority ("AXO"), by phoning the chairperson of its social committee, Emily Lieberman ("Emily"), between a dozen and a dozen and a half times.

Ultimately (about the first week in October), Furlong received Emily's order for one hundred sixty-eight imprinted sweaters at \$21.50 each (plus one free sweater) for delivery on Friday, October 23, 1992, so as to arrive in time for AXO's Midnight Masquerade III on the evening of Saturday, October 24, 1992.



The price was to be \$3,612, [about \$5600 in 2010 dollars] payable as follows: \$2,000 down payment when the contract was made, and \$1,612 balance when the sweaters were delivered.

An oral contract for the sale of goods (the imprinted sweaters) was made between Furlong and AXO, at a definite price and with specified dates for payment and for delivery.

At some point in those phone calls with Furlong, Emily said that the sweaters were to be custom designed with the following specified design: namely, with three colors (hunter green letters on top of maroon letters outlined in navy blue, and hunter green masks). Furlong promised to have them so imprinted (by a third party whom he would select)...Thereafter, he delivered to Emily an Ohio Wesleyan sweater with maroon letters to show her the maroon color....Additionally, he faxed to Emily a two-page description of the sweaters, which not only included the designs for the fronts and the backs of the sweaters, but also included arrows showing where each of the three colors would go (hunter green letters on top of maroon letters outlined in navy blue, and hunter green masks).

Furlong and Emily created an express warranty by each of the above three statutory means: namely, by affirmation of fact (his initial phone calls); by sample (the maroon sweater) by description (the fax). This express warranty became part of the contract. Each of the three methods of showing the express warranty was not in conflict with the other two methods, and thus they are consistent and cumulative, and constitute the warranty. [2-317]

The design was a “dickered” aspect of the individual bargain and went clearly to the essence of that. Thus, the express warranty was that the sweaters would be in accordance with the above design (including types of colors for the letters and the mask, and the number of colors for the same). Further, the express warranty became part of the contract.

On October 13, 1992, AXO mailed Furlong a \$2,000 check for the down payment; he deposited it in his bank account on October 16, 1992. Thereafter, as discussed below, Furlong had the sweaters imprinted (on Thursday, October 22) and delivered to AXO (on Friday, October 23). Upon receipt of the delivery, AXO gave a check to Furlong’s agent in the amount of \$1,612 for the balance of the purchase price. However, later on that day, AXO inspected the sweaters, discovered the design changes (mentioned below), caused AXO’s bank to stop payment on the check, and stated AXO’s objections in a phone call with Furlong. AXO has never paid Furlong that balance on the purchase price.

Furlong's obligation as the seller was to transfer and deliver the goods in accordance with the contract. AXO's obligation was to accept and pay in accordance with that contract. [2-301] We will now discuss whether it legally did so.

Furlong was a jobber for Argento Bros., Inc. ("Argento") and had Argento print the sweaters. In doing so, Furlong worked with Argento's artists. Early in the morning of Thursday (October 22, 1992), the artist(s) began to prepare the art work and recommended changes to the design. Furlong authorized the artist(s) to change the design without the knowledge or consent of AXO. Argento spent about eight hours printing the sweaters all day Thursday. Furlong did not phone AXO about the changes until the next day, Friday (October 23), after the sweaters were printed with those changes. Here are the five design changes that he made:

- The *first change* was to delete the agreed-upon outline for the letters (namely, the navy blue outline).
- The *second change* was to reduce the agreed-upon number of colors for the fronts and the backs (from three colors per side to two colors per side).
- The *third change* was to alter one of the agreed-upon colors (from maroon to red).
- The *fourth change* was to alter the agreed-upon scheme of colors for the letters on the fronts and the backs (namely, both sides were to have the same two colors of maroon and hunter green; whereas in fact the backs had neither of those colors, and instead had a navy blue color for the letters).
- The *fifth change* was to alter the agreed-upon color of the masks (from hunter green to maroon—actually red).

The court specifically finds that the color was *red* (actually, scarlet) and was *not maroon* (like the maroon-colored letters on the Ohio Wesleyan sweater).

The sweaters did not conform to the contract (specifically, the express warranty in the contract). Thus (in the words of the statute), the sweaters did "fail in any respect to conform to the contract." Actually, the sweaters failed in at least five respects. [2-601] Further, not only did they "fail in any respect," they failed in a substantial respect. In either event, they were a nonconforming tender of goods. [2-601]

On Friday morning (October 23), Furlong picked up the five to six boxes of sweaters from Argento and had a friend deliver them from Columbus to Bowling Green. The boxes arrived at the AXO house around midday. Sometime thereafter on the same

day, Emily inspected one of them and screamed her dismay upon discovering that the sweaters were not what AXO had ordered.

The court rejects Furlong's assertion that he did all that he could do under the circumstances. The obvious answer is that he did not do enough. He should have gotten AXO's prior consent to the changes. He could have done this by providing for more lead time—between the time that Argento prepared the art work and the time that it printed the sweaters. Instead, he had both done at the same time (Thursday morning).

Finally, and alternatively, plaintiff should have entered into a contract that gave him discretion to make design changes without AXO's consent. We must remember that "these sweaters," as Furlong himself admits (and describes), were to be "custom-designed" for AXO. Thus, they were to be printed according to AXO's specifications, and not according to Furlong's discretion.

Next, Furlong asserts that AXO—after learning of the changes—should have agreed to his offer of compromise: namely, that he would reduce the unit price of the sweaters in exchange for AXO's keeping them and paying the reduced price. Also, Furlong asserts that AXO should have communicated his compromise offer to AXO's members and pledges. In both respects, the court disagrees: Although the law allowed AXO to do so, it did not require AXO to do. Instead, AXO did exactly what the law allowed: AXO rejected the nonconforming goods in whole.

About 4:00 p.m. on the same day that the sweaters arrived at the AXO house (Friday, October 23), Amy—as the AXO president—phoned Furlong. She said that the sweaters were not what AXO had ordered. She stated the specifics as to why the sweaters were not as ordered. She offered to return the sweaters to him, but he said "No." AXO still has possession or custody of the boxes of sweaters.

[The UCC] provides: "Rejection of goods must be within a reasonable time after their delivery \* \* \*. It is ineffective unless the buyer seasonably notifies the seller." [2-602] AXO did what this statute requires.

That statute further provides: "[I]f the buyer has before rejection taken physical possession of goods \* \* \*, he is under a duty after rejection to hold them with reasonable care at the seller's disposition for a time sufficient to permit the seller to remove them[.]" [2-602(2)(b)] AXO has done this, too. From the above, it is seen that AXO legally rejected the sweaters on the same day that AXO received physical possession of them.

The court disagrees with Furlong's assertion that AXO accepted the sweaters. He is confusing a layman's understanding of the term *accept* ("to receive a thing [with a consenting mind]," Webster's Collegiate Dictionary (5 Ed.1947), at 6, with the statutory meaning of the term. The mere fact that AXO took physical possession of the sweaters does not, by itself, mean that AXO legally "accepted" them.

In regard to...seller's remedies, Furlong has no legal remedies because AXO did not breach the contract. Thus, he is not entitled to an award for the \$1,612 balance that he claims is due on the contract price.

As concluded above, AXO rightfully rejected the sweaters, after having paid part of the purchase price: namely, \$2,000. AXO is entitled to cancel the contract and to recover the partial payment of the purchase price. [2-606]

Also, as concluded above, AXO still has rightful possession or control of the sweaters. AXO has a security interest in the sweaters in its possession or control for the part payment made on the purchase price—but when reimbursed for that part payment AXO must return the sweaters to Furlong.

The court will prepare, file, and serve a judgment entry as follows: dismissing with prejudice Furlong's claim against all defendants; dismissing with prejudice Emily Lieberman's and Amy Altomondo's counterclaims against Furlong; granting AXO's counterclaim (for \$2,000, plus ten percent per annum postjudgment interest and costs).

Further, that entry will order AXO's attorney (Mr. Reddin) to retain possession of the sweaters either until further court order or until AXO's judgment is satisfied in full (whereupon he shall surrender the sweaters to Furlong if Furlong picks them up within thirty days thereafter, or, if Furlong does not, he may then dispose of them as abandoned property without any liability).

Judgment accordingly.

### CASE QUESTIONS

1. Surely the plaintiff could not have thought that the radically altered design would be acceptable for the young women's masquerade ball. On what basis did he think he would be entitled to the full payment contracted for?
2. Whether Amy Altomondo knew it or not, she did what the UCC says a buyer should do when nonconforming goods are delivered. What are those steps?
3. What does it mean that AXO has a security interest in the sweaters? Security for what?

## **19.6 Summary and Exercises**

## Summary

As with most of the Uniform Commercial Code (UCC), the parties may specify the terms of their performance. Only if they fail to do so does Article 2 (and 2A) provide the terms for them. The seller's duty is to make a timely delivery of conforming goods. In the absence of agreement, the time for delivery is a reasonable one, and the place of delivery is the seller's place of business. All goods must be tendered in a single delivery, unless circumstances permit either party the right to make or demand delivery in lots.

If the seller ships nonconforming goods but has time to meet his contractual obligations or if he reasonably believed the goods would be suitable, he may notify the buyer of his intention to cure, and if he does so in a timely manner the buyer must pay.

The buyer's general obligation is to inspect, accept, and pay. If an inspection reveals that the goods are nonconforming, the buyer may reject them; if he has accepted because defects were latent or because he received assurances that the defects would be cured, and they are not, the buyer may revoke his acceptance. He then has some duties concerning the goods in his possession. The buyer must pay for any conforming goods; payment may be in any manner consistent with current business customs. Payment is due at the time and place at which the buyer will ultimately receive the goods.

The general policy of the UCC is to put an aggrieved party in as good a position as she would have been had the other party fully performed. The parties may specify or limit certain remedies, but they may not eliminate all remedies for a breach. However, if circumstances make an agreed-on remedy inadequate, then the UCC's other remedies apply; parties may not unconscionably limit consequential damages; they may agree to liquidated damages, but not to unreasonable penalties.

In general, the seller may pursue the following remedies: withhold further delivery, stop delivery, identify to the contract goods in her possession, resell the goods, recover damages or the price, or cancel the contract. In addition, when it becomes apparent that the buyer is insolvent, the seller may, within certain time periods, refuse to deliver the remaining goods or reclaim goods already delivered.

The buyer, in general, has remedies. For goods not yet received, she may cancel the contract; recover the price paid; cover the goods and recover damages for the difference in price; or recover the specific goods if they are unique or in "other proper circumstances." For goods received and accepted, the buyer may recover ordinary damages for losses that stem from the breach and consequential damages if the seller knew of the buyer's particular needs and the buyer could not reasonably cover.

The UCC provides some excuses for nonperformance: casualty of the goods, through no fault of either party; the nonhappening of presupposed conditions that were a basic assumption of the contract; substituted performance

if the agreed-on methods of performance become impracticable; right to adequate assurances of performance when reasonable grounds for insecurity of performance arise; anticipatory repudiation and resort to any remedy, before time for performance is due, is allowed if either party indicates an unwillingness to perform.



## EXERCISES

1. Anne contracted to sell one hundred cans of yellow tennis balls to Chris, with a delivery to be made by June 15.
  - a. On June 8, Anne delivered one hundred cans of white tennis balls, which were rejected by Chris. What course of action would you recommend for Anne, and why?
  - b. Assume Ann had delivered the one hundred cans of white balls on June 15; these were rejected by Chris. Under what circumstances might Anne be allowed additional time to perform the contract?
  - c. If the contract did not specify delivery, when must Anne deliver the tennis balls?
  
2.
  - a. When Anne delivers the tennis balls, does Chris have a right to inspect them? If Chris accepts the white tennis balls, may the acceptance be revoked?
  - b. Assume Chris decided she could use twenty-five cans of the white balls. Could she accept twenty-five cans and reject the rest?
  - c. Suppose Anne delivered white tennis balls because a fire at her warehouse destroyed her entire stock of yellow balls. Does the fire discharge Anne's contractual duties?
  - d. If Chris rejected the white tennis balls and Anne refused to deliver yellow ones, may Chris recover damages? If so, how would they be calculated?
  
3. In 1961, Dorothy and John Wilson purchased a painting from Hammer Galleries titled *Femme Debout*. It cost \$11,000 (about \$78,000 in 2010 dollars) and came with this promise: "The authenticity of this picture is guaranteed." In 1984, an expert deemed the painting a fake. The district court held that the Wilsons' suit for breach of warranty, filed in February 1987—twenty-one years after its purchase—was barred by the UCC's four-year statute of limitations. The Wilsons argued, however, that the Code's exception to the four-year rule applied: Uniform Commercial Code, Section 2-725(2). "A breach of warranty occurs when tender of delivery is made, except where a warranty explicitly extends to future performance and discovery

must await the time of such performance the cause of action accrues when the breach is or should have been discovered.”

They said the painting “performed” by being an authentic Vuillard—a French artist—and that the warranty of authenticity not only guaranteed the present “being” of the painting but also extended, as required by 2-725(2), to the future existence as a Vuillard. Therefore, they contended, explicit words warranting future performance would be superfluous: a warranty that promises authenticity “now and at all times in the future” would be redundant. How should the court rule?

4. Speedi Lubrication Centers Inc. and Atlas Match Corp. entered into a contract that provided for Speedi to buy 400,000 advertising matchbooks from Atlas, to be paid for within thirty days of delivery of each shipment. Orders for such matches required artwork, artists’ commissions, and printing plates. Atlas sent twenty-two cases of matches to Speedi with an invoice showing \$2,100 owed. Almost ninety days later, Speedi sent Atlas a check for \$1,000, received the same day Atlas sent Speedi a letter declaring Speedi to be in material breach of the contract. A second check for \$1,100 was later received; it bounced but was later replaced by a cashier’s check. The contract provided that an untimely payment was a breach, and it included these provisions related to liquidated damages:

Atlas shall have the right to recover from Purchaser the price of all matchbooks and packaging delivered and/or identified to this agreement at the time of Purchaser’s breach hereof and shall be additionally entitled to recover fifty percent (50%) of the contract price of matchbooks and/or packaging ordered hereby, but not delivered or identified to this Agreement at the time of Purchaser’s breach. Purchaser agrees that the percentage as specified hereinabove...will be reasonable and just compensation for such breach, and Purchaser hereby promises to pay such sum as liquidated damages, not as penalty in the event of any such breach.

On appeal, Speedi complained that the liquidated damages clause was a penalty. Is the matter settled by the contract saying the

liquidated damages are reasonable? On what criteria would a court determine whether liquidated damages are reasonable?

5. Mrs. Kaiden made a \$5,000 deposit on the purchase of new 1973 Rolls-Royce automobile. Lee Oldsmobile, the seller, confirmed the request by transmitting a regular order form, which Mrs. Kaiden signed and returned. The price was \$29,500.00 [about \$150,000 in 2010 dollars]. Some of the correspondence and a notation on Mrs. Kaiden's check indicated that delivery was expected in November. The order form, however, specified no delivery date. Further, it contained a disclaimer of liability for delay in delivery beyond the dealer's control, and it provided that the dealer had the right, upon failure of the purchaser to accept delivery, to retain as liquidated damages any cash deposit made. On November 21, 1973, Mrs. Kaiden notified Lee by telephone that she had purchased another Rolls-Royce elsewhere. She told the salesman to cancel her order. On November 29, Lee Oldsmobile notified Mrs. Kaiden that the car was ready for delivery. She refused delivery and demanded the return of her deposit. The dealer refused. In January 1974, the dealer—without notice to the Kaidens—sold the Rolls-Royce to another purchaser for \$26,495. Mrs. Kaiden sued Lee Oldsmobile for the \$5,000 deposit. The dealer carefully itemized its losses on the Kaiden deal—\$5080.07. On what basis did the court dismiss the liquidated damages clause? What is the consequence of the dealer's failure to give notice of the private sale under UCC, Section 2-706(3)?
6. Hemming saw an advertisement for a Cadillac convertible once owned by the famous early rock 'n' roll singer Elvis Presley. He contracted to buy it from Whitney for \$350,000 and sent Whitney \$10,000 as a deposit. But, after some delay, Whitney returned the \$10,000 and informed Hemming that the car had been sold to another purchaser. What remedy does Hemming have?
7. Murrey manufactured and sold pool tables. He was approached by Madsen, who had an idea for a kind of electronic pool table that would light up and make sounds like a pinball machine. Madsen made a \$70,000 deposit on an order for one hundred tables but then encountered difficulties and notified Murrey that he would be unable to accept delivery of the tables. Murrey broke the tables up, salvaging materials worth about \$15,000 and using the rest for firewood. The evidence was that the tables, if completed by Murrey, could have been sold for \$45,000 as regular pool tables. Madsen gets his deposit back less expenses incurred by Murrey. But what principle affects Murrey's measure of damages, his right to claim expenses incurred?
8. In January 1992, Joseph Perna bought an eleven-year-old Oldsmobile at a New York City police auction sale for \$1,800 plus towing fees. It had been

impounded by the police for nonpayment of parking tickets. The bill of sale from the police to Perna contained this language: “subject to the terms and conditions of any and all chattel mortgages, rental agreements, liens, conditional bills of sale, and encumbrances that may be on the motor vehicle of the [its original owner].” About a year later Perna sold the car to a coworker, Elio Marino, for \$1,200. Marino repaired and improved the car by replacing the radiator, a gasket, and door locks. Ten months after his father bought the car, Marino’s son was stopped by police and arrested for driving a stolen vehicle; Mario paid \$600 to a lawyer to get that matter resolved, and he never got the car back from the police. Is Perna liable to Marino for the value of the car? Is Perna liable for the consequential damages—the attorney’s fees? The relevant UCC sections are 2-312(2) and 2-714.

9. William Stem bought a used BMW from Gary Braden for \$6,600 on Braden’s assertion that as far as he knew the car had not been wrecked and it was in good condition. Less than a week later Stem discovered a disconnected plug; when connected the oil-sensor warning light glowed. Mechanics informed Stem that the car was made up of the front end of a 1979 BMW and the rear end of a 1975 BMW, and the front half had 100,000 more miles on it than Stem thought. Six weeks after he purchased the car, Stem wrote Braden a letter that he refused the car and intended to rescind the sale. Braden did not accept return of the car or refund the money, and Braden continued to drive it for seven months and nearly 9,000 miles before suing. He had no other car and needed to transport his child. These issues were before the Alabama Supreme Court, construing UCC, Section 2-608: did Stem’s use of the car, notwithstanding his letter of rescission, constitute such use of it as to be an acceptance? And if not, does Stem owe Braden anything for its use?
10. Donnelly ordered a leather motorcycle jacket from Leathers Inc. The jacket was specially designed according to Donnelly’s instructions: it had a unique collar, various chromed studs throughout, and buckles, and he required an unusually large size. The coat cost \$6,000. Donnelly paid \$1,200 as a deposit, but after production was nearly complete, he telephoned Leathers Inc. and repudiated the contract. What should Leathers do now?

## SELF-TEST QUESTIONS

1. In the absence of agreement, the place of delivery is
  - a. the buyer's place of business
  - b. the seller's place of business
  - c. either the buyer's place of business or the buyer's residence
  - d. any of the above
  
2. The UCC's statute of limitations is
  - a. two years
  - b. three years
  - c. four years
  - d. none of the above
  
3. Under the UCC, if the buyer breaches, the seller can
  - a. withhold further delivery
  - b. resell the goods still in the seller's possession
  - c. recover damages
  - d. do all of the above
  
4. If the seller breaches, the buyer can generally
  - a. recover the goods, even when the goods have not been identified to the contract and the seller is not insolvent
  - b. purchase substitute goods and recover their cost
  - c. purchase substitute goods and recover the difference between their cost and the contract price
  - d. recover punitive damages
  
5. Following a seller's breach, the buyer can recover the price paid
  - a. if the buyer cancels the contract
  - b. only for goods the buyer has accepted
  - c. for all the goods the buyer was to have received, whether or not they were accepted
  - d. under none of the above conditions

**SELF-TEST ANSWERS**

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

## Chapter 20

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### Products Liability

#### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

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

## 20.1 Introduction: Why Products-Liability Law Is Important

### LEARNING OBJECTIVES

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

In previous chapters, we discussed remedies generally. In this chapter, we focus specifically on remedies available when a defective product causes personal injury or other damages. Products liability describes a type of claim, not a separate theory of liability. Products liability has strong emotional overtones—ranging from the pro-litigation position of consumer advocates to the conservative perspective of the manufacturers.

### History of Products-Liability Law

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

The free enterprise system confers great benefits, and no one can deny that: materialistically, compare the image sketched in the previous paragraph with circumstances today. But those benefits come with a cost, and the fundamental



political issue always is who has to pay. Consider the following famous passage from Upton Sinclair's great novel *The Jungle*. It appeared in 1906. He wrote it to inspire labor reform; to his dismay, the public outrage focused instead on consumer protection reform. Here is his description of the sausage-making process in a big Chicago meatpacking plant:

There was never the least attention paid to what was cut up for sausage; there would come all the way back from Europe old sausage that had been rejected, and that was moldy and white—it would be dosed with borax and glycerin, and dumped into the hoppers, and made over again for home consumption. There would be meat that had tumbled out on the floor, in the dirt and sawdust, where the workers had tramped and spit uncounted billions of consumption germs. There would be meat stored in great piles in rooms; and the water from leaky roofs would drip over it, and thousands of rats would race about on it. It was too dark in these storage places to see well, but a man could run his hand over these piles of meat and sweep off handfuls of the dried dung of rats. These rats were nuisances, and the packers would put poisoned bread out for them; they would die, and then rats, bread, and meat would go into the hoppers together. This is no fairy story and no joke; the meat would be shoveled into carts, and the man who did the shoveling would not trouble to lift out a rat even when he saw one—there were things that went into the sausage in comparison with which a poisoned rat was a tidbit. There was no place for the men to wash their hands before they ate their dinner, and so they made a practice of washing them in the water that was to be ladled into the sausage. There were the butt-ends of smoked meat, and the scraps of corned beef, and all the odds and ends of the waste of the plants, that would be dumped into old barrels in the cellar and left there.

Under the system of rigid economy which the packers enforced, there were some jobs that it only paid to do once in a long time, and among these was the cleaning out of the waste barrels. Every spring they did it; and in the barrels would be dirt and rust and old nails and stale water—and cartload after cartload of it would be taken up and dumped into the hoppers with fresh meat, and sent out to the public's breakfast. Some of it they would make into "smoked" sausage—but as the smoking took time, and was therefore expensive, they would call upon their chemistry department, and preserve it with borax and color it with gelatin to make it brown. All of their sausage came out of the same bowl, but when they came to wrap it they would stamp some of it "special," and for this they would charge two cents more a pound. Upton Sinclair, *The Jungle* (New York: Signet Classic, 1963), 136.

It became clear from Sinclair's exposé that associated with the marvels of then-modern meatpacking and distribution methods was food poisoning: a true cost became apparent. When the true cost of some money-making enterprise (e.g., cigarettes) becomes inescapably apparent, there are two possibilities. First, the

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

If the industry has enough clout to blunt—by various means—a robust proconsumer legislative response so that government regulation is too lax to prevent harm, recourse is had through the legal system. Thus for all the talk about the need for tort reform (discussed later in this chapter), the courts play a vital role in policing the free enterprise system by adjudicating how the true costs of modern consumer culture are allocated.

Obviously the situation has improved enormously in a century, but one does not have to look very far to find terrible problems today. Consider the following, which occurred in 2009–10:

- In the United States, Toyota recalled 412,000 passenger cars, mostly the Avalon model, for steering problems that reportedly led to three accidents.
- Portable baby recliners that are supposed to help fussy babies sleep better were recalled after the death of an infant: the Consumer Product Safety Commission announced the recall of 30,000 Nap Nanny recliners made by Baby Matters of Berwyn, Pennsylvania.
- More than 70,000 children and teens go to the emergency room each year for injuries and complications from medical devices. Contact lenses are the leading culprit, the first detailed national estimate suggests.
- Smith and Noble recalled 1.3 million Roman shades and roller shades after a child was nearly strangled: the Consumer Product Safety Commission says a five-year-old boy in Tacoma, Washington, was entangled in the cord of a roller shade in May 2009. FindLaw, AP reports.
- The Consumer Product Safety Commission reported that 4,521 people were killed in the United States in consumer-product-related incidences in 2009, and millions of people visited hospital emergency rooms from consumer-product-related injuries. US Consumer Product Safety Commission, *2009 Report to the President and the Congress*, accessed

March 1, 2011, <http://www.cpsc.gov/cpsc/pub/pubs/reports/2009rpt.pdf>.

- Reports about the possibility that cell-phone use causes brain cancer continue to be hotly debated. Critics suggest that the studies minimizing the risk were paid for by cell-phone manufacturers. Matt Hamblen, "New Study Warns of Cell Phone Dangers," *Computerworld US*, August 9, 2009, accessed March 1, 2011, <http://news.techworld.com/personal-tech/3200539/new-study-warns-of-cell-phone-dangers>.

Products liability can also be a life-or-death matter from the manufacturer's perspective. In 2009, Bloomberg BusinessWeek reported that the costs of product safety for manufacturing firms can be enormous: "Peanut Corp., based in Lynchburg, Va., has been driven into bankruptcy since health officials linked tainted peanuts to more than 600 illnesses and nine deaths. Mattel said the first of several toy recalls it announced in 2007 cut its quarterly operating income by \$30 million. Earlier this decade, Ford Motor spent roughly \$3 billion replacing 10.6 million potentially defective Firestone tires." Michael Orey, "Taking on Toy Safety," *BusinessWeek*, March 6, 2009, accessed March 1, 2011, [http://www.businessweek.com/managing/content/mar2009/ca2009036\\_271002.htm](http://www.businessweek.com/managing/content/mar2009/ca2009036_271002.htm). Businesses complain, with good reason, about the expenses associated with products-liability problems.

## Current State of the Law

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

In the typical products-liability case, three legal theories are asserted—a contract theory and two tort theories. The contract theory is **warranty**<sup>1</sup>, governed by the UCC, and the two tort theories are **negligence**<sup>2</sup> and **strict products liability**<sup>3</sup>, governed by the common law. See [Figure 20.1 "Major Products Liability Theories"](#).

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

Figure 20.1 Major Products Liability Theories



### KEY TAKEAWAY

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

### EXERCISES

1. How does the separation of production from consumption affect products-liability issues?
2. What other changes in production and consumption have caused the need for the development of products-liability law?
3. How can it be said that courts adjudicate the allocation of the costs of a consumer-oriented economy?

## 20.2 Warranties

### LEARNING OBJECTIVES

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

The UCC governs express warranties and various implied warranties, and for many years it was the only statutory control on the use and meanings of warranties. In 1975, after years of debate, Congress passed and President Gerald Ford signed into law the Magnuson-Moss Act, which imposes certain requirements on manufacturers and others who warrant their goods. We will examine both the UCC and the Magnuson-Moss Act.

### Types of Warranties

#### Express Warranties

An **express warranty**<sup>4</sup> is created whenever the seller affirms that the product will perform in a certain manner. Formal words such as “warrant” or “guarantee” are not necessary. A seller may create an express warranty as part of the basis for the bargain of sale by means of (1) an affirmation of a fact or promise relating to the goods, (2) a description of the goods, or (3) a sample or model. Any of these will create an express warranty that the goods will conform to the fact, promise, description, sample, or model. Thus a seller who states that “the use of rustproof linings in the cans would prevent discoloration and adulteration of the Perform solution” has given an express warranty, whether he realized it or not. *Rhodes Pharmacal Co. v. Continental Can Co.*, 219 N.E.2d 726 (Ill. 1976). Claims of breach of express warranty are, at base, claims of misrepresentation.

But the courts will not hold a manufacturer to every statement that could conceivably be interpreted to be an express warranty. Manufacturers and sellers constantly “puff” their products, and the law is content to let them inhabit that gray area without having to make good on every claim. UCC 2-313(2) says that “an

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

affirmation merely of the value of the goods or a statement purporting to be merely the seller's opinion or commendation of the goods does not create a warranty." Facts do.

It is not always easy, however, to determine the line between an express warranty and a piece of puffery. A salesperson who says that a strawberry huller is "great" has probably puffed, not warranted, when it turns out that strawberries run through the huller look like victims of a massacre. But consider the classic cases of the defective used car and the faulty bull. In the former, the salesperson said the car was in "A-1 shape" and "mechanically perfect." In the latter, the seller said not only that the bull calf would "put the buyer on the map" but that "his father was the greatest living dairy bull." The car, carrying the buyer's seven-month-old child, broke down while the buyer was en route to visit her husband in the army during World War II. The court said that the salesperson had made an express warranty. *Wat Henry Pontiac Co. v. Bradley*, 210 P.2d 348 (Okla. 1949). The bull calf turned out to be sterile, putting the farmer on the judicial rather than the dairy map. The court said the seller's spiel was trade talk, not a warranty that the bull would impregnate cows. *Frederickson v. Hackney*, 198 N.W. 806 (Minn. 1924).

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

**The CISG (Article 35) provides, "The seller must deliver goods which are of the quantity, quality and description required by the contract and which are contained or packaged in the manner required by the contract. [And the goods must possess the qualities of goods which the seller has held out to the buyer as a sample or model.]"**

### **Implied Warranties**

Express warranties are those over which the parties dickered—or could have. Express warranties go to the essence of the bargain. An **implied warranty**<sup>5</sup>, by contrast, is one that circumstances alone, not specific language, compel reading into the sale. In short, an implied warranty is one created by law, acting from an impulse of common sense.

5. A warranty imposed by law that comes along with a product automatically.

## Implied Warranty of Merchantability

Section 2-314 of the UCC lays down the fundamental rule that goods carry an **implied warranty of merchantability**<sup>6</sup> if sold by a merchant-seller. What is merchantability? Section 2-314(2) of the UCC says that merchantable goods are those that conform at least to the following six characteristics:

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

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

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

**The Convention provides (Article 35) that “unless otherwise agreed, the goods sold are fit for the purposes for which goods of the same description would ordinarily be used.”**

## Fitness for a Particular Purpose

Section 2-315 of the UCC creates another implied warranty. Whenever a seller, at the time she contracts to make a sale, knows or has reason to know that the buyer is relying on the seller’s skill or judgment to select a product that is suitable for the particular purpose the buyer has in mind for the goods to be sold, there is an

6. Merchant-seller’s implied warranty that goods are suitable for the goods’ normal uses.

implied warranty that the goods are fit for that purpose. For example, you go to a hardware store and tell the salesclerk that you need a paint that will dry overnight because you are painting your front door and a rainstorm is predicted for the next day. The clerk gives you a slow-drying oil-based paint that takes two days to dry. The store has breached an **implied warranty of fitness for particular purpose**<sup>7</sup>.

Note the distinction between “particular” and “ordinary” purposes. Paint is made to color and when dry to protect a surface. That is its ordinary purpose, and had you said only that you wished to buy paint, no implied warranty of fitness would have been breached. It is only because you had a particular purpose in mind that the implied warranty arose. Suppose you had found a can of paint in a general store and told the same tale, but the proprietor had said, “I don’t know enough about that paint to tell you anything beyond what’s on the label; help yourself.” Not every seller has the requisite degree of skill and knowledge about every product he sells to give rise to an implied warranty. Ultimately, each case turns on its particular circumstances: **“The Convention provides (Article 35): [The goods must be] fit for any particular purpose expressly or impliedly made known to the seller at the time of the conclusion of the contract, except where the circumstances show that the buyer did not rely, or that it was unreasonable for him to rely, on the seller’s skill and judgment.”**

### Other Warranties

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

In *Menzel v. List*, an art gallery sold a painting by Marc Chagall that it purchased in Paris. *Menzel v. List*, 246 N.E.2d 742 (N.Y. 1969). The painting had been stolen by the Germans when the original owner was forced to flee Belgium in the 1930s. Now in the United States, the original owner discovered that a new owner had the painting and successfully sued for its return. The customer then sued the gallery, claiming that it had breached the implied warranty of title when it sold the painting. The court agreed and awarded damages equal to the appreciated value of the painting. A good-faith purchaser who must surrender stolen goods to their true owner has a claim for breach of the implied warranty of title against the person from whom he bought the goods.

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



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

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

### **Problems with Warranty Theory In General**

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

- The claimant must prove that there was a sale.
- The sale was of goods rather than real estate or services.
- The action must be brought within the four-year statute of limitations under Article 2-725, when the tender of delivery is made, not when the plaintiff discovers the defect.
- Under UCC, Section 2-607(3)(a) and Section 2A-516(3)(a), which covers leases, the claimant who fails to give notice of breach within a reasonable time of having accepted the goods will see the suit dismissed, and few consumers know enough to do so, except when making a complaint about a purchase of spoiled milk or about paint that wouldn't dry.

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

### **Exclusion or Modification of Warranties**

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

### **Exclusion of Express Warranties**

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

### **Exclusion of Implied Warranties in General**

Implied warranties can be excluded easily enough also, by describing the product with language such as “as is” or “with all faults.” Nor is exclusion simply a function of what the seller says. The buyer who has either examined or refused to examine the goods before entering into the contract may not assert an implied warranty concerning defects an inspection would have revealed.

**The Convention provides a similar rule regarding a buyer's rights when he has failed to inspect the goods (Article 35): “The seller is not liable...for any lack of conformity of the goods if at the time of the conclusion of the contract the buyer knew or could not have been unaware of such lack of conformity.”**

### **Implied Warranty of Merchantability**

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

### **Implied Warranty of Fitness**

Section 2-316(2) of the UCC permits the seller also to disclaim or modify an implied warranty of fitness. This disclaimer or modification must be in writing, however, and must be conspicuous. It need not mention fitness explicitly; general language

will do. The following sentence, for example, is sufficient to exclude all implied warranties of fitness: “There are no warranties that extend beyond the description on the face of this contract.”

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

### **Conflict between Express and Implied Warranties**

Express and implied warranties and their exclusion or limitation can often conflict. Section 2-317 of the UCC provides certain rules for deciding which should prevail. In general, all warranties are to be construed as consistent with each other and as cumulative. When that assumption is unreasonable, the parties’ intention governs the interpretation, according to the following rules: (a) exact or technical specifications displace an inconsistent sample or model or general language of description; (b) a sample from an existing bulk displaces inconsistent general language of description; (c) express warranties displace inconsistent implied warranties other than an implied warranty of fitness for a particular purpose. Any inconsistency among warranties must always be resolved in favor of the implied warranty of fitness for a particular purpose. This doesn’t mean that warranty cannot be limited or excluded altogether. The parties may do so. But in cases of doubt whether it or some other language applies, the implied warranty of fitness will have a superior claim.

### **The Magnuson-Moss Act and Phantom Warranties**

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

protections, to be able to hire lawyers, and to be able to include the cost of product failures into the prices they charge.

The act has several provisions to meet these consumer concerns; it regulates the content of warranties and the means of disclosing those contents. The act gives the Federal Trade Commission (FTC) the authority to promulgate detailed regulations to interpret and enforce it. Under FTC regulations, any written warranty for a product costing a consumer more than ten dollars must disclose in a single document and in readily understandable language the following nine items of information:

1. The identity of the persons covered by the warranty, whether it is limited to the original purchaser or fewer than all who might come to own it during the warranty period.
2. A clear description of the products, parts, characteristics, components, or properties covered, and where necessary for clarity, a description of what is excluded.
3. A statement of what the warrantor will do if the product fails to conform to the warranty, including items or services the warranty will pay for and, if necessary for clarity, what it will not pay for.
4. A statement of when the warranty period starts and when it expires.
5. A step-by-step explanation of what the consumer must do to realize on the warranty, including the names and addresses of those to whom the product must be brought.
6. Instructions on how the consumer can be availed of any informal dispute resolution mechanism established by the warranty.
7. Any limitations on the duration of implied warranties—since some states do not permit such limitations, the warranty must contain a statement that any limitations may not apply to the particular consumer.
8. Any limitations or exclusions on relief, such as consequential damages—as above, the warranty must explain that some states do not allow such limitations.
9. The following statement: “This warranty gives you specific legal rights, and you may also have other rights which vary from state to state.”

In addition to these requirements, the act requires that the warranty be labeled either a full or limited warranty. A **full warranty**<sup>8</sup> means (1) the defective product or part will be fixed or replaced for free, including removal and reinstallation; (2) it will be fixed within a reasonable time; (3) the consumer need not do anything unreasonable (like shipping the piano to the factory) to get warranty service; (4) the warranty is good for anyone who owns the product during the period of the warranty; (5) the consumer gets money back or a new product if the item cannot be

8. Under the Magnuson-Moss Act, a complete promise of satisfaction limited only in duration.

fixed within a reasonable number of attempts. But the full warranty may not cover the whole product: it may cover only the hard drive in the computer, for example; it must state what parts are included and excluded. A **limited warranty**<sup>9</sup> is less inclusive. It may cover only parts, not labor; it may require the consumer to bring the product to the store for service; it may impose a handling charge; it may cover only the first purchaser. Both full and limited warranties may exclude consequential damages.

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

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

A seller's ability to disclaim implied warranties is also limited by state law in two ways. First, by amendment to the UCC or by separate legislation, some states prohibit disclaimers whenever consumer products are sold. A number of states have special laws that limit the use of the UCC implied warranty disclaimer rules in consumer sales. Some of these appear in amendments to the UCC and others are in separate statutes. The broadest approach is that of the nine states that prohibit the disclaimer of implied warranties in consumer sales (Massachusetts, Connecticut, Maine, Vermont, Maryland, the District of Columbia, West Virginia, Kansas, Mississippi, and, with respect to personal injuries only, Alabama). There is a difference in these states whether the rules apply to manufacturers as well as retailers. Second, the UCC at 2-302 provides that unconscionable contracts or clauses will not be enforced. UCC 2-719(3) provides that limitation of damages for personal injury in the sale of “consumer goods is prima facie unconscionable, but limitation of damages where the loss is commercial is not.” (Unconscionability was discussed in [Chapter 12 "Legality"](#).)

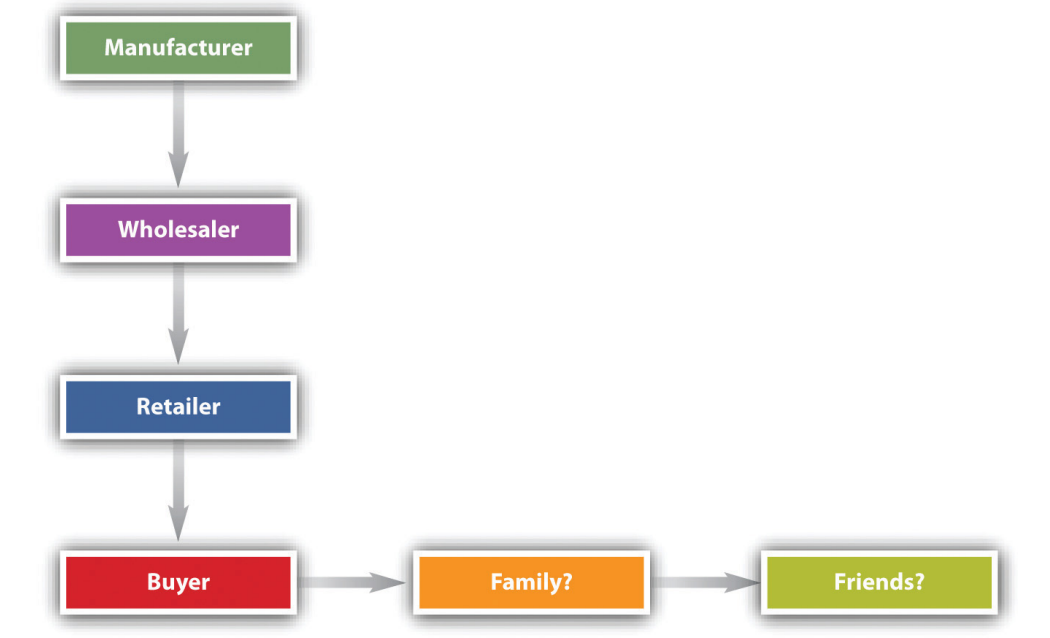
9. Under the Magnuson-Moss Act, a less-than-full warranty.

A first problem with warranty theory, then, is that it's possible to disclaim or limit the warranty. The worst abuses of manipulative and tricky warranties are eliminated by the Magnuson-Moss Act, but there are several other reasons that warranty theory is not the panacea for claimants who have suffered damages or injuries as a result of defective products.

### Privity

A second problem with warranty law (after exclusion and modification of warranties) is that of **privity**<sup>10</sup>. Privity is the legal term for the direct connection between the seller and buyer, the two contracting parties. For decades, the doctrine of privity has held that one person can sue another only if they are in privity. That worked well in the days when most commerce was local and the connection between seller and buyer was immediate. But in a modern industrial (or postindustrial) economy, the product is transported through a much larger distribution system, as depicted in **Figure 20.2 "Chain of Distribution"**. Two questions arise: (1) Is the manufacturer or wholesaler (as opposed to the retailer) liable to the buyer under warranty theory? and (2) May the buyer's family or friends assert warranty rights?

Figure 20.2 Chain of Distribution



10. The relationship between two contracting parties.

### Horizontal Privity

Suppose Carl Consumer buys a new lamp for his family's living room. The lamp is defective: Carl gets a serious electrical shock when he turns it on. Certainly Carl would be covered by the implied warranty of merchantability: he's in direct privity with the seller. But what if Carl's spouse Carlene is injured? She didn't buy the lamp; is she covered? Or suppose Carl's friend David, visiting for an afternoon, gets zapped. Is David covered? This gets to **horizontal privity**<sup>11</sup>, noncontracting parties who suffer damages from defective goods, such as nonbuyer users, consumers, and bystanders. Horizontal privity determines to whose benefit the warranty "flows"—who can sue for its breach. In one of its rare instances of nonuniformity, the UCC does not dictate the result. It gives the states three choices, labeled in Section 2-318 as Alternatives A, B, and C.

Alternative A says that a seller's warranty extends "to any natural person who is in the family or household of his buyer or who is a guest in his home" provided (1) it is reasonable to expect the person suffering damages to use, consume, or be affected by the goods and (2) the warranty extends only to damages for personal injury.

Alternative B "extends to any natural person who may reasonably be expected to use, consume, or be affected by the goods, and who is injured in person by breach of the warranty." It is less restrictive than the first alternative: it extends protection to people beyond those in the buyer's home. For example, what if Carl took the lamp to a neighbor's house to illuminate a poker table: under Alternative B, anybody at the neighbor's house who suffered injury would be covered by the warranty. But this alternative does not extend protection to organizations; "natural person" means a human being.

Alternative C is the same as B except that it applies not only to any "natural person" but "to any person who is injured by breach of the warranty." This is the most far-reaching alternative because it provides redress for damage to *property* as well as for *personal* injury, and it extends protection to corporations and other institutional buyers.

One may incidentally note that having three different alternatives for when third-party nonpurchasers can sue a seller or manufacturer for breach of warranty gives rise to unintended consequences. First, different outcomes are produced among jurisdictions, including variations in the common law. Second, the great purpose of the Uniform Commercial Code in promoting national uniformity is undermined. Third, battles over choice of law—where to file the lawsuit—are generated.

11. The relationship between the original supplier of a product and an ultimate user or a bystander affected by it.

UCC, Section 2A-216, provides basically the same alternatives as applicable to the leasing of goods.

### Vertical Privity

The traditional rule was that remote selling parties were not liable: lack of privity was a defense by the manufacturer or wholesaler to a suit by a buyer with whom these entities did not themselves contract. The buyer could recover damages from the retailer but not from the original manufacturer, who after all made the product and who might be much more financially able to honor the warranty. The UCC takes no position here, but over the last fifty years the judicial trend has been to abolish this **vertical privity**<sup>12</sup> requirement. (See [Figure 20.2 "Chain of Distribution"](#); the entities in the distribution chain are those in vertical privity to the buyer.) It began in 1958, when the Michigan Supreme Court overturned the old theory in an opinion written by Justice John D. Voelker (who also wrote the novel *Anatomy of a Murder*, under the pen name Robert Traver). *Spence v. Three Rivers Builders & Masonry Supply, Inc.*, 90 N.W.2d 873 (Mich. 1958).

### Contributory Negligence, Comparative Negligence, and Assumption of Risk

After disclaimers and privity issues are resolved, other possible impediments facing the plaintiff in a products-liability warranty case are issues of assumption of the risk, contributory negligence, and comparative negligence (discussed in [Chapter 7 "Introduction to Tort Law"](#) on torts).

Courts uniformly hold that assumption of risk is a defense for sellers against a claim of breach of warranty, while there is a split of authority over whether comparative and contributory negligence are defenses. However, the courts' use of this terminology is often conflicting and confusing. The ultimate question is really one of causation: was the seller's breach of the warranty the cause of the plaintiff's damages?

The UCC is not markedly helpful in clearing away the confusion caused by years of discussion of assumption of risk and contributory negligence. Section 2-715(2)(b) of the UCC says that among the forms of consequential damage for which recovery can be sought is "injury to person or property *proximately* resulting from any breach of warranty" (emphasis added). But "proximately" is a troublesome word. Indeed, ultimately it is a circular word: it means nothing more than that the defendant must have been a direct enough cause of the damages that the courts will impose liability. Comment 5 to this section says, "Where the injury involved follows the use of goods without discovery of the defect causing the damage, the question of 'proximate' turns on whether it was reasonable for the buyer to use the goods

12. Privity between parties (manufacturer and retailer) occupying adjoining levels in product distribution systems.



without such inspection as would have revealed the defects. If it was not reasonable for him to do so, or if he did in fact discover the defect prior to his use, the injury would not proximately result from the breach of warranty.”

Obviously if a sky diver buys a parachute and then discovers a few holes in it, his family would not likely prevail in court when they sued to recover for his death because the parachute failed to function after he jumped at 5,000 feet. But the general notion that it must have been reasonable for a buyer to use goods without inspection can make a warranty case difficult to prove.

### KEY TAKEAWAY

A first basis of recovery in products-liability theory is breach of warranty. There are two types of warranties: express and implied. Under the implied category are three major subtypes: the implied warranty of merchantability (only given by merchants), the implied warranty of fitness for a particular purpose, and the implied warranty of title. There are a number of problems with the use of warranty theory: there must have been a sale of the goods; the plaintiff must bring the action within the statute of limitations; and the plaintiff must notify the seller within a reasonable time. The seller may—within the constraints of the Magnuson-Moss Act—limit or exclude express warranties or limit or exclude implied warranties. Privity, or lack of it, between buyer and seller has been significantly eroded as a limitation in warranty theory, but lack of privity may still affect the plaintiff’s recovery; the plaintiff’s assumption of the risk in using defective goods may preclude recovery.

### EXERCISES

1. What are the two main types of warranties and the important subtypes?
2. Who can make each type of warranty?
3. What general problems does a plaintiff have in bringing a products-liability warranty case?
4. What problems are presented concerning exclusion or manipulative express warranties, and how does the Magnuson-Moss Act address them?
5. How are implied warranties excluded?
6. What is the problem of lack of privity, and how does modern law deal with it?

## 20.3 Negligence

### LEARNING OBJECTIVES

1. Recognize how the tort theory of negligence may be of use in products-liability suits.
2. Understand why negligence is often not a satisfactory cause of action in such suits: proof of it may be difficult, and there are powerful defenses to claims of negligence.

Negligence is the second theory raised in the typical products-liability case. It is a tort theory (as compared to breach of warranty, which is of course a contract theory), and it does have this advantage over warranty theory: privity is never relevant. A pedestrian is struck in an intersection by a car whose brakes were defectively manufactured. Under no circumstances would breach of warranty be a useful cause of action for the pedestrian—there is no privity at all. Negligence is considered in detail in the [Chapter 7 "Introduction to Tort Law"](#) on torts; it basically means lack of due care.

### Typical Negligence Claims: Design Defects and Inadequate Warnings

Negligence theory in products liability is most useful in two types of cases: defective design and defective warnings.

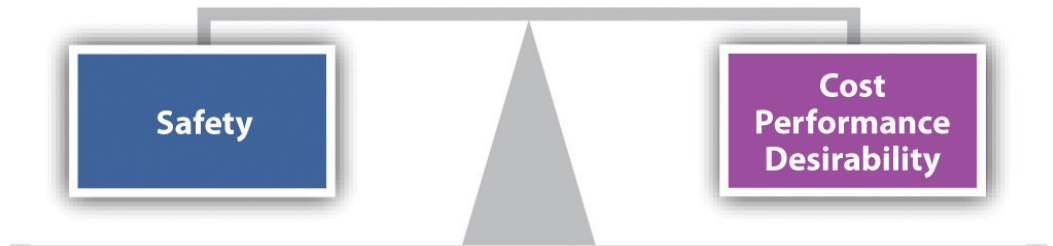
#### Design Defects

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

Defective-design cases can pose severe problems for manufacturing and safety engineers. More safety means more cost. Designs altered to improve safety may impair functionality and make the product less desirable to consumers. At what point safety comes into reasonable balance with performance, cost, and desirability (see [Figure 20.3 "The Reasonable Design Balance"](#)) is impossible to forecast accurately, though some factors can be taken into account. For example, if other

manufacturers are marketing comparable products whose design are intrinsically safer, the less-safe products are likely to lose a test of reasonableness in court.

Figure 20.3 *The Reasonable Design Balance*



### Warning Defects

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

The law governing the necessity to warn and the adequacy of warnings is complex. What is reasonable turns on the degree to which a product is likely to be misused and, as the disturbing *Laaperi* case ([Section 20.6.3 "Failure to Warn"](#)) illustrates, whether the hazard is obvious.

### Problems with Negligence Theory

Negligence is an ancient cause of action and, as was discussed in the torts chapter, it carries with it a number of well-developed defenses. Two categories may be mentioned: common-law defenses and preemption.

#### Common-Law Defenses against Negligence

Among the problems confronting a plaintiff with a claim of negligence in products-liability suits (again, these concepts are discussed in the torts chapter) are the following:

- Proving negligence at all: just because a product is defective does not necessarily prove the manufacturer breached a duty of care.

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

### Preemption

**Preemption**<sup>13</sup> (or “pre-emption”) is illustrated by this problem: suppose there is a federal standard concerning the product, and the defendant manufacturer meets it, but the standard is not really very protective. (It is not uncommon, of course, for federal standard makers of all types to be significantly influenced by lobbyists for the industries being regulated by the standards.) Is it enough for the manufacturer to point to its satisfaction of the standard so that such satisfaction preempts (takes over) any common-law negligence claim? “We built the machine to federal standards: we can’t be liable. Our compliance with the federal safety standard is an affirmative defense.”

Preemption is typically raised as a defense in suits about (1) cigarettes, (2) FDA-approved medical devices, (3) motor-boat propellers, (4) pesticides, and (5) motor vehicles. This is a complex area of law. Questions inevitably arise as to whether there was federal preemption, express or implied. Sometimes courts find preemption and the consumer loses; sometimes the courts don’t find preemption and the case goes forward. According to one lawyer who works in this field, there has been “increasing pressure on both the regulatory and congressional fronts to preempt state laws.” That is, the usual defendants (manufacturers) push Congress and the regulatory agencies to state explicitly in the law that the federal standards preempt and defeat state law. C. Richard Newsome and Andrew F. Knopf, “Federal Preemption: Products Lawyers Beware,” *Florida Justice Association Journal*, July 27, 2007, accessed March 1, 2011, <http://www.newsomelaw.com/resources/articles/federal-preemption-products-lawyers-beware>.

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

### KEY TAKEAWAY

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

### EXERCISES

1. What two types of products-liability cases are most often brought under negligence?
2. How could it be said that merely because a person suffers injury as the result of a defective product, proof of negligence is not necessarily made?
3. What is "preemption" and how is it used as a sword to defeat products-liability plaintiffs?

## 20.4 Strict Liability in Tort

### LEARNING OBJECTIVES

1. Know what “strict products liability” means and how it differs from the other two products-liability theories.
2. Understand the basic requirements to prove strict products liability.
3. See what obstacles to recovery remain with this doctrine.

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

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

To overcome the obstacles, judges have gone beyond the commercial statutes and the ancient concepts of negligence. They have fashioned a tort theory of products liability based on the principle of **strict products liability**. One court expressed the rationale for the development of the concept as follows: “The rule of strict liability for defective products is an example of necessary paternalism judicially shifting risk of loss by application of tort doctrine because [the UCC] scheme fails to adequately cover the situation. Judicial paternalism is to loss shifting what garlic is to a stew—sometimes necessary to give full flavor to statutory law, always distinctly noticeable in its result, overwhelmingly counterproductive if excessive, and never an end in itself.” *Kaiser Steel Corp. v. Westinghouse Electric Corp.*, 127 Cal. Rptr. 838 (Cal. 1976). Paternalism or not, strict liability has become a very important legal theory in products-liability cases.

### Strict Liability Defined

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

(1) One who sells any product in a defective condition unreasonably dangerous to the user or consumer or to his property is subject to liability for physical harm thereby caused to the ultimate user or consumer, or to his property, if

(a) the seller is engaged in the business of selling such a product, and

(b) it is expected to and does reach the user or consumer without substantial change in the condition in which it is sold.

(2) This rule applies even though

(a) the seller has exercised all possible care in the preparation and sale of his product, and

(b) the user or consumer has not bought the product from or entered into any contractual relation with the seller.

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

Strict liability avoids some negligence traps, too. No proof of negligence is required. See [Figure 20.4 "Major Difference between Warranty and Strict Liability"](#).

Figure 20.4 Major Difference between Warranty and Strict Liability

	Warranty	Strict Liability
1. Notice of Defect from Buyer to Seller Required?	Yes	No
2. Disclaimer Possible?	Yes	No
3. Privity Required?	Sometimes	No

## **Section 402A Elements**

### **Product in a Defective Condition**

Sales of goods but not sales of services are covered under the Restatement, Section 402A. Furthermore, the plaintiff will not prevail if the product was safe for normal handling and consumption when sold. A glass soda bottle that is properly capped is not in a defective condition merely because it can be broken if the consumer should happen to drop it, making the jagged glass dangerous. Chocolate candy bars are not defective merely because you can become ill by eating too many of them at once. On the other hand, a seller would be liable for a product defectively packaged, so that it could explode or deteriorate and change its chemical composition. A product can also be in a defective condition if there is danger that could come from an anticipated wrongful use, such as a drug that is safe only when taken in limited doses. Under those circumstances, failure to place an adequate dosage warning on the container makes the product defective.

The plaintiff bears the burden of proving that the product is in a defective condition, and this burden can be difficult to meet. Many products are the result of complex feats of engineering. Expert witnesses are necessary to prove that the products were defectively manufactured, and these are not always easy to come by. This difficulty of proof is one reason why many cases raise the failure to warn as the dispositive issue, since in the right case that issue is far easier to prove. The *Anderson* case (detailed in the exercises at the end of this chapter) demonstrates that the plaintiff cannot prevail under strict liability merely because he was injured. It is not the fact of injury that is dispositive but the defective condition of the product.

### **Unreasonably Dangerous**

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



Even high risks of danger are not necessarily unreasonable. Some products are unavoidably unsafe; rabies vaccines, for example, can cause dreadful side effects. But the disease itself, almost always fatal, is worse. A product is unavoidably unsafe when it cannot be made safe for its intended purpose given the present state of human knowledge. Because important benefits may flow from the product's use, its producer or seller ought not to be held liable for its danger.

However, the failure to warn a potential user of possible hazards can make a product defective under Restatement, Section 402A, whether unreasonably dangerous or even unavoidably unsafe. The dairy farmer need not warn those with common allergies to eggs, because it will be presumed that the person with an allergic reaction to common foodstuffs will be aware of them. But when the product contains an ingredient that could cause toxic effects in a substantial number of people and its danger is not widely known (or if known, is not an ingredient that would commonly be supposed to be in the product), the lack of a warning could make the product unreasonably dangerous within the meaning of Restatement, Section 402A. Many of the suits brought by asbestos workers charged exactly this point; "The utility of an insulation product containing asbestos may outweigh the known or foreseeable risk to the insulation workers and thus justify its marketing. The product could still be unreasonably dangerous, however, if unaccompanied by adequate warnings. An insulation worker, no less than any other product user, has a right to decide whether to expose himself to the risk." *Borel v. Fibreboard Paper Products Corp.*, 493 F.2d 1076 (5th Cir. 1973). This rule of law came to haunt the Manville Corporation: it was so burdened with lawsuits, brought and likely to be brought for its sale of asbestos—a known carcinogen—that it declared Chapter 11 bankruptcy in 1982 and shucked its liability. *In re Johns-Manville Corp.*, 36 R.R. 727 (So. Dist. N.Y. 1984).

### **Engaged in the Business of Selling**

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

The requirement that the defendant be in the business of selling gets to the rationale for the whole concept of strict products liability: businesses should shoulder the cost of injuries because they are in the best position to spread the risk and distribute the expense among the public. This same policy has been the

rationale for holding bailors and lessors liable for defective equipment just as if they had been sellers. *Martin v. Ryder Rental, Inc.*, 353 A.2d 581 (Del. 1976).

### **Reaches the User without Change in Condition**

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

### **Liability Despite Exercise of All Due Care**

Strict liability applies under the Restatement rule even though “the seller has exercised all possible care in the preparation and sale of his product.” This is the crux of “strict liability” and distinguishes it from the conventional theory of negligence. It does not matter how reasonably the seller acted or how exemplary is a manufacturer’s quality control system—what matters is whether the product was defective and the user injured as a result. Suppose an automated bottle factory manufactures 1,000 bottles per hour under exacting standards, with a rigorous and costly quality-control program designed to weed out any bottles showing even an infinitesimal amount of stress. The plant is “state of the art,” and its computerized quality-control operation is the best in the world. It regularly detects the one out of every 10,000 bottles that analysis has shown will be defective. Despite this intense effort, it proves impossible to weed out every defective bottle; one out of one million, say, will still escape detection. Assume that a bottle, filled with soda, finds its way into a consumer’s home, explodes when handled, sends glass shards into his eye, and blinds him. Under negligence, the bottler has no liability; under strict liability, the bottler will be liable to the consumer.

### **Liability without Contractual Relation**

Under Restatement, Section 402A(2)(b), strict liability applies even though the user has not purchased the product from the seller nor has the user entered into any contractual relation with the seller. In short, privity is abolished and the injured user may use the theory of strict liability against manufacturers and wholesalers as well as retailers. Here, however, the courts have varied in their approaches; the trend has been to allow bystanders recovery. The Restatement explicitly leaves open the question of the bystander’s right to recover under strict liability.

## Problems with Strict Liability

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

The rule stated in this Section is not governed by the provisions of the Uniform Commercial Code, as to warranties; and it is not affected by limitations on the scope and content of warranties, or by limitation to “buyer” and “seller” in those statutes. Nor is the consumer required to give notice to the seller of his injury within a reasonable time after it occurs, as provided by the Uniform Act. The consumer’s cause of action does not depend upon the validity of his contract with the person from whom he acquires the product, and it is not affected by any disclaimer or other agreement, whether it be between the seller and his immediate buyer, or attached to and accompanying the product into the consumer’s hands. In short, “warranty” must be given a new and different meaning if it is used in connection with this Section. It is much simpler to regard the liability here stated as merely one of strict liability in tort.

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

### Disclaimers

Comment *m* specifically says the cause of action under Restatement, Section 402A, is not affected by disclaimer. But in *nonconsumer* cases, courts have allowed clear and specific disclaimers. In 1969, the Ninth Circuit observed: “In *Kaiser Steel Corp.* the [California Supreme Court] court upheld the dismissal of a strict liability action when the parties, dealing from positions of relatively equal economic strength, contracted in a commercial setting to limit the defendant’s liability. The court went on to hold that in this situation the strict liability cause of action does not apply at all. In reaching this conclusion, the court in *Kaiser* reasoned that strict liability ‘is designed to encompass situations in which the principles of sales warranties serve their purpose “fitfully at best.”’ [Citation]” It concluded that in such commercial settings the UCC principles work well and “to apply the tort doctrines of products liability will displace the statutory law rather than bring out its full flavor.” *Idaho Power Co. v. Westinghouse Electric Corp.*, 596 F.2d 924, 9CA (1979).

### **Plaintiff's Conduct**

Conduct by the plaintiff herself may defeat recovery in two circumstances.

### **Assumption of Risk**

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

### **Misuse or Abuse of the Product**

Where the plaintiff does not know a use of the product is dangerous but nevertheless uses for an incorrect purpose, a defense arises, but only if such misuse was not foreseeable. If it was, the manufacturer should warn against that misuse. In *Eastman v. Stanley Works*, a carpenter used a framing hammer to drive masonry nails; the claw of the hammer broke off, striking him in the eye. *Eastman v. Stanley Works*, 907 N.E.2d 768 (Ohio App. 2009). He sued. The court held that while a defense does exist “where the product is used in a capacity which is unforeseeable by the manufacturer and completely incompatible with the product’s design...misuse of a product suggests a use which was unanticipated or unexpected by the product manufacturer, or unforeseeable and unanticipated [but] it was not the case that reasonable minds could only conclude that appellee misused the [hammer]. Though the plaintiff’s use of the hammer might have been *unreasonable*, unreasonable use is not a defense to a strict product-liability action or to a negligence action.”

### **Limited Remedy**

The Restatement says recovery under strict liability is limited to “physical harm thereby caused to the ultimate user or consumer, or to his property,” but not other losses and not economic losses. In *Atlas Air v. General Electric*, a New York court held that the “economic loss rule” (no recovery for economic losses) barred strict products-liability and negligence claims by the purchaser of a used airplane against the airplane engine manufacturer for damage to the plane caused by an emergency landing necessitated by engine failure, where the purchaser merely alleged economic losses with respect to the plane itself, and not damages for personal injury (recovery for damage to the engine was allowed). *Atlas Air v. General Electric*, 16 A.D.3d 444 (N.Y.A.D. 2005).

But there are exceptions. In *Duffin v. Idaho Crop Imp. Ass'n*, the court recognized that a party generally owes no duty to exercise due care to avoid purely economic loss, but if there is a “special relationship” between the parties such that it would be equitable to impose such a duty, the duty will be imposed. *Duffin v. Idaho Crop Imp. Ass'n*, 895 P.2d 1195 (Idaho 1995). “In other words, there is an extremely limited group of cases where the law of negligence extends its protections to a party’s economic interest.”

### The Third Restatement

The law develops. What seemed fitting in 1964 when the Restatement (Second) announced the state of the common-law rules for strict liability in Section 402A seemed, by 1997, not to be tracking common law entirely closely. The American Law Institute came out with the Restatement (Third) in that year. The Restatement changes some things. Most notably it abolishes the “unreasonably dangerous” test and substitutes a “risk-utility test.” That is, a product is not defective unless its riskiness outweighs its utility. More important, the Restatement (Third), Section 2, now requires the plaintiff to provide a reasonable alternative design to the product in question. In advancing a reasonable alternative design, the plaintiff is not required to offer a prototype product. The plaintiff must only show that the proposed alternative design exists and is superior to the product in question. The Restatement (Third) also makes it more difficult for plaintiffs to sue drug companies successfully. One legal scholar commented as follows on the Restatement (Third):

The provisions of the Third Restatement, if implemented by the courts, will establish a degree of fairness in the products liability arena. If courts adopt the Third Restatement’s elimination of the “consumer expectations test,” this change alone will strip juries of the ability to render decisions based on potentially subjective, capricious and unscientific opinions that a particular product design is unduly dangerous based on its performance in a single incident. More important, plaintiffs will be required to propose a reasonable alternative design to the product in question. Such a requirement will force plaintiffs to prove that a better product design exists other than in the unproven and untested domain of their experts’ imaginations. Quinlivan Wexler LLP, “The 3rd Restatement of Torts—Shaping the Future of Products Liability Law,” June 1, 1999, accessed March 1, 2011, <http://library.findlaw.com/1999/Jun/1/127691.html>.

Of course some people put more faith in juries than is evident here. The new Restatement has been adopted by a few jurisdictions and some cases the adopting jurisdictions incorporate some of its ideas, but courts appear reluctant to abandon familiar precedent.

### KEY TAKEAWAY

Because the doctrines of breach of warranty and negligence did not provide adequate relief to those suffering damages or injuries in products-liability cases, beginning in the 1960s courts developed a new tort theory: strict products liability, restated in the Second Restatement, section 402A. Basically the doctrine says that if goods sold are unreasonably dangerous or defective, the merchant-seller will be liable for the immediate property loss and personal injuries caused thereby. But there remain obstacles to recovery even under this expanded concept of liability: disclaimers of liability have not completely been dismissed, the plaintiff's conduct or changes to the goods may limit recovery, and—with some exceptions—the remedies available are limited to personal injury (and damage to the goods themselves); economic loss is not recoverable. Almost forty years of experience with the Second Restatement's section on strict liability has seen changes in the law, and the Third Restatement introduces those, but it has not been widely accepted yet.

### EXERCISES

1. What was perceived to be inadequate about warranty and negligence theories that necessitated the development of strict liability?
2. Briefly describe the doctrine.
3. What defects in goods render their sellers strictly liable?
4. Who counts as a liable seller?
5. What obstacles does a plaintiff have to overcome here, and what limitations are there to recovery?

## 20.5 Tort Reform

### LEARNING OBJECTIVES

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

### The Cry for Reform

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

Each side vilifies the other in very unseemly language: probusiness advocates call consumer-oriented states “judicial hell-holes” and complain of “well-orchestrated campaign[s] by tort lawyer lobbyists and allies to undo years of tort reform at the state level,” American Tort Reform Association website, accessed March 1, 2011, <http://www.atra.org>. while pro-plaintiff interests claim that there is “scant evidence” of any tort abuse. [http://www.shragerlaw.com/html/legal\\_rights.html](http://www.shragerlaw.com/html/legal_rights.html). It would be more amusing if it were not so shrill and partisan. Perhaps the most one can say with any certainty is that peoples’ perception of reality is highly colored by their self-interest. In any event, there have been reforms (or, as the detractors say, “deforms”).

### State Reforms

Prodded by astute lobbying by manufacturing and other business trade associations, state legislatures responded to the cries of manufacturers about the

hardships that the judicial transformation of the products-liability lawsuit ostensibly worked on them. Most state legislatures have enacted at least one of some three dozen “reform” proposals pressed on them over the last two decades. Some of these measures do little more than affirm and clarify case law. Among the most that have passed in several states are outlined in the next sections.

### **Statutes of Repose**

Perhaps nothing so frightens the manufacturer as the occasional reports of cases involving products that were fifty or sixty years old or more at the time they injured the plaintiff. Many states have addressed this problem by enacting the so-called **statute of repose**<sup>14</sup>. This statute establishes a time period, generally ranging from six to twelve years; the manufacturer is not liable for injuries caused by the product after this time has passed.

### **State-of-the-Art Defense**

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

### **Failure to Warn**

Since it is often easier to prove that an injury resulted because the manufacturer failed to warn against a certain use than it is to prove an injury was caused by a defective design, manufacturers are subjected to a considerable degree of hindsight. Some of the state statutes limit the degree to which the failure to warn can be used to connect the product and the injury. For example, the manufacturer has a valid defense if it would have been impossible to foresee that the consumer might misuse the product in a certain way.

### **Comparative Fault for Consumer Misuse**

Contributory negligence is generally not a defense in a strict liability action, while assumption of risk is. In states that have enacted so-called comparative fault statutes, the user’s damages are pegged to the percentage of responsibility for the injury that the defendant bears. Thus if the consumer’s misuse of the product is assessed as having been 20 percent responsible for the accident (or for the extent of

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



the injuries), the consumer is entitled to only 80 percent of damages, the amount for which the defendant manufacturer is responsible.

### **Criminal Penalties**

Not all state reform is favorable to manufacturers. Under the California Corporate Criminal Liability Act, which took effect twenty years ago, companies and managers must notify a state regulatory agency if they know that a product they are selling in California has a safety defect, and the same rule applies under certain federal standards, as Toyota executives were informed by their lawyers following alarms about sudden acceleration in some Toyota automobiles. Failure to provide notice may result in corporate and individual criminal liability.

### **Federal Reform**

Piecemeal reform of products-liability law in each state has contributed to the basic lack of uniformity from state to state, giving it a crazy-quilt effect. In the nineteenth century, this might have made little difference, but today most manufacturers sell in the national market and are subjected to the varying requirements of the law in every state. For years there has been talk in and out of Congress of enacting a federal products-liability law that would include reforms adopted in many states, as discussed earlier. So far, these efforts have been without much success.

Congressional tort legislation is not the only possible federal action to cope with products-related injuries. In 1972, Congress created the Consumer Product Safety Commission (CPSC) and gave the commission broad power to act to prevent unsafe consumer products. The CPSC can issue mandatory safety standards governing design, construction, contents, performance, packaging, and labeling of more than 10,000 consumer products. It can recall unsafe products, recover costs on behalf of injured consumers, prosecute those who violate standards, and require manufacturers to issue warnings on hazardous products. It also regulates four federal laws previously administered by other departments: the Flammable Fabrics Act, the Hazardous Substances Act, the Poison Prevention Packaging Act, and the Refrigerator Safety Act. In its early years, the CPSC issued standards for bicycles, power mowers, television sets, architectural glass, extension cords, book matches, pool slides, and space heaters. But the list of products is long, and the CPSC's record is mixed: it has come under fire for being short on regulation and for taking too long to promulgate the relatively few safety standards it has issued in a decade.

### KEY TAKEAWAY

Business advocates claim the American tort system—products-liability law included—is broken and corrupted by grasping plaintiffs’ lawyers; plaintiffs’ lawyers say businesses are greedy and careless and need to be smacked into recognition of its responsibilities to be more careful. The debate rages on, decade after decade. But there have been some reforms at the state level, and at the federal level the Consumer Product Safety Act sets out standards for safe products and requires recalls for defective ones. It is regularly castigated for (1) being officious and meddling or (2) being too timid.

### EXERCISES

1. Why is it so difficult to determine if there really is a “tort crisis” in the United States?
2. What reforms have been made to state tort law?
3. What federal legislation affects consumer safety?

## 20.6 Cases

### Implied Warranty of Merchantability and the Requirement of a “Sale”

Sheeskin v. Giant Food, Inc.

318 A.2d 874 (Md. App. 1974)

Davidson, J.

Every Friday for over two years Nathan Seigel, age 73, shopped with his wife at a Giant Food Store. This complex products liability case is before us because on one of these Fridays, 23 October 1970, Mr. Seigel was carrying a six-pack carton of Coca-Cola from a display bin at the Giant to a shopping cart when one or more of the bottles exploded. Mr. Seigel lost his footing, fell to the floor and was injured.

In the Circuit Court for Montgomery County, Mr. Seigel sued both the Giant Food, Inc., and the Washington Coca-Cola Bottling Company, Inc., for damages resulting from their alleged negligence and breach of an implied warranty. At the conclusion of the trial Judge Walter H. Moorman directed a verdict in favor of each defendant....

In an action based on breach of warranty it is necessary for the plaintiff to show the existence of the warranty, the fact that the warranty was broken and that the breach of warranty was the proximate cause of the loss sustained. [UCC] 2-314....The retailer, Giant Food, Inc., contends that appellant failed to prove that an implied warranty existed between himself and the retailer because he failed to prove that there was a sale by the retailer to him or a contract of sale between the two. The retailer maintains that there was no sale or contract of sale because at the time the bottles exploded Mr. Seigel had not yet paid for them. We do not agree.

[UCC] 2-314(1) states in pertinent part:

Unless excluded or modified, a warranty that the goods shall be merchantable is implied **in a contract for their sale** if the seller is a merchant with respect to goods of that kind. Uniform Commercial Code, Section 2-316. (emphasis added)

Thus, in order for the implied warranties of 2-314 to be applicable there must be a “contract for sale.” In Maryland it has been recognized that neither a completed ‘sale’ nor a fully executed contract for sale is required. It is enough that there be in existence an executory contract for sale....

Here, the plaintiff has the burden of showing the existence of the warranty by establishing that at the time the bottles exploded there was a contract for their sale existing between himself and the Giant. [Citation] Mr. Titus, the manager of the Giant, testified that the retailer is a “self-service” store in which “the only way a customer can buy anything is to select it himself and take it to the checkout counter.” He stated that there are occasions when a customer may select an item in the store and then change his mind and put the item back. There was no evidence to show that the retailer ever refused to sell an item to a customer once it had been selected by him or that the retailer did not consider himself bound to sell an item to the customer after the item had been selected. Finally, Mr. Titus said that an employee of Giant placed the six-pack of Coca-Cola selected by Mr. Seigel on the shelf with the purchase price already stamped upon it. Mr. Seigel testified that he picked up the six-pack with the intent to purchase it.

We think that there is sufficient evidence to show that the retailer’s act of placing the bottles upon the shelf with the price stamped upon the six-pack in which they were contained manifested an intent to offer them for sale, the terms of the offer being that it would pass title to the goods when Mr. Seigel presented them at the check-out counter and paid the stated price in cash. We also think that the evidence is sufficient to show that Mr. Seigel’s act of taking physical possession of the goods with the intent to purchase them manifested an intent to accept the offer and a promise to take them to the checkout counter and pay for them there.

[UCC] 2-206 provides in pertinent part:

- (1) Unless otherwise unambiguously indicated by the language or circumstances
  - (a) An offer to make a contract shall be construed as inviting acceptance in any manner and by any medium reasonable in the circumstances....

The Official Comment 1 to this section states:

Any reasonable manner of acceptance is intended to be regarded as available unless the offeror has made quite clear that it will not be acceptable.

In our view the manner by which acceptance was to be accomplished in the transaction herein involved was not indicated by either language or circumstances. The seller did not make it clear that acceptance could not be accomplished by a promise rather than an act. Thus it is equally reasonable under the terms of this specific offer that acceptance could be accomplished in any of three ways: 1) by the act of delivering the goods to the check-out counter and paying for them; 2) by the promise to pay for the goods as evidenced by their physical delivery to the check-out counter; and 3) by the promise to deliver the goods to the check-out counter and to pay for them there as evidenced by taking physical possession of the goods by their removal from the shelf.

The fact that customers, having once selected goods with the intent to purchase them, are permitted by the seller to return them to the shelves does not preclude the possibility that a selection of the goods, as evidenced by taking physical possession of them, could constitute a reasonable mode of acceptance. Section 2-106(3) provides:

“Termination” occurs when either party pursuant to a power created by agreement or law puts an end to the contract otherwise than for its breach. On “termination” all obligations which are still executory on both sides are discharged but any right based on prior breach or performance survives.

Here the evidence that the retailer permits the customer to “change his mind” indicates only an agreement between the parties to permit the consumer to end his contract with the retailer irrespective of a breach of the agreement by the retailer. It does not indicate that an agreement does not exist prior to the exercise of this option by the consumer....

Here Mr. Seigel testified that all of the circumstances surrounding his selection of the bottles were normal; that the carton in which the bottles came was not defective; that in lifting the carton from the shelf and moving it toward his basket the bottles neither touched nor were touched by anything other than his hand; that they exploded almost instantaneously after he removed them from the shelf; and that as a result of the explosion he fell injuring himself. It is obvious that Coca-Cola bottles which would break under normal handling are not fit for the ordinary use for which they were intended and that the relinquishment of physical control of such a defective bottle to a consumer constitutes a breach of warranty. Thus the evidence was sufficient to show that when the bottles left the retailer’s control they did not conform to the representations of the warranty of merchantability, and that this breach of the warranty was the cause of the loss sustained....

[Judgment in favor of Giant Foods is reversed and the case remanded for a new trial. Judgment in favor of the bottler is affirmed because the plaintiff failed to prove that the bottles were defective when they were delivered to the retailer.]

### CASE QUESTIONS

1. What warranty did the plaintiff complain was breached here?
2. By displaying the soda pop, the store made an offer to its customers. How did the court say such offers might be accepted?
3. Why did the court get into the discussion about “termination” of the contract?
4. What is the controlling rule of law applied in this case?

### Strict Liability and Bystanders

Embs v. Pepsi-Cola Bottling Co. of Lexington, Kentucky, Inc.

528 S.W.2d 703 (Ky. 1975)

Jukowsky, J.

On the afternoon of July 25, 1970 plaintiff-appellant entered the self-service retail store operated by the defendant-appellee, Stamper’s Cash Market, Inc., for the purpose of “buying soft drinks for the kids.” She went to an upright soft drink cooler, removed five bottles and placed them in a carton. Unnoticed by her, a carton of Seven-Up was sitting on the floor at the edge of the produce counter about one foot from where she was standing. As she turned away from the cooler she heard an explosion that sounded “like a shotgun.” When she looked down she saw a gash in her leg, pop on her leg, green pieces of a bottle on the floor and the Seven-Up carton in the midst of the debris. She did not kick or otherwise come into contact with the carton of Seven-Up prior to the explosion. Her son, who was with her, recognized the green pieces of glass as part of a Seven-Up bottle.

She was immediately taken to the hospital by Mrs. Stamper, a managing agent of the store. Mrs. Stamper told her that a Seven-Up bottle had exploded and that several bottles had exploded that week. Before leaving the store Mrs. Stamper instructed one of her children to clean up the mess. Apparently, all of the physical evidence went out with the trash. The location of the Seven-Up carton immediately before the explosion was not a place where such items were ordinarily kept....

When she rested her case, the defendants-appellees moved for a directed verdict in their favor. The trial court granted the motion on the grounds that the doctrine of strict product liability in tort does not extend beyond users and consumers and that the evidence was insufficient to permit an inference by a reasonably prudent man that the bottle was defective or if it was, when it became so.

In [Citation] we adopted the view of strict product liability in tort expressed in Section 402 A of the American Law Institute's Restatement of Torts 2d.

### **402 A. Special Liability of Seller of Product for Physical Harm to User or Consumer**

(1) One who sells any product in a defective condition unreasonably dangerous to the user or to his property is subject to liability for physical harm thereby caused to the ultimate user or consumer, or to his property, if

(a) the seller is engaged in the business of selling such a product, and

(b) it is expected to and does reach the user or consumer without substantial change in the condition in which it was sold.

(2) The rule stated in Subsection (1) applies although

(a) the seller has exercised all possible care in the preparation and sale of his product, and

(b) the user or consumer has not bought the product from or entered into any contractual relation with the seller.

Comment *f* on that section makes it abundantly clear that this rule applies to any person engaged in the business of supplying products for use or consumption, including any manufacturer of such a product and any wholesale or retail dealer or distributor.

Comment *c* points out that on whatever theory, the justification for the rule has been said to be that the seller, by marketing his product for use and consumption, has undertaken and assumed a special responsibility toward any member of the consuming public who may be injured by it; that the public has the right to and does expect that reputable sellers will stand behind their goods; that public policy

demands that the burden of accidental injuries caused by products intended for consumption be placed upon those who market them, and be treated as a cost of production against which liability insurance can be obtained; and that the consumer of such products is entitled to the maximum of protection at the hands of someone, and the proper persons to afford it are those who market the products.

The caveat to the section provides that the Institute expresses no opinion as to whether the rule may not apply to harm to persons other than users or consumers. Comment on caveat o states the Institute expresses neither approval nor disapproval of expansion of the rule to permit recovery by casual bystanders and others who may come in contact with the product, and admits there may be no essential reason why such plaintiffs should not be brought within the scope of protection afforded, other than they do not have the same reasons for expecting such protection as the consumer who buys a marketed product, and that the social pressure which has been largely responsible for the development of the rule has been a consumer's pressure, and there is not the same demand for the protection of casual strangers....

The caveat articulates the essential point: Once strict liability is accepted, bystander recovery is *fait accompli*.

Our expressed public policy will be furthered if we minimize the risk of personal injury and property damage by charging the costs of injuries against the manufacturer who can procure liability insurance and distribute its expense among the public as a cost of doing business; and since the risk of harm from defective products exists for mere bystanders and passersby as well as for the purchaser or user, there is no substantial reason for protecting one class of persons and not the other. The same policy requires us to maximize protection for the injured third party and promote the public interest in discouraging the marketing of products having defects that are a menace to the public by imposing strict liability upon retailers and wholesalers in the distributive chain responsible for marketing the defective product which injures the bystander. The imposition of strict liability places no unreasonable burden upon sellers because they can adjust the cost of insurance protection among themselves in the course of their continuing business relationship.

We must not shirk from extending the rule to the manufacturer for fear that the retailer or middleman will be impaled on the sword of liability without regard to fault. Their liability was already established under Section 402 A of the Restatement of Torts 2d. As a matter of public policy the retailer or middleman as well as the manufacturer should be liable since the loss for injuries resulting from defective products should be placed on those members of the marketing chain best able to



pay the loss, who can then distribute such risk among themselves by means of insurance and indemnity agreements. [Citation]...

The result which we reach does not give the bystander a “free ride.” When products and consumers are considered in the aggregate, bystanders, as a class, purchase most of the same products to which they are exposed as bystanders. Thus, as a class, they indirectly subsidize the liability of the manufacturer, middleman and retailer and in this sense do pay for the insurance policy tied to the product....

For the sake of clarity we restate the extension of the rule. The protections of Section 402 A of the Restatement of Torts 2d extend to bystanders whose injury from the defective product is reasonably foreseeable....

The judgment is reversed and the cause is remanded to the Clark Circuit Court for further proceedings consistent herewith.

Stephenson, J. (dissenting):

I respectfully dissent from the majority opinion to the extent that it subjects the seller to liability. Every rule of law in my mind should have a rational basis. I see none here.

Liability of the seller to the user, or consumer, is based upon warranty. Restatement, Second, Torts s 403A. To extend this liability to injuries suffered by a bystander is to depart from any reasonable basis and impose liability by judicial fiat upon an otherwise innocent defendant. I do not believe that the expression in the majority opinion which justifies this rule for the reason that the seller may procure liability insurance protection is a valid legal basis for imposing liability without fault. I respectfully dissent.

## CASE QUESTIONS

1. Why didn't the plaintiff here use warranty as a theory of recovery, as Mr. Seigel did in the previous case?
2. The court offers a rationale for the doctrine of strict products liability. What is it?
3. Restatement, Section 402A, by its terms extends protection "to the ultimate user or consumer," but Mrs. Embs [plaintiff-appellant] was not that. What rationale did the court give for expanding the protection here?
4. Among the entities in the vertical distribution chain—manufacturer, wholesaler, retailer—who is liable under this doctrine?
5. What argument did Judge Stephenson have in dissent? Is it a good one?
6. What is the controlling rule of law developed in this case?

### Failure to Warn

Laaperi v. Sears, Roebuck & Co., Inc.

787 F.2d 726 C.A.1 (Mass. 1986)

Campbell, J.

In March 1976, plaintiff Albin Laaperi purchased a smoke detector from Sears. The detector, manufactured by the Pittway Corporation, was designed to be powered by AC (electrical) current. Laaperi installed the detector himself in one of the two upstairs bedrooms in his home.

Early in the morning of December 27, 1976, a fire broke out in the Laaperi home. The three boys in one of the upstairs bedrooms were killed in the blaze. Laaperi's 13-year-old daughter Janet, who was sleeping in the other upstairs bedroom, received burns over 12 percent of her body and was hospitalized for three weeks.

The uncontroverted testimony at trial was that the smoke detector did not sound an alarm on the night of the fire. The cause of the fire was later found to be a short circuit in an electrical cord that was located in a cedar closet in the boys' bedroom. The Laaperi home had two separate electrical circuits in the upstairs bedrooms: one which provided electricity to the outlets and one which powered the lighting fixtures. The smoke detector had been connected to the outlet circuit, which was the circuit that shorted and cut off. Because the circuit was shorted, the AC-

operated smoke detector received no power on the night of the fire. Therefore, although the detector itself was in no sense defective (indeed, after the fire the charred detector was tested and found to be operable), no alarm sounded.

Laaperi brought this diversity action against defendants Sears and Pittway, asserting negligent design, negligent manufacture, breach of warranty, and negligent failure to warn of inherent dangers. The parties agreed that the applicable law is that of Massachusetts. Before the claims went to the jury, verdicts were directed in favor of defendants on all theories of liability other than failure to warn....

Laaperi's claim under the failure to warn theory was that he was unaware of the danger that the very short circuit which might ignite a fire in his home could, at the same time, incapacitate the smoke detector. He contended that had he been warned of this danger, he would have purchased a battery-powered smoke detector as a back-up or taken some other precaution, such as wiring the detector to a circuit of its own, in order better to protect his family in the event of an electrical fire.

The jury returned verdicts in favor of Laaperi in all four actions on the failure to warn claim. The jury assessed damages in the amount of \$350,000 [\$1,050,000, or about \$3,400,000 in 2010 dollars] each of the three actions brought on behalf of the deceased sons, and \$750,000 [about \$2,500,000 in 2010 dollars] in the action brought on behalf of Janet Laaperi. The defendants' motions for directed verdict and judgment notwithstanding the verdict were denied, and defendants appealed.

Defendants ask us to declare that the risk that an electrical fire could incapacitate an AC-powered smoke detector is so obvious that the average consumer would not benefit from a warning. This is not a trivial argument; in earlier—some might say sounder—days, we might have accepted it.... Our sense of the current state of the tort law in Massachusetts and most other jurisdictions, however, leads us to conclude that, today, the matter before us poses a jury question; that “obviousness” in a situation such as this would be treated by the Massachusetts courts as presenting a question of fact, not of law. To be sure, it would be obvious to anyone that an electrical outage would cause this smoke detector to fail. But the average purchaser might not comprehend the specific danger that a fire-causing electrical problem can simultaneously knock out the circuit into which a smoke detector is wired, causing the detector to fail at the very moment it is needed. Thus, while the failure of a detector to function as the result of an electrical malfunction due, say, to a broken power line or a neighborhood power outage would, we think, be obvious as a matter of law, the failure that occurred here, being associated with the very risk—fire—for which the device was purchased, was not, or so a jury could find....

Finally, defendants contend that the award of \$750,000 [\$2.5 million in 2010 dollars] in damages to Janet Laaperi was excessive, and should have been overturned by the district court....

Janet Laaperi testified that on the night of the fire, she woke up and smelled smoke. She woke her friend who was sleeping in her room, and they climbed out to the icy roof of the house. Her father grabbed her from the roof and took her down a ladder. She was taken to the hospital. Although she was in “mild distress,” she was found to be “alert, awake, [and] cooperative.” Her chest was clear. She was diagnosed as having first and second degree burns of her right calf, both buttocks and heels, and her left lower back, or approximately 12 percent of her total body area. She also suffered from a burn of her tracheobronchial mucosa (i.e., the lining of her airway) due to smoke inhalation, and multiple superficial lacerations on her right hand.

The jury undoubtedly, and understandably, felt a great deal of sympathy for a young girl who, at the age of 13, lost three brothers in a tragic fire. But by law the jury was only permitted to compensate her for those damages associated with her own injuries. Her injuries included fright and pain at the time of and after the fire, a three-week hospital stay, some minor discomfort for several weeks after discharge, and a permanent scar on her lower back. Plaintiff has pointed to no cases, and we have discovered none, in which such a large verdict was sustained for such relatively minor injuries, involving no continuing disability.

The judgments in favor of Albin Laaperi in his capacity as administrator of the estates of his three sons are affirmed. In the action on behalf of Janet Laaperi, the verdict of the jury is set aside, the judgment of the district court vacated, and the cause remanded to that court for a new trial limited to the issue of damages.

### CASE QUESTIONS

1. The “C.A. 1” under the title of the case means it is a US Court of Appeals case from the First Circuit in Massachusetts. Why is this case in federal court?
2. Why does the court talk about its “sense of the current state of tort law in Massachusetts” and how this case “would be treated by the Massachusetts courts,” as if it were not in the state at all but somehow outside?
3. What rule of law is in play here as to the defendants’ liability?
4. This is a tragic case—three boys died in a house fire. Speaking dispassionately—if not heartlessly—though, did the fire actually cost Mr. Laaperi, or did he lose \$3.4 million (in 2010 dollars) as the result of his sons’ deaths? Does it make sense that he should become a millionaire as a result? Who ends up paying this amount? (The lawyers’ fees probably took about half.)
5. Is it likely that smoke-alarm manufacturers and sellers changed the instructions as a result of this case?

## **20.7 Summary and Exercises**

## Summary

Products liability describes a type of claim—for injury caused by a defective product—and not a separate theory of liability. In the typical case, three legal doctrines may be asserted: (1) warranty, (2) negligence, and (3) strict liability.

If a seller asserts that a product will perform in a certain manner or has certain characteristics, he has given an express warranty, and he will be held liable for damages if the warranty is breached—that is, if the goods do not live up to the warranty. Not every conceivable claim is an express warranty; the courts permit a certain degree of “puffing.”

An implied warranty is one created by law. Goods sold by a merchant-seller carry an implied warranty of merchantability, meaning that they must possess certain characteristics, such as being of average quality for the type described and being fit for the ordinary purposes for which they are intended.

An implied warranty of fitness for a particular purpose is created whenever a seller knows or has reason to know that the buyer is relying on the seller’s knowledge and skill to select a product for the buyer’s particular purposes.

Under UCC Article 2, the seller also warrants that he is conveying good title and that the goods are free of any rightful claim by a third person.

UCC Article 2 permits sellers to exclude or disclaim warranties in whole or in part. Thus a seller may exclude express warranties. He may also disclaim many implied warranties—for example, by noting that the sale is “as is.” The Magnuson-Moss Act sets out certain types of information that must be included in any written warranty. The act requires the manufacturer or seller to label the warranty as either “full” or “limited” depending on what types of defects are covered and what the customer must do to obtain repair or replacement. The act also abolishes “phantom warranties.”

Privity once stood as a bar to recovery in suits brought by those one or more steps removed in the distribution chain from the party who breached a warranty. But the nearly universal trend in the state courts has been to abolish privity as a defense.

Because various impediments stand in the way of warranty suits, courts have adopted a tort theory of strict liability, under which a seller is liable for injuries resulting from the sale of any product in a defective condition if it is unreasonably dangerous to the user or consumer. Typical issues in strict liability cases are these: Is the defendant a seller engaged in the business of selling? Was the product sold in a defective condition? Was it

unreasonably dangerous, either on its face or because of a failure to warn? Did the product reach the consumer in an unchanged condition? Strict liability applies regardless of how careful the seller was and regardless of his lack of contractual relation with the consumer or user.

Manufacturers can also be held liable for negligence—most often for faulty design of products and inadequate warnings about the hazards of using the product.

The products-liability revolution prompted many state legislatures to enact certain laws limiting to some degree the manufacturer's responsibility for defective products. These laws include statutes of repose and provide a number of other defenses.



## EXERCISES

1. Ralph's Hardware updated its accounting system and agreed to purchase a computer system from a manufacturer, Bits and Bytes (BB). During contract negotiations, BB's sales representative promised that the system was "A-1" and "perfect." However, the written contract, which the parties later signed, disclaimed all warranties, express and implied. After installation the computer produced only random numbers and letters, rather than the desired accounting information. Is BB liable for breaching an express warranty? Why?
2. Kate owned a small grocery store. One day John went to the store and purchased a can of chip dip that was, unknown to Kate or John, adulterated. John became seriously ill after eating the dip and sued Kate for damages on the grounds that she breached an implied warranty of merchantability. Is Kate liable? Why?
3. Carrie visited a neighborhood store to purchase some ham, which a salesperson cut by machine in the store. The next day she made a ham sandwich. In eating the sandwich, Carrie bit into a piece of cartilage in the ham. As a result, Carrie lost a tooth, had to undergo root canal treatments, and must now wear a full-coverage crown to replace the tooth. Is the store liable for the damage? Why?
4. Clarence, a business executive, decided to hold a garage sale. At the sale, his neighbor Betty mentioned to Clarence that she was the catcher on her city-league baseball team and was having trouble catching knuckleball pitches, which required a special catcher's mitt. Clarence pulled an old mitt from a pile of items that were on sale and said, "Here, try this." Betty purchased the mitt but discovered during her next game that it didn't work. Has Clarence breached an express or implied warranty? Why?
5. Sarah purchased several elegant picture frames to hang in her dorm room. She also purchased a package of self-sticking hangers. Late one evening, while Sarah was studying business law in the library, the hangers came loose and her frames came crashing to the floor. After Sarah returned to her room and discovered the rubble, she examined the box in which the hangers were packaged and found the following language: "There are no warranties except for the description on this package and specifically there is NO IMPLIED WARRANTY OF MERCHANTABILITY." Assuming the hangers are not of fair, average, ordinary quality, would the hanger company be liable for breaching an implied warranty of merchantability? Why?
6. A thirteen-year-old boy received a Golfing Gizmo—a device for training novice golfers—as a gift from his mother. The label on the shipping carton and the cover of the instruction booklet urged players to "drive

the ball with full power” and further stated: “COMPLETELY SAFE BALL WILL NOT HIT PLAYER.” But while using the device, the boy was hit in the eye by the ball. Should lack of privity be a defense to the manufacturer? The manufacturer argued that the Gizmo was a “completely safe” training device only when the ball is hit squarely, and—the defendant argued—plaintiffs could not reasonably expect the Gizmo to be “completely safe” under all circumstances, particularly those in which the player hits beneath the ball. What legal argument is this, and is it valid?

7. A bank repossessed a boat and sold it to Donald. During the negotiations with Donald, Donald stated that he wanted to use the boat for charter service in Florida. The bank officers handling the sale made no representations concerning the boat during negotiations. Donald later discovered that the boat was defective and sued the bank for breach of warranty. Is the bank liable? Why?
8. Tom Anderson, the produce manager at the Thriftway Market in Pasco, Washington, removed a box of bananas from the top of a stack of produce. When he reached for a lug of radishes that had been under the bananas, a six-inch spider—*Heteropoda venatoria*, commonly called a banana spider—leaped from some wet burlap onto his left hand and bit him. Nine months later he died of heart failure. His wife brought an action against Associated Grocers, parent company of Thriftway Market, on theories of (1) strict products liability under Restatement, Section 402(a); (2) breach of the implied warranty of merchantability; and (3) negligence. The trial court ruled against the plaintiff on all three theories. Was that a correct ruling? Explain.
9. A broken water pipe flooded a switchboard at RCA’s office. The flood tripped the switchboard circuit breakers and deactivated the air-conditioning system. Three employees were assigned to fix it: an electrical technician with twelve years on-the-job training, a licensed electrician, and an electrical engineer with twenty years of experience who had studied power engineering in college. They switched on one of the circuit breakers, although the engineer said he knew that one was supposed to test the operation of a wet switchboard before putting it back into use. There was a “snap” and everyone ran from the room up the stairs and a “big ball of fire” came after them up the stairs. The plaintiffs argued that the manufacturer of the circuit breaker had been negligent in failing to give RCA adequate warnings about the circuit breakers. How should the court rule, and on what theory should it rule?
10. Plaintiff’s business was to convert vans to RVs, and for this purpose it had used a 3M adhesive to laminate carpeting to the van walls. This adhesive, however, failed to hold the fabric in place in hot weather, so Plaintiff approached Northern Adhesive Co., a manufacturer of

adhesives, to find a better one. Plaintiff told Northern why it wanted the adhesive, and Northern—Defendant—sent several samples to Plaintiff to experiment with. Northern told Plaintiff that one of the adhesives, Adhesive 7448, was “a match” for the 3M product that previously failed. Plaintiff tested the samples in a cool plant and determined that Adhesive 7448 was better than the 3M product. Defendant had said nothing except that “what they would ship would be like the sample. It would be the same chemistry.” Plaintiff used the adhesive during the fall and winter; by spring complaints of delamination came in: Adhesive 7448 failed just as the 3M product had. Over 500 vans had to be repaired. How should the court rule on Plaintiff’s claims of breach of (1) express warranty, (2) implied warranty of merchantability, and (3) implied warranty of fitness for a particular purpose?

## SELF-TEST QUESTIONS

1. In a products-liability case
  - a. only tort theories are typically asserted
  - b. both tort and contract theories are typically asserted
  - c. strict liability is asserted only when negligence is not asserted
  - d. breach of warranty is not asserted along with strict liability
  
2. An implied warranty of merchantability
  - a. is created by an express warranty
  - b. is created by law
  - c. is impossible for a seller to disclaim
  - d. can be disclaimed by a seller only if the disclaimer is in writing
  
3. A possible defense to breach of warranty is
  - a. lack of privity
  - b. absence of an express warranty
  - c. disclaimer of implied warranties
  - d. all of the above
  
4. Under the strict liability rule in Restatement, Section 402A, the seller is liable for all injuries resulting from a product
  - a. even though all possible care has been exercised
  - b. regardless of the lack of a contract with the user
  - c. in both of the above situations
  - d. in none of the above situations
  
5. An individual selling her car could be liable
  - a. for breaching the implied warranty of merchantability
  - b. under the strict liability theory
  - c. for breaching the implied warranty of fitness
  - d. under two of the above

**SELF-TEST ANSWERS**

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

## Chapter 21

# Bailments and the Storage, Shipment, and Leasing of Goods

### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. What the elements of a bailment are
2. What the bailee's liability is
3. What the bailor's liability is
4. What other rights and duties—compensation, bailee's liens, casualty to goods—arise
5. What special types of bailments are recognized: innkeepers, warehousing
6. What rules govern the shipment of goods
7. How commodity paper is negotiated and transferred

## 21.1 Introduction to Bailment Law

### LEARNING OBJECTIVES

1. Understand what a bailment is, and why the law of bailment is important.
2. Recognize how bailments compare with sales.
3. Point out the elements required to create a bailment.

Finally, we turn to the legal relationships that buyers and sellers have with warehousemen and carriers—the parties responsible for physically transferring goods from seller to buyer. This topic introduces a new branch of law—that of bailments; we’ll examine it before turning directly to warehousemen and carriers.

### Overview of Bailments

A **bailment**<sup>1</sup> is the relationship established when someone entrusts his property temporarily to someone else without intending to give up title. Although bailment has often been said to arise only through a contract, the modern definition does not require that there be an agreement. One widely quoted definition holds that a bailment is “the rightful possession of goods by one who is not the owner. It is the element of lawful possession, however created, and the duty to account for the thing as the property of another, that creates the bailment, regardless of whether such possession is based upon contract in the ordinary sense or not.” *Zuppa v. Hertz*, 268 A.2d 364 (N.J. 1970).

The word *bailment* derives from a Latin verb, *bajulare*, meaning “to bear a burden,” and then from French, *bailler*, which means “to deliver” (i.e., into the hands or possession of someone). The one who bails out a boat, filling a bucket and emptying it overboard, is a water-bearer. The one who bails someone out of jail takes on the burden of ensuring that the one sprung appears in court to stand trial; he also takes on the risk of loss of bond money if the jailed party does not appear in court. The one who is a **bailee**<sup>2</sup> takes on the burden of being responsible to return the goods to their owner.

1. A delivery of goods to one who does not have title.
2. The person to whom property is delivered to hold in bailment.

The law of bailments is important to virtually everyone in modern society: anyone who has ever delivered a car to a parking lot attendant, checked a coat in a restaurant, deposited property in a safe-deposit box, rented tools, or taken items, clothes or appliance in to a shop for repair. In commercial transactions, bailment

law governs the responsibilities of warehousemen and the carriers, such as UPS and FedEx, that are critical links in the movement of goods from manufacturer to the consumer. Bailment law is an admixture of common law (property and tort), state statutory law (in the Uniform Commercial Code; UCC), federal statutory law, and—for international issues—treaty. Here is a link to a history of bailment law: Globusz Publishing, “Lecture v. the Bailee at Common Law,” accessed March 1, 2011, <http://www.globusz.com/ebooks/CommonLaw/00000015.htm>.

## **Bailments Compared with Sales**

### **Bailment versus Sales**

In a sale, the buyer acquires title and must pay for the goods. In a bailment, the bailee acquires possession and must return the identical object. In most cases the distinction is clear, but difficult borderline cases can arise. Consider the sad case of the leased cows: *Carpenter v. Griffen* (N.Y. 1841). Carpenter leased a farm for five years to Spencer. The lease included thirty cows. At the end of the term, Spencer was to give Carpenter, the owner, “cows of equal age and quality.” Unfortunately, Spencer fell into hard times and had to borrow money from one Griffin. When the time came to pay the debt, Spencer had no money, so Griffin went to court to levy against the cows (i.e., he sought a court order giving him the cows in lieu of the money owed). Needless to say, this threatened transfer of the cows upset Carpenter, who went to court to stop Griffin from taking the cows. The question was whether Spencer was a bailee, in which case the cows would still belong to Carpenter (and Griffin could not levy against them), or a purchaser, in which case Spencer would own the cows and Griffin could levy against them. The court ruled that title had passed to Spencer—the cows were his. Why? The court reasoned that Spencer was not obligated to return the identical cows to Carpenter, hence Spencer was not a bailee. *Carpenter v. Spencer & Griffin*, 37 Am. Dec. 396 (N.Y. 1841). Section 2-304(1) of the UCC confirms this position, declaring that whenever the price of a sale is payable in goods, each party is a seller of the goods that he is to transfer.

Note the implications that flow from calling this transaction a sale. Creditors of the purchaser can seize the goods. The risk of loss is on the purchaser. The seller cannot recover the goods (to make up for the buyer’s failure to pay him) or sell them to a third party.

### **Fungible Goods**

Fungible goods (goods that are identical, like grain in a silo) present an especially troublesome problem. In many instances the goods of several owners are mingled, and the identical items are not intended to be returned. For example, the operator of a grain elevator agrees to return an equal quantity of like-quality grain but not the actual kernels deposited there. Following the rule in Carpenter’s cow case, this



might seem to be a sale, but it is not. Under the UCC, Section 2-207, the depositors of fungible goods are “tenants in common” of the goods; in other words, the goods are owned by all. This distinction between a sale and a bailment is important. When there is a loss through natural causes—for example, if the grain elevator burns—the depositors must share the loss on a pro rata basis (meaning that no single depositor is entitled to take all his grain out; if 20 percent of the grain was destroyed, then each depositor can take out no more than 80 percent of what he deposited).

## Elements of a Bailment

As noted, bailment is defined as “the rightful possession of goods by one who is not the owner.” For the most part, this definition is clear (and note that it does not dictate that a bailment be created by contract). Bailment law applies to the delivery of goods—that is, to the delivery personal property. Personal property is usually defined as anything that can be owned other than real estate. As we have just seen in comparing bailments to sales, the definition implies a duty to return the identical goods when the bailment ends.

But one word in the definition is both critical and troublesome: possession. Possession requires both a physical and a mental element. We examine these in turn.

### Possession: Physical Control

In most cases, physical control is proven easily enough. A car delivered to a parking garage is obviously within the physical control of the garage. But in some instances, physical control is difficult to conceptualize. For example, you can rent a safe-deposit box in a bank to store valuable papers, stock certificates, jewelry, and the like. The box is usually housed in the bank’s vault. To gain access, you sign a register and insert your key after a bank employee inserts the bank’s key. You may then inspect, add to, or remove contents of the box in the privacy of a small room maintained in the vault for the purpose. Because the bank cannot gain access to the box without your key and does not know what is in the box, it might be said to have no physical control. Nevertheless, the rental of a safe-deposit box is a bailment. In so holding, a New York court pointed out that if the bank was not in possession of the box renter’s property “it is difficult to know who was. Certainly [the renter] was not, because she could not obtain access to the property without the consent and active participation of the defendant. She could not go into her safe unless the defendant used its key first, and then allowed her to open the box with her own key; thus absolutely controlling [her] access to that which she had deposited within the safe. The vault was the [company’s] and was in its custody, and its contents were under the same conditions.” *Lockwood v. Manhattan Storage & Warehouse Co.*, 50 N.Y.S. 974 (N.Y. 1898). Statutes in some states, however, provide that the

relationship is not a bailment but that of a landlord and tenant, and many of these statutes limit the bank's liability for losses.

### Possession: Intent to Possess

In addition to physical control, the bailee must have had an intent to possess the goods; that is, to exercise control over them. This mental condition is difficult to prove; it almost always turns on the specific circumstances and, as a fact question, is left to the jury to determine. To illustrate the difficulty, suppose that one crisp fall day, Mimi goes to Sally Jane's Boutique to try on a jacket. The sales clerk hands Mimi a jacket and watches while Mimi takes off her coat and places it on a nearby table. A few minutes later, when Mimi is finished inspecting herself in the mirror, she goes to retrieve her coat, only to discover it is missing. Who is responsible for the loss? The answer depends on whether the store is a bailee. In some sense the boutique had physical control, but did it intend to exercise that control? In a leading case, the court held that it did, even though no one said anything about guarding the coat, because a store invites its patrons to come in. Implicit in the act of trying on a garment is the removal of the garment being worn. When the customer places it in a logical place, with the knowledge of and without objection from the salesperson, the store must exercise some care in its safekeeping. *Bunnell v. Stern*, 25 N.E. 910 (N.Y. 1890).

Now suppose that when Mimi walked in, the salesperson told her to look around, to try on some clothes, and to put her coat on the table. When the salesperson was finished with her present customer, she said, she would be glad to help Mimi. So Mimi tried on a jacket and minutes later discovered her coat gone. Is this a bailment? Many courts, including the New York courts, would say no. The difference? The salesperson was helping another customer. Therefore, Mimi had a better opportunity to watch over her own coat and knew that the salesperson would not be looking out for it. This is a subtle distinction, but it has been sufficient in many cases to change the ruling. *Wamser v. Browning, King & Co.*, 79 N.E. 861 (N.Y. 1907).

Questions of intent and control frequently arise in parking lot cases. As someone once said, "The key to the problem is the key itself." The key is symbolic of possession and intent to possess. If you give the attendant your key, you are a **bailor**<sup>3</sup> and he (or the company he works for) is the bailee. If you do not give him the key, no bailment arises. Many parking lot cases do not fall neatly within this rule, however. Especially common are cases involving self-service airport parking lots. The customer drives through a gate, takes a ticket dispensed by a machine, parks his car, locks it, and takes his key. When he leaves, he retrieves the car himself and pays at an exit gate. As a general rule, no bailment is created under these circumstances. The lot operator does not accept the vehicle nor intend to

3. An owner of property who delivers it to another to hold in bailment.

watch over it as bailee. In effect, the operator is simply renting out space. *Wall v. Airport Parking Co. of Chicago*, 244 N.E.2d 190 (Ill. 1969). But a slight change of facts can alter this legal conclusion. Suppose, for instance, that the lot had an attendant at the single point of entrance and exit, that the attendant jotted down the license number on the ticket, one portion of which he retained, and that the car owner must surrender the ticket when leaving or prove that he owns the car. These facts have been held to add up to an intention to exercise custody and control over the cars in the lot, and hence to have created a bailment. *Continental Insurance Co. v. Meyers Bros. Operations, Inc.*, 288 N.Y.S.2d 756 (Civ. Ct. N.Y. 1968).

For a bailment to exist, the bailee must know or have reason to know that the property exists. When property is hidden within the main object entrusted to the bailee, lack of notice can defeat the bailment in the hidden property. For instance, a parking lot is not responsible for the disappearance of valuable golf clubs stored in the trunk of a car, nor is a dance hall cloak room responsible for the disappearance of a fur wrap inside a coat, if they did not know of their existence. *Samples v. Geary*, 292 S.W. 1066 (Mo. App. 1927). This result is usually justified by observing that when a person is unaware that goods exist or does not know their value, it is inequitable to hold him responsible for their loss since he cannot take steps to prevent it. This rule has been criticized: trunks are meant to hold things, and if the car was within the garage's control, surely its contents were too. Some courts soften the impact of the rule by holding that a bailee is responsible for goods that he might reasonably expect to be present, like gloves in a coat checked at a restaurant or ordinary baggage in a car checked at a hotel.

### KEY TAKEAWAY

A bailment arises when one person (a bailee) rightfully holds property belonging to another (a bailor). The law of bailments addresses the critical links in the movement of goods from the manufacturer to the end user in a consumer society: to the storage and transportation of goods. Bailments only apply to personal property; a bailment requires that the bailor deliver physical control of the goods to the bailee, who has an intention to possess the goods and a duty to return them.

## EXERCISES

1. Dennis takes his Mercedes to have the GPS system repaired. In the trunk of his car is a briefcase containing \$5,000 in cash. Is the cash bailed goods?
2. Marilyn wraps up ten family-heirloom crystal goblets, packages them carefully in a cardboard box, and drops the box off at the local UPS store. Are the goblets bailed goods?
3. Bob agrees to help his friend Roger build a deck at Roger's house. Bob leaves some of his tools—without Bob's noticing—around the corner of the garage at the foot of a rhododendron bush. The tools are partly hidden. Are they bailed goods?

## 21.2 Liability of the Parties to a Bailment

### LEARNING OBJECTIVES

1. Understand how the bailee's liability arises and operates.
2. Recognize the cases in which the bailee can disclaim liability, and what limits are put on such disclaimers.
3. Understand what duty and liability the bailor has.
4. Know other rights and duties that arise in a bailment.
5. Understand the extent to which innkeepers—hotel and motels—are liable for their guests' property.

### Liability of the Bailee

#### Duty of Care

The basic rule is that the bailee is expected to return to its owner the bailed goods when the bailee's time for possession of them is over, and he is presumed liable if the goods are not returned. But that a bailee has accepted delivery of goods does not mean that he is responsible for their safekeeping no matter what. The law of bailments does not apply a standard of absolute liability: the bailee is not an insurer of the goods' safety; her liability depends on the circumstances.

#### The Ordinary Care Rule

Some courts say that the bailee's liability is the straightforward standard of "ordinary care under the circumstances." The question becomes whether the bailee exercised such care. If she did, she is not liable for the loss.

#### The Benefit-of-the-Bargain Rule

Most courts use a complex (some say annoying) tripartite division of responsibility. If the bailment is for the sole benefit of the owner (the bailor), the bailee is answerable only for gross neglect or fraud: the duty of care is slight. For example, imagine that your car breaks down on a dark night and you beg a passing motorist to tow it to a gas station; or you ask your neighbor if you can store your utility trailer in her garage.

On the other hand, if the goods are entrusted to the bailee for his sole benefit, then he owes the bailor extraordinary care. For example, imagine that your neighbor

asks you to let him borrow your car to go to the grocery store downtown because his car is in the shop; or a friend asks if she can borrow your party canopy.

If the bailment is for the mutual benefit of bailee and bailor, then the ordinary negligence standard of care will govern. For example, imagine you park your car in a commercial parking lot, or you take your suit jacket to a dry cleaner (see [Figure 21.1 "Duty of Care"](#)).

Figure 21.1 *Duty of Care*

Bailment for	Duty of Care
1. Benefit of Owner	Slight
2. Benefit of Bailee	Extraordinary
3. Mutual Benefit	Ordinary

One problem with using the majority approach is the inherent ambiguity in the standards of care. What constitutes “gross” negligence as opposed to “ordinary” negligence? The degree-of-care approach is further complicated by the tendency of the courts to take into account the value of the goods; the lesser the value of the goods, the lesser the obligation of the bailee to watch out for them. To some degree, this approach makes sense, because it obviously behooves a person guarding diamonds to take greater precautions against theft than one holding three paperback books. But the value of the goods ought not to be the whole story: some goods obviously have great value to the owner, regardless of any lack of intrinsic value.

Another problem in using the majority approach to the standard of care is determining whether or not a benefit has been conferred on the bailee when the bailor did not expressly agree to pay compensation. For example, a bank gives its customers free access to safe-deposit boxes. Is the bank a “gratuitous bailee” that owes its bailor only a slight degree of care, or has it made the boxes available as a commercial matter to hold onto its customers? Some courts cling to one theory, some to the other, suggesting the difficulty with the tripartite division of the standard of care. However, in many cases, whatever the formal theory, the courts look to the actual benefits to be derived. Thus when a customer comes to an automobile showroom and leaves her car in the lot while she test-drives the new car, most courts would hold that two bailments for mutual benefit have been created: (1) the bailment to hold the old car in the lot, with the customer as the bailor; and (2) the bailment to try out the new car, with the customer as the bailee.

### **Burden of Proof**

In a bailment case, the plaintiff bailor has the burden of proving that a loss was caused by the defendant bailee's failure to exercise due care. However, the bailor establishes a prima facie ("at first sight"—on first appearance, but subject to further investigation) case by showing that he delivered the goods into the bailee's hands and that the bailee did not return them or returned them damaged. At that point, a presumption of negligence arises, and to avoid liability the defendant must rebut that presumption by showing affirmatively that he was not negligent. The reason for this rule is that the bailee usually has a much better opportunity to explain why the goods were not returned or were returned damaged. To put this burden on the bailor might make it impossible for him to win a meritorious case.

### **Liability of the Bailor**

As might be expected, most bailment cases involve the legal liability of bailees. However, a body of law on the liability of bailors has emerged.

### **Negligence of Bailor**

A bailor may be held liable for negligence. If the bailor receives a benefit from the bailment, then he has a duty to inform the bailee of known defects and to make a reasonable inspection for other defects. Suppose the Tranquil Chemical Manufacturing Company produces an insecticide that it wants the Plattsville Chemical Storage Company to keep in tanks until it is sold. One of the batches is defectively acidic and oozes out of the tanks. This acidity could have been discovered through a routine inspection, but Tranquil neglects to inspect the batch. The tanks leak and the chemical builds up on the floor until it explodes. Since Tranquil, the bailor, received a benefit from the storage, it had a duty to warn Plattsville, and its failure to do so makes it liable for all damages caused by the explosion.

If the bailor does not receive any benefit, however, then his only duty is to inform the bailee of known defects. Your neighbor asks to borrow your car. You have a duty to tell her that the brakes are weak, but you do not need to inspect the car beforehand for unknown defects.

### **Other Types of Liability**

The theory of products liability discussed in [Chapter 20 "Products Liability"](#) extends to bailors. Both warranty and strict liability theories apply. The rationale for extending liability in the absence of sale is that in modern commerce, damage can

be done equally by sellers or lessors of equipment. A rented car can inflict substantial injury no less than a purchased one.

In several states, when an automobile owner (bailor) lends a vehicle to a friend (bailee) who causes an accident, the owner is liable to third persons injured in the accident.

## **Disclaimers of Liability**

### **Bailee's Disclaimer**

Bailees frequently attempt to disclaim their liability for loss or damage. But courts often refuse to honor the disclaimers, usually looking to one of two justifications for invalidating them.

### **Lack of Notice**

The disclaimer must be brought to the attention of the bailor and must be unambiguous. Thus posted notices and receipts disclaiming or limiting liability must set forth clearly and legibly the legal effects intended. Most American courts follow the rule that the defendant bailee must show that the bailor in fact knew about the disclaimer. Language printed on the back side of a receipt will not do.

### **Public Policy Exception**

Even if the bailor reads the disclaimer, some courts will nevertheless hold the bailee liable on public policy grounds, especially when the bailee is a "business bailee," such as a warehouse or carrier. Indeed, to the extent that a business bailee attempts to totally disclaim liability, he will probably fail in every American jurisdiction. But the Restatement (Second) of Contracts, Section 195(2)(b), does not go quite this far for most nonbusiness bailees. They may disclaim liability as long as the disclaimer is read and does not relieve the bailee from wanton carelessness.

### **Bailor's Disclaimer**

Bailors most frequently attempt to disclaim liability in rental situations. For example, in *Zimmer v. Mitchell and Ness*, the plaintiff went to the defendant's rental shop at the Camelback ski area to rent skis, boots, and poles. *Zimmer v. Mitchell and Ness*, 385 A.2d 437 (Penn. 1978). He signed a rental agreement before accepting the ski equipment. He was a lessee and a bailee. Later, while descending the beginners' slope, he fell. The bindings on his skis did not release, thereby causing him to sustain numerous injuries. The plaintiff sued the defendant and Camelback Ski Corporation, alleging negligence, violation of Section 402A of the Restatement



(Second) of Torts, and breach of warranty. The defendant filed an answer and claimed that the plaintiff signed a rental agreement that fully released the defendant from liability. In his reply, the plaintiff admitted signing the agreement but generally denied that it released the defendant from liability. The defendant won on summary judgment.

On appeal, the Pennsylvania Supreme Court held for the defendant and set out the law: “The test for determining the validity of exculpatory clauses, admittedly not favored in the law, is set out in [Citation]. The contract must not contravene any policy of the law. It must be a contract between individuals relating to their private affairs. Each party must be a free bargaining agent, not simply one drawn into an adhesion contract, with no recourse but to reject the entire transaction....We must construe the agreement strictly and against the party asserting it [and], the agreement must spell out the intent of the parties with the utmost particularity.” The court here was satisfied with the disclaimer.

## Other Rights and Duties

### Compensation

If the bailor hires the bailee to perform services for the bailed property, then the bailee is entitled to compensation. Remember, however, that not every bailment is necessarily for compensation. The difficult question is whether the bailee is entitled to compensation when nothing explicit has been said about incidental expenses he has incurred to care for the bailed property—as, for example, if he were to repair a piece of machinery to keep it running. No firm rule can be given. Perhaps the best generalization that can be made is that, in the absence of an express agreement, ordinary repairs fall to the bailee to pay, but extraordinary repairs are the bailor’s responsibility. An express agreement between the parties detailing the responsibilities would solve the problem, of course.

### Bailee’s Lien

*Lien* is from the French, originally meaning “line,” “string,” or “tie.” In law a **lien**<sup>4</sup> is the hold that someone has over the property of another. It is akin, in effect, to a security interest. A common type is the **mechanic’s lien**<sup>5</sup> (“mechanic” here means one who works with his hands). For example, a carpenter builds a room on your house and you fail to pay him; he can secure a lien on your house, meaning that he has a property interest in the house and can start foreclosure proceedings if you still fail to pay. Similarly, a bailee is said to have a lien on the bailed property in his possession and need not redeliver it to the bailor until he has been paid. Try to take your car out of a parking lot without paying and see what happens. The attendant’s refusal to give you the car is entirely lawful under a common-law rule now more than a century and a half old. As the rule is usually stated, the common law confers

4. An encumbrance upon property to secure payment.

5. A claim allowed to one who furnishes labor, services, or materials to improve property.

the lien on the bailee if he has added value to the property through his labor, skill, or materials. But that statement of the rule is somewhat deceptive, since the person who has simply housed the goods is entitled to a lien, as is a person who has altered or repaired the goods without measurably adding value to them. Perhaps a better way of stating the rule is this: a lien is created when the bailee performs some special benefit to the goods (e.g., preserving them or repairing them).

Many states have enacted statutes governing various types of liens. In many instances, these have broadened the bailee's common-law rights. This book discusses two types of liens in great detail: the liens of warehousemen and those of common carriers. Recall that a *lease* creates a type of bailment: the lessor is the bailor and the lessee is the bailee. This book references the UCC's take on leasing in its discussion of the sale of goods. Uniform Commercial Code, Section 2A.

### **Rights When Goods Are Taken or Damaged by a Third Party**

The general rule is that the bailee can recover damages in full if the bailed property is damaged or taken by a third party, but he must account in turn to the bailor. A delivery service is carrying parcels—bailed goods entrusted to the trucker for delivery—when the truck is struck from behind and blows up. The carrier may sue the third person who caused the accident and recover for the total loss, including the value of the packages. The bailor may also recover for damages to the parcels, but not if the bailee has already recovered a judgment. Suppose the bailee has sued and lost. Does the bailor have a right to sue independently on the same grounds? Ordinarily, the principle of *res judicata* would prevent a second suit, but if the bailor did not know of and cooperate in the bailee's suit, he probably has the right to proceed on his own suit.

### **Innkeepers' Liability**

The liability of an innkeeper—a type of bailor—is thought to have derived from the warlike conditions that prevailed in medieval England, where brigands and bandits roamed the countryside and the innkeeper himself might not have been above stealing from his guests. The innkeeper's liability extended not merely to loss of goods through negligence. His was an insurer's liability, extending to any loss, no matter how occasioned, and even to losses that occurred in the guest's room, a place where the guest had the primary right of possession. The only exception was for losses due to the guest's own negligence.

Most states have enacted statutes providing exceptions to this extraordinarily broad common-law duty. Typically, the statutes exempt the hotel keeper from insurer's liability if the hotelier furnishes a safe in which the guests can leave their

jewels, money, and other valuables and if a notice is posted a notice advising the guests of the safe's availability. The hotelier might face liability for valuables lost or stolen from the safe but not from the rooms.

### KEY TAKEAWAY

If the bailee fails to redeliver the goods to the bailor, a presumption of negligence arises, but the bailee can rebut the presumption by showing that she exercised appropriate care. What is “appropriate care” depends on the test used in the jurisdiction: some courts use the “ordinary care under the circumstances,” and some determine how much care the bailee should have exercised based on the extent to which she was benefited from the transaction compared to the bailor. The bailor can be liable too for negligently delivering goods likely to cause damage to the bailee. In either case reasonable disclaimers of liability are allowed. If the bailed goods need repair while in the bailee's possession, the usual rule is that ordinary repairs are the bailee's responsibility, extraordinary ones the bailor's. Bailees are entitled to liens to enforce payment owing to them. In common law, innkeepers were insurers of their guests' property, but hotels and motels today are governed mostly by statute: they are to provide a safe for their guests' valuables and are not liable for losses from the room.

### EXERCISES

1. What is the “ordinary care under the circumstances” test for a bailee's liability when the bailed goods are not returned?
2. What is the tripartite test?
3. What liability does a bailor have for delivering defective goods to a bailee?
4. Under what circumstances are disclaimers of liability by the bailee or bailor acceptable?
5. Jason takes his Ford Mustang to a repair shop but fails to pay for the repairs. On what theory can the shop keep and eventually sell the car to secure payment?

## 21.3 The Storage and Shipping of Goods

### LEARNING OBJECTIVES

1. Understand a warehouse’s liability for losing goods, what types of losses a warehouse is liable for, and what rights the warehouse has concerning the goods.
2. Know the duties, liabilities, and exceptions to liability a carrier of freight has, and what rights the carrier has.
3. Understand the liability that is imposed on entities whose business it is to carry passengers.

### Storage of Goods

Warehousing has been called the “second oldest profession,” stemming from the biblical story of Joseph, who stored grain during the seven good years against the famine of the seven bad years. Whatever its origins, warehousing is today a big business, taking in billions of dollars to stockpile foods and other goods. As noted previously, the source of law governing warehousing is Article 7 of the UCC, but noncode law also can apply. Section 7-103 of the Uniform Commercial Code (UCC) specifically provides that any federal statute or treaty and any state regulation or tariff supersedes the provisions of Article 7. A federal example is the United States Warehouse Act, which governs receipts for stored agricultural products. Here we take up, after some definitions, the warehouse’s liabilities and rights. A warehouse is a special type of bailee.

### Definitions

A **warehouse**<sup>6</sup> is defined in UCC, Section 7-102(h), as “a person engaged in the business of storing goods for hire,” and under Section 1-201(45) a **warehouse receipt**<sup>7</sup> is any receipt issued by a warehouse. The warehouse receipt is an important document because it can be used to transfer title to the goods, even while they remain in storage: it is worth money. No form is prescribed for the warehouse receipt, but unless it lists in its terms the following nine items, the warehouse is liable to anyone who is injured by the omission of any of them:

6. One whose business it is to store goods.

7. A written document for items warehoused, serving as evidence of title to the stored goods.

1. Location of the warehouse
2. Date receipt was issued
3. Consecutive number of the receipt

4. Statement whether the goods will be delivered to bearer, to a specified person, or “to a specified person or his order”
5. The rate of storage and handling charges
6. Description of the goods or the packages containing them
7. Signature of the warehouse, which his or her authorized agent may make
8. The warehouse’s ownership of the goods, if he or she has a sole or part ownership in them
9. The amount (if known, otherwise the fact) of advances made and liabilities incurred for which the warehouse claims a lien or security interest

### **General Duty of Care**

The warehouse’s general duty of care is embodied in the tort standard for measuring negligence: he is liable for any losses or injury to the goods caused by his failure to exercise “such care in regard to them as a reasonably careful man would exercise under like circumstances.” Uniform Commercial Code, Section 7-204(1). However, subsection 4 declares that this section does not repeal or dilute any other state statute that imposes a higher responsibility on a warehouse. Nor does the section invalidate contractual limitations otherwise permissible under Article 7. The warehouse’s duty of care under this section is considerably weaker than the carrier’s duty. Determining when a warehouse becomes a carrier, if the warehouse is to act as shipper, can become an important issue.

### **Limitation of Liability**

The warehouse may limit the amount of damages she will pay by so stating in the warehouse receipt, but she must strictly observe that section’s requirements, under which the limitation must be stated “per article or item, or value per unit of weight.” Uniform Commercial Code, Section 7-204(2). Moreover, the warehouse cannot force the bailor to accept this limitation: the bailor may demand in writing increased liability, in which event the warehouse may charge more for the storage. If the warehouse converts the goods to her own UCC, the limitation of liability does not apply.

### **Specific Types of Liability and Duties**

Several problems recur in warehousing, and the law addresses them.

### **Nonreceipt or Misdescription**

Under UCC Section 7-203, a warehouse is responsible for goods listed in a warehouse receipt that were not in fact delivered to the warehouse (or were misdescribed) and must pay damages to a good-faith purchaser or party to a document of title. To avoid this liability, the issuer must conspicuously note on the document that he does not know whether the goods were delivered or are correctly described. One simple way is to mark on the receipt that “contents, condition, and quality are unknown.”

### **Delivery to the Wrong Party**

The bailee is obligated to deliver the goods to any person with documents that entitle him to possession, as long as the claimant pays any outstanding liens and surrenders the document so that it can be marked “cancelled” (or can be partially cancelled in the case of partial delivery). The bailee can avoid liability for no delivery by showing that he delivered the goods to someone with a claim to possession superior to that of the claimant, that the goods were lost or destroyed through no fault of the bailee, or that certain other lawful excuses apply. Uniform Commercial Code, Section 7-403(1). Suppose a thief deposits goods he has stolen with a warehouse. Discovering the theft, the warehouse turns the goods over to the rightful owner. A day later the thief arrives with a receipt and demands delivery. Because the rightful owner had the superior claim, the warehouse is not liable in damages to the thief.

Now suppose you are moving and have placed your goods with a local storage company. A few weeks later, you accidentally drop your wallet, which contains the receipt for the goods and all your identification. A thief picks up the wallet and immediately heads for the warehouse, pretending to be you. Having no suspicion that anything is amiss—it’s a large place and no one can be expected to remember what you look like—the warehouse releases the goods to the thief. This time you are probably out of luck. Section 7-404 says that “a bailee who in good faith including observance of reasonable commercial standards has received goods and delivered...them according to the terms of the document of title...is not liable.” This rule is true even though the person to whom he made delivery had no authority to receive them, as in the case of the thief. However, if the warehouse had a suspicion and failed to take precautions, then he might be liable to the true owner.

### **Duty to Keep Goods Separate**

Except for fungible goods, like grain, the warehouse must keep separate goods covered by each warehouse receipt. The purpose of this rule, which may be negated

by explicit language in the receipt, is to permit the bailor to identify and take delivery of his goods at any time.

### **Rights of the Warehouser**

The warehouser has certain rights concerning the bailed goods.

### **Termination**

A warehouser is not obligated to store goods indefinitely. Many warehouse receipts will specify the period of storage. At the termination of the period, the warehouser may notify the bailor to pay and to recover her goods. If no period is fixed in the receipt or other document of title, the warehouser may give notice to pay and remove within no less than thirty days. The bailor's failure to pay and remove permits the warehouser to sell the goods for her fee. Suppose the goods begin to deteriorate. Sections 7-207(2) and 7-207(3) of the UCC permit the warehouser to sell the goods early if necessary to recover the full amount of her lien or if the goods present a hazard. But if the rightful owner demands delivery before such a sale, the warehouser is obligated to do so.

### **Liens**

Section 7-209(1) of the UCC provides that a warehouser has a lien on goods covered by a warehouse receipt to recover the following charges and expenses: charges for storage or transportation, insurance, labor, and expenses necessary to preserve the goods. The lien is not discharged if the bailor transfers his property interest in the goods by negotiating a warehouse receipt to a purchaser in good faith, although the warehouser is limited then to an amount or a rate fixed in the receipt or to a reasonable amount or rate if none was stated. The lien attaches automatically and need not be spelled out in the warehouse receipt.

The warehouser may enforce the lien by selling the goods at a public or private sale, as long as she does so in a commercially reasonable manner, as defined in Section 7-210. All parties known to be claiming an interest in the goods must be notified of the sale and told the amount due, the nature of the sale, and its time and place. Any person who in good faith purchases the goods takes them free of any claim by the bailor, even if the warehouser failed to comply with the requirements of Section 7-210. However, her failure to comply subjects her to damages, and if she has willfully violated the provisions of this section she is liable to the bailor for conversion.

## Shipment of Goods

### Introduction and Terminology

The shipment of goods throughout the United States and abroad is a very big business, and many specialized companies have been established to undertake it, including railways, air cargo operations, trucking companies, and ocean carriers. Article 7 of the UCC applies to carriage of goods as it does to warehousing, but federal law is more important. The Federal Bill of Lading Act (FBLA) covers bills of lading issued by common carriers for transportation of goods in interstate or foreign commerce (i.e., from one state to another; in federal territory; or to foreign countries). The Carmack Amendment was enacted in 1906 as an amendment to the Interstate Commerce Act of 1887, and it is now part of the Interstate Commerce Commission Termination Act of 1995; it covers liability of interstate carriers for loss, destruction, and damage to goods. The **shipper**<sup>8</sup> is the entity hiring the one who transports the goods: if you send your sister crystal goblets for her birthday, you are the shipper.

Two terms are particularly important in discussing shipment of goods. One is common carrier; the **common carrier**<sup>9</sup> is “one who undertakes for hire or reward to transport the goods of such as chooses to employ him, from place to place.” *Ace High Dresses v. J. C. Trucking Co.*, 191 A. 536 (Conn. 1937). This definition contains three elements: (1) the carrier must hold itself out for all in common for hire—the business is not restricted to particular customers but is open to all who apply for its services; (2) it must charge for his services—it is for hire; (3) the service in question must be carriage. Included within this tripartite definition are numerous types of carriers: household moving companies, taxicabs, towing companies, and even oil and gas pipelines. Note that to be a common carrier it is not necessary to be in the business of carrying every type of good to every possible point; common carriers may limit the types of goods or the places to which they will transport them.

A **bill of lading**<sup>10</sup> is any document that evidences “the receipt of goods for shipment issued by a person engaged in the business of transporting or forwarding goods.” Uniform Commercial Code, Section 1-206(6). This is a comprehensive definition and includes documents used by contract carriers—that is, carriers who are not common carriers. An example of a bill of lading is depicted in [Figure 21.2 "A Bill of Lading Form"](#).

8. One who engages the services of a carrier.
9. A carrier that holds itself open to any member of the public for a fee.
10. A document of title acknowledging receipt of goods by a carrier.



Chapter 21 Bailments and the Storage, Shipment, and Leasing of Goods

Figure 21.2 A Bill of Lading Form

[Face Side]

**UNIFORM ORDER BILL OF LADING**  
ORIGINAL

Shipper's No. \_\_\_\_\_  
Agent's No. \_\_\_\_\_  
Company \_\_\_\_\_

RECEIVED, subject to the classifications and tariffs in effect on the date of the issue of this Bill of Lading at \_\_\_\_\_, 20\_\_\_\_

from \_\_\_\_\_  
the property described below, in apparent good order, except as noted (contents and condition of contents of packages unknown), marked, consigned, and destined to indicated below, which said company (the word company being understood throughout this contract as meaning any person or corporation in possession of the property under the contract) agrees to carry to its usual place of delivery at said destination, if on its own road or on its own water line, otherwise to deliver to another carrier on the route to said destination. It is mutually agreed, as to each carrier of all or any of said property over all or any portion of said route to destination, and as to each part at any time interested in all or any of said property, that every service to be performed hereunder shall be subject to all the conditions not prohibited by law whether printed or written, herein contained, including the conditions on back hereof, which are hereby agreed to by the shipper and accepted for himself and his assigns.

The surrender of this Original ORDER Bill of Lading properly indorsed shall be required before the delivery of the property. Inspection of property covered by this bill of lading will not be permitted unless provided by law or unless permission is indorsed on this original bill of lading or given in writing by the shipper.

Consigned to ORDER of \_\_\_\_\_ State of \_\_\_\_\_ County of \_\_\_\_\_  
Destination \_\_\_\_\_ State of \_\_\_\_\_ County of \_\_\_\_\_  
Notify \_\_\_\_\_ State of \_\_\_\_\_ County of \_\_\_\_\_  
At \_\_\_\_\_ State of \_\_\_\_\_ County of \_\_\_\_\_  
Route \_\_\_\_\_  
Delivering Carrier \_\_\_\_\_ Car Initial \_\_\_\_\_ Car No. \_\_\_\_\_

No. Packages	Description of Articles, Special Marks, and Exceptions	*Weight (Subject to Correction)	Class or Rate	Check Column	Subject to Section 7 of conditions, if this shipment is to be delivered to the consignee without recourse on the consignee, the consignee shall sign the following statement: The carrier shall not make delivery of this shipment without payment of freight and all other lawful charges. (Signature of consignee) If charges are to be prepaid, write or stamp here, "To be Prepaid" Received \$ _____ to apply in prepayment of the charges on the property described hereon. Agent or Cashier _____ Per _____ (The signature here acknowledges only the amount prepaid.)

\* If the shipment moves between two ports by a carrier by water, the law requires that the bill of lading shall state whether it is "carrier's or shipper's weight."

Note.— Where the rate is dependent on value, shippers are required to state specifically in writing the agreed or declared value of the property.  
The agreed or declared value of the property is hereby specifically stated by the shipper to be not exceeding \_\_\_\_\_ per \_\_\_\_\_  
\$ \_\_\_\_\_

Shipper \_\_\_\_\_ per \_\_\_\_\_ Agent \_\_\_\_\_  
Permanent postoffice address of shipper \_\_\_\_\_

Source: Form 3 from UCC Section 7-301

Duties and Liabilities

The transportation of goods has been an important part of all evolved economic systems for a long time, and certainly it is critical to the development and operation of any capitalistic system. The law regarding it is well developed.

Absolute Liability

Damage, destruction, and loss are major hazards of transportation for which the carrier will be liable. Who will assert the claim against the carrier depends on who bears the risk of loss. The rules governing risk of loss (examined in Chapter 18 "Title and Risk of Loss") determine whether the buyer or seller will be the plaintiff. But whoever is the plaintiff, the common carrier defendant faces absolute liability. With five exceptions explored two paragraphs on, the common carrier is an insurer of goods, and regardless of the cause of damage or loss—that is, whether or not the carrier was negligent—it must make the owner whole. This ancient common-law rule is codified in state law, in the federal Carmack Amendment, and in the UCC, Section 7-309(1), all of which hold the common carrier to absolute liability to the extent that the common law of the state had previously done so.

Absolute liability was imposed in the early cases because the judges believed such a rule was necessary to prevent carriers from conspiring with thieves. Since it is difficult for the owner, who was not on the scene, to prove exactly what happened, the judges reasoned that putting the burden of loss on the carrier would prompt him to take extraordinary precautions against loss (and would certainly preclude him from colluding with thieves). Note that the rules in this section govern only common carriers; contract carriers that do not hold themselves out for transport for hire are liable as ordinary bailees.

### **Exceptions to Absolute Liability**

In general, the burden of proof rests on the carrier in favor of the shipper. The shipper (or consignee of the shipper) can make out a prima facie case by showing that it delivered the goods to the carrier in good condition and that the goods either did not arrive or arrived damaged in a specified amount. Thereafter the carrier has the burden of proving that it was not negligent and that the loss or damage was caused by one of the five following recognized exceptions to the rule of absolute liability.

#### **Act of God**

No one has ever succeeded in defining precisely what constitutes an act of God, but the courts seem generally agreed that it encompasses acts that are of sudden and extraordinary natural, as opposed to human, origin. Examples of acts of God are earthquakes, hurricanes, and fires caused by lightning against which the carrier could not have protected itself. Rapid River Carriers contracts to transport a refrigerated cargo of beef down the Mississippi River on the SS *Rapid*. When the ship is en route, it is hit by a tornado and sinks. This is an act of God. But a contributing act of negligence by a carrier overcomes the act of God exception. If it could be shown that the captain was negligent to set sail when the weather warned of imminent tornados, the carrier might be liable.

#### **Act of Public Enemy**

This is a narrow exception that applies only to acts committed by pirates at high sea or by the armed forces of enemies of the state to which the carrier owes allegiance. American ships at sea that are sunk during wartime by enemy torpedoes would not be liable for losses to the owners of cargo. Moreover, public enemies do not include lawless mobs or criminals listed on the FBI's Ten Most Wanted list, even if federal troops are required, as in the Pullman Strike of 1894, to put down the violence. After the Pullman Strike, carriers were held liable for property destroyed by violent strikers.

### **Act of Public Authority**

When a public authority—a sheriff or federal marshal, for example—through lawful process seizes goods in the carrier’s possession, the carrier is excused from liability. Imagine that federal agents board the SS *Rapid* in New Orleans and, as she is about to sail, show the captain a search warrant and seize several boxes of cargo marked “beef” that turn out to hold cocaine. The owner or consignee of this illegal cargo will not prevail in a suit against the carrier to recover damages. Likewise, if the rightful owner of the goods obtains a lawful court order permitting him to attach them, the carrier is obligated to permit the goods to be taken. It is not the carrier’s responsibility to contest a judicial writ or to face the consequences of resisting a court order. The courts generally agree that the carrier must notify the owner whenever goods are seized.

### **Act of Shipper**

When goods are lost or damaged because of the shipper’s negligence, the shipper is liable, not the carrier. The usual situation under this exception arises from defective packing. The shipper who packs the goods defectively is responsible for breakage unless the defect is apparent and the carrier accepts the goods anyway. For example, if you ship your sister crystal goblets packed loosely in the box, they will inevitably be broken when driven in trucks along the highways. The trucker who knowingly accepts boxes in this condition is liable for the damage. Likewise, the carrier’s negligence will overcome the exception and make him absolutely liable. A paper supplier ships several bales of fine stationery in thin cardboard boxes susceptible to moisture. Knowing their content, SS *Rapid* accepts the bales and exposes them to the elements on the upper deck. A rainstorm curdles the stationery. The carrier is liable.

### **Inherent Nature of the Goods**

The fifth exception to the rule of absolute liability is rooted in the nature of the goods themselves. If they are inherently subject to deterioration or their inherent characteristics are such that they might be destroyed, then the loss must lie on the owner. Common examples are chemicals that can explode spontaneously and perishable fruits and vegetables. Of course, the carrier is responsible for seeing that foodstuffs are properly stored and cared for, but if they deteriorate naturally and not through the carrier’s negligence, he is not liable.

### **Which Carrier Is Liable?**

The transportation system is complex, and few goods travel from portal to portal under the care of one carrier only. In the nineteenth century, the shipper whose

goods were lost had a difficult time recovering their value. Initial carriers blamed the loss on subsequent carriers, and even if the shipper could determine which carrier actually had possession of the goods when the damage or loss occurred, diverse state laws made proof burdensome. The Carmack Amendment ended the considerable confusion by placing the burden on the initial carrier; connecting carriers are deemed agents of the initial carrier. So the plaintiff, whether seller or buyer, need sue only the initial carrier, no matter where the loss occurred. Likewise, Section 7-302 of the UCC fastens liability on an initial carrier for damages or loss caused by connecting carriers.

### **When Does Carrier Liability Begin and End?**

When a carrier's liability begins and ends is an important issue because the same company can act both to store the goods and to carry them. The carrier's liability is more stringent than the warehouse's. So the question is, when does a warehouse become a carrier and vice versa?

The basic test for the beginning of carrier liability is whether the shipper must take further action or give further instructions to the carrier before its duty to transport arises. Suppose that Cotton Picking Associates delivers fifty bales of cotton to Rapid River Carriers for transport on the SS *Rapid*. The SS *Rapid* is not due back to port for two more days, so Rapid River Carrier stores the cotton in its warehouse, and on the following day the warehouse is struck by lightning and burns to the ground. Is Rapid River Carriers liable in its capacity as a carrier or warehouse? Since nothing was left for the owner to do, and Rapid River was storing the cotton for its own convenience awaiting the ship's arrival, it was acting as a carrier and is liable for the loss. Now suppose that when Cotton Picking Associates delivered the fifty bales it said that another fifty bales would be coming in a week and the entire lot was to be shipped together. Rapid River stores the first fifty bales and lightning strikes. Since more remained for Cotton Picking to do before Rapid River was obligated to ship, the carrier was acting in its warehousing capacity and is not liable.

The carrier's absolute liability ends when it has delivered the goods to the consignee's residence or place of business, unless the agreement states otherwise (as it often does). By custom, certain carriers—notably rail carriers and carriers by water—are not required to deliver the goods to the consignee (since rail lines and oceans do not take the carrier to the consignee's door). Instead, consignees must take delivery at the dock or some other place mutually agreed on or established by custom.

When the carrier must make personal delivery to the consignee, carrier liability continues until the carrier has made reasonable efforts to deliver. An express

trucking company cannot call on a corporate customer on Sunday or late at night, for instance. If reasonable efforts to deliver fail, it may store the goods in its own warehouse, in which case its liability reverts to that of a warehouseman.

If personal delivery is not required (e.g., as in shipment by rail), the states use different approaches for determining when the carrier's liability terminates. The most popular intrastate approach provides that the carrier continues to be absolutely responsible for the goods until the consignee has been notified of their arrival and has had a reasonable opportunity to take possession of them.

Interstate shipments are governed by the Carmack Amendment, which generally provides that liability will be determined by language in the bill of lading. The typical bill of lading (or "BOL" and "B/L") provides that if the consignee does not take the goods within a stated period of time after receiving notice of their arrival, the carrier will be liable as warehouseman only.

### **Disclaimers**

The apparently draconian liability of the carrier—as an insurer of the goods—is in practice easily minimized. Under neither federal nor state law may the carrier disclaim its absolute liability, but at least as to commercial transactions it may limit the damages payable under certain circumstances. Both the Carmack Amendment and Section 7-309 of the UCC permit the carrier to set alternate tariffs, one costing the shipper more and paying full value, the other costing less and limited to a dollar per pound or some other rate less than full value. The shipper must have a choice; the carrier may not impose a lesser tariff unilaterally on the shipper, and the loss must not be occasioned by the carrier's own negligence.

### **Specific Types of Liability**

The rules just discussed relate to the general liability of the carrier for damages to the goods. There are two specific types of liability worth noting.

#### **Nonreceipt or Misdescription**

Under the UCC, Section 7-301(1), the owner of the goods (e.g., a consignee) described in a bill of lading may recover damages from the issuer of the bill (the carrier) if the issuer did not actually receive the goods from the shipper, if the goods were misdescribed, or if the bill was misdated. The issuer may avoid liability by reciting in the bill of lading that she does not know whether the goods were received or if they conform to the description; the issuer may avoid liability also by marking the goods with such words as "contents or condition of contents

unknown.” Even this qualifying language may be ineffective. For instance, a common carrier may not hide behind language indicating that the description was given by the shipper; the carrier must actually count the packages of goods or ascertain the kind and quantity of bulk freight. Just because the carrier is liable to the consignee for errors in description does not mean that the shipper is free from blame. Section 7-301(5) requires the shipper to indemnify the carrier if the shipper has inaccurately described the goods in any way (including marks, labels, number, kind, quantity, condition, and weight).

### **Delivery to the Wrong Party**

The rule just discussed for warehouse applies to carriers under both state and federal law: carriers are absolutely liable for delivering the goods to the wrong party. In the classic case of *Southern Express Co. v. C. L. Ruth & Son*, a clever imposter posed as the representative of a reputable firm and tricked the carrier into delivering a diamond ring. *Southern Express Co. v. C. L. Ruth & Son*, 59 So. 538 (Ala. Ct. App. 1912). The court held the carrier liable, even though the carrier was not negligent and there was no collusion. The UCC contains certain exceptions; under Section 7-303(1), the carrier is immune from liability if the holder, the consignor, or (under certain circumstances) the consignee gives instructions to deliver the goods to someone other than a person named in the bill of lading.

### **Carrier’s Right to Lien and Enforcement of Lien**

Just as the warehouse can have a lien, so too can the carrier. The lien can cover charges for storage, transportation, and preservation of goods. When someone has purchased a negotiable bill of lading, the lien is limited to charges stated in the bill, allowed under applicable tariffs, or, if none are stated, to a reasonable charge. A carrier who voluntarily delivers or unjustifiably refuses to deliver the goods loses its lien. The carrier has rights paralleling those of the warehouse to enforce the lien.

### **Passengers**

In addition to shipping goods, common carriers also transport passengers and their baggage. The carrier owes passengers a high degree of care; in 1880 the Supreme Court described the standard as “the utmost caution characteristic of very careful prudent men.” *Pennsylvania Co. v. Roy*, 102 US 451 (1880). This duty implies liability for a host of injuries, including mental distress occasioned by insults (“lunatic,” “whore,” “cheap, common scalawag”) and by profane or indecent language. In *Werndli v. Greyhound*, *Werndli v. Greyhound Corp.*, 365 So.2d 177 (Fla. Ct. App., 1978) Mrs. Werndli deboarded the bus at her destination at 2:30 a.m.; finding the bus station closed, she walked some distance to find a bathroom. While doing so, she

became the victim of an assault. The court held Greyhound liable: it should have known the station was closed at 2:30 a.m. and that it was located in a area that became dangerous after hours. The case illustrates the degree to which a carrier is responsible for its passengers' safety and comfort.

The baggage carrier is liable as an insurer unless the baggage is not in fact delivered to the carrier. A passenger who retains control over his hand luggage by taking it with him to his seat has not delivered the baggage to the carrier, and hence the carrier has no absolute liability for its loss or destruction. The carrier remains liable for negligence, however. When the passenger does deliver his luggage to the carrier, the question often arises whether the property so delivered is "baggage." If it is not, the carrier does not have an insurer's liability toward it. Thus a person who transports household goods in a suitcase would not have given the carrier "baggage," as that term is usually defined (i.e., something transported for the passenger's personal use or convenience). At most, the carrier would be responsible for the goods as a gratuitous bailee.

#### KEY TAKEAWAY

The storage of goods is a special type of bailment. People who store goods can retrieve them or transfer ownership of them by transferring possession of the warehouse receipt: whoever has rightful possession of the receipt can take the goods, and the warehouse is liable for misdelivery or for mixing up goods. The warehouse has a right to a lien to secure his fee, enforceable by selling the goods in a commercially reasonable way. The shipping of goods is of course an important business. Common carriers (those firms that hire out their trucks, airplanes, ships, or trains to carry cargo) are strictly liable to ensure the proper arrival of the goods to their destination, with five exceptions (act of God, public enemy, public authority, shipper; inherent nature of the goods); the first carrier to receive them is liable—others who subsequently carry are that carrier's agents. The carrier may also store goods: if it does so for its own convenience it is liable as a carrier; if it does so for the shipper's convenience, it is liable as a warehouse. As with warehouse, the carrier is liable for misdelivery and is entitled to a lien to enforce payment. Carriers also carry people, and the standard of care they owe to passengers is very high. Carrying passengers' baggage, the carrier is liable as an insurer—it is strictly liable.

## EXERCISES

1. How are warehousemen any different from the more generic bailees?
2. How do the duties and liabilities of warehousemen differ from those of carriers?
3. What rights do warehousemen and carriers have to ensure their payment?
4. May a carrier limit its liability for losses not its fault?



## 21.4 Negotiation and Transfer of Documents of Title (or Commodity Paper)

### LEARNING OBJECTIVES

1. Understand how commodity paper operates in the sale of goods.
2. Recognize when the transferee of a properly negotiated document of title gets better rights than her transferor had and the exceptions to this principle.

### Overview of Negotiability

We have discussed in several places the concept of a **document of title**<sup>11</sup> (also called **commodity paper**<sup>12</sup>). That is a written description, identification, or declaration of goods authorizing the holder—usually a bailee—to receive, hold, and dispose of the document and the goods it covers. Examples of documents of title are warehouse receipts, bills of lading, and delivery orders. The document of title, properly negotiated (delivered), gives its holder ownership of the goods it represents. It is much easier to pass around a piece of paper representing the ownership interest in goods than it is to pass around the goods themselves.

It is a basic feature of our legal system that a person cannot transfer more rights to property than he owns. It would follow here that no holder of a document of title has greater rights in the goods than the holder's transferor—the one from whom she got the document (and thus the goods). But there are certain exceptions to this rule; for example, [Chapter 17 "Introduction to Sales and Leases"](#) discusses the power of a merchant in certain circumstances to transfer title to goods, even though the merchant himself did not have title to them. A critically important exception to the general rule arises when certain types of paper are sold. [Chapter 23 "Negotiation of Commercial Paper"](#) discusses this rule as it relates to commercial paper such as checks and notes. To conclude this chapter, we discuss the rule as it applies to documents of title, sometimes known as commodity paper.

11. A written description of goods authorizing its holder to have them.

12. A loan or cash advance secured by commodities, bills of lading, or warehouse receipts.

### The Elements and Effect of Negotiation

If a document of title is “negotiable” and is “duly negotiated,” the purchaser can obtain rights greater than those of the storer or shipper. In the following discussion, we refer only to the Uniform Commercial Code (UCC), although federal law also distinguishes between negotiable and nonnegotiable documents of title

(some of the technical details in the federal law may differ, but these are beyond the scope of this book).

### **Negotiable Defined**

Any document of title, including a warehouse receipt and a bill of lading, is negotiable or becomes negotiable if by its terms the goods are to be delivered “to bearer or to the order of” a named person. Uniform Commercial Code, Section 7-104(1)(a). All other documents of title are nonnegotiable. Suppose a bill of lading says that the goods are consigned to Tom Thumb but that they may not be delivered unless Tom signs a written order that they be delivered. Under Section 7-104(2), that is not a negotiable document of title. A negotiable document of title must bear words such as “Deliver to the bearer” or “deliver to the order of Tom Thumb.” These are the “magic words” that create a negotiable document.

### **Duly Negotiated**

To transfer title effectively through **negotiation** of the document of title, it must be “duly negotiated.” In general terms, under Section 7-501 of the UCC, a negotiable document of title is **duly negotiated**<sup>13</sup> when the person named in it indorses (signs it over—literally “on the back of”) and delivers it to a holder who purchases it in good faith and for value, without any notice that someone else might have a claim against the goods, assuming the transaction is in the regular course of business or financing. Note that last part: assuming the transaction is in the regular course of business. If you gave your roommate a negotiable document of title in payment for a car you bought from her, your roommate would have something of value, but it would not have been duly negotiated. Paper made out “to bearer” (**bearer paper**<sup>14</sup>) is negotiated by delivery alone; no indorsement is needed. A **holder**<sup>15</sup> is anyone who possesses a document of title that is drawn to his order, indorsed to him, or made out “to bearer.”

### **Effect**

13. The transfer of commercial paper to a legitimate transferee, usually by indorsement.

14. A negotiable instrument payable to whoever has possession.

15. One who has legal possession of a negotiable instrument and who is entitled to payment.

As a general rule, if these requirements are not met, the transferee acquires only those rights that the transferor had and nothing more. And if a nonnegotiable document is sold, the buyer’s rights may be defeated. For example, a creditor of the transferor might be entitled to treat the sale as void.

Under Section 7-502 of the UCC, however, if the document is duly negotiated, then the holder acquires (1) title to the document, (2) title to the goods, (3) certain rights to the goods delivered to the bailee after the document itself was issued, and (4) the

right to have the issuer of the document of title hold the goods or deliver the goods free of any defense or claim by the issuer.

To contrast the difference between sale of goods and negotiation of the document of title, consider the plight of Lucy, the owner of presidential campaign pins and other political memorabilia. Lucy plans to hold them for ten years and then sell them for many times their present value. She does not have the room in her cramped apartment to keep them, so she crates them up and takes them to a friend for safekeeping. The friend gives her a receipt that says simply: “Received from Lucy, five cartons; to be stored for ten years at \$25 per year.” Although a document of title, the receipt is not negotiable. Two years later, a browser happens on Lucy’s crates, discovers their contents, and offers the friend \$1,000 for them. Figuring Lucy will forget all about them, the friend sells them. As it happens, Lucy comes by a week later to check on her memorabilia, discovers what her former friend has done, and sues the browser for their return. Lucy would prevail. Now suppose instead that the friend, who has authority from Lucy to store the goods, takes the cartons to the Trusty Storage Company, receives a negotiable warehouse receipt (“deliver to bearer five cartons”), and then negotiates the receipt. This time Lucy would be out of luck. The bona fide purchaser from her friend would cut off Lucy’s right to recover the goods, even though the friend never had good title to them.

A major purpose of the concept is to allow banks and other creditors to loan money with the right to the goods as represented on the paper as collateral. They can, in effect, accept the paper as collateral without fear that third parties will make some claim on the goods.

But even if the requirements of negotiability are met, the document of title still will confer no rights in certain cases. For example, when a thief forges the indorsement of the owner, who held negotiable warehouse receipts, the bona fide purchaser from the thief does not obtain good title. Only if the receipts were in bearer form would the purchaser prevail in a suit by the owner. Likewise, if the owner brought his goods to a repair shop that warehoused them without any authority and then sold the negotiable receipts received for them, the owner would prevail over the subsequent purchaser.

Another instance in which an apparent negotiation of a document of title will not give the bona fide purchaser superior rights occurs when a term in the document is altered without authorization. But if blanks are filled in without authority, the rule states different consequences for bills of lading and warehouse receipts. Under Section 7-306 of the UCC, any unauthorized filling in of a blank in a bill of lading leaves the bill enforceable only as it was originally. However, under Section 7-208, an unauthorized filling in of a blank in a warehouse receipt permits the good-faith

purchaser with no notice that authority was lacking to treat the insertion as authorized, thus giving him good title. This section makes it dangerous for a warehouseman to issue a receipt with blanks in it, because he will be liable for any losses to the owner if a good-faith purchaser takes the goods.

Finally, note that a purchaser of a document of title who is unable to get his hands on the goods—perhaps the document was forged—might have a breach of warranty action against the seller of the document. Under Section 7-507 of the UCC, a person who negotiates a document of title warrants to his immediate purchaser that the document is genuine, that he has no knowledge of any facts that would impair its validity, and that the negotiation is rightful and effective. Thus the purchaser of a forged warehouse receipt would not be entitled to recover the goods but could sue his transferor for breach of the warranty.

#### KEY TAKEAWAY

It is a lot easier to move pieces of paper around than goods in warehouses. Therefore commercial paper, or commodity paper, was invented: the paper represents the goods, and the paper is transferred from one person to another by negotiation. The holder signs on the back of the paper and indicates who its next holder should be (or foolishly leaves that blank); that person then has rights to the goods and, indeed, better rights. On due negotiation the transferee does not merely stand in the transferor's shoes: the transferee takes free of defects and defenses that could have been available against the transferor. For a document of title to be a negotiable one, it must indicate that the intention of it is that it should be passed on through commerce, with the words "to bearer" or "to the order of [somebody]," and it must be duly negotiated: signed off on by its previous holder (or without any signature needed if it was bearer paper).

## EXERCISES

1. “George Baker deposited five cardboard boxes in my barn’s loft, and he can pick them up when he wants.” Is this statement a negotiable document of title?
2. “George Baker deposited five cardboard boxes in my barn’s loft, and he or anybody to his order can pick them up.” Is this statement a negotiable document of title?
3. Why is the concept of being a holder of duly negotiated documents of title important?

## 21.5 Cases

### **Bailments and Disclaimers of Bailee's Liability**

Carr v. Hoosier Photo Supplies, Inc.

441 N.E.2d 450 (Ind. 1982)

Givan, J.

Litigation in this cause began with the filing of a complaint in Marion Municipal Court by John R. Carr, Jr. (hereinafter "Carr"), seeking damages in the amount of \$10,000 from defendants Hoosier Photo Supplies, Inc. (hereinafter "Hoosier") and Eastman Kodak Company (hereinafter "Kodak"). Carr was the beneficiary of a judgment in the amount of \$1,013.60. Both sides appealed. The Court of Appeals affirmed the trial court in its entirety.

The facts were established by stipulation agreement between the parties and thus are not in dispute. In the late spring or early summer of 1970, Carr purchased some Kodak film from a retailer not a party to this action, including four rolls of Kodak Ektachrome-X 135 slide film that are the subject matter of this dispute. During the month of August, 1970, Carr and his family vacationed in Europe. Using his own camera Carr took a great many photographs of the sites they saw, using among others the four rolls of film referred to earlier. Upon their return to the United States, Carr took a total of eighteen [18] rolls of exposed film to Hoosier to be developed. Only fourteen [14] of the rolls were returned to Carr after processing. All efforts to find the missing rolls or the pictures developed from them were unsuccessful. Litigation commenced when the parties were unable to negotiate a settlement.

The film Carr purchased, manufactured by Kodak, is distributed in boxes on which there is printed the following legend:

#### **READ THIS NOTICE**

This film will be replaced if defective in manufacture, labeling, or packaging, or if damaged or lost by us or any subsidiary company even though by negligence or other fault. Except for such replacement, the sale, processing, or other handling of this film for any purpose is without other warranty of liability.

In the stipulation of facts it was agreed though Carr never read this notice on the packages of film he bought, he knew there was printed on such packages “a limitation of liability similar or identical to the Eastman Kodak limitation of liability.” The source of Carr’s knowledge was agreed to be his years of experience as an attorney and as an amateur photographer.

When Carr took all eighteen [18] rolls of exposed film to Hoosier for processing, he was given a receipt for each roll. Each receipt contained the following language printed on the back side:

Although film price does not include processing by Kodak, the return of any film or print to us for processing or any other purpose, will constitute an agreement by you that if any such film or print is damaged or lost by us or any subsidiary company, even though by negligence or other fault, it will be replaced with an equivalent amount of Kodak film and processing and, except for such replacement, the handling of such film or prints by us for any purpose is without other warranty or liability.

Again, it was agreed though Carr did not read this notice he was aware Hoosier “[gave] to their customers at the time of accepting film for processing, receipts on which there are printed limitations of liability similar or identical to the limitation of liability printed on each receipt received by Carr from Hoosier Photo.”

It was stipulated upon receipt of the eighteen [18] rolls of exposed film only fourteen [14] were returned to Hoosier by Kodak after processing. Finally, it was stipulated the four rolls of film were lost by either Hoosier or Kodak....

That either Kodak or Hoosier breached the bailment contract, by negligently losing the four rolls of film, was established in the stipulated agreement of facts. Therefore, the next issue raised is whether either or both, Hoosier or Kodak, may limit their liability as reflected on the film packages and receipts....

[A] prerequisite to finding a limitation of liability clause in a contract unconscionable and therefore void is a showing of disparity in bargaining power in favor of the party whose liability is thus limited....In the case at bar the stipulated facts foreclose a finding of disparate bargaining power between the parties or lack of knowledge or understanding of the liability clause by Carr. The facts show Carr is an experienced attorney who practices in the field of business law. He is hardly in a position comparable to that of the plaintiff in *Weaver, supra*. Moreover, it was stipulated he was aware of the limitation of liability on both the film packages and

the receipts. We believe these crucial facts belie a finding of disparate bargaining power working to Carr's disadvantage.

Contrary to Carr's assertions, he was not in a "take it or leave it position" in that he had no choice but to accept the limitation of liability terms of the contract. As cross-appellants Hoosier and Kodak correctly point out, Carr and other photographers like him do have some choice in the matter of film processing. They can, for one, undertake to develop their film themselves. They can also go to independent film laboratories not a part of the Kodak Company. We do not see the availability of processing as limited to Kodak....

We hold the limitation of liability clauses operating in favor of Hoosier and Kodak were assented to by Carr; they were not unconscionable or void. Carr is, therefore, bound by such terms and is limited in his remedy to recovery of the cost of four boxes of unexposed Kodak Ektachrome-X 135 slide film.

The Court of Appeals' opinion in this case is hereby vacated. The cause is remanded to the trial court with instructions to enter a judgment in favor of appellant, John R. Carr, Jr., in the amount of \$13.60, plus interest. Each party is to bear its own costs.

Hunter and Pivarnik, JJ., concur. Prentice, J., concurs in result without opinion.

DeBruler, J., dissenting.

...As a general rule the law does not permit professional bailees to escape or diminish liability for their own negligence by posting signs or handing out receipts. [Citations] The statements on the film box and claim check used by Kodak and Hoosier Photo are in all respects like the printed forms of similar import which commonly appear on packages, signs, chits, tickets, tokens and receipts with which we are all bombarded daily. No one does, or can reasonably be expected, to take the time to carefully read the front, back, and sides of such things. We all know their gist anyway.

The distinguished trial judge below characterizes these statements before us as "mere notices" and concludes that plaintiff below did not "assent" to them so as to render them a binding part of the bailment contract. Implicit here is the recognition of the exception to the general rule regarding such notices, namely, that they may attain the dignity of a special contract limiting liability where the bailor overtly assents to their terms. [Citations] To assent to provisions of this sort requires more than simply placing the goods into the hands of the bailee and taking back a receipt or claim check. Such acts are as probative of ignorance as they are of



knowledge. However, according to the agreed statement of facts, plaintiff Carr “knew” by past experience that the claim checks carried the limitation of liability statements, but he did not read them and was unaware of the specific language in them. There is nothing in this agreed statement that Carr recalled this knowledge to present consciousness at the time of these transactions. Obviously we all know many things which we do not recall or remember at any given time. The assent required by law is more than this; it is, I believe, to perform an act of understanding. There is no evidence of that here.

The evidence presented tending to support the award of damages included an actual uncontroverted amount of \$13.60 thereby precluding mere nominal damages. There was further evidence that 150 exposures were lost. The actual award of \$1,014.60 amounted to between \$6.00 and \$7.00 per picture. Carr provided evidence that the pictures were of exceptional value to him, having been taken in a once-in-a-lifetime European trip costing \$6000 [about \$33,000 in 2110 dollars], including visits arranged there before hand with relatives. The award was fair and just compensation for the loss of value to the owner and does not include sentimental or fanciful value.

The trial court judgment should be affirmed.

### CASE QUESTIONS

1. Four out of eighteen rolls of film were not returned to the bailor, Mr. Carr. The court here affirmed a judgment for about \$6 per lost image. How could an image taken by an amateur photographer be worth \$6 a piece?
2. The European trip cost him \$6,000 in 1970; he asked for \$10,000 (about \$55,000 in 2010 dollars). Upon what basis could such damages be arrived? What did he apparently want?
3. What argument did the plaintiff make as to why the limitation of liability should not be enforced? What response did the court have to that?
4. Would it have made a difference if the plaintiff were not himself a business attorney? Why or why not?
5. Why did the dissent think the court of appeals’ decision to award the plaintiff \$1,000 was correct and the majority’s opinion incorrect?

### Bailed Goods of Sentimental Value

Mieske v. Bartell Drug Co.

593 P.2d 1308 (Wash. 1979)

Brachtenbach, J.

This case determines the measure of damages for personal property, developed movie film, which is destroyed, and which cannot be replaced or reproduced. It also decides the legal effect of a clause which purports to limit the responsibility of a film processor to replacement of film....

The facts are that over a period of years the plaintiffs had taken movie films of their family activities. The films started with the plaintiffs' wedding and honeymoon and continued through vacations in Mexico, Hawaii and other places, Christmas gatherings, birthdays, Little League participation by their son, family pets, building of their home and irreplaceable pictures of members of their family, such as the husband's brother, who are now deceased.

Plaintiffs had 32 50-foot reels of such developed film which they wanted spliced together into four reels for convenience of viewing. Plaintiff wife visited defendant Bartell's camera department, with which she had dealt as a customer for at least 10 years. She was told that such service could be performed.

The films were put in the order which plaintiffs desired them to be spliced and so marked. They were then placed in four separate paper bags which in turn were placed in one large bag and delivered to the manager of Bartell. The plaintiff wife explained the desired service and the manner in which the films were assembled in the various bags. The manager placed a film processing packet on the bag and gave plaintiff wife a receipt which contained this language: "We assume no responsibility beyond retail cost of film unless otherwise agreed to in writing." There was no discussion about the language on the receipt. Rather, plaintiff wife told the manager, "Don't lose these. They are my life."

Bartell sent the film package to defendant GAF Corporation, which intended to send them to another processing lab for splicing. Plaintiffs assumed that Bartell did this service and were unaware of the involvement of two other firms.

The bag of films arrived at the processing lab of GAF. The manager of the GAF lab described the service ordered and the packaging as very unusual. Yet it is undisputed that the film was in the GAF lab at the end of one day and gone the next morning. The manager immediately searched the garbage disposal dumpster which already had been emptied. The best guess is that the plaintiffs' film went from GAF's

lab to the garbage dumpster to a truck to a barge to an up-Sound landfill where it may yet repose.

After several inquiries to Bartell, plaintiff wife was advised to call GAF. Not surprisingly, after being advised of the complete absence and apparent fatality of plaintiffs' films, this lawsuit ensued....

Two main issues are raised: (1) the measure of damages and (2) the effect of the exclusionary clause appearing on the film receipt.

On damages, the defendants assign error to (a) the court's damages instruction and (b) the court's failure to give their proposed damages instruction.

The standard of recovery for destruction of personal property was summarized in [McCurdy]. We recognized in McCurdy that (1) personal property which is destroyed may have a market value, in which case that market value is the measure of damages; (2) if destroyed property has no market value but can be replaced or reproduced, then the measure is the cost of replacement or reproduction; (3) if the destroyed property has no market value and cannot be replaced or reproduced, then the value to the owner is to be the proper measure of damages. However, while not stated in McCurdy, we have held that in the third McCurdy situation, damages are not recoverable for the sentimental value which the owner places on the property. [Citations]

The defendants argue that plaintiffs' property comes within the second rule of McCurdy, i.e., the film could be replaced and that their liability is limited to the cost of replacement film. Their position is not well taken. Defendants' proposal would award the plaintiffs the cost of acquiring film without pictures imposed thereon. That is not what plaintiffs lost. Plaintiffs lost not merely film able to capture images by exposure but rather film upon which was recorded a multitude of frames depicting many significant events in their lives. Awarding plaintiffs the funds to purchase 32 rolls of blank film is hardly a replacement of the 32 rolls of images which they had recorded over the years. Therefore the third rule of McCurdy is the appropriate measure of damages, i.e., the property has no market value and cannot be replaced or reproduced.

The law, in those circumstances, decrees that the measure of damages is to be determined by the value to the owner, often referred to as the intrinsic value of the property. Restatement of Torts s. 911 (1939).

Necessarily the measure of damages in these circumstances is the most imprecise of the three categories. Yet difficulty of assessment is not cause to deny damages to a plaintiff whose property has no market value and cannot be replaced or reproduced. [Citations]

The fact that damages are difficult to ascertain and measure does not diminish the loss to the person whose property has been destroyed. Indeed, the very statement of the rule suggests the opposite. If one's destroyed property has a market value, presumably its equivalent is available on the market and the owner can acquire that equivalent property. However, if the owner cannot acquire the property in the market or by replacement or reproduction, then he simply cannot be made whole.

The problem is to establish the value to the owner. Market and replacement values are relatively ascertainable by appropriate proof. Recognizing that value to the owner encompasses a subjective element, the rule has been established that compensation for sentimental or fanciful values will not be allowed. [Citations] That restriction was placed upon the jury in this case by the court's damages instruction....

Under these rules, the court's damages instruction was correct. In essence it allowed recovery for the actual or intrinsic value to the plaintiffs but denied recovery for any unusual sentimental value of the film to the plaintiffs or a fanciful price which plaintiffs, for their own special reasons, might place thereon....

The next issue is to determine the legal effect of the exclusionary clause which was on the film receipt given plaintiff wife by Bartell. As noted above, it read: "We assume no responsibility beyond retail cost of film unless otherwise agreed to in writing."

Is the exclusionary clause valid? Defendants rely upon 2-719(3), a section of the Uniform Commercial Code, which authorizes a limitation or exclusion of consequential damages unless the limitation is unconscionable.

Plaintiffs, on the other hand, argue that the Uniform Commercial Code is not applicable to this transaction....It is now clearly established that the reach of Article 2 goes considerably beyond the confines of that type transaction which the Code itself defines to be a "sale"; namely, the passing of title from a party called the seller to one denominated a buyer for a price. Chief opportunity for this expansion is found in Section 2-102, which states that the article applies to "transactions in goods." "Article 2 sections are finding their way into more and more decisions involving transactions which are not sales, but which are used as substitutes for a

sale or which to a court appear to have attributes to which sales principles or at least some of them seem appropriate for application....Most important of these is the application of the Article's warranty provisions to leases, bailments, or construction contracts. Of growing importance is the tendency of courts to find the Section on unconscionability, Section 2-302, appropriate to nonsales deals."

Application of the Uniform Commercial Code to this transaction leads to defendants' next two contentions. First, they urge that the code's recognition of course of dealings and trade usage validates the exclusionary clause. Second, defendants assign error to the grounds upon which the court found the clause to be unconscionable and therefore invalid.

Defendants contend that it is the uniform trade practice of film processors to impose an exclusionary clause similar to that contained in Bartell's film receipt. However, the existence of a trade usage is to be established as a fact [Citation]. It was proved as a usage among film processors, but not as between commercial film processors and their retail customers....Consequently, defendants' reliance on trade usage to uphold the exclusionary clause is not well founded.

As to course of dealings, the record is clear that Mrs. Mieske and the Bartell manager never discussed the exclusionary clause. Mrs. Mieske had never read it, she viewed the numbered slip as merely a receipt. The manager was not "too clear on what it said." There was no showing what was the language on any other receipt given in prior dealings between the parties. In summary, defendants' proof fell short of that required by the express language of 1-205(3). Defendants contend we should apply a course of dealing standard as a matter of law, but cite no authority for such proposition. We decline the invitation.

Defendants next assert that the trial court held the exclusionary clause to be unconscionable without considering the rules laid down in *Schroeder v. Fageol Motors, Inc.*, 544 P.2d 20 (1975). In *Schroeder*, we recognized that the term unconscionable is not defined in the Uniform Commercial Code. We acknowledge that the code mandates the court to determine unconscionability as a matter of law, 2-302(1). *Schroeder* held that numerous factors enter into a determination of unconscionability. No one element is controlling. The court must examine all the circumstances surrounding the transaction, including conspicuousness of the clause, prior course of dealings between the parties, negotiations about the clause, the commercial setting and usage of the trade. Not each element will be applicable factually to every transaction....

The real question is whether the court considered the necessary elements of *Schroeder*. A review of the record convinces us that it did. The court had the facts,

the Schroeder case was argued, the criteria set forth therein were discussed by defendants' counsel both on objections and on exceptions. There was no error. Judgment affirmed.

### CASE QUESTIONS

1. This case presents pretty much the same fact situation as the previous one, but it comes out the other way. Why? What's the difference?
2. The court said there could be "recovery for the actual or intrinsic value to the plaintiffs but [not for] for any unusual sentimental value of the film to the plaintiffs or a fanciful price which plaintiffs, for their own special reasons, might place thereon." What actual value does a role of film have if not sentimental value, and if the court were not concerned about the sentimental value, why did it mention all the irreplaceable memories recorded on the film—what difference would it make what was on the film if it had an ascertainable "actual value"?
3. Determining that this bailment was governed by the UCC opened up three lines of argument for the defendant. What were they?
4. Why did the court here say the disclaimer was unconscionable?

### Liability of Carrier; Limitations on Liability

Calvin Klein Ltd. v. Trylon Trucking Corp.

892 F.2d 191C.A.2 (N.Y. 1989)

Miner, J.

Defendant-appellant Trylon Trucking Corp. ("Trylon") appeals from a judgment...in favor of plaintiff-appellee Calvin Klein Ltd. ("Calvin Klein") for the full value of a lost shipment of clothing. The appeal presents a novel issue under New York law: whether a limitation of liability agreement between a shipper and a carrier is enforceable when the shipment is lost as a result of the carrier's gross negligence.

The district court held that the parties' customary limitation of liability agreement did not extend to the shipment at issue, due to the absence of assent and consideration. The court observed that, had there been such an agreement, the liability of the carrier for its gross negligence would be limited. For the reasons that follow, we reverse the judgment of the district court, find that the parties agreed to

the limitation of liability, and determine that the agreement limits Trylon's liability for its gross negligence....

Trylon is a New Jersey trucking firm which engaged in the business of transporting goods from New York City's airports for delivery to its customers' facilities. Calvin Klein, a New York clothing company, had used the services of Trylon for at least three years, involving hundreds of shipments, prior to the lost shipment at issue. In past deliveries Calvin Klein, through its customs broker, would contact Trylon to pick up the shipment from the airport for delivery to Calvin Klein's facility. After completing the carriage, Trylon would forward to Calvin Klein an invoice, which contained a limitation of liability provision as follows:

In consideration of the rate charged, the shipper agrees that the carrier shall not be liable for more than \$50.00 on any shipment accepted for delivery to one consignee unless a greater value is declared, in writing, upon receipt at time of shipment and charge for such greater value paid, or agreed to be paid, by the shipper.

A shipment of 2,833 blouses from Hong Kong arrived at John F. Kennedy International Airport for Calvin Klein on March 27, 1986. Calvin Klein arranged for Trylon to pick up the shipment and deliver it to Calvin Klein's New Jersey warehouse. On April 2, Trylon dispatched its driver, Jamahl Jefferson, to pick up this shipment. Jefferson signed a receipt for the shipment from Calvin Klein's broker. By April 2, the parties discovered that Jefferson had stolen Trylon's truck and its shipment. The shipment never was recovered. Calvin Klein sent a claim letter to Trylon for the full value of the lost blouses. In the absence of any response by Trylon, Calvin Klein filed this action...to recover \$150,000, allegedly the value of the lost shipment....

In their stipulation in lieu of a jury trial, the parties agreed that Trylon is liable to Calvin Klein for the loss of the shipment and that Trylon was grossly negligent in the hiring and supervision of Jefferson. They also agreed that "[t]he terms and conditions of [Trylon]'s carriage [were] that liability for loss or damage to cargo is limited to \$50 in accordance with the legend on Trylon's invoice forms." Calvin Klein conceded that it was aware of this limitation of liability, and that it did not declare a value on the blouses at the time of shipment.

The parties left at issue whether the limitation of liability clause was valid and enforceable. Calvin Klein argued in the district court, as it does here, that the limitation clause was not enforceable for two reasons: no agreement existed between Calvin Klein and Trylon as to the limitation of liability; and, if such an agreement existed, public policy would prevent its enforcement because of Trylon's gross negligence.

The district court applied New York law, finding that the carriage was exempt from the Interstate Commerce Commission's jurisdiction, being entirely within the New York City commercial zone....

A common carrier...under New York law is strictly liable for the loss of goods in its custody. "Where the loss is not due to the excepted causes [that is, act of God or public enemy, inherent nature of goods, or shipper's fault], it is immaterial whether the carrier was negligent or not...." [Citations] Even in the case of loss from theft by third parties, liability may be imposed up on a negligent common carrier. [Citation]

A shipper and a common carrier may contract to limit the carrier's liability in cases of loss to an amount agreed to by the parties [Citations], so long as the language of the limitation is clear, the shipper is aware of the terms of the limitation, and the shipper can change the terms by indicating the true value of the goods being shipped. [Citations]...(similar scheme under Interstate Commerce Act). Such a limitation agreement is generally valid and enforceable despite carrier negligence. The limitation of liability provision involved here clearly provides that, at the time of delivery, the shipper may increase the limitation by written notice of the value of the goods to be delivered and by payment of a commensurately higher fee.

The parties stipulated to the fact that the \$50 limitation of liability was a term and condition of carriage and that Calvin Klein was aware of that limitation. This stipulated fact removes the first issue, namely whether an agreement existed as to a liability limitation between the parties, from this case. Calvin Klein's argument that it never previously acknowledged this limitation by accepting only \$50 in settlement of a larger loss does not alter this explicit stipulation. "[A] stipulation of fact that is fairly entered into is controlling on the parties and the court is bound to enforce it." [Citations] Neither party here has argued that the stipulation was unfairly entered into....

The remaining issue concerns the enforceability of the limitation clause in light of Trylon's conceded gross negligence. The district court considered that, assuming an agreement between the parties as to Trylon's liability, Trylon's gross negligence would not avoid the enforcement of a limitation clause.

The district court found that New York law, as opposed to federal interstate commerce law, applies in this case. The parties do not seriously contest this choice of law. With the choice thus unchallenged, we must apply both established New York law as well as our belief of how the New York Court of Appeals would rule if this case were before it....



Although the New York Court of Appeals has addressed a limitation of liability provision in the context of a contract between an airline and a passenger, [Citation] (refusing to enforce unilateral limitation provision for death of passenger due to defendant's negligence), that court has never been called upon to enforce a limitation provision in the case of a grossly negligent common carrier of goods. The various departments of the Appellate Division of the New York State Supreme Court have addressed whether gross negligence bars enforcement of limitations of liability in the context of contracts for the installation, maintenance and monitoring of burglar alarm systems and are divided on the issue. Compare [Citation] (enforcing limitation despite gross negligence) and [Citation] (even if gross negligence were established, plaintiff's recovery would be limited by limitation clause) with [Citation] (limitation clause cannot limit liability for gross negligence) and [Citation] (finding "no significant distinction" between complete exculpation and limitation "to a nominal sum," therefore limitation is ineffective). The First Department distinguished between exculpatory provisions and limitation provisions, indicating that the latter would be effective even if the former are unenforceable due to the contracting party's gross negligence. [Citations]....The other departments which have considered the question applied the holding of [Citation], that "[a]greements which purport to exempt a party from liability for willful or grossly negligent acts are contrary to public policy and are void."...

Absent a rule of decision formulated by the New York Court of Appeals, we are not bound by the opinions issued by the state's lower courts....

In the absence of direct New York authority, we must make our best estimate as to how New York's highest court would rule in this case. In making that determination, we are free to consider all the resources the highest court of the state could use, including decisions reached in other jurisdictions....We believe that the New York Court of Appeals would not differentiate between gross negligence and ordinary negligence in recognizing the validity of the limitation of liability in this case.

Since carriers are strictly liable for loss of shipments in their custody and are insurers of these goods, the degree of carrier negligence is immaterial. [Citation] The common carrier must exercise reasonable care in relation to the shipment in its custody. U.C.C. § 7-309(1). Carriers can contract with their shipping customers on the amount of liability each party will bear for the loss of a shipment, regardless of the degree of carrier negligence. See U.C.C. § 7-309(2) (allowing limitation of liability for losses from any cause save carrier conversion). Unlike the parachute school student, see [Citation], or the merchant acquiring a burglar alarm, the shipper can calculate the specific amount of its potential damages in advance, declare the value of the shipment based on that calculation, and pay a

commensurately higher rate to carry the goods, in effect buying additional insurance from the common carrier.

In this case, Calvin Klein and Trylon were business entities with an on-going commercial relationship involving numerous carriages of Calvin Klein's goods by Trylon. Where such entities deal with each other in a commercial setting, and no special relationship exists between the parties, clear limitations between them will be enforced. [Citation]. Here, each carriage was under the same terms and conditions as the last, including a limitation of Trylon's liability. See [Citation] (court enforced limitation on shipper who possessed over five years of the carrier's manifests which included the \$50 limitation). This is not a case in which the shipper was dealing with the common carrier for the first time or contracting under new or changed terms. Calvin Klein was aware of the terms and was free to adjust the limitation upon a written declaration of the value of a given shipment, but failed to do so with the shipment at issue here. Since Calvin Klein failed to adjust the limitation, the limitation applies here, and no public policy that dictates otherwise can be identified.

Calvin Klein now argues that the limitation is so low as to be void....This amount is immaterial because Calvin Klein had the opportunity to negotiate the amount of coverage by declaring the value of the shipment....Commercial entities can easily negotiate the degree of risk each party will bear and which party will bear the cost of insurance. That this dispute actually involves who will bear the cost of insurance is illustrated by the fact that this case has been litigated not by the principal parties, but by their insurers. Calvin Klein could have increased Trylon's coverage by declaring the value of its shipment, but did not do so. Calvin Klein had the opportunity to declare a higher value and we find all of its arguments relating to the unreasonableness of the limitation to be without merit.

We reverse and remand to the district court with instructions to enter judgment against defendant in the sum of \$50.

### CASE QUESTIONS

1. Why is the federal court here trying to figure out what the New York high court would do if it had this case in front of it?
2. Did the federal court find direct New York State law to apply?
3. What is the legal issue here?
4. What argument did Calvin Klein make as to why the \$50 limitation should not be valid?
5. The common-law rule was that carriers were strictly liable. Why didn't the court apply that rule?
6. Would this case have come out differently if the shipper (a) were an unsophisticated in matters of relevant business or (b) if it had never done business with Trylon before?

## **21.6 Summary and Exercises**

## Summary

Ownership and sale of goods are not the only important legal relationships involving goods. In a modern economy, possession of goods is often temporarily surrendered without surrendering title. This creates a bailment, which is defined as the lawful possession of goods by one who is not the owner.

To create a bailment, the goods must be in the possession of the bailee. Possession requires physical control and intent. Whether the owner or someone else must bear a loss often hinges on whether the other person is or is not a bailee.

The bailee's liability for loss depends on the circumstances. Some courts use a straightforward standard of ordinary care. Others use a tripartite test, depending on whether the bailment was for the benefit of the owner (the standard then is gross negligence), for the bailee (extraordinary care), or for both (ordinary care). Bailees may disclaim liability unless they have failed to give adequate notice or unless public policy prohibits disclaimers. A bailee who converts the property will be held liable as an insurer.

A bailor may have liability toward the bailee—for example, for negligent failure to warn of hazards in the bailed property and for strict liability if the injury was caused by a dangerous object in a defective condition.

Special bailments arise in the cases of innkeepers (who have an insurer's liability toward their guests, although many state statutes provide exceptions to this general rule), warehouses, carriers, and leases.

A warehouse is defined as a person engaged in the business of storing goods for hire. The general standard of care is the same as that of ordinary negligence. Many states have statutes imposing a higher standard.

A common carrier—one who holds himself out to all for hire to transport goods—has an insurer's liability toward the goods in his possession, with five exceptions: act of God, act of public enemy, act of public authority, negligence of shipper, and inherent nature of the goods. Because many carriers are involved in most commercial shipments of goods, the law places liability on the initial carrier. The carrier's liability begins once the shipper has given all instructions and taken all action required of it. The carrier's absolute liability ends when it has delivered the goods to the consignee's place of business or residence (unless the agreement states otherwise) or, if no delivery is required, when the consignee has been notified of the arrival of the goods and has had a reasonable opportunity to take possession.

Commodity paper—any document of title—may be negotiated; that is, through proper indorsements on the paper, title may be transferred without physically touching the goods. A duly negotiated document gives the holder title to the document and to the goods, certain rights to the goods delivered to the bailee after the

document was issued, and the right to take possession free of any defense or claim by the issuer of the document of title. Certain rules limit the seemingly absolute right of the holder to take title better than that held by the transferor.

## EXERCISES

1. Joe Andrews delivered his quarter horse I'll Call Ya (worth about \$319,000 in 2010 dollars) to Harold Stone for boarding and stabling. Later he asked Stone if Stone could arrange for the horse's transportation some distance, and Stone engaged the services of the Allen brothers for that purpose. Andrews did not know the Allens, but Stone had previously done business with them. On the highway the trailer with I'll Call Ya in it became disengaged from the Allens' truck and rolled over. The mare, severely injured, "apparently lingered for several hours on the side of the road before she died without veterinary treatment." The evidence was that the Allens had properly secured the horse's head at the front of the trailer and used all other equipment that a reasonably prudent person would use to secure and haul the horse; that the ball was the proper size and in good condition; that the ball was used without incident to haul other trailers after the accident; that Ronny Allen was driving at a safe speed and in a safe manner immediately before the accident; that after the accident the sleeve of the trailer hitch was still in the secured position; and that they made a reasonable effort to obtain veterinary treatment for the animal after the accident. The court determined this was a mutual-benefit bailment. Are the Allens liable? *Andrews v. Allen*, 724 S.W.2d 893 (Tex. Ct. App., 1987).
2. Fisher Corporation, a manufacturer of electronic equipment, delivered VCRs to Consolidated Freightways' warehouse in California for shipment to World Radio Inc., an electronics retailer in Council Bluffs, Iowa. World Radio rejected the shipments as duplicative, and they were returned to Consolidated's terminal in Sarpy County, Nebraska, pending Fisher's instructions. The VCRs were loaded onto a trailer; the doors of the trailer were sealed but not padlocked, and the trailer was parked at the south end of the terminal. Padlocks were not used on any trailers so as not to call attention to a trailer containing expensive cargo. The doors of the trailer faced away from the terminal toward a cyclone fence that encircled the yard. Two weeks later, on Sunday, July 15, a supervisor checked the grounds and found nothing amiss. On Tuesday, July 17, Consolidated's employees discovered a 3 × 5 foot hole had been cut in the fence near the trailer, and half the VCRs were gone; they were never recovered. Consolidated received Fisher's return authorization after the theft occurred. If Consolidated is considered a carrier, it would be strictly liable for the loss; if it is considered a bailee, it is not liable unless negligent. Which is it?
3. Plaintiff purchased a Greyhound bus ticket in St. Petersburg, Florida, for a trip to Fort Meyers. The bus left at 11:30 p.m. and arrived at 4:15 a.m. When Plaintiff got off the bus, she noticed that the station and

restrooms were darkened, closed, and locked. She left the terminal to cross at a lighted service station to use the bathroom. As she walked away from the terminal, she was attacked by an unknown person and injured. The terminal was located in a high-crime area of Fort Meyers. Is Greyhound liable?

4. Mrs. Carter, Plaintiff, took her fur coat to Reichlin Furriers for cleaning, glazing, and storage until the next winter season. She was given a printed receipt form on the front of which Furrier's employee had written "\$100" as the coat's value, though Mrs. Carter did not discuss its value with the employee, did not know that such a value had been noted, and didn't read the receipt. A space for the customer's signature on the front of the receipt was blank; below this in prominent type was this notice: "see reverse side for terms and conditions." On the back was a statement that this was a storage contract and the customer would be bound by the terms unless contrary notice was given within ten days. There were fifteen conditions, one of which was the following: "Storage charges are based upon valuation herein declared by the depositor and amount recoverable for loss or damage shall not exceed...the depositor's valuation appearing in this receipt." Six months later, when Mrs. Carter sought to retrieve her coat, she was informed by Furrier that it was lost. Carter sued Furrier for \$450 (about \$2,200 in 2010 dollars); Furrier claimed its liability was limited to \$100. Who wins and why?
5. Michael Capezzaro (Plaintiff) reported to the police that he had been robbed of \$30,000 (in 2010 dollars) at gunpoint by a woman. The next day police arrested a woman with \$9,800 in her possession. Plaintiff identified her as the woman who had robbed him, and the money was impounded as evidence. Two years later the case against her was dismissed because she was determined to have been insane when she committed the crime, and the money in the police property room was released to her. Plaintiff then sued the police department, which claimed it was "obligated to return the money to [the woman] as bailor." Who wins and why?
6. Harley Hightower delivered his Cadillac to Auto Auction, where it was damaged. Auto Auction defended itself against Hightower's claim that it was a negligent bailee by asserting (1) that he had not met the required burden of proof that a proximate cause of the injury was Auto Auction's negligence because it introduced evidence that negligence of a third party was a proximate cause of the damage to his car and (2) that it was entitled to judgment in the absence of evidence of specific acts of negligence of the bailee. There was evidence that a Mrs. Tune drove her automobile onto the lot to sell it and parked it where she was directed to; that the automobiles on said lot for sale were ordinarily lined up and numbered by Auto Auction; that Plaintiff's Cadillac was not so parked by



the auction company but was parked so that if Mrs. Tune's automobile continued forward it would strike Hightower's Cadillac broadside; that when Mrs. Tune stopped her Buick and alighted, her car rolled down the incline on the lot toward Hightower's car; that she attempted to stop her car but it knocked her down and continued rolling toward appellee's Cadillac and, finally, struck and damaged it. Who wins and why?

7. Several student radicals led by Richard Doctor, ranked number three on the FBI's Ten Most Wanted list, destroyed a shipment of military cargo en route from Colorado to a military shipping facility in Washington State. Should the carrier be liable for the loss?
8. Everlena Mitchell contracted in writing with All American Van & Storage to transport and store her household goods and furnishings, and she was to pay all charges incurred on a monthly basis. As security she granted All American a warehouse's lien giving it the right to sell the property if the charges remained unpaid for three months and if, in the opinion of the company, such action would be necessary to protect accrued charges. Everlena fell eight months in arrears and on October 20 she received notice that the amount owed was to be paid by October 31, 1975. The notice also stated that if payment was not made, her goods and furnishings would be sold on November 7, 1975. Everlena had a pending claim with the Social Security Administration, and advised All American that she would be receiving a substantial sum of money soon from the Social Services Administration; this was confirmed by two government agents. However, All American would not postpone the sale. Everlena's property was sold on November 7, 1975, for \$925.50. Near the end of November 1975, Everlena received approximately \$5,500 (about \$22,000 in 2010 dollars) from the United States as a disability payment under the Social Security Act, and she sued All American for improperly selling her goods. The trial court ruled for All American on summary judgment. What result should Everlena obtain on appeal?
9. Roland delivered a shipment of desks to Security Warehouse and received from Security a negotiable receipt. Peter broke into Roland's office, stole the document, and forged Roland's signature as an indorsement, making Peter himself the holder. Peter then indorsed the document over to Billings, who knew nothing of the theft. Does Billings get good title to the desks?
10. Baker's Transfer & Storage Company, Defendant, hauled household goods and personal effects by trucks "anywhere for hire." Its trucks did not travel on regular routes or between established terminals; it hauled household goods and personal effects on private contracts with the owners as and when the opportunity presented itself. Baker contracted to haul the Klein family's household goods from Bakersfield, California, to Hollywood. En route the goods were destroyed by fire without Baker's

negligence. Baker's contract provided it would redeliver the property "damage by the elements excepted." If Baker were a common carrier, its liability would be statutorily limited to less than the amount ordered by the trial court; if it were a private carrier, its liability would be either based on ordinary negligence or as the parties' contract provided. Working with both points, what result obtains here?

## SELF-TEST QUESTIONS

1. In a bailment, the bailee
  - a. must return similar goods
  - b. must return identical goods
  - c. acquires title to the goods
  - d. must pay for the goods
  
2. In a bailment for the benefit of a bailee, the bailee's duty of care is
  - a. slight
  - b. extraordinary
  - c. ordinary
  
3. A disclaimer of liability by a bailee is
  - a. never allowed
  - b. sometimes allowed
  - c. always allowed
  - d. unheard of in business
  
4. A bailor may be held liable to the bailee on
  - a. a negligence theory
  - b. a warranty theory
  - c. a strict liability theory
  - d. all of the above
  
5. The highest duty of care is imposed on which of the following?
  - a. a common carrier
  - b. a lessee
  - c. a warehouseman
  - d. an innkeeper

**SELF-TEST ANSWERS**

1. b
2. b
3. b
4. d
5. a

## Chapter 22

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### Nature and Form of Commercial Paper

#### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. Why commercial paper is important in modern economic systems
2. How the law of commercial paper has developed over the past four hundred years, and what role it plays in economics and finance
3. What the types of commercial paper are, and who the parties to such paper are
4. What is required for paper to be negotiable

Here we begin our examination of commercial paper, documents representing an obligation by one party to pay another money. You are familiar with one kind of commercial paper: a check.

## 22.1 Introduction to Commercial Paper

### LEARNING OBJECTIVES

1. Understand why commercial paper is an important concept in modern finance.
2. Be familiar with the historical development of commercial paper.
3. Recognize how commercial paper is viewed in economics and finance.

### The Importance of Commercial Paper

Because commercial paper is a vital invention for the working of our economic system, brief attention to its history and its function as a medium of exchange in economics and finance is appropriate.

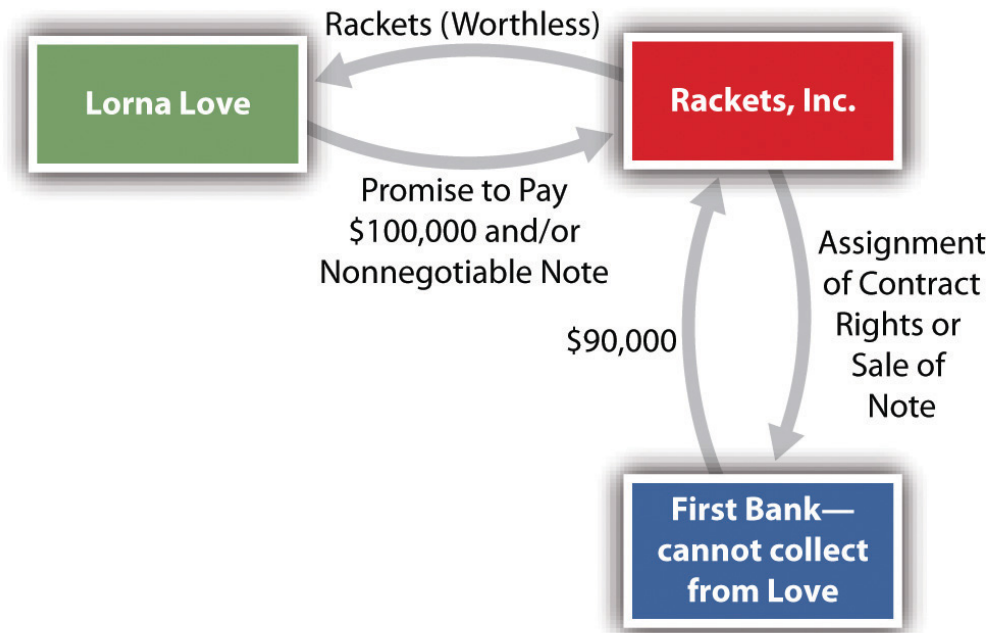
### The Central Role of Commercial Paper

Commercial paper is the collective term for various financial instruments, or tools, that include checks drawn on commercial banks, drafts (drawn on something other than a bank), certificates of deposit, and notes evidencing a promise to pay. Like money, commercial paper is a medium of exchange, but because it is one step removed from money, difficulties arise that require a series of interlocking rules to protect both sellers and buyers.

To understand the importance of commercial paper, consider the following example. It illustrates a distinction that is critical to the discussion in our four chapters on commercial paper.

Lorna Love runs a tennis club. She orders a truckload of new tennis rackets from Rackets, Inc., a manufacturer. The contract price of the rackets is \$100,000. Rackets ships the rackets to Love. Rackets then sells for \$90,000 its contract rights (rights to receive the payment from Love of \$100,000) to First Bank (see [Figure 22.1 "Assignment of Contract Rights"](#)). Unfortunately, the rackets that arrive at Love's are warped and thus commercially worthless. Rackets files for bankruptcy.

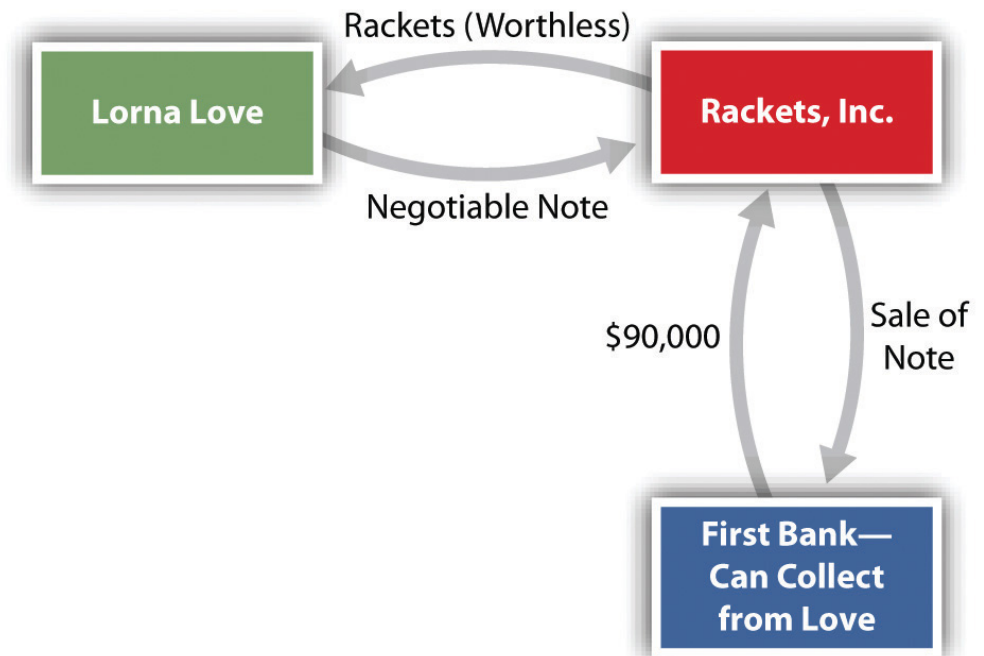
Figure 22.1 *Assignment of Contract Rights*



May the bank collect from Love \$100,000, the value of the contract rights it purchased? No. Under the contract rule discussed in [Chapter 14 "Third-Party Rights"](#), an assignee—here, the bank—steps into the shoes of the assignor and takes the assigned rights subject to any defense of the obligor, Love. (Here, of course, Love’s defense against paying is that the rackets are worthless.) The result would be the same if Love had given Rackets a nonnegotiable note, which Rackets proceeded to sell to the bank. (By nonnegotiable we do not mean that the note cannot be sold but only that certain legal requirements, discussed in [Section 22.3 "Requirements for Negotiability"](#) of this chapter, have not been met.)

Now let us add one fact: In addition to signing a contract, Love gives Rackets a *negotiable* note in exchange for the rackets, and Rackets sells the note to the bank. By adding that the note is negotiable, the result changes significantly. Because the note is negotiable and because the bank, we assume, bought the note in good faith (i.e., unaware that the rackets were warped), the bank will recover the \$100,000 (see [Figure 22.2 "Sale of Negotiable Note"](#)).

Figure 22.2 Sale of Negotiable Note



The key to the central role that commercial paper plays in modern finance is **negotiability**<sup>1</sup>. *Negotiability* means that the paper is freely and unconditionally transferable from one person to another by delivery or by delivery and indorsement. (“Indorsement,” not “endorsement,” is the spelling used in the UCC, though the latter is more common in nonlegal usage.) Without the ability to pay and finance through commercial paper, the business world would be paralyzed. At bottom, negotiability is the means by which a person is empowered to transfer to another more than what the transferor himself possesses. In essence, this is the power to convey to a transferee the right in turn to convey clear title, when the original transferor does not have clear title.

### Overview of Chapters on Commercial Paper

In this chapter, we examine the history and nature of commercial paper and define the types of parties (persons who have an interest in the paper) and the types of instruments. We then proceed to four fundamental issues that must be addressed to determine whether parties such as First Bank, in the preceding example, can collect:

1. Transferable from one person to another by delivery or by delivery and indorsement.

1. Is the paper negotiable? That is, is the paper in the proper form? We explore that issue in this chapter.



2. Was the paper negotiated properly? See [Chapter 23 "Negotiation of Commercial Paper"](#).
3. Is the purchaser of the paper a holder in due course? See [Chapter 24 "Holder in Due Course and Defenses"](#).
4. Does the maker of the paper have available any defenses against even the holder in due course? See [Chapter 24 "Holder in Due Course and Defenses"](#).

In most transactions, especially when the first three questions are answered affirmatively, the purchaser will have little trouble collecting. But when the purchaser is unable to collect, questions of liability arise. These questions, along with termination of liability, are discussed in [Chapter 25 "Liability and Discharge"](#).

Finally, in [Chapter 26 "Legal Aspects of Banking"](#) we examine other legal aspects of banking, including letters of credit and electronic funds transfer.

## History of Commercial Paper

### Development of the Law

Negotiable instruments are no modern invention; we know that merchants used them as long ago as the age of Hammurabi, around 1700 BC. They fell into disuse after the collapse of the Roman Empire and then reappeared in Italy around the fourteenth century. They became more common as long-distance commerce spread. In an era before paper currency, payment in coins or bullion was awkward, especially for merchants who traveled great distances across national boundaries to attend the fairs at which most economic exchanges took place. Merchants and traders found it far more efficient to pay with paper.

Bills of exchange, today commonly known as *drafts*, were recognized instruments in the law merchant. (The “law merchant” was the system of rules and customs recognized and adopted by early-modern traders and is the basis of the UCC Article 3.) A draft is an unconditional order by one person (the drawer) directing another person (drawee or payor) to pay money to a named third person or to bearer; a check is the most familiar type of draft. The international merchant courts regularly enforced drafts and permitted them to be transferred to others by indorsement (the legal spelling of *endorsement*). By the beginning of the sixteenth century, the British common-law courts began to hear cases involving bills of exchange, but it took a half century before the courts became comfortable with them and accepted them as crucial to the growing economy.

Courts were also hesitant until the end of the seventeenth century about sanctioning a transferor’s assignment of a promissory note if it meant that the

transferee would have better title than the transferor. One reason for the courts' reluctance to sanction assignments stemmed from the law that permitted debtors to be jailed, a law that was not repealed until 1870. The buyer of goods might have been willing originally to give a promissory note because he knew that a particular seller would not attempt to jail him for default, but who could be sure that a transferee, probably a complete stranger, would be so charitable?

The inability to negotiate promissory notes prevented a banking system from fully developing. During the English Civil War in the seventeenth century, merchants began to deposit cash with the goldsmiths, who lent it out at interest and issued the depositors promissory notes, the forerunner of bank notes. But a judicial decision in 1703 declared that promissory notes were not negotiable, whether they were made payable to the order of a specific person or to the bearer. Parliament responded the following year with the Promissory Notes Act, which for the first time permitted an assignee to sue the note's maker.

Thereafter the courts in both England and the United States began to shape the modern law of negotiable instruments. By the late nineteenth century, Parliament had codified the law of negotiable instruments in England. Codification came later in the United States. In 1896, the National Conference of Commissioners on Uniform State Laws proposed the Negotiable Instruments Act, which was adopted in all states by 1924. That law eventually was superseded by the adoption of Articles 3 and 4 of the Uniform Commercial Code (UCC), which we study in these chapters.

In 1990, the American Law Institute and the National Conference of Commissioners on Uniform State Laws approved revised Article 3, entitled "Negotiable Instruments," and related amendments in Article 4. The revisions clarified and updated the law. All states except New York and North Carolina have adopted Articles 3 and 4.

### **The Future of Commercial Paper: Federal and International Preemption**

State law governing commercial paper is vulnerable to federal preemption. This preemption could take two major forms. First, the Federal Reserve Board governs the activities of Federal Reserve Banks. As a result, Federal Reserve regulations provide important guidelines for the check collection process. Second, Article 3 of the UCC can be preempted by federal statutes. An important example is the Expedited Funds Availability Act, which became effective in 1988 (discussed in [Chapter 26 "Legal Aspects of Banking"](#)).

Federal preemption may also become intertwined with international law. In 1988, the United Nations General Assembly adopted the Convention on International Bills

of Exchange and International Promissory Notes. Progress on the treaty emanating from the convention has been slow, however: the United States, Canada, and Russia have approved the convention (in 1989 and 1990) but have not ratified the treaty; Gabon, Guinea, Honduras, Liberia, and Mexico are the only countries to have ratified it.

## **Commercial Paper in Economics and Finance**

### **Economics**

To the economist, one type of commercial paper—the bank check—is the primary component of M1, the basic money supply. It is easy to see why. When you deposit cash in a checking account, you may either withdraw the currency—coins and bills—or draw on the account by writing out a check. If you write a check to “cash,” withdraw currency, and pay a creditor, there has been no change in the money supply. But if you pay your creditor by check, the quantity of money has increased: the cash you deposited remains available, and your creditor deposits the check to his own account as though it were cash. (A more broadly defined money supply, M2, includes savings deposits at commercial banks.)

### **Finance**

Commercial paper is defined more narrowly in finance than in law. To the corporate treasurer and other financiers, commercial paper ordinarily means short-term promissory notes sold by finance companies and large corporations for a fixed rate of interest. Maturity dates range from a low of three days to a high of nine months. It is an easy way for issuers to raise short-term money quickly. And although short-term notes are unsecured, historically they have been almost as safe as obligations of the US government. By contrast, for legal purposes, commercial paper includes long-term notes (which are often secured), drafts, checks, and certificates of deposit.

### KEY TAKEAWAY

Commercial paper is a medium of exchange used like cash but safer than cash; cash is rarely used today except for small transactions. The key to the success of this invention is the concept of negotiability: through this process, a person can pass on—in most cases—better title to receive payment than he had; thus the transferee of such paper will most likely get paid by the obligor and will not be subject to most defenses of any prior holders. The law of commercial paper has developed over the past four hundred years. It is now the Uniform Commercial Code that governs most commercial paper transactions in the United States, but federal or international preemption is possible in the future. Commercial paper is important in both economics and finance.

### EXERCISES

1. If there were no such thing as commercial paper, real or virtual (electronic funds transfers), how would you pay your bills? How did merchants have to pay their bills four hundred years ago?
2. What is it about negotiability that it is the key to the success of commercial paper?
3. How could state law—the UCC—be preempted in regard to commercial paper?

## 22.2 Scope of Article 3 and Types of Commercial Paper and Parties

### LEARNING OBJECTIVES

1. Understand the scope of Article 3 of the Uniform Commercial Code.
2. Recognize the types of commercial paper: drafts, checks, notes, and certificates of deposit.
3. Give the names of the various parties to commercial paper.

### Scope of Article 3

Article 3 of the Uniform Commercial Code (UCC) covers commercial paper but explicitly excludes money, documents of title, and investment securities. Documents of title include bills of lading and warehouse receipts and are governed by Article 7 of the UCC. Investment securities are covered by Article 8. Instruments that fall within the scope of Article 3 may also be subject to Article 4 (bank deposits and collections), Article 8 (securities), and Article 9 (secured transactions). If so, the rules of these other articles supersede the provisions of Article 3 to the extent of conflict. Article 3 is a set of general provisions on negotiability; the other articles deal more narrowly with specific transactions or instruments.

### Types of Commercial Paper

There are four types of commercial paper: drafts, checks, notes, and certificates of deposit.

#### Drafts

A **draft**<sup>2</sup> is an unconditional written order by one person (the drawer) directing another person (the drawee) to pay a certain sum of money on demand or at a definite time to a named third person (the payee) or to bearer. The draft is one of the two basic types of commercial paper; the other is the note. As indicated by its definition, the draft is a three-party transaction.

#### Parties to a Draft

The **drawer**<sup>3</sup> is one who directs a person or an entity, usually a bank, to pay a sum of money stated in an instrument—for example, a person who makes a draft or writes a check. The drawer prepares a document (a form, usually)—the

2. A document ordering the payment of money; drawn by one person or bank on another.
3. The person who makes out (draws) a check or draft.

draft—ordering the drawee to remit a stated sum of money to the payee. The **drawee**<sup>4</sup> is the person or entity that a draft is directed to and that is ordered to pay the amount stated on it. The most common drawee is a bank. The drawer, drawee, and payee need not be different people; the same person may have different capacities in a single transaction. For example, a drawer (the person asking that payment be made) may also be the payee (the person to whom the payment is to be made). A drawee who signs the draft becomes an **acceptor**<sup>5</sup>: the drawee pledges to honor the draft as written. To accept, the drawee need only sign her name on the draft, usually vertically on the face, but anywhere will do. Words such as “accepted” or “good” are unnecessary. However, a drawee who indicates that she might refuse to pay will not be held to have accepted. Thus in the archetypal case, the court held that a drawee who signed his name and appended the words “Kiss my foot” did not accept the draft. *Norton v. Knapp*, 19 N.W. 867 (IA 1884).

The drawer directs the funds to be drawn from—pulled from—the drawee, and the drawee pays the person entitled to payment as directed.

### Types of Drafts

Drafts can be divided into two broad subcategories: sight drafts and time drafts.

A **sight draft**<sup>6</sup> calls for payment “on sight,” that is, when presented. Recall from [Section 22.1 "Introduction to Commercial Paper"](#) that Lorna Love wished to buy tennis rackets from Rackets, Inc. Suppose Love had the money to pay but did not want to do so before delivery. Rackets, on the other hand, did not want to ship before Love paid. The solution: a sight draft, drawn on Love, to which would be attached an order bill of lading that Rackets received from the trucker when it shipped the rackets. The sight draft and bill of lading go to a bank in Love’s city. When the tennis rackets arrive, the carrier notifies the bank, which presents the draft to Love for payment. When she has done so, the bank gives Love the bill of lading, entitling her to receive the shipment. The bank forwards the payment to Rackets’ bank, which credits Rackets’ account with the purchase amount.

A **time draft**<sup>7</sup>, not surprisingly, calls for payment on a date specified in the draft. Suppose that Love will not have sufficient cash to pay until she has sold the rackets but that Rackets needs to be paid immediately. The solution: a common form of time draft known as a trade acceptance. Rackets, the seller, draws a draft on Love, who thus becomes a drawee. The draft orders Love to pay the purchase price to the order of Rackets, as payee, on a fixed date. Rackets presents the draft to Love, who accepts it by signing her name. Rackets then can indorse the draft (by signing it) and sell it, at a discount, to its bank or some other financial institution. Rackets thus

4. The person (or bank) expected to pay a check or draft when it is presented for payment.

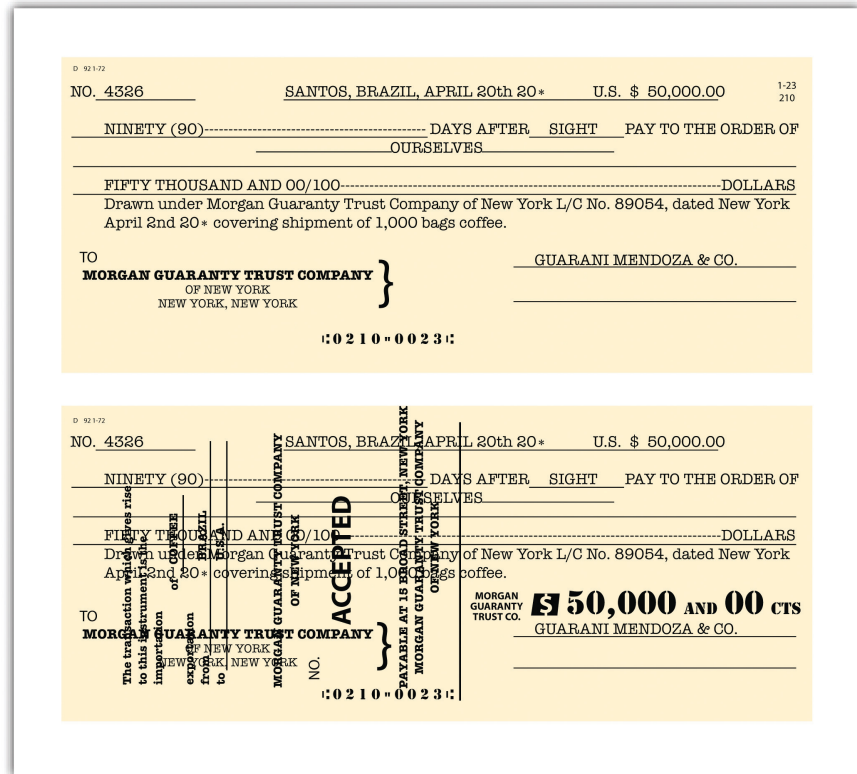
5. A drawee who accepts a draft, agreeing to be primarily responsible for paying it.

6. A draft or bill that is payable on demand or upon presentation. Also called demand draft.

7. Draft (bill of exchange) payable to a third party on a specified or determinable future date.

gets its money right away; the bank may collect from Love on the date specified. See the example of a time draft in [Figure 22.3 "A Time Draft"](#).

Figure 22.3 A Time Draft



### Drafts in International Trade

Drafts are an international convention. In England and the British Commonwealth, drafts are called bills of exchange. Like a draft, a **bill of exchange**<sup>8</sup> is a kind of check or promissory note without interest. Used primarily in international trade, it is a written order by one person to pay another a specific sum on a specific date sometime in the future. If the bill of exchange is drawn on a bank, it is called a bank draft. If it is drawn on another party, it is called a trade draft. Sometimes a bill of exchange will simply be called a draft, but whereas a draft is always negotiable (transferable by endorsement), this is not necessarily true of a bill of exchange.

- 8. A written order by one person to pay a sum of money to a third person.
- 9. A draft or bill of exchange accepted by a bank where the accepting institution guarantees payment. Used extensively in foreign trade transactions.

A widely used draft in international trade is the **banker's acceptance**<sup>9</sup>. It is a short-term credit investment created by a nonfinancial firm and guaranteed by a bank. This instrument is used when an exporter agrees to extend credit to an importer.

Assume Love, the importer, is in New York; Rackets, the exporter, is in Taiwan. Rackets is willing to permit Love to pay ninety days after shipment. Love makes a deal with her New York bank to issue Rackets' bank in Taiwan a letter of credit. This tells the seller's bank that the buyer's bank is willing to accept a draft drawn on the buyer in accordance with terms spelled out in the letter of credit. Love's bank may insist on a security interest in the tennis rackets, or it may conclude that Love is creditworthy. On receipt of the letter of credit, Rackets presents its bank in Taiwan with a draft drawn on Love's bank. That bank antes up the purchase amount (less its fees and interest), paying Rackets directly. It then forwards the draft, bill of lading, and other papers to a correspondent bank in New York, which in turn presents it to Love's bank. If the papers are in order, Love's bank will "accept" the draft (sign it). The signed draft is the banker's acceptance (see [Figure 22.3 "A Time Draft"](#)). It is returned to the bank in Taiwan, which can then discount the banker's acceptance if it wishes payment immediately or else wait the ninety days to present it to the New York bank for payment. After remitting to the Taiwanese bank, the New York bank then demands payment from Love.

### Checks

A second type of commercial paper is the common bank check, a special form of draft. Section 3-104(2)(b) of the UCC defines a **check**<sup>10</sup> as "a draft drawn on a bank and payable on demand." **Postdating**<sup>11</sup> a check (putting in a future date) does not invalidate it or change its character as payable on demand. Postdating simply changes the first time at which the payee may demand payment. Checks are, of course, usually written on paper forms, but a check can be written on anything—a door, a shirt, a rock—though certainly the would-be holder is not obligated to accept it.

Like drafts, checks may be accepted by the drawee bank. Bank acceptance of a check is called **certification**<sup>12</sup>; the check is said to be certified by stamping the word "certified" on the face of the check. When the check is certified, the bank guarantees that it will honor the check when presented. It can offer this guarantee because it removes from the drawer's account the face amount of the check and holds it for payment. The payee may demand payment from the bank but not from the drawer or any prior indorser of the check.

A certified check is distinct from a cashier's check. A **cashier's check**<sup>13</sup> is drawn on the account of the bank itself and signed by an authorized bank representative in return for a cash payment to it from the customer. The bank guarantees payment of the cashier's check also.

10. A negotiable instrument drawn against deposited funds to pay a specified amount of money to a specific person upon demand.

11. Putting a date on an instrument (e.g., a check) that is later than the actual date.

12. The acceptance by a drawee of a check or draft.

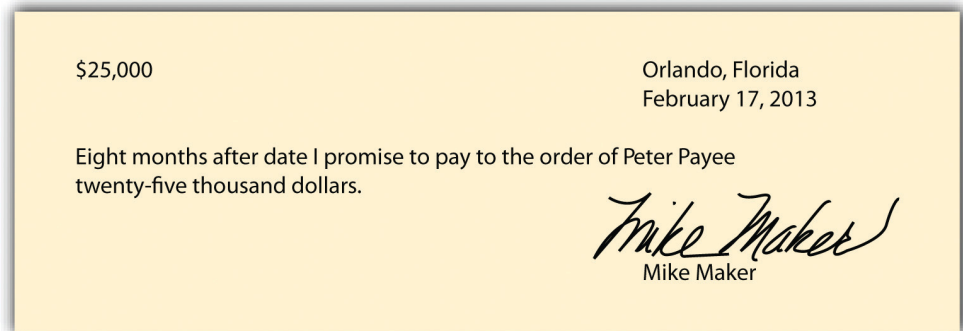
13. A check guaranteed by a bank and so as good as cash.



## Notes

A note—often called a **promissory note**<sup>14</sup>—is a written promise to pay a specified sum of money on demand or at a definite time. There are two parties to a note: the **maker**<sup>15</sup> (promisor), and the **payee**<sup>16</sup> (promisee). For an example of a promissory note, see [Figure 22.4 "A Promissory Note"](#). The maker might execute a promissory note in return for a money loan from a bank or other financial institution or in return for the opportunity to make a purchase on credit.

Figure 22.4 A Promissory Note



## Certificates of Deposit

A fourth type of commercial paper is the **certificate of deposit**<sup>17</sup>, commonly called a CD. The CD is a written acknowledgment by a bank that it has received money and agrees to repay it at a time specified in the certificate. The first negotiable CD was issued in 1961 by First National City Bank of New York (now Citibank); it was designed to compete for corporate cash that companies were investing in Treasury notes and other funds. Because CDs are negotiable, they can be traded easily if the holder wants cash, though their price fluctuates with the market.

## Other Parties to Commercial Paper

In addition to makers, drawees, and payees, there are five other capacities in which one can deal with commercial paper.

### Indorser and Indorsee

The **indorser**<sup>18</sup> (also spelled *endorser*) is one who transfers ownership of a negotiable instrument by signing it. A depositor indorses a check when presenting it for deposit by signing it on the back. The bank deposits its own funds, in the amount of the check, to the depositor's account. By indorsing it, the depositor

14. A written promise to pay or repay a specified sum of money at a stated time or on demand.

15. A party that signs a promissory note.

16. The person who is to receive payment on a draft or note.

17. A debt instrument issued by a bank; usually pays interest.

18. The person who indorses.

transfers ownership of the check to the bank. The depositor's bank then can present it to the drawer's bank for repayment from the drawer's funds. The **indorsee**<sup>19</sup> is the one to whom a draft or note is indorsed. When a check is deposited in a bank, the bank is the indorsee.

### Holder

A **holder**<sup>20</sup> is "a person in possession of a negotiable that is payable either to bearer, or to an identified person that is the person in possession." Uniform Commercial Code, Section 1-201(21). *Holder* is thus a generic term that embraces several of the specific types of parties already mentioned. An indorsee and a drawee can be holders. But a holder can also be someone unnamed whom the original parties did not contemplate by name—for example, the holder of a bearer note.

### Holder in Due Course

A **holder in due course**<sup>21</sup> is a special type of holder who, if certain requirements are met, acquires rights beyond those possessed by the transferor (we alluded to this in describing the significance of Lorna Love's making of a negotiable—as opposed to a nonnegotiable—instrument). We discuss the requirements for a holder in due course in Chapter 24 "Holder in Due Course and Defenses".

### Accommodation Party

An **accommodation party**<sup>22</sup> is one who signs a negotiable instrument in order to lend her name to another party to the instrument. It does not matter in what capacity she signs, whether as maker or comaker, drawer or codrawer, or indorser. As a signatory, an accommodation party is always a surety (Chapter 26 "Legal Aspects of Banking"; a surety is one who guarantees payment if the primarily obligated party fails to pay). The extent of the accommodation party's liability to pay depends on whether she has added language specifying her purposes in signing. Section 3-416 of the UCC distinguishes between a guaranty of payment and a guaranty of collection. An accommodation party who adds words such as "payment guaranteed" subjects herself to primary liability: she is guaranteeing that she will pay if the principal signatory fails to pay when the instrument is due. But if the accommodation party signs "collection guaranteed," the holder must first sue the maker and win a court judgment. Only if the judgment is unsatisfied can the holder seek to collect from the accommodation party. When words of guaranty do not specify the type, the law presumes a payment guaranty.

19. The person to whom a note or bill is indorsed, or assigned by indorsement.

20. One who has legal possession of a draft, note, or other negotiable instrument and who is entitled to payment.

21. Good-faith holder who has taken a negotiable instrument for value, without notice that it was overdue or had been dishonored or that there was any defense against or claim to it.

22. One who signs an instrument as drawer, indorser, or acceptor to help another raise money.

### KEY TAKEAWAY

The modern law of commercial paper is, in general, covered by UCC Article 3. The two basic types of commercial paper are drafts and notes. The note is a two-party instrument whereby one person (maker) promises to pay money to a second person (payee). The draft is a three-party instrument whereby one person (drawer) directs a second (drawee) to pay money to the third (payee). Drafts may be sight drafts, payable on sight, or they may be time drafts, payable at a date specified on the draft. Checks are drafts drawn on banks. Other parties include indorser and indorsee, holder, holder in due course, and accommodation party.

### EXERCISES

1. What are the two basic types of commercial paper?
2. What are the two types of drafts?
3. What kind of commercial paper is a check?

## 22.3 Requirements for Negotiability

### LEARNING OBJECTIVE

1. Know what is required for an instrument to be negotiable.

### Overview

Whether or not a paper is negotiable is the first of our four major questions, and it is one that nonlawyers must confront. Auditors, retailers, and financial institutions often handle notes and checks and usually must make snap judgments about negotiability. Unless the required elements of Sections 3-103 and 3-104 of the Uniform Commercial Code (UCC) are met, the paper is not negotiable. Thus the paper meets the following criteria:

1. It must be in writing.
2. It must be signed by the maker or drawer.
3. It must be an unconditional promise or order to pay.
4. It must be for a fixed amount in money.
5. It must be payable on demand or at a definite time.
6. It must be payable to order or bearer, unless it is a check.

This definition states the basic premise of a negotiable instrument: the holder must be able to ascertain all essential terms from the face of the instrument.

### Analysis of Required Elements

#### In Writing

Under UCC Section 1-201, “written” or “writing” includes “printing, typewriting or any other intentional reduction to tangible form.” That definition is broad—so broad, in fact, that from time to time the newspapers report checks written on material ranging from a girdle (an Ohio resident wanted to make his tax payment stretch) to granite. Since these are tangible materials, the checks meet the writing requirement. The writing can be made in any medium: ink, pencil, or even spray paint, as was the case with the granite check. Of course, there is a danger in using pencil or an ink that can be erased, since the drawer might be liable for alterations. For example, if you write out in pencil a check for \$10 and someone erases your figures and writes in \$250, you may lose your right to protest when the bank cashes it.

### **Signed by the Maker or Drawer**

Signature is not limited to the personal handwriting of one's name. "Any symbol executed or adopted by a party with present intention to authenticate a writing" will serve. Uniform Commercial Code, Section 1-201(39). That means that a maker or drawer may make an impression of his signature with a rubber stamp or even an X if he intends that by so doing he has signed. It can be typed or by thumbprint. In some cases, an appropriate letterhead may serve to make the note or draft negotiable without any other signature. Nor does the position of the signature matter. Blackstone Kent's handwritten note, "Ten days from this note, I, Blackstone Kent, promise to pay \$5,000 to the order of Webster Mews," is sufficient to make the note negotiable, even though there is no subsequent signature. Moreover, the signature may be in a trade name or an assumed name. (Note: special problems arise when an agent signs on behalf of a principal. We consider these problems in [Chapter 25 "Liability and Discharge"](#).)

### **Unconditional Promise or Order to Pay**

Section 3-106(a) of the UCC provides that an instrument is *not* negotiable if it "states (i) an express condition to payment, (ii) that the promise or order is subject to or governed by another writing, or (iii) that rights or obligations with respect to the promise or order are stated in another writing. A reference to another writing does not of itself make the promise or order conditional." Under 3-106(b), a promise is not made conditional by "(i) reference to another writing for a statement of rights with respect to collateral, pre-payment, or acceleration, or (ii) because payment is limited to resort to a particular fund or source." As to "reference to another writing," see *Holly Hill Acres, Ltd. v. Charter Bank of Gainesville*, in [Section 22.4 "Cases"](#).

The only permissible promise or order in a negotiable instrument is to pay a sum certain in money. Any other promise or order negates negotiability. The reason for this rule is to prevent an instrument from having an indeterminate value. The usefulness of a negotiable instrument as a substitute for money would be seriously eroded if the instrument's holder had to investigate whether a stipulation or condition had been met before the thing had any value (i.e., before the obligor's obligation to pay ripened).

### **Fixed Amount in Money**

The value of the paper must be fixed (specific) so it can be ascertained, and it must be payable in money.

### **Fixed Amount**

The instrument must recite an exact amount of money that is to be paid, although the exact amount need not be expressed in a single figure. For example, the note can state that the principal is \$1,000 and the interest is 11.5 percent, without specifying the total amount. Or the note could state the amount in installments: twelve equal installments of \$88.25. Or it could state different interest rates before and after a certain date or depending on whether or not the maker has defaulted; it could be determinable by a formula or by reference to a source described in the instrument. Uniform Commercial Code, Section 3-112(b). It could permit the maker to take a discount if he pays before a certain date or could assess a penalty if he pays after the date. It could also provide for an attorney's fees and the costs of collection on default. If it is clear that interest is to be included but no interest amount is set, UCC Section 3-112 provides that it is "payable at the judgment rate in effect at the place of payment of the instrument and at the time interest first accrues." The fundamental rule is that for any time of payment, the holder must be able to determine, after the appropriate calculations, the amount then payable. See Section 22.4 "Cases", *Centerre Bank of Branson v. Campbell*, for a case involving the "fixed amount" rule.

### **In Money**

Section 1-201(24) of the UCC defines money as "a medium of exchange authorized or adopted by a domestic or foreign government as a part of its currency." As long as the medium of exchange was such at the time the instrument was made, it is payable in money, even if the medium of exchange has been abolished at the time the instrument is due. Section 3-107 provides the following as to payment in foreign currency: "Unless the instrument otherwise provides, an instrument that states the amount payable in foreign money may be paid in the foreign money or in an equivalent amount in dollars calculated by using the current bank-offered spot rate at the place of payment for the purchase of dollars on the day on which the instrument is paid."

### **Payable on Demand or at a Definite Time**

An instrument that says it is payable on sight is payable on demand, as is one that states no time for payment. "Definite time" may be stated in several ways; it is not necessary to set out a specific date. For example, a note might say that it is payable on or before a stated date, at a fixed period after the date, at a fixed period after sight, at a definite time subject to acceleration, or at a definite time subject to extension at the option of the holder or automatically on or after the occurrence of a particular event. However, if the only time fixed is on the occurrence of a contingent event, the time is not definite, even though the event in fact has already

occurred. An example of a valid acceleration clause is the following: “At the option of the holder, this note shall become immediately due and payable in the event that the maker fails to comply with any of the promises contained in this note or to perform any other obligation of the maker to the holder.”

Is the note “Payable ten days after I give birth” negotiable? No, because the date the baby is due is uncertain. Is the note “Payable on January 1, but if the Yankees win the World Series, payable four days earlier” negotiable? Yes: this is a valid acceleration clause attached to a definite date.

One practical difference between a demand instrument and a time instrument is the date on which the statute of limitations begins to run. (A statute of limitations is a limit on the time a creditor has to file a lawsuit to collect the debt.) Section 3-118(1) of the UCC says that a lawsuit to enforce payment at a definite time “must be commenced within six years after the due date” (or the accelerated due date). For demand paper, an action must be brought “within six years after the demand.”

### **Payable to Order or Bearer**

An instrument payable to order is one that will be paid to a particular person or organization identifiable in advance. To be payable to order, the instrument must so state, as most ordinarily do, by placing the words “payable to order of” before the name of the payee. An instrument may be payable to the order of the maker, drawer, drawee, or someone else. It also may be payable to the order of two or more payees (together or in the alternative), to an estate, a trust, or a fund (in which case it is payable to the representative, to an office or officer, or to a partnership or unincorporated association). Suppose a printed form says that the instrument is payable both to order and to bearer. In that event, the instrument is payable only to order. However, if the words “to bearer” are handwritten or typewritten, then the instrument can be payable either to order or to bearer.

A negotiable instrument not payable to a particular person must be payable to bearer, meaning to any person who presents it. To be payable to bearer, the instrument may say “payable to bearer” or “to the order of bearer.” It may also say “payable to John Doe or bearer.” Or it may be made payable to cash or the order of cash.

Section 3-104(c) of the UCC excepts checks from the requirement that the instrument be “payable to bearer or order.” Official Comment 2 to that section explains why checks are not required to have the “payable” wording: “Subsection (c) is based on the belief that it is good policy to treat checks, which are payment instruments, as negotiable instruments whether or not they contain the words ‘to

the order of.’ These words are almost always pre-printed on the check form....Absence of the quoted words can easily be overlooked and should not affect the rights of holders who may pay money or give credit for a check without being aware that it is not in the conventional form.”

Also affecting this policy is the fact that almost all checks are now read by machines, not human beings. There is no one to see that the printed form does not contain the special words, and the significance of the words is recognized by very few people. In short, it doesn’t matter for checks.

### **Missing and Ambiguous Terms**

The rules just stated make up the conditions for negotiability. Dealing with two additional details—missing terms or ambiguous terms—completes the picture. Notwithstanding the presence of readily available form instruments, sometimes people leave words out or draw up confusing documents.

#### **Incompleteness**

An incomplete instrument—one that is missing an essential element, like the due date or amount—can be signed before being completed if the contents at the time of signing show that the maker or drawer intends it to become a negotiable instrument. Unless the date of an instrument is required to determine when it is payable, an undated instrument can still be negotiable. Uniform Commercial Code, Section 3-113(b). Otherwise, to be enforceable, the instrument must first be completed—if not by the maker or drawer, then by the holder in accordance with whatever authority he has to do so. Uniform Commercial Code, Section 3-115. See the case presented in Section 22.4 "Cases", *Newman v. Manufacturers Nat. Bank of Detroit*.

#### **Ambiguity**

When it is unclear whether the instrument is a note or draft, the holder may treat it as either. Handwritten terms control typewritten and printed terms, and typewritten terms control printed terms. Words control figures, unless the words themselves are ambiguous, in which case the figures control. If the instrument contains a “conspicuous statement, however expressed, to the effect that the promise or order is not negotiable,” its negotiability is destroyed, except for checks, and “an instrument may be a check even though it is described on its face by another term, such as ‘money order.’” Uniform Commercial Code, Section 3-104(d); Uniform Commercial Code, Section 3-104(f).



### KEY TAKEAWAY

If an instrument is not negotiable, it generally will not be acceptable as payment in commercial transactions. The UCC requires that the value of a negotiable instrument be ascertainable on its face, without reference to other documents. Thus the negotiable instrument must be in writing, signed by the maker or drawer, an unconditional promise or order to pay, for a fixed amount in money, payable on demand or at a definite time, and payable to order or bearer, unless it is a check. If the instrument is incomplete or ambiguous, the UCC provides rules to determine what the instrument means.

### EXERCISES

1. Why does the UCC require that the value of a negotiable instrument be ascertainable from its face, without extrinsic reference?
2. What are the six requirements for an instrument to meet the negotiability test?
3. Why are the words “pay to order” or “pay to bearer” or similar words required on negotiable instruments (except for checks—and why not for checks)?
4. If an instrument is incomplete, is it invalid?

## 22.4 Cases

### Negotiability: Requires Unconditional Promise to Pay

Holly Hill Acres, Ltd. v. Charter Bank of Gainesville

314 So.2d 209 (Fla. App. 1975)

Scheb, J.

Appellant/defendant [Holly Hill] appeals from a summary judgment in favor of appellee/plaintiff Bank in a suit wherein the plaintiff Bank sought to foreclose a note and mortgage given by defendant.

The plaintiff Bank was the assignee from Rogers and Blythe of a promissory note and purchase money mortgage executed and delivered by the defendant. The note, executed April 28, 1972, contains the following stipulation:

This note with interest is secured by a mortgage on real estate, of even date herewith, made by the maker hereof in favor of the said payee, and shall be construed and enforced according to the laws of the State of Florida. **The terms of said mortgage are by this reference made a part hereof.** (emphasis added)

Rogers and Blythe assigned the promissory note and mortgage in question to the plaintiff Bank to secure their own note. Plaintiff Bank sued defendant [Holly Hill] and joined Rogers and Blythe as defendants alleging a default on their note as well as a default on defendant's [Holly Hill's] note.

Defendant answered incorporating an affirmative defense that fraud on the part of Rogers and Blythe induced the sale which gave rise to the purchase money mortgage. Rogers and Blythe denied the fraud. In opposition to plaintiff Bank's motion for summary judgment, the defendant submitted an affidavit in support of its allegation of fraud on the part of agents of Rogers and Blythe. The trial court held the plaintiff Bank was a holder in due course of the note executed by defendant and entered a summary final judgment against the defendant.

The note having incorporated the terms of the purchase money mortgage was not negotiable. The plaintiff Bank was not a holder in due course, therefore, the

defendant was entitled to raise against the plaintiff any defenses which could be raised between the appellant and Rogers and Blythe. Since defendant asserted an affirmative defense of fraud, it was incumbent on the plaintiff to establish the non-existence of any genuine issue of any material fact or the legal insufficiency of defendant's affirmative defense. Having failed to do so, plaintiff was not entitled to a judgment as a matter of law; hence, we reverse.

The note, incorporating by reference the terms of the mortgage, did not contain the unconditional promise to pay required by [the UCC]. Rather, the note falls within the scope of [UCC 3-106(a)(ii)]: "A promise or order is unconditional unless it states that...it is subject to or governed by any other writing."

Plaintiff Bank relies upon *Scott v. Taylor* [Florida] 1912 [Citation], as authority for the proposition that its note is negotiable. *Scott*, however, involved a note which stated: "this note secured by mortgage." Mere reference to a note being secured by mortgage is a common commercial practice and such reference in itself does not impede the negotiability of the note. There is, however, a significant difference in a note stating that it is "secured by a mortgage" from one which provides, "the terms of said mortgage are by this reference made a part hereof." In the former instance the note merely refers to a separate agreement which does not impede its negotiability, while in the latter instance the note is rendered non-negotiable.

As a general rule the assignee of a mortgage securing a non-negotiable note, even though a bona fide purchaser for value, takes subject to all defenses available as against the mortgagee. [Citation] Defendant raised the issue of fraud as between himself and other parties to the note, therefore, it was incumbent on the plaintiff Bank, as movant for a summary judgment, to prove the non-existence of any genuinely triable issue. [Citation]

Accordingly, the entry of a summary final judgment is reversed and the cause remanded for further proceedings.

### CASE QUESTIONS

1. What was wrong with the promissory note that made it nonnegotiable?
2. How did the note's nonnegotiability—as determined by the court of appeals—benefit the defendant, Holly Hill?
3. The court determined that the bank was not a holder in due course; on remand, what happens now?

## Negotiability: Requires Fixed Amount of Money

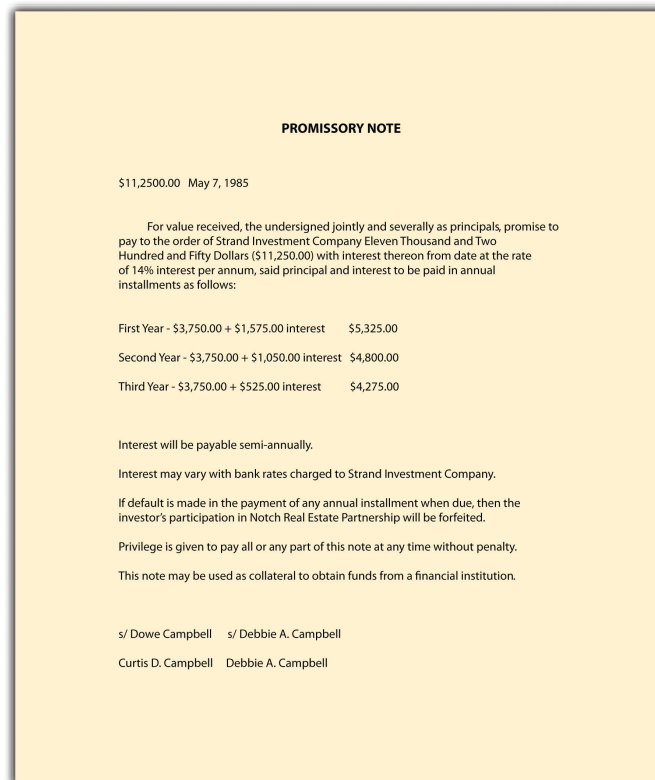
Centerre Bank of Branson v. Campbell

744 S.W.2d 490 (Mo. App. 1988)

Crow, J.

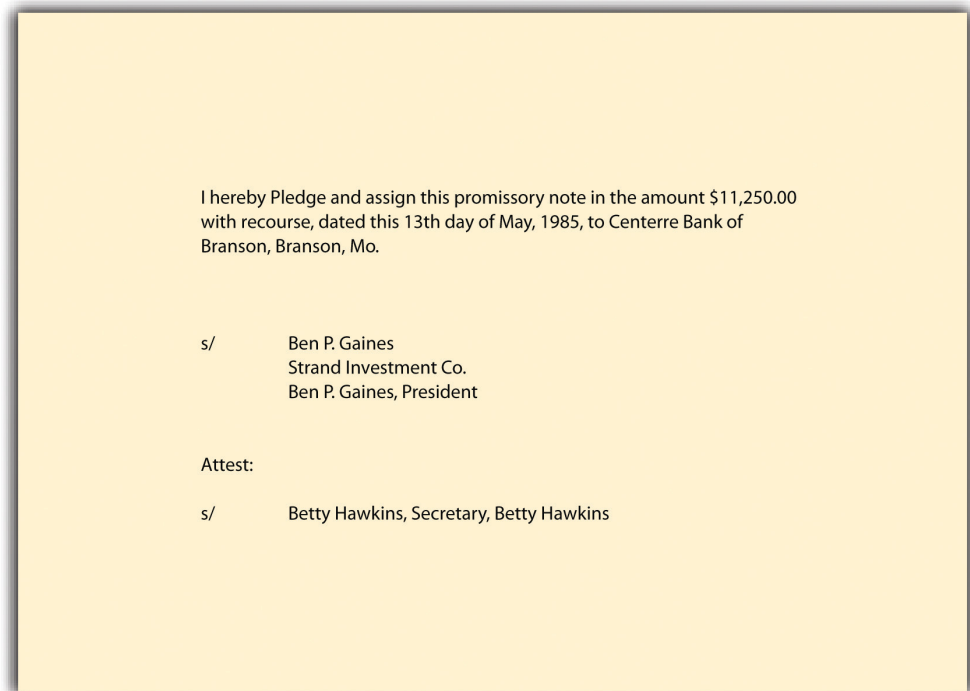
On or about May 7, 1985, appellants (“the Campbells”) signed the following document:

Figure 22.5



On May 13, 1985, the president and secretary of Strand Investment Company (“Strand”) signed the following provision [see Figure 22.6] on the reverse side of the above [Figure 22.5] document:

Figure 22.6



On June 30, 1986, Centerre Bank of Branson (“Centerre”) sued the Campbells. Pertinent to the issues on this appeal, Centerre’s petition averred:

“1. ...on [May 7,] 1985, the [Campbells] made and delivered to Strand...their promissory note...and thereby promised to pay to Strand...or its order...(\$11,250.00) with interest thereon from date at the rate of fourteen percent (14%) per annum; that a copy of said promissory note is attached hereto...and incorporated herein by reference.

2. That thereafter and before maturity, said note was assigned and delivered by Strand...to [Centerre] for valuable consideration and [Centerre] is the owner and holder of said promissory note.”

Centerre’s petition went on to allege that default had been made in payment of the note and that there was an unpaid principal balance of \$9,000, plus accrued interest, due thereon. Centerre’s petition prayed for judgment against the Campbells for the unpaid principal and interest.

[The Campbells] aver that the note was given for the purchase of an interest in a limited partnership to be created by Strand, that no limited partnership was

thereafter created by Strand, and that by reason thereof there was “a complete and total failure of consideration for the said promissory note.” Consequently, pled the answers, Centerre “should be estopped from asserting a claim against [the Campbells] on said promissory note because of such total failure of consideration for same.”

The cause was tried to the court, all parties having waived trial by jury. At trial, the attorney for the Campbells asked Curtis D. Campbell what the consideration was for the note. Centerre’s attorney interrupted: “We object to any testimony as to the consideration for the note because it’s our position that is not a defense in this lawsuit since the bank is the holder in due course.” ...

The trial court entered judgment in favor of Centerre and against the Campbells for \$9,000, plus accrued interest and costs. The trial court filed no findings of fact or conclusions of law, none having been requested. The trial court did, however, include in its judgment a finding that Centerre “is a holder in due course of the promissory note sued upon.”

The Campbells appeal, briefing four points. Their first three, taken together, present a single hypothesis of error consisting of these components: (a) the Campbells showed “by clear and convincing evidence a valid and meritorious defense in that there existed a total lack and failure of consideration for the promissory note in question,” (b) Centerre acquired the note subject to such defense in that Centerre was not a holder in due course, as one can be a holder in due course of a note only if the note is a negotiable instrument, and (c) the note was not a negotiable instrument inasmuch as “it failed to state a sum certain due the payee.” ...

We have already noted that if Centerre is not a holder in due course, the Campbells can assert the defense of failure of consideration against Centerre to the same degree they could have asserted it against Strand. We have also spelled out that Centerre cannot be a holder in due course if the note is not a negotiable instrument. The pivotal issue, therefore, is whether the provision that interest may vary with bank rates charged to Strand prevents the note from being a negotiable instrument....

Neither side has cited a Missouri case applying [UCC 3-104(a)] to a note containing a provision similar to: “Interest may vary with bank rates charged to Strand.” Our independent research has likewise proven fruitless. There are, however, instructive decisions from other jurisdictions.

In *Taylor v. Roeder*, [Citation, Virginia] (1987), a note provided for interest at “[t]hree percent (3.00%) over Chase Manhattan prime to be adjusted monthly.” A second note provided for interest at “3% over Chase Manhattan prime adjusted monthly.” Applying sections of the Uniform Commercial Code adopted by Virginia identical to [the Missouri UCC], the court held the notes were not negotiable instruments in that the amounts required to satisfy them could not be ascertained without reference to an extrinsic source, the varying prime rate of interest charged by Chase Manhattan Bank.

In *Branch Banking and Trust Co. v. Creasy*, [Citation, North Carolina] (1980), a guaranty agreement provided that the aggregate amount of principal of all indebtedness and liabilities at any one time for which the guarantor would be liable shall not exceed \$35,000. The court, emphasizing that to be a negotiable instrument a writing must contain, among other things, an unconditional promise to pay a sum certain in money, held the agreement was not a negotiable instrument. The opinion recited that for the requirement of a sum certain to be met, it is necessary that at the time of payment the holder be able to determine the amount which is then payable from the instrument itself, with any necessary computation, without reference to any outside source. It is essential, said the court, for a negotiable instrument “to bear a definite sum so that subsequent holders may take and transfer the instrument without having to plumb the intricacies of the instrument’s background....

In *A. Alport & Son, Inc. v. Hotel Evans, Inc.*, [Citation] (1970), a note contained the notation “with interest at bank rates.” Applying a section of the Uniform Commercial Code adopted by New York identical to [3-104(a)] the court held the note was not a negotiable instrument in that the amount of interest had to be established by facts outside the instrument.

In the instant case, the Campbells insist that it is impossible to determine from the face of the note the amount due and payable on any payment date, as the note provides that interest may vary with bank rates charged to Strand. Consequently, say the Campbells, the note is not a negotiable instrument, as it does not contain a promise to pay a “sum certain” [UCC 3-104(a)].

Centerre responds that the provision that interest may vary with bank rates charged to Strand is not “directory,” but instead is merely “discretionary.” The argument begs the question. Even if one assumes that Strand would elect not to vary the interest charged the Campbells if interest rates charged Strand by banks changed, a holder of the note would have to investigate such facts before determining the amount due on the note at any time of payment. We hold that under 3-104 and 3-106, supra, and the authorities discussed earlier, the provision that interest may vary with bank rates charged to Strand bars the note from being a

negotiable instrument, thus no assignee thereof can be a holder in due course. The trial court therefore erred as a matter of law in ruling that Centerre was a holder in due course....

An alert reader will have noticed two other extraordinary features about the note, not mentioned in this opinion. First, the note provides in one place that principal and interest are to be paid in annual installments; in another place it provides that interest will be payable semiannually. Second, there is no acceleration clause providing that if default be made in the payment of any installment when due, then all remaining installments shall become due and payable immediately. It would have thus been arguable that, at time of trial, only the first year's installment of principal and interest was due. No issue is raised, however, regarding any of these matters, and we decline to consider them sua sponte [on our own].

The judgment is reversed and the cause is remanded for a new trial.

### CASE QUESTIONS

1. What was defective about this note that made it nonnegotiable?
2. What was the consequence to Centerre of the court's determination that the note was nonnegotiable?
3. What did the Campbells give the note for in the first place, and why do they deny liability on it?

### Undated or Incomplete Instruments

Newman v. Manufacturers Nat. Bank of Detroit

152 N.W.2d 564 (Mich. App. 1967)

Holbrook, J.

As evidence of [a debt owed to a business associate, Belle Epstein], plaintiff [Marvin Newman in 1955] drew two checks on the National Bank of Detroit, one for \$1,000 [about \$8,000 in 2010 dollars] and the other for \$200 [about \$1,600 in 2010 dollars]. The checks were left undated. Plaintiff testified that he paid all but \$300 of this debt during the following next 4 years. Thereafter, Belle Epstein told plaintiff that she had destroyed the two checks....



Plaintiff never notified defendant Bank to stop payment on the checks nor that he had issued the checks without filling in the dates. The date line of National Bank of Detroit check forms contained the first 3 numbers of the year but left the last numeral, month and day entries, blank, viz., "Detroit 1, Mich. \_ \_ 195\_ \_." The checks were cashed in Phoenix, Arizona, April 17, 1964, and the date line of each check was completed...They were presented to and paid by Manufacturers National Bank of Detroit, April 22, 1964, under the endorsement of Belle Epstein. The plaintiff protested such payment when he was informed of it about a month later. Defendant Bank denied liability and plaintiff brought suit....

The two checks were dated April 16, 1964. It is true that the dates were completed in pen and ink subsequent to the date of issue. However, this was not known by defendant. Defendant had a right to rely on the dates appearing on the checks as being correct. [UCC 3-113] provides in part as follows:

(a) An instrument may be antedated or postdated.

Also, [UCC 3-114] provides in part as follows:

[T]ypewritten terms prevail over printed terms, handwritten terms prevail over both...

Without notice to the contrary, defendant was within its rights to assume that the dates were proper and filled in by plaintiff or someone authorized by him....

Plaintiff admitted at trial that defendant acted in good faith in honoring the two checks of plaintiff's in question, and therefore defendant's good faith is not in issue.

In order to determine if defendant bank's action in honoring plaintiff's two checks under the facts present herein constituted an exercise of proper procedure, we turn to article 4 of the UCC....[UCC 4-401(d)] provides as follows:

A bank that in good faith makes payment to a holder may charge the indicated account of its customer according to:

(1) the original tenor of his altered item; or

(2) the tenor of his completed item, even though the bank knows the item has been completed unless the bank has notice that the completion was improper.

...[W]e conclude it was shown that two checks were issued by plaintiff in 1955, filled out but for the dates which were subsequently completed by the payee or someone else to read April 16, 1964, and presented to defendant bank for payment, April 22, 1964. Applying the rules set forth in the UCC as quoted herein, the action of the defendant bank in honoring plaintiff's checks was in good faith and in accord with the standard of care required under the UCC.

Since we have determined that there was no liability under the UCC, plaintiff cannot succeed on this appeal.

Affirmed.

### CASE QUESTIONS

1. Why does handwriting control over printing or typing on negotiable instruments?
2. How could the plaintiff have protected himself from liability in this case?

## 22.5 Summary and Exercises

### Summary

Commercial paper is the collective term for a variety of instruments—including checks, certificates of deposit, and notes—that are used to pay for goods; commercial paper is basically a contract to pay money. The key to the central role of commercial paper is negotiability, the means by which a person is empowered to transfer to another more than what the transferor himself possesses. The law regulating negotiability is Article 3 of the Universal Commercial Code.

Commercial paper can be divided into two basic types: the draft and the note. A draft is a document prepared by a drawer ordering the drawee to remit a stated sum of money to the payee. Drafts can be subdivided into two categories: sight drafts and time drafts. A note is a written promise to pay a specified sum of money on demand or at a definite time.

A special form of draft is the common bank check, a draft drawn on a bank and payable on demand. A special form of note is the certificate of deposit, a written acknowledgment by a bank that it has received money and agrees to repay it at a time specified in the certificate.

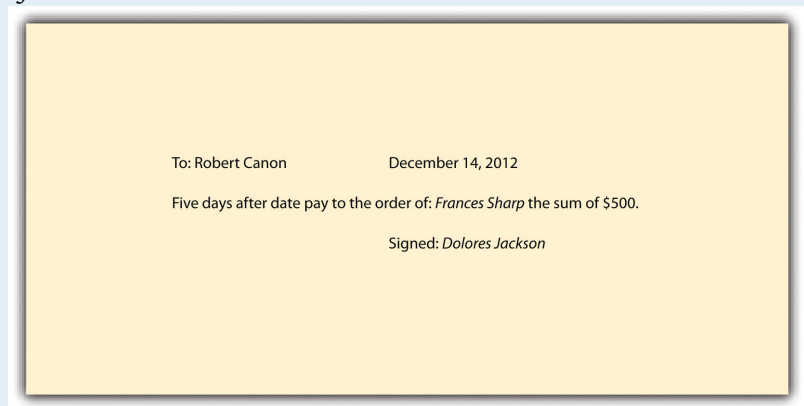
In addition to drawers, makers, drawees, and payees, one can deal with commercial paper in five other capacities: as indorsers, indorsees, holders, holders in due course, and accommodation parties.

A holder of a negotiable instrument must be able to ascertain all essential terms from its face. These terms are that the instrument (1) be in writing, (2) be signed by the maker or drawer, (3) contain an unconditional promise or order to pay (4) a sum certain in money, (5) be payable on demand or at a definite time, and (6) be payable to order or to bearer. If one of these terms is missing, the document is not negotiable, unless it is filled in before being negotiated according to authority given.

## EXERCISES

1. Golf Inc. manufactures golf balls. Jack orders 1,000 balls from Golf and promises to pay \$4,000 two weeks after delivery. Golf Inc. delivers the balls and assigns its contract rights to First Bank for \$3,500. Golf Inc. then declares bankruptcy. May First Bank collect \$3,500 from Jack? Explain.
2. Assume in problem 1 that Jack gives Golf Inc. a nonnegotiable note for \$3,500 and Golf sells the note to the bank shortly after delivering the balls. May the bank collect the \$3,500? Would the result be different if the note were negotiable? Explain.
3. George decides to purchase a new stereo system on credit. He signs two documents—a contract and a note. The note states that it is given “in payment for the stereo” and “if stereo is not delivered by July 2, the note is cancelled.” Is the note negotiable? Explain.
4. Is the following instrument a note, check, or draft? Explain.

Figure 22.7



5. State whether the following provisions in an instrument otherwise in the proper form make the instrument nonnegotiable and explain why:
  - a. A note stating, “This note is secured by a mortgage of the same date on property located at 1436 Dayton Street, Jameson, New York”
  - b. A note for \$25,000 payable in twenty installments of \$1,250 each that provides, “In the event the maker dies all unpaid installments are cancelled”
  - c. An instrument reading, “I.O.U., Rachel Donaldson, \$3,000”

- d. A note reading, “I promise to pay Rachel Donaldson \$3,000”
  - e. A note stating, “In accordance with our telephone conversation of January 7th, I promise to pay Sally Wilkenson or order \$1,500”
  - f. An undated note for \$1,500 “payable one year after date”
  - g. A note for \$1,500 “payable to the order of Marty Dooley, six months after Nick Solster’s death”
  - h. A note for \$18,000 payable in regular installments also stating, “In the event any installment is not made as provided here, the entire amount remaining unpaid may become due immediately”
6. Lou enters into a contract to buy Alan’s car and gives Alan an instrument that states, “This acknowledges my debt to Alan in the amount of \$10,000 that I owe on my purchase of the 2008 Saturn automobile I bought from him today.” Alan assigns the note to Judy for \$8,000. Alan had represented to Lou that the car had 20,000 miles on it, but when Lou discovered the car had 120,000 miles he refused to make further payments on the note. Can Judy successfully collect from Lou? Explain.
  7. The same facts as above are true, but the instrument Lou delivered to Alan reads, “I promise to pay to Alan or order \$10,000 that I owe on my purchase of the 2008 automobile I bought from him today.” Can Judy successfully collect from Lou? Explain.
  8. Joe Mallen, of Sequim, Washington, was angry after being cited by a US Fish and Wildlife Service for walking his dog without a leash in a federal bird refuge. He was also aggravated with his local bank because it held an out-of-state check made out to Mallen for ten days before honoring it. To vent his anger at both, Mallen spray painted a twenty-five-pound rock from his front yard with three coats of white paint, and with red paint, spelled out his account number, the bank’s name, the payee, his leash law citation number, and his signature. Should the US District Court in Seattle—the payee—attempt to cash the rock, would it be good? Explain. Joel Schwarz, “Taking Things for Granite,” *Student Lawyer*, December 1981.
  9. Raul Castana purchased a new stereo system from Eddington Electronics Store. He wrote a check on his account at Silver Bank in the amount of \$1,200 and gave it to Electronics’ clerk. David Eddington, the store owner, stamped the back of the check with his rubber indorsement stamp, and then wrote, “Pay to the order of City Water,” and he mailed it to City Water to pay the utility bill. Designate the parties to this instrument using the vocabulary discussed in this chapter.

10. Would Castana's signed note made out to Eddington Electronics Store be negotiable if it read, "I promise to pay Eddington's or order \$1,200 on or before May 1, 2012, but only if the stereo I bought from them works to my satisfaction"? Explain. And—disregarding negotiability for a moment—designate the parties to this instrument using the vocabulary discussed in this chapter.

## SELF-TEST QUESTIONS

1. A negotiable instrument must
  - a. be signed by the payee
  - b. contain a promise to pay, which may be conditional
  - c. include a sum certain
  - d. be written on paper or electronically
  
2. The law governing negotiability is found in
  - a. Article 3 of the UCC
  - b. Article 9 of the UCC
  - c. the Uniform Negotiability Act
  - d. state common law
  
3. A sight draft
  - a. calls for payment on a certain date
  - b. calls for payment when presented
  - c. is not negotiable
  - d. is the same as a certificate of deposit
  
4. A note reads, “Interest hereon is 2% above the prime rate as determined by First National Bank in New York City.” Under the UCC,
  - a. the interest rate provision is not a “sum certain” so negotiability is destroyed
  - b. the note is not negotiable because the holder must look to some extrinsic source to determine the interest rate
  - c. the note isn’t negotiable because the prime rate can vary before the note comes due
  - d. variable interest rates are OK
  
5. A “maker” in negotiable instrument law does what?
  - a. writes a check
  - b. becomes obligated to pay on a draft
  - c. is the primary obligor on a note

d. buys commercial paper of dubious value for collection

### SELF-TEST ANSWERS

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



## Chapter 23

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### Negotiation of Commercial Paper

#### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The distinction between *transfer* and *negotiation* of commercial paper
2. The liability of a person who transfers paper
3. The types of indorsements and their effects
4. Special problems that arise with forged indorsements

In the previous chapter, we took up the requirements for paper to be negotiable. Here we take up negotiation.

## 23.1 Transfer and Negotiation of Commercial Paper

### LEARNING OBJECTIVES

1. Understand what a transfer of commercial paper is.
2. Recognize the rights and liabilities of transferees and the liabilities of transferors.
3. Know how a transfer becomes a negotiation payable to order or to bearer.

### Definitions, Rights, and Liabilities

**Transfer**<sup>1</sup> means physical delivery of any instrument—negotiable or not—intending to pass title. Section 3-203(a) of the Uniform Commercial Code (UCC) provides that “an instrument is transferred when it is delivered by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument.”

### Negotiation and Holder

Section 3-201(a) of the UCC defines **negotiation**<sup>2</sup> as “a transfer of possession, whether voluntary or involuntary, of an instrument to a person who thereby becomes its holder if possession is obtained from a person other than the issuer of the instrument.” A **holder**<sup>3</sup> is defined in Section 1-201(2) as “a person who is in possession of an instrument drawn, issued, or indorsed to him or his order or to bearer or in blank” (“in blank” means that no indorsement is required for negotiation). The original issuing or making of an instrument is not negotiation, though a holder can be the beneficiary of either a transfer or a negotiation. The Official Comment to 3-201(a) is helpful:

1. Delivery of an instrument by a person other than its issuer for the purpose of giving the transferee rights to enforce the instrument.
2. The act of transferring commercial paper to a subsequent holder.
3. Person in possession of an instrument drawn, issued, or indorsed to him or to his order, or to bearer, or in blank.

A person can become holder of an instrument when the instrument is issued to that person, or the status of holder can arise as the result of an event that occurs after issuance. “Negotiation” is the term used in article 3 to describe this post-issuance event. Normally, negotiation occurs as the result of a voluntary transfer of possession of an instrument by a holder to another person who becomes the holder as a result of the transfer. Negotiation always requires a change in possession of the instrument because nobody can be a holder without possessing the instrument, either directly or through an agent. But in some cases the transfer of possession is involuntary and in some cases the person transferring possession is not a

holder....[S]ubsection (a) states that negotiation can occur by an involuntary transfer of possession. For example, if an instrument is payable to bearer and it is stolen by Thief or is found by Finder, Thief or Finder becomes the holder of the instrument when possession is obtained. In this case there is an involuntary transfer of possession that results in negotiation to Thief or Finder. Uniform Commercial Code, Section 3-201, Official Comment.

In other words, to qualify as a holder, a person must possess an instrument that runs to her. An instrument “runs” to a person if (1) it has been issued to her or (2) it has been transferred to her by negotiation (negotiation is the “post-issuance event” cited in the comment). Commercially speaking, the status of the immediate person to whom the instrument was issued (the payee) is not very interesting; the thing of interest is whether the instrument is passed *on* by the payee *after* possession, through negotiation. Yes, the payee of an instrument is a holder, and can be a holder in due course, but the crux of negotiable instruments involves taking an instrument free of defenses that might be claimed by anybody against paying on the instrument; the payee would know of defenses, usually, so—as the comment puts it—“use of the holder-in-due-course doctrine by the payee of an instrument is not the normal situation....[r]ather, the holder in due course is an immediate or remote transferee of the payee.” Uniform Commercial Code, Section 3-302, Comment 4.

### **Liability of Transferors**

We discuss liability in [Chapter 25 "Liability and Discharge"](#). However, a brief introduction to liability will help in understanding the types of indorsements discussed in this chapter. There are two types of liability affecting transferors: contract liability and warranty liability.

#### **Contract Liability**

Persons who sign the instrument—that is, makers, acceptors, drawers, indorsers—have signed a contract and are subject to contract liabilities. Drafts (checks) and notes are, after all, contracts. Makers and acceptors are *primary parties* and are unconditionally liable to pay the instrument. Drawers and indorsers are *secondary parties* and are conditionally liable. The conditions creating liability—that is, presentment, dishonor, and notice—are discussed in [Chapter 25 "Liability and Discharge"](#).

#### **Warranty Liability**

The transferor’s *contract* liability is limited. It applies only to those who sign and only if certain additional conditions are met and, as will be discussed, can even be

disclaimed. Consequently, a holder who has not been paid often must resort to a suit based on one of five warranties. These warranties are implied by law; UCC, Section 3-416, details them:

(A) A person who transfers an instrument for consideration warrants all of the following to the transferee and, if the transfer is by indorsement, to any subsequent transferee:

- (1) The warrantor is a person entitled to enforce the instrument.
- (2) All signatures on the instrument are authentic and authorized.
- (3) The instrument has not been altered.
- (4) The instrument is not subject to a defense or claim in recoupment of any party which can be asserted against the warrantor.
- (5) The warrantor has no knowledge of any insolvency proceeding commenced with respect to the maker or acceptor or, in the case of an unaccepted draft, the drawer.

Breach of one of these warranties must be proven at trial if there is no general contract liability.

### **Liability of Transferees**

The transferee takes by assignment; as an assignee, the new owner of the instrument has only those rights held by the assignor. Claims that could be asserted by third parties against the assignor can be asserted against the assignee. A negotiable instrument can be transferred in this sense without being negotiated. A payee, for example, might fail to meet all the requirements of negotiation; in that event, the instrument might wind up being merely transferred (assigned). When all requirements of negotiability and negotiation have been met, the buyer is a holder and may (if a holder in due course—see [Chapter 24 "Holder in Due Course and Defenses"](#)) collect on the instrument without having to prove anything more. But if the instrument was not properly negotiated, the purchaser is at most a transferee and cannot collect if defenses are available, even if the paper itself is negotiable.

### **How Negotiation Is Accomplished**

Negotiation can occur with either bearer paper or order paper.

### Negotiation of Instrument Payable to Bearer

An instrument payable to bearer—**bearer paper**<sup>4</sup>—can be negotiated simply by delivering it to the transferee (see [Figure 23.1 "Negotiation of Bearer Paper"](#); recall that “Lorna Love” is the proprietor of a tennis club introduced in [Chapter 22 "Nature and Form of Commercial Paper"](#)): bearer paper runs to whoever is in possession of it, even a thief. Despite this simple rule, the purchaser of the instrument may require an indorsement on some bearer paper anyway. You may have noticed that sometimes you are requested to indorse your own check when you make it out to cash. That is because the indorsement increases the liability of the indorser if the holder is unable to collect. *Chung v. New York Racing Association* ([Section 23.4 "Cases"](#)) deals with issues involving bearer paper.

Figure 23.1 *Negotiation of Bearer Paper*



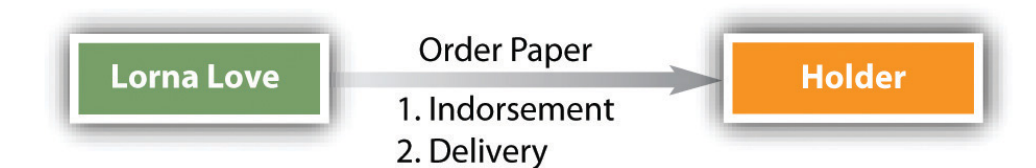
### Negotiation of Instrument Payable to Order

Negotiation is usually voluntary, and the issuer usually directs payment “to order”—that is, to someone’s order, originally the payee. **Order paper**<sup>5</sup> is this negotiable instrument that by its term is payable to a specified person or his assignee. If it is to continue its course through the channels of commerce, it must be indorsed—signed, usually on the back—by the payee and passed on to the transferee. Continuing with the example used in [Chapter 22 "Nature and Form of Commercial Paper"](#), Rackets, Inc. (the payee) negotiates Lorna Love’s check (Lorna is the issuer or drawer) drawn to the order of Rackets when an agent of Rackets “signs” the company’s name on the reverse of the check and passes it to the indorsee, such as the bank or someone to whom Rackets owed money. (A company’s signature is usually a rubber stamp for mere deposit, but an agent can sign the company name and direct the instrument elsewhere.) The transferee is a holder (see [Figure 23.2 "Negotiation of Order Paper"](#)). Had Rackets neglected to indorse the check, the transferee, though in physical possession, would not be a holder. Issues regarding indorsement are discussed in [Section 23.2 "Indorsements"](#).

4. A negotiable instrument payable to whoever has possession.

5. Negotiable instrument that by its term is payable to a specified person or his or her assignee (as opposed to bearer paper).

Figure 23.2 *Negotiation of Order Paper*



### KEY TAKEAWAY

A transfer is the physical delivery of an instrument with the intention to pass title—the right to enforce it. A mere transferee stands in the transferor’s shoes and takes the instrument subject to all the claims and defenses against paying it that burdened it when the transferor delivered it. Negotiation is a special type of transfer—voluntary or involuntary—to a holder. A holder is a person who has an instrument drawn, issued, or indorsed to him or his order or to bearer or in blank. If the instrument is order paper, negotiation is accomplished by indorsement and delivery to the next holder; if it is bearer paper or blank paper, delivery alone accomplishes negotiation. Transferors incur two types of liability: those who sign the instrument are contractually liable; those who sign or those who do not sign are liable to the transferee in warranty.

### EXERCISES

1. What is a transfer of commercial paper, and what rights and liabilities has the transferee?
2. What is a negotiation of commercial paper?
3. What is a holder?
4. How is bearer paper negotiated?
5. How is order paper negotiated?

## 23.2 Indorsements

### LEARNING OBJECTIVES

1. Understand the meaning of indorsement and its formal requirements.
2. Know the effects of various types of indorsements: no indorsement, partial, blank, special, restrictive, conditional, qualified.

### Definition and Formal Requirements of Indorsement

#### Definition

Most commonly, paper is transferred by indorsement. The indorsement is evidence that the indorser intended the instrument to move along in the channels of commerce. An **indorsement**<sup>6</sup> is defined by UCC Section 3-204(a) as

a signature, other than that of a signer as maker, drawer, or acceptor, that alone or accompanied by other words is made on an instrument for the purpose of (i) negotiating the instrument, (ii) restricting payment of the instrument, or (iii) incurring indorser's liability on the instrument, but regardless of the intent of the signer, a signature and its accompanying words is an indorsement unless the accompanying words, terms of the instrument, place of the signature, or other circumstances unambiguously indicated that the signature was made for a purpose other than indorsement.

#### Placement of Indorsement

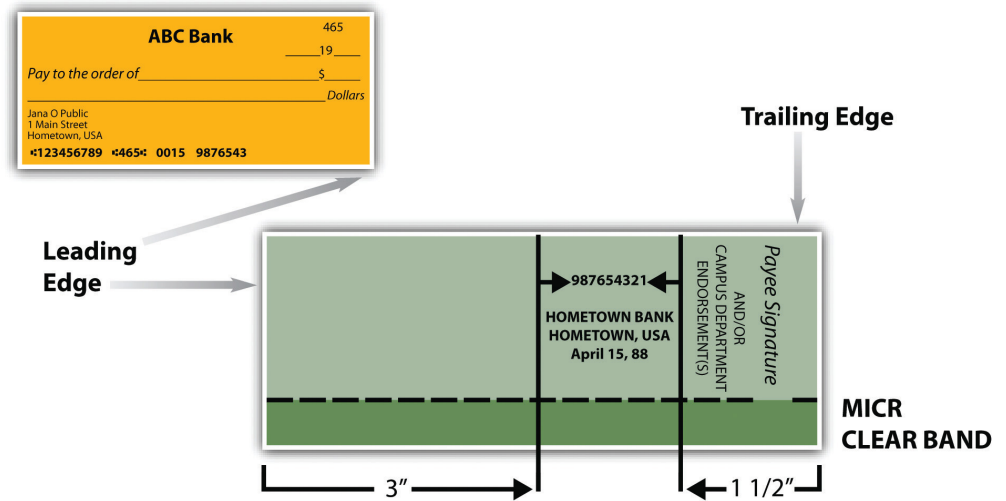
*Indorse* (or *endorse*) literally means “on the back of,” as fish, say, have dorsal fins—fins on their backs. Usually indorsements are on the back of the instrument, but an indorsement could be on a piece of paper affixed to the instrument. Such an attachment is called an **allonge**<sup>7</sup>—it comes along with the instrument (UCC, Section 3-204(a)).

6. The act of a payee, drawee, accommodation party, indorser, or holder of an instrument in writing his name on the back of same with the intention of negotiating it.

7. A piece of paper firmly affixed to an instrument.

There are rules about where indorsements are placed. The Expedited Funds Availability Act was enacted in 1987 by Congress to standardize holding periods on deposits made to commercial banks and to regulate institutions' use of deposit holds—that is, how soon customers can access the money after they have deposited a check in the bank. The Federal Reserve Board subsequently adopted “Regulation CC, Check Endorsement Standards” to improve funds availability and expedite the return of checks. See [Figure 23.3 "Indorsement Standard"](#).

Figure 23.3 *Indorsement Standard*



From UC Irvine Administrative Policies & Procedures, Business and Financial Affairs, Financial Services, Sec. 704-13: Check Endorsement Procedures, at <http://www.policies.uci.edu/adm/procs/700/704-13.html>.

As shown in **Figure 23.3 "Indorsement Standard"**, specific implementing guidelines define criteria for the placement, content, and ink color of endorsement areas on the back of checks for the depositary bank (bank of first deposit), subsequent indorsers (paying banks), and corporate or payee indorsers. Indorsements must be made within 1½ inches of the trailing (left) edge of the back of the check; remaining space is for bank indorsements. There is no penalty for violating the standard—it is a guideline. The abbreviation “MICR” stands for magnetic ink character recognition. The “clear band” is a section of the back of the check that is not supposed to be intruded upon with any magnetic (machine-readable) printing that would interfere with machine reading on the front side (the bank routing numbers).

Sometimes an indorser adds words intended to strengthen the indorsement; for example, “I hereby assign all my right, title, and interest in this note to Carl Carpenter.” Words of assignment such as these and also words of condition, waiver, guaranty, limitation, or disclaimer of liability do not negate the effect of an indorsement.

### Misspelled or Incorrect Indorsements

When the instrument is made payable to a person under a misspelled name (or in a name other than his own), he may indorse in the wrong name or the right one or both. It is safer to sign in both names, and the purchaser of the instrument may demand a signature in both names (UCC, Section 3-204(d)).



## Various Indorsements and Their Effects

A holder can indorse in a variety of ways; indorsements are not identical and have different effects.

### No Indorsement

If the instrument requires a signature, transfer without indorsement is an assignment only. Bearer paper does not require indorsement, so it can be negotiated simply by delivering it to the transferee, who becomes a holder. The transferor has no contract liability on the instrument, however, because he has not signed it. He does remain liable on the warranties, but only to the person who receives the paper, not to subsequent transferees.

Because it is common practice for a depository bank (the bank into which a person makes a deposit) to receive unindorsed checks under so-called lockbox agreements from customers who receive a high volume of checks, a customer who is a holder can deposit a check or other instrument for credit to his account without indorsement. Section 4-205(1) of the UCC provides that a “depository bank becomes a holder...at the time it receives the item for collection if the customer at the time of delivery was a holder, whether or not the customer indorses the item.”

### Partial Indorsement

To be effective as negotiation, an indorsement must convey the entire instrument. An indorsement that purports to convey only a portion of the sum still due amounts to a partial assignment. If Rackets’ agent signs the check “Rackets, Inc.” together with the words “Pay half to City Water, /s/ Agent” and delivers the check to City Water, that does not operate as an indorsement, and City Water becomes an assignee, not a holder.

### Blank Indorsement

A **blank indorsement**<sup>8</sup> consists of the indorser’s signature alone (see [Figure 23.4 "Forms of Endorsement"](#), left). A blank indorsement converts the instrument into paper closely akin to cash. Since the indorsement does not specify to whom the instrument is to be paid, it is treated like bearer paper—assuming, of course, that the first indorser is the person to whom the instrument was payable originally. A paper with blank indorsement may be negotiated by delivery alone, until such time as a holder converts it into a *special indorsement* (discussed next) by writing over the signature any terms consistent with the indorsement. For example, a check

8. Indorsement of a check or other negotiable paper without naming a further indorsee (usually simply the indorser’s name).

indorsed by the payee (signed on the back) may be passed from one person to another and cashed in by any of them.

Figure 23.4 *Forms of Endorsement*



A blank indorsement creates conditional contract liability in the indorser: he is liable to pay if the paper is dishonored. The blank indorser also has warranty liability toward subsequent holders.

### Special Indorsement

A **special indorsement**<sup>9</sup>, sometimes known as an “indorsement in full,” names the transferee-holder. The payee of a check can indorse it over to a third party by writing “Pay to the order of [name of the third party]” and then signing his name (see [Figure 23.4 "Forms of Endorsement"](#), center). Once specially indorsed, the check (or other instrument) can be negotiated further only when the special indorsee adds his own signature. A holder may convert a blank indorsement into a special indorsement by writing above the signature of the indorser words of a contractual nature consistent with the character of the instrument.

So, for example, Lorna Love’s check to Rackets, Inc., indorsed in blank (signed by its agent or stamped with Rackets’ indorsement stamp—its name alone) and handed to City Water, is not very safe: it is bearer paper. If the check fell onto the floor, anybody could be a holder and cash it. It can easily be converted into a check with special indorsement: City Water’s clerk need only add the words “Pay City Water” above Rackets’ indorsement. (The magic words of negotiability—“pay to order of bearer”—are not required in an indorsement.) Before doing so, City Water could have negotiated it simply by giving it to someone (again, a blank indorsement acts as bearer paper). After converting it to a special indorsement, City Water must indorse it in order to transfer it by negotiation to someone else. The liabilities of a special indorser are the same as those of a blank indorser.

9. Indorsement that names the transferee-holder.

The dichotomy here of indorsement in blank or special indorsement is the indorser’s way of indicating how the instrument can be subsequently negotiated: with or without further indorsing.

### Restrictive Indorsement

A **restrictive indorsement**<sup>10</sup> attempts to limit payment to a particular person or otherwise prohibit further transfer or negotiation. We say “attempts to limit” because a restrictive indorsement is generally invalid. Section 3-206(a) of the UCC provides that an attempt to limit payment to a particular person or prohibit further transfer “is not effective.” Nor is “[a]n indorsement stating a condition to the right of the indorsee to receive payment”; the restriction may be disregarded. However, two legitimate restrictive indorsements are valid: collection indorsements and trust indorsements. *Wisner Elevator Company, Inc. v. Richland State Bank* ([Section 23.4 "Cases"](#)) deals with conditional and restrictive indorsements.

### Collection Indorsement

It is very common for people and businesses to mail checks to their bank for deposit to their accounts. Sometimes mail goes astray or gets stolen. Surely it must be permissible for the customer to safeguard the check by restricting its use to depositing it in her account. A **collection indorsement**<sup>11</sup>, such as “For deposit” or “For collection,” is effective. Section 3-206(c) of the UCC provides that anybody other than a bank who purchases the instrument with such an indorsement converts the instrument—effectively steals it. A depository bank that takes it must deposit it as directed, or the bank has converted it. A payor bank that is also the depository bank that takes the instrument for immediate payment over the counter converts it: the check cannot be cashed; it must be deposited (see [Figure 23.4 "Forms of Endorsement"](#)).

To illustrate, suppose that Kate Jones indorses her paycheck “For deposit only, Kate Jones,” which is by far the most common type of restrictive indorsement (see [Figure 23.4 "Forms of Endorsement"](#), right). A thief steals the check, indorses his name below the restrictive indorsement, and deposits the check in Last Bank, where he has an account, or cashes it. The check moves through the collection process to Second Bank and then to First Bank, which pays the check. Kate has the right to recover only from Last Bank, which did not properly honor the indorsement by depositing the payment in her account.

10. Indorsement specifying the use to which an instrument may be put; most common is “For deposit only.”

11. Indorsement restricting payment to collection or deposit.

12. An indorsement to a person who is to hold or use the funds for the benefit of the indorser or a third party.

### Trust Indorsement

A second legitimate restrictive indorsement is indorsement in trust, called a **trust indorsement**<sup>12</sup> (sometimes *agency indorsement*). Suppose Paul Payee owes Carlene Creditor a debt. Payee indorses a check drawn to him by a third party, “Pay to Tina Attorney in trust for Carlene Creditor.” Attorney indorses in blank and delivers it to (a) a holder for value, (b) a depository bank for collection, or (c) a payor bank for payment. In each case, these takers can safely pay Attorney so long as they have no

notice under Section 3-307 of the UCC of any breach of fiduciary duty that Attorney may be committing. For example, under Section 3-307(b), these takers have notice of a breach of trust if the check was taken in any transaction known by the taker to be for Attorney's personal benefit. Subsequent transferees of the check from the holder or depository bank are not affected by the restriction unless they have knowledge that Attorney dealt with the check in breach of trust (adapted from UCC, Section 3-206, Official Comment 4). (Of course Attorney should not indorse in blank; she should indorse "Tina Attorney, in trust for Carlene Creditor" and deposit the check in her trust account.)

The dichotomy here between restrictive and unrestrictive indorsements is the indorser's way of showing to what use the instrument may be put.

### Conditional Indorsement

An indorser might want to condition the negotiation of an instrument upon some event, such as "Pay Carla Green if she finishes painting my house by July 15." Such a **conditional indorsement**<sup>13</sup> is generally ineffective: the UCC, Section 3-206(b), says a person paying for value can disregard the condition without liability.

### Qualified Indorsement

An indorser can limit his liability by making a **qualified indorsement**<sup>14</sup>. The usual qualified indorsement consists of the words "**without recourse**"<sup>15</sup>, which mean that the indorser has no contract liability to subsequent holders if a maker or drawee defaults. A qualified indorsement does not impair negotiability. The qualification must be in writing by signature on the instrument itself. By disclaiming contract liability, the qualified indorser also limits his warranty liabilities, though he does not eliminate them. Section 3-415(a) of the UCC narrows the indorser's warranty that no defense of any party is good against the indorser. In its place, the qualified indorser warrants merely that he has no *knowledge* of any defense.

13. Indorsement that makes instrument's payment dependent on the occurrence of some event specified in the indorsement; generally invalid.

14. Wording designed to limit the indorser's contract liability; "without recourse" is the most frequently seen example.

15. Language used in a qualified indorsement to limit indorser's contract liability.

"Without recourse" indorsements can have a practical impact on the balance sheet. A company holding a promissory note can obtain cash by discounting it—indorsing it over to a bank for maturity value less the bank's discount. As an indorser, however, the company remains liable to pay the amount to subsequent holders should the maker default at maturity. The balance sheet must reflect this possibility as a contingent liability. However, if the note is indorsed without recourse, the company need not account for any possible default of the maker as a contingent liability.

The dichotomy here between qualified and unqualified indorsements is the indorser's way of indicating what liability she is willing to incur to subsequent holders.

#### KEY TAKEAWAY

An indorsement is, usually, the signature of an instrument's holder on the back of the instrument, indicating an intention that the instrument should proceed through the channels of commerce. The Federal Reserve Board has recommendations for how instruments should be indorsed to speed machine reading of them. Indorsements are either blank or special; they are either restrictive or nonrestrictive; and they are either qualified or unqualified. These pairings show the indorser's intention as to *how* further negotiation may be accomplished, to *what* uses the instrument may be put, and *what liability* the indorser is willing to assume.

#### EXERCISES

1. If an instrument is not indorsed according to Federal Reserve Board standards, is it still valid?
2. Suppose that Indorsee signs an instrument in blank and drops it. Suppose that the instrument is found by Finder and that Finder delivers it to Third Person with the intention to sell it. Is this successful negotiation?
3. Why would a person make a restrictive indorsement? A qualified indorsement?

## 23.3 Problems and Issues in Negotiation

### LEARNING OBJECTIVES

1. Recognize under what circumstances a negotiation is subject to rescission.
2. Know the effect of reacquisition of an instrument.
3. Understand how instruments made payable to two or more persons are negotiated.
4. Understand how the UCC treats forged indorsements, imposters, and other signatures in the name of the payee.

### Common Issues Arising in Negotiation of Commercial Paper

A number of problems commonly arise that affect the negotiation of commercial paper. Here we take up three.

#### Negotiation Subject to Rescission

A negotiation—again, transfer of possession to a person who becomes a holder—can be effective even when it is made by a person without the capacity to sign. Section 3-202(a) of the UCC declares that negotiation is effective even when the indorsement is made by an infant or by a corporation exceeding its powers; is obtained by fraud, duress, or mistake; is part of an illegal transaction; or is made in breach of a duty.

However, unless the instrument was negotiated to a holder in due course, the indorsement can be rescinded or subjected to another appropriate legal remedy. The Official Comment to this UCC section is helpful:

Subsection (a) applies even though the lack of capacity or the illegality is of a character which goes to the essence of the transaction and makes it entirely void. It is inherent in the character of negotiable instruments that any person in possession of an instrument which by its terms is payable to that person or to bearer is a holder and may be dealt with by anyone as a holder. The principle finds its most extreme application in the well-settled rule that a holder in due course may take the instrument even from a thief and be protected against the claim of the rightful owner. The policy of subsection (a) is that any person to whom an instrument is

negotiated is a holder until the instrument has been recovered from that person's possession. Uniform Commercial Code, Section 3-404, Official Comment 1.

So suppose a mentally incapacitated person under a guardianship evades her guardian, goes to town, and writes a check for a new car. Normally, contracts made by such persons are void. But the check is negotiable here. If the guardian finds out about the escapade before the check leaves the dealer's hands, the deal could be rescinded: the check could be retrieved and the car returned.

### **Effect of Reacquisition**

A prior party who reacquires an instrument may reissue it or negotiate it further. But doing so discharges intervening parties as to the reacquirer and to later purchasers who are not holders in due course. Section 3-207 of the UCC permits the reacquirer to cancel indorsements unnecessary to his title or ownership; in so doing, he eliminates the liability of such indorsers even as to holders in due course.

### **Instruments Payable to Two or More Persons**

A note or draft can be payable to two or more persons. In form, the payees can be listed in the alternative or jointly. When a commercial paper says "Pay to the order of Lorna Love or Rackets, Inc.," it is stated in the alternative. Either person may negotiate (or discharge or enforce) the paper without the consent of the other. On the other hand, if the paper says "Pay to the order of Lorna Love and Rackets, Inc." or does not clearly state that the payees are to be paid in the alternative, then the instrument is payable to both of them and may be negotiated (or discharged or enforced) only by both of them acting together. The case presented in [Section 23.4 "Cases"](#), *Wisner Elevator Company, Inc. v. Richland State Bank*, deals, indirectly, with instruments payable to two or more persons.

## **Forged Indorsements, Imposters, and Fictitious Payees**

### **The General Rule on Forged Indorsements**

When a check already made out to a payee is stolen, an unscrupulous person may attempt to negotiate it by forging the payee's name as the indorser. Under UCC Section 1-201(43), a forgery is an "unauthorized signature." Section 3-403(a) provides that any unauthorized signature on an instrument is "ineffective except as the signature of the unauthorized signer." The consequence is that, generally, the loss falls on the first party to take the instrument with a forged or unauthorized signature because that person is in the best position to prevent the loss.

Lorna Love writes a check to Steve Supplier on her account at First State Bank, but the check goes astray and is found by Carl Crooks. Crooks indorses the check “Steve Supplier” and presents it for cash to a busy teller who fails to request identification. Two days later, Steve Supplier inquires about his check. Love calls First State Bank to stop payment. Too late—the check has been cashed. Who bears the loss—Love, Supplier, or the bank? The bank does, and it must recredit Love’s account. The forged indorsement on the check was ineffective; the bank was not a holder, and the check should not have been allowed into the channels of commerce. This is why banks may retain checks for a while before allowing access to the money. It is, in part, what the Expedited Funds Availability Act (mentioned in [Section 23.2 "Indorsements"](#), “Indorsements”) addresses—giving banks time to assess the validity of checks.

### Exceptions: Imposter, Fictitious Payee, and Dishonest Employee Rules

The loss for a forged indorsement usually falls on the first party to take the instrument with a forged signature. However, there are three important exceptions to this general rule: the imposter rule, the fictitious payee rule, and the dishonest employee rule.

#### The Imposter Rule

If one person poses as the named payee or as an agent of the named payee, inducing the maker or drawer to issue an instrument in the name of the payee to the imposter (or his confederate), the imposter’s indorsement of the payee’s name is effective. The paper can be negotiated according to the **imposter rule**<sup>16</sup>.

If the named payee is a real person or firm, the negotiation of the instrument by the imposter is good and has no effect on whatever obligation the drawer or maker has to the named payee. Lorna Love owes Steve Supplier \$2,000. Knowing of the debt, Richard Wright writes to Love, pretending to be Steve Supplier, requesting her to send a check to Wright’s address in Supplier’s name. When the check arrives, Wright indorses it by signing “Pay to the order of Richard Wright, (signed) Steve Supplier,” and then indorses it in his own name and cashes it. Love remains liable to Steve Supplier for the money that she owes him, and Love is out the \$2,000 unless she can find Wright.

16. Rule stating that if an impostor endorses a negotiable instrument and receives payment in good faith, the drawer of the instrument is responsible for the loss.

The difference between this case and the one involving the forger Carl Crooks is that in the second case the imposter (Wright) “induced the maker or drawer [Lorna Love] to issue the instrument...by impersonating the payee of the instrument [Steve Supplier]” (UCC, Section 3-404(a)), whereas in the first case the thief did not induce Love to issue the check to him—he simply found it. And the rationale for making



Lorna Love bear the loss is that she failed to detect the scam: she *intended* the imposter, Wright, to receive the instrument. Section 3-404(c) provides that the indorsement of the imposter (Wright, posing as Steve Supplier) is effective. The same rule applies if the imposter poses as an agent: if the check is payable to Supplier, Inc., a company whose president is Steve Supplier, and an impostor impersonates Steve Supplier, the check could be negotiated if the imposter indorses it as Supplier, Inc.'s, agent "Steve Supplier." Uniform Commercial Code, Section 3-404, Official Comment 1.

Similarly, suppose Love is approached by a young man who says to her, "My company sells tennis balls, and we're offering a special deal this month: a can of three high-quality balls for \$2 each. We'll send your order to you by UPS." He hands her a sample ball: it is substantial, and the price is good. Love has heard of the company the man says he represents; she makes out a check for \$100 to "Sprocket Athletic Supply." The young man does not represent the company at all, but he cashes the check by forging the indorsement and the bank pays. Love takes the loss: surely she is more to blame than the bank.

### The Fictitious Payee Rule

Suppose Lorna Love has a bookkeeper, Abby Accountant. Abby presents several checks for Love to sign, one made out to Carlos Aquino. Perhaps there really is no such person, or perhaps he is somebody whom Love deals with regularly, but Accountant intends him to have no interest here. No matter: Love signs the check in the amount of \$2,000. Accountant takes the check and indorses it: "Carlos Aquino, pay to the order of Abby Accountant." Then she signs her name as the next indorser and cashes the check at Love's bank. The check is good, even though it was never intended by Accountant that "Carlos Aquino"—the **fictitious payee**<sup>17</sup>—have any interest in the instrument. The theory here is to "place the loss on the drawer of the check rather than on the drawee or the Depository Bank that took the check for collection....The drawer is in the best position to avoid the fraud and thus should take the loss." Uniform Commercial Code, Section 3-404, Comment 3. This is also known as "the padded-payroll rule."

In the *imposter* cases, Love drew checks made out to real names but gave them to the wrong person (the imposter); in the *fictitious payee* cases she wrote checks to a nonexistent person (or a real person who was not intended to have any interest at all).

17. A payee who has no existence or is intended to have no interest in the instrument.

### The Dishonest Employee Rule

The UCC takes head-on the recurring problem of a dishonest employee. It says that if an employer “entrust[s] an employee with responsibility with respect to the instrument and the employee or a person acting in concert with the employee makes a fraudulent indorsement of the instrument, the indorsement is effective.” Uniform Commercial Code, Section 3-405(B). For example (adapted from UCC 3-405, Official Comment 3; the Comment does not use the names of these characters, of course), the duties of Abby Accountant, a bookkeeper, include posting the amounts of checks payable to Lorna Love to the accounts of the drawers of the checks. Accountant steals a check payable to Love, which was entrusted to Accountant, and forges Love’s indorsement. The check is deposited by Accountant to an account in the depositary bank that Accountant opened in the same name as Lorna Love, and the check is honored by the drawee bank. The indorsement is effective as Love’s indorsement because Accountant’s duties include processing checks for bookkeeping purposes. Thus Accountant is entrusted with “responsibility” with respect to the check. Neither the depositary bank nor the drawee bank is liable to Love for conversion of the check. The same result would follow if Accountant deposited the check in the account in the depositary bank without indorsement (UCC, Section 4-205(a)). Under Section 4-205(c), deposit in a depositary bank in an account in a name substantially similar to that of Lorna Love is the equivalent of an indorsement in the name of Lorna Love. If, say, the janitor had stolen the checks, the result would be different, as the janitor is not entrusted with responsibility regarding the instrument.

### Negligence

Not surprisingly, though, if a person fails to exercise ordinary care and thereby substantially contributes to the success of a forgery, that person cannot assert “the alteration or the forgery against a person that, in good faith, pays the instrument or takes it for value.” Uniform Commercial Code, Section 4-406(a). If the issuer is also negligent, the loss is allocated between them based on comparative negligence theories. Perhaps the bank teller in the example about the tennis-ball scam should have inquired whether the young man had any authority to cash the check made out to Sprocket Athletic Supply. If so, the bank could be partly liable. Or suppose Lorna Love regularly uses a rubber signature stamp for her tennis club business but one day carelessly leaves it unprotected. As a result, the stamp and some checks are stolen; Love bears any loss for being negligent. Similarly liable is a person who has had previous notice that his signature has been forged and has taken no steps to prevent reoccurrences, as is a person who negligently mails a check to the wrong person, one who has the same name as the payee. The UCC provides that the negligence of two or more parties might be compared in order to determine whether each party bears a percentage of the loss, as illustrated in *Victory Clothing Co., Inc. v. Wachovia Bank, N.A.* ([Section 23.4 "Cases"](#)).

### KEY TAKEAWAY

A negotiation is effective even if the transaction involving it is void or voidable, but the transferor—liable on the instrument—can regain its possession and rescind the deal (except as to holders in due course or a person paying in good faith without notice). Instruments may be made payable to two or more parties in the alternative or jointly and must be indorsed accordingly. Generally, a forged indorsement is ineffective, but exceptions hold for cases involving imposters, fictitious payees, and certain employee dishonesty. If a person's own negligence contributes to the forgery, that person must bear as much of the loss as is attributable to his or her negligence.

### EXERCISES

1. A makes a check out to B for \$200 for property both parties know is stolen. Is the check good?
2. What is the difference between (a) the imposter rule, (b) the fictitious payee rule, and (c) the dishonest employee rule?
3. How does comparative negligence work as it relates to forged indorsements?

## 23.4 Cases

### Bearer Paper

(Note: this is a trial court's opinion.)

Chung v. New York Racing Ass'n

714 N.Y.S.2d 429 (N.Y. Dist. Ct. 2000)

Gartner, J.

A published news article recently reported that an investigation into possible money laundering being conducted through the racetracks operated by the defendant New York Racing Association was prompted by a small-time money laundering case in which a Queens bank robber used stolen money to purchase betting vouchers and then exchanged the vouchers for clean cash. [Citation] The instant case does not involve any such question of wrongdoing, but does raise a novel legal issue regarding the negotiability of those same vouchers when their possession is obtained by a thief or finder. The defendant concedes that “there are no cases on point.”

The defendant is a private stock corporation incorporated and organized in New York as a non-profit racing association pursuant to [New York law]. The defendant owns and operates New York's largest thoroughbred racetracks—Belmont Park Racetrack, Aqueduct Racetrack, and Saratoga Racetrack—where it stages thoroughbred horse races and conducts pari-mutuel wagering on them pursuant to a franchise granted to the defendant by the State of New York.

The plaintiff was a Belmont Park Racetrack horse player. He attended the track and purchased from the defendant a voucher for use in SAMS machines. As explained in [Citation]:

In addition to accepting bets placed at parimutuel facility windows staffed by facility employees, [some] facilities use SAMS. SAMS are automated machines which permit a bettor to enter his bet by inserting money, vouchers or credit cards into the machine, thereby enabling him to select the number or combination he wishes to purchase. A ticket is issued showing those numbers. Authors' note: Pari-mutuel betting (from the French *pari mutuel*, meaning mutual stake) is a betting system in

which all bets of a particular type are placed together in a pool; taxes and a house take are removed, and payoff odds are calculated by sharing the pool among all winning bets.

When a voucher is utilized for the purpose of placing a bet at a SAMS machine, the SAMS machine, after deducting the amount bet by the horse player during the particular transaction, provides the horse player with, in addition to his betting ticket(s), a new voucher showing the remaining balance left on the voucher.

In the instant case, the unfortunate horse player departed the SAMS machine with his betting tickets, but *without* his new voucher—showing thousands of dollars in remaining value—which he inadvertently left sitting in the SAMS machine. Within several minutes he realized his mistake and hurried back to the SAMS machine, only to find the voucher gone. He immediately notified a security guard. The defendant’s personnel thereafter quickly confirmed the plaintiff as the original purchaser of the lost voucher. The defendant placed a computerized “stop” on the voucher. However, whoever had happened upon the voucher in the SAMS machine and taken it had acted even more quickly: the voucher had been brought to a nearby track window and “cashed out” within a minute or so of the plaintiff having mistakenly left it in the SAMS machine.

The plaintiff now sues the defendant, contending that the defendant should be liable for having failed to “provide any minimal protection to its customers” in checking the identity and ownership of vouchers prior to permitting their “cash out.” The defendant, in response, contends that the voucher consists of “bearer paper,” negotiable by anyone having possession, and that it is under no obligation to purchasers of vouchers to provide any such identity or ownership checks.

As opposed to instruments such as ordinary checks, which are typically made payable to the order of a specific person and are therefore known as “order paper,” bearer paper is payable to the “bearer,” *i.e.*, whoever walks in carrying (or “bearing”) the instrument. Pursuant to [New York’s UCC] “[a]n instrument is payable to bearer when by its terms it is payable to...(c) ‘cash’ or the order of ‘cash’, or any other indication which does not purport to designate a specific payee.”

Each New York Racing Association voucher is labeled “Cash Voucher.” Each voucher contains the legend “Bet Against the Value or Exchange for Cash.” Each voucher is also encoded with certain computer symbols which are readable by SAMS machines. The vouchers do by their terms constitute “bearer paper.”

There is no doubt that under the [1990 Revision] Model Uniform Commercial Code the defendant would be a “holder in due course” of the voucher, deemed to have taken it free from all defenses that could be raised by the plaintiff. As observed in 2 White & Summers, *Uniform Commercial Code* pp. 225–226, 152–153 (4th ed.1995):

Consider theft of bearer instruments...[T]he thief can make his or her transferee a holder simply by transfer to one who gives value in good faith. If the thief’s transferee cashes the check and so gives value in good faith and without notice of any defense, that transferee will be a holder in due course under 3-302, free of all claims to the instrument on the part...of any person and free of all personal defenses of any prior party. Therefore, the holder in due course will not be liable in conversion to the true owner....Of course, the owner of the check will have a good cause of action against the thief, but no other cause of action....

If an instrument is payable to bearer...the possessor of the instrument will be a holder and, if he meets the other tests, a holder in due course. This is so even though the instrument may have passed through the hands of a thief; the holder in due course is one of the few purchasers in Anglo-Saxon jurisprudence who may derive a good title from a chain of title that includes a thief in its links.

However, the Model Uniform Commercial Code in its present form is not in effect in New York. Authors’ note: As of 2010, New York is the sole remaining state yet to adopt the 1990 revisions to Articles 3 and 4; it entertained a bill in 2007 and 2008 that would have enacted the 1990 revisions as amended by the 2002 amendments. However, that bill floundered. Keith A. Rowley, *UCC Update* [American Bar Association, Business Law Committee], available at <http://www.abanet.org/buslaw/committees/CL190000pub/newsletter/200901/subcommittees/developments.pdf>. In 1990, the National Conference of Commissioners on Uniform State Laws and the American Law Institute approved a revised Article 3. This revised Article 3 has never been enacted in New York. Comment 1 to § 3-201 of the [1990] Uniform Commercial Code, commenting on the difference between it and its predecessor (which is still in effect in New York), states:

A person can become holder of an instrument...as the result of an event that occurs after issuance. “Negotiation” is the term used in Article 3 to describe this post-issuance event....In defining “negotiation” former Section 3-202(1) used the word “transfer,” an undefined term, and “delivery,” defined in Section 1-201(14) to mean voluntary change of possession. Instead, subsections (a) and (b) [now] use the term “transfer of possession,” and subsection (a) states that negotiation can occur by an involuntary transfer of possession. For example, if an instrument is payable to bearer and it is stolen by Thief or is found by Finder, Thief or Finder becomes the

holder of the instrument when possession is obtained. In this case there is an involuntary transfer of possession that results in negotiation to Thief or Finder.

Thus, it would initially appear that under the prior Model Uniform Commercial Code, still in effect in New York, a thief or finder of bearer paper, as the recipient of an involuntary transfer, could not become a “holder,” and thus could not pass holder-in-due-course status, or good title, to someone in the position of the defendant.

This conclusion, however, is not without doubt. For instance, in 2 Anderson, *Uniform Commercial Code* § 3-202:35 (2nd ed.1971), it was observed that:

The Code states that bearer paper is negotiated by “delivery.” This is likely to mislead for one is not inclined to think of the acquisition of paper by a finder or a thief as a “voluntary transfer of possession.”

By stating that the Code’s terminology was “misleading,” the treatise appears to imply that despite the literal import of the words, the contrary was true—negotiation could be accomplished by involuntary transfer, *i.e.*, loss or theft.

In [Citation], the Appellate Division determined that the Tropicana Casino in New Jersey became a holder in due course of signed cashier’s checks with blank payee designations which a thief had stolen from the defendant and negotiated to the casino for value after filling in the payee designation with his brother-in-law’s name. The Appellate Division, assuming without discussion that the thief was a “holder” of the stolen instruments and therefore able to transfer good title, held the defendant obligated to make payment on the stolen checks. *Accord* [Citation] (check cashing service which unknowingly took for value from an intervening thief the plaintiff’s check, which the plaintiff had endorsed in blank and thus converted to a bearer instrument, was a holder in due course of the check, having received good title from the thief).

Presumably, these results have occurred because the courts in New York have implicitly interpreted the undefined term “transfer” as utilized in [the pre-1990] U.C.C. § 3-202(1) as including the involuntary transfer of possession, so that as a practical matter the old Code (as still in effect in New York) has the same meaning as the new Model Uniform Commercial Code, which represents a clarification rather than a change in the law.

This result makes sense. A contrary result would require extensive verification procedures to be undertaken by all transferees of bearer paper. The problem with

imposing an identity or ownership check requirement on the negotiation of bearer paper is that such a requirement would impede the free negotiability which is the essence of bearer paper. As held in [Citation (1970)],

[Where] the instrument entrusted to a dishonest messenger or agent was freely negotiable bearer paper...the drawee bank [cannot] be held liable for making payment to one presenting a negotiable instrument in bearer form who may properly be presumed to be a holder [citations omitted].

...Moreover, the plaintiff in the instant case knew that the voucher could be “Exchange[d] for cash.” The plaintiff conceded at trial that (1) when he himself utilized the voucher prior to its loss, no identity or ownership check was ever made; and (2) he nevertheless continued to use it. The plaintiff could therefore not contend that he had any expectation that the defendant had in place any safeguards against the voucher’s unencumbered use, or that he had taken any actions in reliance on the same.

This Court is compelled to render judgment denying the plaintiff’s claim, and in favor of the defendant.

### CASE QUESTIONS

1. Was the instrument in question a note or a draft?
2. How did the court determine it was bearer paper?
3. What would the racetrack have to have done if it wanted the machine to dispense order paper?
4. What confusion arose from the UCC’s pre-1990 use of the words “transfer” and “delivery,” which was clarified by the revised Article 3’s use of the phrase “transfer of possession”? Does this offer any insight into why the change was made?
5. How had—have—the New York courts decided the question as to whether a thief could be a holder when the instrument was acquired from its previous owner involuntarily?

### **Forged Drawer’s Signature, Forged Indorsements, Fictitious Payee, and Comparative Negligence**

Victory Clothing Co., Inc. v. Wachovia Bank, N.A.



2006 WL 773020 (Penn. [Trial Court] 2006)

Abramson, J.

### **Background**

This is a subrogation action brought by the insurance carrier for plaintiff Victory Clothing, Inc. (“Victory”), to recover funds paid to Victory under an insurance policy. This matter arises out of thefts from Victory’s commercial checking account by its office manager and bookkeeper, Jeanette Lunny (“Lunny”). Lunny was employed by Victory for approximately twenty-four (24) years until she resigned in May 2003. From August 2001 through May 2003, Lunny deposited approximately two hundred (200) checks drawn on Victory’s corporate account totaling \$188,273.00 into her personal checking account at defendant Wachovia Bank (“Wachovia”). Lunny’s scheme called for engaging in “double forgeries” (discussed *infra*). Lunny would prepare the checks in the company’s computer system, and make the checks payable to known vendors of Victory (e.g., Adidas, Sean John), to whom no money was actually owed. The checks were for dollar amounts that were consistent with the legitimate checks to those vendors. She would then forge the signature of Victory’s owner, Mark Rosenfeld (“Rosenfeld”), on the front of the check, and then forge the indorsement of the unintended payee (Victory’s various vendors) on the reverse side of the check. The unauthorized checks were drawn on Victory’s bank account at Hudson Bank (the “drawee bank” or “payor bank”). After forging the indorsement of the payee, Lunny either indorsed the check with her name followed by her account number, or referenced her account number following the forged indorsement. She then deposited the funds into her personal bank account at Wachovia (the “depository bank” or “collecting bank”).

At the time of the fraud by Lunny, Wachovia’s policies and regulations regarding the acceptance of checks for deposit provided that “checks payable to a non-personal payee can be deposited ONLY into a non-personal account with the same name.” [Emphasis in original]

Rosenfeld reviewed the bank statements from Hudson Bank on a monthly basis. However, among other observable irregularities, he failed to detect that Lunny had forged his signature on approximately two hundred (200) checks. Nor did he have a procedure to match checks to invoices.

In its Complaint, Victory asserted a claim against Wachovia pursuant to the Pennsylvania Commercial Code, [3-405]...[it] states, in relevant part:

### Employer's responsibility for fraudulent indorsement by employee

(b) RIGHTS AND LIABILITIES.-For the purpose of determining the rights and liabilities of a person who, in good faith, pays an instrument or takes it for value or for collection, if an employer entrusted an employee with responsibility with respect to the instrument and the employee or a person acting in concert with the employee makes a fraudulent indorsement of the instrument, the indorsement is effective as the indorsement of the person to whom the instrument is payable if it is made in the name of that person. If the person paying the instrument or taking it for value or for collection fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss resulting from the fraud, the person bearing the loss may recover from the person failing to exercise ordinary care to the extent the failure to exercise ordinary care contributed to the loss.

In essence, Victory contends that Wachovia's actions in accepting the checks payable to various businesses for deposit into Lunny's personal account were commercially unreasonable, contrary to Wachovia's own internal rules and regulations, and exhibited a want of ordinary care.

### **Discussion**

#### **I. Double Forgeries**

As stated supra, this case involves a double forgery situation. This matter presents a question of first impression in the Pennsylvania state courts, namely how should the loss be allocated in double forgery situations. A double forgery occurs when the negotiable instrument contains both a forged maker's [bank customer's] signature and a forged indorsement. The Uniform Commercial Code ("UCC" or "Code") addresses the allocation of liability in cases where either the maker's signature is forged or where the indorsement of the payee or holder is forged. [Citation] ("the Code accords separate treatment to forged drawer signatures...and forged indorsements"). However, the drafters of the UCC failed to specifically address the allocation of liability in double forgery situations....Consequently, the courts have been left to determine how liability should be allocated in a double forgery case....

#### **II. The Effect of the UCC Revisions**

In 1990, new revisions to Articles 3 and 4 of the UCC were implemented (the "revisions")....The new revisions made a major change in the area of double forgeries. Before the revisions, the case law was uniform in treating a double forgery case as a forged drawer's signature case [only], with the loss falling [only] on the drawee bank. The revisions, however, changed this rule by shifting to a

comparative fault approach. Under the revised version of the UCC, the loss in double forgery cases is allocated between the depository and drawee banks based on the extent that each contributed to the loss....

Specifically, revised § 3-405 of the UCC, entitled “Employer’s Responsibility for Fraudulent Indorsement by Employee,” introduced the concept of comparative fault as between the employer of the dishonest employee/embezzler and the bank(s). This is the section under which Victory sued Wachovia. Section 3-405(b) states, in relevant part:

If the person paying the instrument or taking it for value or for collection fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss resulting from the fraud, the person bearing the loss may recover from the person failing to exercise ordinary care to the extent the failure to exercise ordinary care contributed to the loss.

Wachovia argues that this section is applicable only in cases of forged indorsements, and not in double forgery situations. However, at least one court has found that the new revisions have made section 3-405 apply to double forgery situations. “Nothing in the [Revised UCC] statutory language indicates that, where the signature of the drawer is forged...the drawer is otherwise precluded from seeking recovery from a depository bank under these sections” [Citation]...The Court finds the reasoning persuasive and holds that...Victory can maintain its cause of action against Wachovia.

### **III. The Fictitious Payee Rule**

Lunny made the fraudulent checks payable to actual vendors of Victory with the intention that the vendors not get paid. Wachovia therefore argues that Victory’s action against it should be barred by the fictitious payee rule under UCC 3-404 [which] states, in relevant part:

(b) Fictitious Payee. If a person...does not intend the person identified as payee to have any interest in the instrument or the person identified as payee of an instrument is a fictitious person, the following rules apply until the instrument is negotiated by special indorsement:

(1) Any person in possession of the instrument is its holder.

(2) An indorsement by any person in the name of the payee stated in the instrument is effective as the indorsement of the payee in favor of a person who, in good faith, pays the instrument or takes it for value or for collection....

The theory under the rule is that since the indorsement is “effective,” the drawee bank was justified in debiting the company’s account. Therefore, [Wachovia argues] the loss should fall on the company whose employee committed the fraud.

...[However] under revised UCC §§ 3-404 and 3-405, the fictitious payee defense triggers principles of comparative fault, so a depository bank’s own negligence may be considered by the trier of fact....Therefore, based on the foregoing reasons, the fictitious payee defense does not help Wachovia in this case.

#### IV. Allocation of Liability

As stated supra, comparative negligence applies in this case because of the revisions in the Code. In determining the liability of the parties, the Court has considered, *inter alia* [among other things], the following factors:

- At the time of the fraud by Lunny, Wachovia’s policies and regulations regarding the acceptance of checks for deposit provided that “checks payable to a non-personal payee can be deposited ONLY into a non-personal account with the same name.” [Emphasis in original]
- Approximately two hundred (200) checks drawn on Victory’s corporate account were deposited into Lunny’s personal account at Wachovia.
- The first twenty-three (23) fraudulent checks were made payable to entities that were not readily distinguishable as businesses, such as “Sean John.” The check dated December 17, 2001 was the first fraudulent check made payable to a payee that was clearly a business, specifically “Beverly Hills Shoes, Inc.”
- In 2001, Victory had approximately seventeen (17) employees, including Lunny.
- Lunny had been a bookkeeper for Victory from approximately 1982 until she resigned in May 2003. Rosenfeld never had any problems with Lunny’s bookkeeping before she resigned.
- Lunny exercised primary control over Victory’s bank accounts.
- Between 2001 and 2003, the checks that were generated to make payments to Victory’s vendors were all computerized checks generated by Lunny. No other Victory employee, other than Lunny, knew how to generate the computerized checks, including Rosenfeld.

- The fraudulent checks were made payable to known vendors of Victory in amounts that were consistent with previous legitimate checks to those vendors.
- After forging the indorsement of the payee, Lunny either indorsed the check with her name followed by her account number, or referenced her account number following the forged indorsement.
- About ten (10) out of approximately three hundred (300) checks each month were forged by Lunny and deposited into her personal account.
- Rosenfeld reviewed his bank statements from Hudson Bank on a monthly basis.
- Rosenfeld received copies of Victory's cancelled checks from Hudson Bank on a monthly basis. However, the copies of the cancelled checks were not in their normal size; instead, they were smaller, with six checks (front and back side) on each page.
- The forged indorsements were written out in longhand, i.e., Lunny's own handwriting, rather than a corporate stamped signature.
- Victory did not match its invoices for each check at the end of each month.
- An outside accounting firm performed quarterly reviews of Victory's bookkeeping records, and then met with Rosenfeld. This review was not designed to pick up fraud or misappropriation.

Based on the foregoing, the Court finds that Victory and Wachovia are comparatively negligent.

With regard to Wachovia's negligence, it is clear that Wachovia was negligent in violating its own rules in repeatedly depositing corporate checks into Lunny's personal account at Wachovia. Standard commercial bank procedures dictate that a check made payable to a business be accepted only into a business checking account with the same title as the business. Had a single teller at Wachovia followed Wachovia's rules, the fraud would have been detected as early as December 17, 2001, when the first fraudulently created non-personal payee check was presented for deposit into Lunny's personal checking account. Instead, Wachovia permitted another one hundred and seventy-six (176) checks to be deposited into Lunny's account after December 17, 2001. The Court finds that Wachovia failed to exercise ordinary care, and that failure substantially contributed to Victory's loss resulting from the fraud. Therefore, the Court concludes that Wachovia is seventy (70) percent liable for Victory's loss.

Victory, on the other hand, was also negligent in its supervision of Lunny, and for not discovering the fraud for almost a two-year period. Rosenfeld received copies of the cancelled checks, albeit smaller in size, on a monthly basis from Hudson Bank. The copies of the checks displayed both the front and back of the checks. Rosenfeld

was negligent in not recognizing his own forged signature on the front of the checks, as well as not spotting his own bookkeeper's name and/or account number on the back of the checks (which appeared far too many times and on various "payees" checks to be seen as regular by a non-negligent business owner).

Further, there were inadequate checks and balances in Victory's record keeping process. For example, Victory could have ensured that it had an adequate segregation of duties, meaning that more than one person would be involved in any control activity. Here, Lunny exercised primary control over Victory's bank accounts. Another Victory employee, or Rosenfeld himself, could have reviewed Lunny's work. In addition, Victory could have increased the amount of authorization that was needed to perform certain transactions. For example, any check that was over a threshold monetary amount would have to be authorized by more than one individual. This would ensure an additional control on checks that were larger in amounts. Furthermore, Victory did not match its invoices for each check at the end of each month. When any check was created by Victory's computer system, the value of the check was automatically assigned to a general ledger account before the check could be printed. The values in the general ledger account could have been reconciled at the end of each month with the actual checks and invoices. This would not have been overly burdensome or costly because Victory already had the computer system that could do this in place. Based on the foregoing, the Court concludes that Victory is also thirty (30) percent liable for the loss.

### **Conclusion**

For all the foregoing reasons, the Court finds that Wachovia is 70% liable and Victory is 30% liable for the \$188,273.00 loss. Therefore, Victory Clothing Company, Inc. is awarded \$131,791.10.

## CASE QUESTIONS

1. How does the double-forgery scam work?
2. What argument did Wachovia make as to why it should not be liable for the double forgeries?
3. What argument did Wachovia make as to why it should not be liable under the fictitious payee rule?
4. What change in the revised UCC (from the pre-1990 version) made Wachovia's arguments invalid, in the court's opinion?
5. What factors appear to have caused the court to decide that Wachovia was more than twice as responsible for the embezzlement as Victory was?

### Joint Payees and Conditional and Restrictive Indorsements

Wisner Elevator Company, Inc. v. Richland State Bank

862 So.2d 1112 (La. App. 2003)

Gaskins, J.

Wisner Elevator Company, Inc. [plaintiff] ("Wisner"), appeals from a summary judgment in favor of the defendant, Richland State Bank. At issue is the deposit of a check with a typed statement on the back directing that a portion of the funds be paid to a third party. We affirm the trial court judgment.

#### Facts

On July 13, 2001, the United States Treasury, through the Farm Service Agency, issued a check in the amount of \$17,420.00, made payable to Chad E. Gill. On the back of the check the following was typed:

PAY TO THE ORDER OF RICHLAND STATE BANK FOR ISSUANCE OF A CASHIER'S CHECK PAYABLE TO WISNER ELEVATOR IN THE AMOUNT OF \$13,200.50 AND PAY THE BALANCE TO CHAD GILL IN THE AMOUNT OF \$4,219.50.

On July 23, 2001, the check was deposited into Gill's checking account at Richland State Bank. Gill's signature is found on the back of the check below the typed

paragraph. No cashier check to Wisner Elevator was issued; instead the entire amount was deposited into Gill's checking account as per Gill's deposit ticket.

...On May 28, 2002, Wisner filed suit against the bank, claiming that its failure to apply the funds as per the restrictive indorsement constituted a conversion of the portion of the check due to Wisner under UCC 3-206(c)(2) [that a depository bank converts an instrument if it pays out on an indorsement "indicating a purpose of having the instrument collected for the indorser or for a particular account"].

[The bank] asserted that the indorsement on the back of the check was a conditional indorsement and ineffective under 3-206(b), [which states:]

An indorsement stating a condition to the right of the indorsee to receive payment does not affect the right of the indorsee to enforce the instrument. A person paying the instrument or taking it for value or collection may disregard the condition, and the rights and liabilities of that person are not affected by whether the condition has been fulfilled.

...[T]he bank asserts the fault of the United States Treasury..., in failing to make the check payable to both Gill and Wisner. To the extent that the indorsement was conditional, the bank contends that it was unenforceable; to the extent that it was restrictive, it maintains that the restrictions were waived by the indorser when he deposited the full amount of the check into his own checking account.

Wisner...[stated that it] was owed \$13,200.50 by Gill for seeds, chemicals, crop supplies and agricultural seed technology fees. [It] further stated that Gill never paid the \$13,200.50 he owed and that Wisner did not receive a cashier's check issued in that amount by Richland State Bank....According to [the bank teller], Gill asked to deposit the entire amount in his account. She further stated that the bank was unaware that the indorsement was written by someone other than Gill.

...The court found that the typed indorsement placed on the check was the indorsement of the maker, not Gill. However, when Gill signed below the indorsement, he made it his own indorsement. The court concluded that Gill had the legal power and authority to verbally instruct that the entire proceeds be deposited into his account. The court stated that as long as the indorsement was his own, whether it was restrictive or conditional, Gill had the power to ignore it, strike it out or give contrary instructions. The court further concluded that the bank acted properly when it followed the verbal instructions given by Gill to the teller and the written instructions on his deposit slip to deposit the entire proceeds into



Gill's account. Consequently, the court gave summary judgment in favor of the bank. Wisner appeals....

### **Discussion**

Wisner contends that the trial court erred in holding that the bank could disregard what Wisner characterizes as a special and restrictive indorsement on the back of the check. It claims that under UCC 3-206, the amount paid by the bank had to be "applied consistently with" the indorsement and that the bank's failure to comply with the indorsement made it liable to Wisner. According to Wisner, Gill was not entitled to deposit the amount due to Wisner by virtue of his own special indorsement and the bank converted the check under 3-420 by crediting the full amount to Gill's account.

The bank argues that the indorsement was conditional and thus could be ignored pursuant to 3-206(b). It also asserts that nothing on the check indicated that the indorsement was written by someone other than Gill. Since the check was made payable to Gill, the indorsement was not necessary to his title and could be ignored, struck out or simply waived. The bank also claims that Wisner had no ownership interest in the check, did not receive delivery of the check, and had no claim for conversion under 3-420.

We agree with the bank that the true problem in this case is the failure of the government to issue the check jointly to Gill and Wisner as co-payees. Had the government done so, there would be no question as to Wisner's entitlement to a portion of the proceeds from the check.

Although the writing on the back of the check is referred to as an indorsement, we note that, standing alone, it does not truly conform to the definition found in 3-204(a) [which states]:

"Indorsement" means a signature, other than that of a signer as maker, drawer, or acceptor, that alone or accompanied by other words is made on an instrument for the purpose of (i) negotiating the instrument, (ii) restricting payment of the instrument, or (iii) incurring indorser's liability on the instrument, but regardless of the intent of the signer, a signature and its accompanying words is an indorsement unless the accompanying words, terms of the instrument, place of the signature, or other circumstances unambiguously indicate that the signature was made for a purpose other than indorsement.

This paragraph was placed on the back of the check by the government as the maker or drawer of the check. Consequently, the bank argues that Gill as sole payee could waive, ignore or strike out the language.

Although the Louisiana jurisprudence contains no similar case dealing with the Uniform Commercial Code, we may look to other jurisdictions for guidance...In [Citation, a New Jersey case] (1975), the drawer of a check placed instructions on the backs of several checks...that the instruments not be deposited until a specific future date. However, the payee presented some of the checks prior to the date specified on the back. The court found that the drawer did not have the capacity to indorse the instruments; as a result the typed instructions on the backs of the checks could not be indorsements. Instead, they were “merely requests to plaintiff who may or may not comply at its own pleasure. The instructions are neither binding on plaintiff nor the subsequent holders.” In other words, the payee could ignore the instructions.

In the instant case, the payee did precisely that. Gill ignored the writing on the back of the check and instructed the teller at the defendant bank to do the same through verbal and written instructions.

Wisner argues that by affixing his signature under the writing on the back of the check, Gill made it his own indorsement. Furthermore, it asserts that it was a restrictive indorsement, not a conditional one which could be disregarded pursuant to 3-206. Wisner relies upon the provisions of 3-206 for the proposition that the check had a restrictive indorsement and that the bank converted the check because it failed to apply the amount it paid consistently with the indorsement. However, Comment 3 to 3-206 states, in pertinent part:

This Article does not displace the law of waiver as it may apply to restrictive indorsements. The circumstances under which a restrictive indorsement may be waived by the person who made it is not determined by this Article.

Not all jurisdictions recognize a doctrine of waiver of restrictive indorsements. [Citing cases from various jurisdictions in which a bank customer effectively requested the bank to disregard a restrictive indorsement; some cases affirmed the concept that the restriction could be waived (disregarded), others did not.]...

In two cases arising under pre-UCC law, Louisiana recognized that indorsements could be ignored or struck out. In [Citation] (1925), the Louisiana Supreme Court held that the holder of a check could erase or strike out a restrictive indorsement on a check that was not necessary to the holder's title. In [Citation] (1967), the court

stated that an erroneous indorsement could be ignored and even struck out as unnecessary to the plaintiff's title.

Like the trial court, we find that when Gill affixed his signature under the writing on the back of the check, he made it his own indorsement. We further find that the indorsement was restrictive, not conditional. As Gill's own restrictive indorsement, he could waive it and direct that the check, upon which he was designated as the sole payee, be deposited in his account in its entirety.

Affirmed.

### CASE QUESTIONS

1. Notice that the check was made payable to Chad Gill—he was the named payee on the front side of the check. To avoid the problems here, if the drawer (the US government) wanted to control the uses to which the check could be put, how should it have named the payee?
2. The court held that when Gill “affixed his signature under the writing on the back of the check, he made it his own indorsement.” But why wasn't it the indorsement of the drawer—the US government?
3. If the language on the back was considered his own conditional indorsement (the instrument was not valid unless the stated conditions were met), how could the condition be disregarded by the bank?
4. If it was his own restrictive indorsement, how could it be disregarded by the bank?
5. What recourse does Wisner have now?

## 23.5 Summary and Exercises

### Summary

Negotiation is the transfer of an instrument in such a form that the transferee becomes a holder. There are various methods for doing so; if the procedures are not properly adhered to, the transfer is only an assignment.

An instrument payable to the order of someone must be negotiated by indorsement and delivery to the transferee. The indorsement must convey the entire instrument. An instrument payable to bearer may be negotiated simply by delivery to the transferee.

Those who sign the instrument have made a contract and are liable for its breach. Makers and acceptors are primary parties and are liable to pay the instrument. Drawers and indorsers are secondary parties and are conditionally liable. Signatories are liable under a warranty theory.

Various forms of indorsement are possible: blank or special, restrictive or unrestrictive, qualified or unqualified.

Between drawer and drawee, liability for a forged instrument—one signed without authority—usually falls on the drawee who paid it. There are, however, several exceptions to this rule: where an imposter induces the maker or drawer to issue an instrument in the name of the payee, where the instrument is made to a fictitious payee (or to a real person who is intended to have no interest in it), and where the instrument is made by an employee authorized generally to deal in such paper

## EXERCISES

1. Mal, a minor, purchased a stereo from Howard for \$425 and gave Howard a negotiable note in that amount. Tanker, a thief, stole the note from Howard, indorsed Howard's signature and sold the note to Betty. Betty then sold the note to Carl; she did not indorse it. Carl was unable to collect on the note because Mal disaffirmed the contract. Is Betty liable to Carl on a contract or warranty theory? Why?
2. Would the result in Exercise 1 be different if Betty had given a qualified indorsement? Explain.
3. Alphonse received a check one Friday from his employer and cashed the check at his favorite tavern, using a blank indorsement. After the tavern closed that evening, the owner, in reviewing the receipts for the evening, became concerned that if the check was stolen and cashed by a thief, the loss would fall on the tavern. Is this concern justified? What can the owner of the tavern do for protection?
4. Martha owns a sporting goods store. She employs a bookkeeper, Bob, who is authorized to indorse checks received by the store and to deposit them in the store's bank account at Second Bank. Instead of depositing all the checks, Bob cashes some of them and uses the proceeds for personal purposes. Martha sues the bank for her loss, claiming that the bank should have deposited the money in the store's account rather than paying Bob. Is the bank liable? Explain.
5. Daniel worked as a writer in order to support himself and his wife while she earned her MBA degree. Daniel's paychecks were important, as the couple had no other source of income. One day, Daniel drove to Old Faithful State Bank to deposit his paycheck. Standing at a counter, he indorsed the check with a blank indorsement and then proceeded to fill out a deposit slip. While he was completing the slip, a thief stole the check and cashed it. Whose loss? How could the loss be avoided?
6. You are the branch manager of a bank. A well-respected local attorney walks into the bank with a check for \$100,000 that he wants to deposit in the general account his firm has at your bank. The payee on the check is an elderly widow, Hilda Jones, who received the check from the profit-sharing plan of her deceased husband, Horatio Jones. The widow indorsed the check "Pay to the order of the estate of Horatio Jones. Hilda Jones." The attorney produces court documents showing that he is the executor of the estate. After the attorney indorses the check, you deposit the check in the attorney's account. The attorney later withdraws the \$100,000 and spends it on a pleasure trip, in violation of his duties as executor. Discuss the bank's liability.
7. Stephanie borrows \$50,000 from Ginny and gives Ginny a negotiable note in that amount. Ginny sells the note to Roe for \$45,000. Ginny's

indorsement reads, “For valuable consideration, I assign all of my rights in this note to Roe. Ginny.” When Stephanie refuses to pay the note and skips town, Roe demands payment from Ginny, claiming contract liability on the basis of her signature. Ginny argues that she is not liable because the indorsement is qualified by the language she used on the note. Who is correct? Explain.

8. The state of California issued a check that read, “To Alberto Cruz and Roberta Gonzales.” Alberto endorsed it “Pay to the order of Olivia Cruz.” What rights does Olivia get in the instrument?
  
9.
  - a. Bill’s weekly paycheck was stolen by a thief. The thief indorsed Bill’s name and cashed the check at the drawee bank before Bill’s employer had time to stop payment. May the drawee bank charge this payment against the drawer’s account? Explain.
  - b. Would the result change in (a) if Bill had carelessly left his check where it could easily be picked up by the thief? Explain.
  - c. Would the result change in (a) if the bank had specific regulations that tellers were not to cash any check without examining the identification of the person asking for cash?
  - d. Would the result change if Bill’s employer had carelessly left the check where it could be found by the thief?

## SELF-TEST QUESTIONS

1. A person who signs a negotiable instrument with a blank endorsement has
  - a. warranty liability
  - b. contract liability
  - c. both of the above
  - d. neither of the above
  
2. “For deposit” is an example of
  - a. a special indorsement
  - b. a restrictive indorsement
  - c. a qualified indorsement
  - d. a blank indorsement
  
3. “Pay to the order of XYZ Company” is an example of
  - a. a special indorsement
  - b. a restrictive indorsement
  - c. a qualified indorsement
  - d. a blank indorsement
  
4. The indorser’s signature alone is
  - a. a special indorsement
  - b. a restrictive indorsement
  - c. a qualified indorsement
  - d. a blank indorsement
  
5. Generally, liability for a forged instrument falls on
  - a. the drawer
  - b. the drawee
  - c. both of the above
  - d. neither of the above
  
6. State whether each of the following is (1) blank or special, (2) restrictive or nonrestrictive, or (3) qualified or unqualified:

- a. "Pay to David Murphy without recourse."
- b. "Ronald Jackson"
- c. "For deposit only in my account at Industrial Credit Union."
- d. "Pay to ABC Co."
- e. "I assign to Ken Watson all my rights in this note."

#### SELF-TEST ANSWERS

1. c
2. b
3. a
4. d
5. b
  
6.
  - a. special, nonrestrictive, qualified
  - b. blank, nonrestrictive, unqualified
  - c. special, nonrestrictive, unqualified
  - d. special, restrictive, unqualified
  - e. special, restrictive, unqualified



## Chapter 24

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### Holder in Due Course and Defenses

#### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. What a holder in due course is, and why that status is critical to commercial paper
2. What defenses are good against a holder in due course
3. How the holder-in-due-course doctrine is modified in consumer transactions

In this chapter, we consider the final two questions that are raised in determining whether a holder can collect:

1. Is the holder a holder in due course?
2. What defenses, if any, can be asserted against the holder in due course to prevent collection on the instrument?

## 24.1 Holder in Due Course

### LEARNING OBJECTIVES

1. Understand why the concept of holder in due course is important in commercial transactions.
2. Know what the requirements are for being a holder in due course.
3. Determine whether a payee may be a holder in due course.
4. Know what the shelter rule is and why the rule exists.

### Overview of the Holder-in-Due-Course Concept

#### Importance of the Holder-in-Due-Course Concept

A holder is a person in possession of an instrument payable to bearer or to the identified person possessing it. But a holder's rights are ordinary, as we noted briefly in [Chapter 22 "Nature and Form of Commercial Paper"](#). If a person to whom an instrument is negotiated becomes nothing more than a holder, the law of commercial paper would not be very significant, nor would a negotiable instrument be a particularly useful commercial device. A mere holder is simply an assignee, who acquires the assignor's rights but also his liabilities; an ordinary holder must defend against claims and overcome defenses just as his assignor would. The holder in due course is really the crux of the concept of commercial paper and the key to its success and importance. What the holder in due course gets is an instrument free of claims or defenses by previous possessors. A holder with such a preferred position can then treat the instrument almost as money, free from the worry that someone might show up and prove it defective.

#### Requirements for Being a Holder in Due Course

Under Section 3-302 of the Uniform Commercial Code (UCC), to be a holder in due course (HDC), a transferee must fulfill the following:

1. Be a holder of a negotiable instrument;
2. Have taken it:
  - a) for value,

b) in good faith,

c) without notice

(1) that it is overdue or

(2) has been dishonored (not paid), or

(3) is subject to a valid claim or defense by any party, or

(4) that there is an uncured default with respect to payment of another instrument issued as part of the same series, or

(5) that it contains an unauthorized signature or has been altered, and

3. Have no reason to question its authenticity on account of apparent evidence of forgery, alteration, irregularity or incompleteness.

The point is that the HDC should honestly pay for the instrument and not know of anything wrong with it. If that's her status, she gets paid on it, almost no matter what.

### **Specific Analysis of Holder-in-Due-Course Requirements**

#### **Holder**

Again, a holder is a person who possesses a negotiable instrument "payable to bearer or, the case of an instrument payable to an identified person, if the identified person is in possession." Uniform Commercial Code, Section 1-201(20). An instrument is payable to an identified person if she is the named payee, or if it is indorsed to her. So a holder is one who possesses an instrument and who has all the necessary indorsements.

#### **Taken for Value**

Section 3-303 of the UCC describes what is meant by transferring an instrument "for value." In a broad sense, it means the holder has given something for it, which sounds like consideration. But "value" here is not the same as consideration under contract law. Here is the UCC language:

An instrument is issued or transferred for value if any of the following apply:

- (1) The instrument is issued or transferred for a promise of performance, to the extent the promise has been performed.
- (2) The transferee acquires a security interest or other lien in the instrument other than a lien obtained by judicial proceeding.
- (3) The instrument is issued or transferred as payment of, or as security for, an antecedent claim against any person, whether or not the claim is due.
- (4) The instrument is issued or transferred in exchange for a negotiable instrument.
- (5) The instrument is issued or transferred in exchange for the incurring of an irrevocable obligation to a third party by the person taking the instrument.

1. *For a promise, to the extent performed.* Suppose A contracts with B: “I’ll buy your car for \$5,000.” Under contract law, A has given consideration: the promise is enough. But this executory (not yet performed) promise given by A is not giving “value” to support the HDC status because the promise has not been performed.

Lorna Love sells her car to Paul Purchaser for \$5,000, and Purchaser gives her a note in that amount. Love negotiates the note to Rackets, Inc., for a new shipment of tennis rackets to be delivered in thirty days. Rackets never delivers the tennis rackets. Love has a claim for \$5,000 against Rackets, which is not an HDC because its promise to deliver is still executory. Assume Paul Purchaser has a defense against Love (a reason why he doesn’t want to pay on the note), perhaps because the car was defective. When Rackets presents the note to Purchaser for payment, he refuses to pay, raising his defense against Love. If Rackets had been an HDC, Purchaser would be obligated to pay on the note regardless of the defense he might have had against Love, the payee. See *Carter & Grimsley v. Omni Trading, Inc.*, [Section 24.3 "Cases"](#), regarding value as related to executory contracts.

A taker for value can be a partial HDC if the consideration was only partly performed. Suppose the tennis rackets were to come in two lots, each worth \$2,500, and Rackets only delivered one lot. Rackets would be an HDC only to the extent of \$2,500, and the debtor—Paul Purchaser—could refuse to pay \$2,500 of the promised sum.

The UCC presents two exceptions to the rule that an executory promise is not value. Section 3-303(a)(4) provides that an instrument is issued or transferred for value if the issuer or transferor gives it in exchange for a negotiable instrument, and Section 3-303(5) says an instrument is transferred for value if the issuer gives it in exchange for an irrevocable obligation to a third party.

2. *Security interest.* Value is not limited to cash or the fulfillment of a contractual obligation. A holder who acquires a lien on, or a security interest in, an instrument other than by legal process has taken for value.

3. *Antecedent debt.* Likewise, taking an instrument in payment of, or as security for, a prior claim, whether or not the claim is due, is a taking for value. Blackstone owes Webster \$1,000, due in thirty days. Blackstone unexpectedly receives a refund check for \$1,000 from the Internal Revenue Service and indorses it to Webster. Webster is an HDC though he gave value in the past.

The rationale for the rule of value is that if the holder has not yet given anything of value in exchange for the instrument, he still has an effective remedy should the instrument prove defective: he can rescind the transaction, given the transferor's breach of warranty.

### In Good Faith

Section 3-103(4) of the UCC defines **good faith**<sup>1</sup> as “honesty in fact and the observance of reasonable commercial standards of fair dealing.”

### Honesty in Fact

“Honesty in fact” is subjectively tested. Suppose Lorna Love had given Rackets, Inc., a promissory note for the tennis rackets. Knowing that it intended to deliver defective tennis rackets and that Love is likely to protest as soon as the shipment arrives, Rackets offers a deep discount on the note to its fleet mechanic: instead of the \$1,000 face value of the note, Rackets will give it to him in payment of an outstanding bill of \$400. The mechanic, being naive in commercial dealings, has no suspicion from the large discount that Rackets might be committing fraud. He has acted in good faith under the UCC test. That is not to say that no set of circumstances will ever exist to warrant a finding that there was a lack of good faith.

1. Defined in the Uniform Commercial Code as “honesty in fact and the observance of reasonable commercial standards of fair dealing.”

### **Observance of Reasonable Commercial Standards of Fair Dealing**

Whether reasonable commercial standards were observed in the dealings is objectively tested, but buying an instrument at a discount—as was done in the tennis rackets example—is not commercially unreasonable, necessarily.

### **Without Notice**

It obviously would be unjust to permit a holder to enforce an instrument that he knew—when he acquired it—was defective, was subject to claims or defenses, or had been dishonored. A purchaser with knowledge cannot become an HDC. But proving knowledge is difficult, so the UCC at Section 3-302(2) lists several types of notice that presumptively defeat any entitlement to status as HDC. Notice is not limited to receipt of an explicit statement; it includes an inference that a person should have made from the circumstances. The explicit things that give a person notice include those that follow.

### **Without Notice That an Instrument Is Overdue**

The UCC provides generally that a person who has notice that an instrument is overdue cannot be an HDC. What constitutes notice? When an inspection of the instrument itself would show that it was due before the purchaser acquired it, notice is presumed. A transferee to whom a promissory note due April 23 is negotiated on April 24 has notice that it was overdue and consequently is not an HDC. Not all paper contains a due date for the entire amount, and demand paper has no due date at all. In Sections 3-302(a)(2) and 3-304, the UCC sets out specific rules dictating what is overdue paper.

### **Without Notice That an Instrument Has Been Dishonored**

**Dishonor**<sup>2</sup> means that instrument is not paid when it is presented to the party who should pay it.

### **Without Notice of a Defense or Claim**

A purchaser of an instrument cannot be an HDC if he has notice that there are any defenses or claims against it. A defense is a reason why the would-be obligor will not pay; a claim is an assertion of ownership in the instrument. If a person is fraudulently induced to issue or make an instrument, he has a claim to its ownership and a defense against paying.

2. Failure to pay or refusal to accept a note, a bill, or another commercial obligation.

### Without Notice of Unauthorized Signature or Alteration

This is pretty clear: a person will fail to achieve the HDC status if he has notice of alteration or an unauthorized signature.

### Without Reason to Question the Instrument's Authenticity Because of Apparent Forgery, Alteration, or Other Irregularity or Incompleteness as to Call into Question Its Authenticity

This also is pretty straightforward, though it is worth observing that a holder will flunk the HDC test if she has notice of unauthorized signature or alteration, or if she *should* have notice on account of apparent irregularity. So a clever forgery would not by itself defeat the HDC status, unless the holder had notice of it.

### Payee as Holder in Due Course

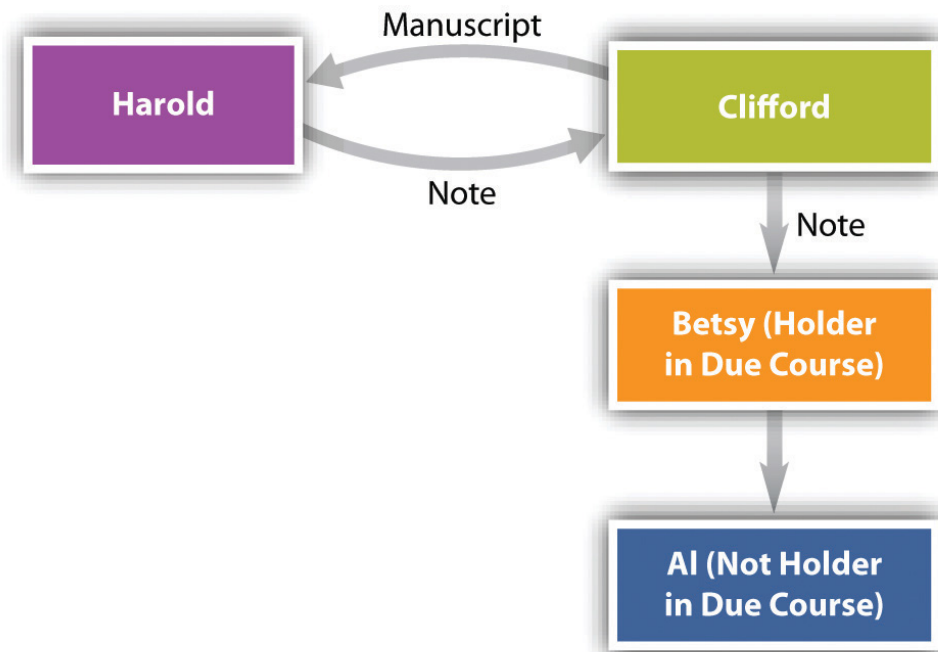
The payee can be an HDC, but in the usual circumstances, a payee would have knowledge of claims or defenses because the payee would be one of the original parties to the instrument. Nevertheless, a payee may be an HDC if all the prerequisites are met. For instance, Blackstone fraudulently convinces Whitestone into signing a note as a comaker, with Greenstone as the payee. Without authority, Blackstone then delivers the note for value to Greenstone. Having taken the note in good faith, for value, without notice of any problems, and without cause to question its validity because of apparent irregularities, Greenstone is an HDC. In any event, typically the HDC is not the payee of the instrument, but rather, is an immediate or remote transferee of the payee.

### The Shelter Rule

There is one last point to mention before we get to the real nub of the holder-in-due-course concept (that the sins of her predecessors are washed away for an HDC). The **shelter rule**<sup>3</sup> provides that the transferee of an instrument acquires the same rights that the transferor had. Thus a person who does not himself qualify as an HDC can still acquire that status if some previous holder (someone “upstream”) was an HDC.

On June 1, Clifford sells Harold the original manuscript of Benjamin Franklin’s autobiography. Unknown to Harold, however, the manuscript is a forgery. Harold signs a promissory note payable to Clifford for \$250,000 on August 1. Clifford negotiates the note to Betsy on July 1 for \$200,000; she is unaware of the fraud. On August 2, Betsy gives the note to Al as a token of her affection. Al is Clifford’s friend and knows about the scam (see [Figure 24.1 "The Shelter Rule"](#)). May Al collect?

3. Under Article 3 of the Uniform Commercial Code, the transferee of an instrument acquires the same rights his or her transferor had.

Figure 24.1 *The Shelter Rule*

Begin the analysis by noting that Al is not an HDC. Why? For three reasons: he did not take the instrument for value (it was a gift), he did not take in good faith (he knew of the fraud), and he had notice (he acquired it after the due date). Nevertheless, Al is entitled to collect from Harold the full \$250,000. His right to do so flows from UCC, Section 3-203(b): “Transfer of an instrument, whether or not the transfer is a negotiation, vests in the transferee any right of the transferor to enforce the instrument, including any right as a holder in due course, but the transferee cannot acquire rights of a holder in due course by a direct or indirect transfer from a holder in due course if the transferee engaged in fraud or illegality affecting the instrument.”

By virtue of the shelter rule, Al as transferee from Betsy acquires all rights that she had as transferor. Clearly Betsy is an HDC: she paid for the instrument, she took it in good faith, had no notice of any claim or defense against the instrument, and there were no apparent irregularities. Since Betsy is an HDC, so is Al. His knowledge of the fraud does not undercut his rights as HDC because he was not a party to it and was not a prior holder. Now suppose that after negotiating the instrument to Betsy, Clifford repurchased it from her. He would not be an HDC—and would not acquire all Betsy’s rights—because he had been a party to fraud and as a prior holder had notice of a defense. The purpose of the shelter rule is “to assure the holder in due course a free market for the paper.” Uniform Commercial Code, Section 3-203, Comment 2.



### KEY TAKEAWAY

The holder-in-due-course doctrine is important because it allows the holder of a negotiable instrument to take the paper free from most claims and defenses against it. Without the doctrine, such a holder would be a mere transferee. The UCC provides that to be an HDC, a person must be a holder of paper that is not suspiciously irregular, and she must take it in good faith, for value, and without notice of anything that a reasonable person would recognize as tainting the instrument. A payee may be an HDC but usually would not be (because he would know of problems with it). The shelter rule says that a transferee of an instrument acquires the same rights her transferor had, so a person can have the rights of an HDC without satisfying the requirements of an HDC (provided she does not engage in any fraud or illegality related to the transaction).

### EXERCISES

1. Summarize the requirements to be a holder in due course.
2. Why is the status of holder in due course important in commercial transactions?
3. Why is it unlikely that a payee would be a holder in due course?
4. What is the shelter rule, and why does it exist?

## 24.2 Defenses and Role in Consumer Transactions

### LEARNING OBJECTIVE

1. Know to what defenses the holder in due course is not subject.
2. Know to what defenses the holder in due course is subject.
3. Understand how the holder-in-due-course doctrine has been modified for consumer transactions and why.

### Defenses

We mentioned in [Section 24.1 "Holder in Due Course"](#) that the importance of the holder-in-due-course status is that it promotes ready transferability of commercial paper by giving transferees confidence that they can buy and in turn sell negotiable instruments without concern that somebody upstream—previous holders in the chain of distribution—will have some reason not to pay. The holder-in-due-course doctrine makes the paper almost as readily transferable as cash. Almost, but not quite. We examine first the defenses to which the holder in due course (HDC) is *not subject* and then—the “almost” part—the defenses to which even HDCs are subject.

#### Holder in Due Course Is Not Subject to Personal Defenses

An HDC is *not* subject to the obligor’s **personal defenses**<sup>4</sup>. But a holder who is not an HDC is subject to them: he takes a negotiable instrument subject to the possible personal claims and defenses of numerous people.

In general, the personal defenses—to which the HDC is *not* subject—are similar to the whole range of defenses for breach of simple contract: lack of consideration; failure of consideration; duress, undue influence, and misrepresentation that does not render the transaction void; breach of warranty; unauthorized completion of an incomplete instrument; prior payment. Incapacity that does not render the transaction void (except infancy) is also a personal defense. As the Uniform Commercial Code (UCC) puts it, this includes “mental incompetence, guardianship, ultra vires acts or lack of corporate capacity to do business, or any other incapacity apart from infancy. If under the state law the effect is to render the obligation of the instrument entirely null and void, the defense may be asserted against a holder in due course. If the effect is merely to render the obligation voidable at the election of the obligor, the defense is cut off.” Uniform Commercial Code, Section 3-305, Comment 1. James White and Robert Summers, in their hornbook on the UCC,

4. In negotiable-instrument law, defenses that are not good against a holder in due course.

opine that unconscionability is almost always a personal defense, not assertable against an HDC. James White and Robert Summers, Uniform Commercial Code, 2/e, 575 (1980). But again, the HDC takes free only from personal defenses of parties with whom she has not dealt. So while the payee of a note can be an HDC, if he dealt with the maker, he is subject to the maker's defenses.

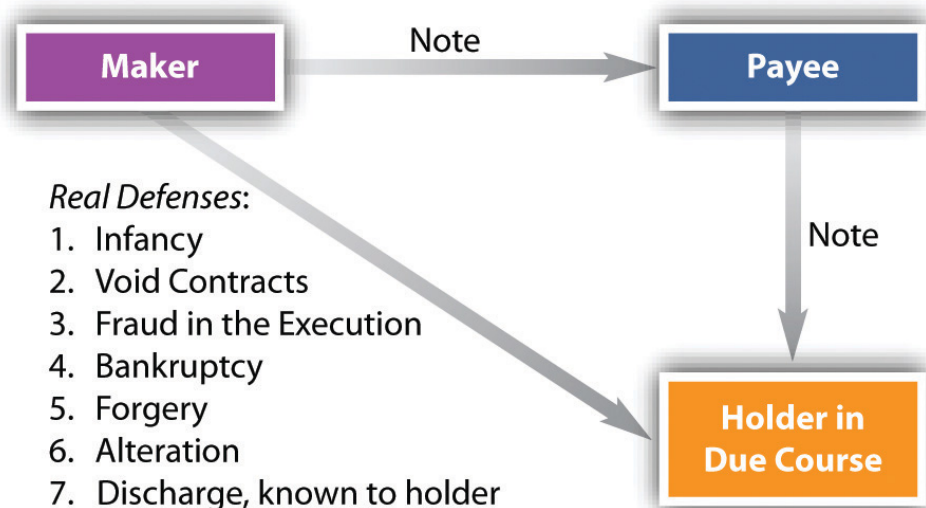
### Holder in Due Course Is Subject to Real Defenses

An HDC in a nonconsumer transaction is not subject to personal defenses, but he is subject to the so-called **real defenses**<sup>5</sup> (or “universal defenses”)—they are good against an HDC.

The real defenses good against any holder, including HDCs, are as follows (see [Figure 24.2 "Real Defenses"](#)):

1. Unauthorized signature (forgery) (UCC, Section 3-401(a))
2. Bankruptcy (UCC, Section 3-305(a))
3. Infancy (UCC, Section 3-305(a))
4. Fraudulent alteration (UCC, Section 3-407(b) and (c))
5. Duress, mental incapacity, or illegality that renders the obligation void (UCC, Section 3-305(a))
6. Fraud in the execution (UCC, Section 3-305(a))
7. Discharge of which the holder has notice when he takes the instrument (UCC, Section 3-601)

Figure 24.2 *Real Defenses*



5. In negotiable-instrument law, defenses that are good against a holder in due course.

### **Analysis of the Real Defenses**

Though most of these concepts are pretty clear, a few comments by way of analysis are appropriate.

#### **Forgery**

Forgery is a real defense to an action by an HDC. As we have noted, though, negligence in the making or handling of a negotiable instrument may cut off this defense against an HDC—as, for example, when a drawer who uses a rubber signature stamp carelessly leaves it unattended. And notice, too, that Section 3-308 of the UCC provides that signatures are presumed valid unless their validity is specifically denied, at which time the burden shifts to the person claiming validity. These issues are discussed in *Triffin v. Somerset Valley Bank*, in [Section 24.3 "Cases"](#) of this chapter.

#### **Bankruptcy**

Drawers, makers, and subsequent indorsers are not liable to an HDC if they have been discharged in bankruptcy. If they were, bankruptcy would not serve much purpose.

#### **Infancy**

Whether an infant's signature on a negotiable instrument is a valid defense depends on the law of the state. In some states, for instance, an infant who misrepresents his age is estopped from asserting infancy as a defense to a breach of contract. In those states, infancy would not be available as a defense against the effort of an HDC to collect.

#### **Fraudulent Alteration**

Under Section 3-407 of the UCC, "fraudulent alteration" means either (1) an unauthorized change in an instrument that purports to modify in any respect the obligation of a party or (2) an unauthorized addition of words or numbers or other change to an incomplete instrument relating to the obligation of a party. An alteration fraudulently made discharges a party whose obligation is affected by the alteration unless that party assents or is precluded from asserting the alteration. But a nonfraudulent alteration—for example, filling in an omitted date or giving the obligor the benefit of a lower interest rate—does not discharge the obligor. In any case, the person paying or taking the instrument may pay or collect "according to its original terms, or in the case of an incomplete instrument that is altered by unauthorized completion, according to its terms as completed. If blanks are filled or

an incomplete instrument is otherwise completed, subsection (c) places the loss upon the party who left the instrument incomplete by permitting enforcement in its completed form. This result is intended even though the instrument was stolen from the issuer and completed after the theft.” A moral here: don’t leave instruments lying around with blanks that could be filled in.

### Void Contract

A void contract is distinguished from a voidable contract; only the former is a real defense.

### Fraud in the Execution

You may recall that this is the rather unusual situation in which a person is tricked into signing a document. Able holds out a piece of paper for her boss and points to the signature line, saying, “This is a receipt for goods we received a little while ago.” Baker signs it. It is not a receipt; it’s the signature line on a promissory note. Able has committed fraud in the execution, and the note is void.

### Discharge of Which the Holder Has Notice

If the holder knows that the paper—a note, say—has already been paid, she cannot enforce it. That’s a good reason to take back any note you have made from the person who presents it to you for payment.

### Consumer Transactions and Holders in Due Course

The holder-in-due-course doctrine often worked considerable hardship on the consumer, usually as the maker of an installment note.

For example, a number of students are approached by a gym owner who induces them to sign one-year promissory notes for \$150 for a one-year gym membership. The owner says, “I know that right now the equipment in the gym is pretty rudimentary, but then, too, \$150 is about half what you’d pay at the YMCA or Gold’s Gym. And the thing is, as we get more customers signing up, we’re going to use the money to invest in new equipment. So within several months we’ll have a fully equipped facility for your use.” Several students sign the notes, which the owner sells to a **factor**<sup>6</sup> (one that lends money to another, taking back a negotiable instrument as security, usually at about a 20 percent discount). The factor takes as an apparent HDC, but the gym idea doesn’t work and the owner declares bankruptcy. If this were a commercial transaction, the makers (the students) would

6. One that lends money to another, taking back a negotiable instrument as security.

still owe on the notes even if there was, as here, a complete failure of consideration (called “paying on a dead horse”). But the students don’t have to pay.

Whether the gym owner here committed fraud is uncertain, but the holder-in-due-course doctrine did often work to promote fraud. Courts frequently saw cases brought by credit companies (factors) against consumers who bought machines that did not work and services that did not live up to their promises. The ancient concept of an HDC did not square with the realities of modern commerce, in which instruments by the millions are negotiated for uncompleted transactions. The finance company that bought such commercial paper could never have honestly claimed (in the sociological sense) to be wholly ignorant that many makers will have claims against their payees (though they could and did make the claim in the legal sense).

Acting to curb abuses, the Federal Trade Commission (FTC) in 1976 promulgated a trade regulation rule that in effect abolished the holder-in-due-course rule for consumer credit transactions. Under the FTC rule titled “Preservation of Consumers’ Claims and Defenses,”<sup>16</sup> *Code of Federal Regulations*, Section 433. the creditor becomes a mere holder and stands in the shoes of the seller, subject to all claims and defenses that the debtor could assert against the seller. Specifically, the rule requires the seller to provide notice in any consumer credit contract that the debtor is entitled to raise defenses against any subsequent purchaser of the paper. It also bars the seller from accepting any outside financing unless the loan contract between the consumer and the outside finance company contains a similar notice. (The required notice, to be printed in no less than ten-point, boldface type, is set out in [Figure 24.3 "Notice of Defense"](#).) The effect of the rule is to ensure that a consumer’s claim against the seller will not be defeated by a transfer of the paper. The FTC rule has this effect because the paragraph to be inserted in the consumer credit contract gives the holder notice sufficient to prevent him from becoming an HDC.

The rule applies only to consumer credit transactions. A **consumer transaction**<sup>7</sup> is defined as a purchase of goods or services by a natural person, not a corporation or partnership, for personal, family, or household use from a seller in the ordinary course of business. Uniform Commercial Code, Section 2-201(11). Purchases of goods or services for commercial purposes and purchases of interests in real property, commodities, or securities are not affected. The rule applies to any credit extended by the seller himself (except for credit card transactions) or to any “purchase money loan.” This type of loan is defined as a cash advance to the consumer applied in whole or substantial part to a purchase of goods or services from a seller who either (a) refers consumers to the creditor or (b) is affiliated with the creditor. The purpose of this definition is to prevent the seller from making an end run around the rule by arranging a loan for the consumer through an outside finance company.

7. A transaction in which an individual incurs an obligation primarily for personal, family, or household purposes.

The rule does not apply to a loan that the consumer arranges with an independent finance company entirely on his own.

The net effect of the FTC rule is this: the holder-in-due-course doctrine is virtually dead in consumer credit contracts. It remains alive and flourishing as a legal doctrine in all other business transactions.

Figure 24.3 *Notice of Defense*

**NOTICE**

**ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.**

### KEY TAKEAWAY

The privileged position of the HDC stands up against the so-called personal defenses, which are—more or less—the same as typical defenses to obligation on any contract, *not including*, however, the real defenses. Real defenses are good against any holder, including an HDC. These are infancy, void obligations, fraud in the execution, bankruptcy, discharge of which holder has notice, unauthorized signatures, and fraudulent alterations. While a payee may be an HDC, his or her rights as such are limited to avoiding defenses of persons the payee did not deal with. The shelter rule says that the transferee of an instrument takes the same rights that the transferor had. The Federal Trade Commission has abrogated the holder-in-due-course doctrine for consumer transactions.

## EXERCISES

1. What purpose does the holder-in-due-course doctrine serve?
2. What defenses is an HDC not subject to? What defenses is an HDC subject to?
3. What is the Shelter Rule, and what purpose does it serve?
4. For what transactions has the FTC abolished the holder-in-due-course doctrine and why?
5. Under what circumstances is a forged signature valid?



## 24.3 Cases

### Executory Promise as Satisfying “Value”

Carter & Grimsley v. Omni Trading, Inc.

716 N.E.2d 320 (Ill. App. 1999)

Lytton, J.

#### Facts

Omni purchased some grain from Country Grain, and on February 2, 1996, it issued two checks, totaling \$75,000, to Country Grain. Country Grain, in turn, endorsed the checks over to Carter as a retainer for future legal services. Carter deposited the checks on February 5; Country Grain failed the next day. On February 8, Carter was notified that Omni had stopped payment on the checks. Carter subsequently filed a complaint against Omni...alleging that it was entitled to the proceeds of the checks, plus pre-judgment interest, as a holder in due course....[Carter moved for summary judgment; the motion was denied.]

#### Discussion

Carter argues that its motion for summary judgment should have been granted because, as a holder in due course, it has the right to recover on the checks from the drawer, Omni.

The Illinois Uniform Commercial Code (UCC) defines a holder in due course as:

“the holder of an instrument if:

(1) the instrument when issued does not bear such apparent evidence of forgery or alteration or is not otherwise so irregular or incomplete as to call into question its authenticity, and (2) the holder took the instrument (i) for value,...

Section 3-303(a) of the UCC also states that:

(a) “An instrument is issued or transferred for value if: (1) the instrument is issued or transferred for a promise of performance, **to the extent that the promise has been performed \* \* \***” (emphasis added)

Carter contends that in Illinois a contract for future legal services should be treated differently than other executory contracts. It contends that when the attorney-client relationship is created by payment of a fee or retainer, the contract is no longer executory. Thus, Carter would achieve holder in due course status. We are not persuaded.

A retainer is the act of a client employing an attorney; it also denotes the fee paid by the client when he retains the attorney to act for him. [Citation] We have found no Illinois cases construing section 3-303(a) as it relates to a promise to perform future legal services under a retainer. The general rule, however, is that “an executory promise is not value.” [Citation] “[T]he promise does not rise to the level of ‘value’ in the commercial paper market until it is actually performed.” [Citation]

The UCC comment to section 303 gives the following example:

“Case # 2. X issues a check to Y in consideration of Y’s promise to perform services in the future. Although the executory promise is consideration for issuance of the check it is value only to the extent the promise is performed.

We have found no exceptions to these principles for retainers. Indeed, courts in other jurisdictions interpreting similar language under section 3-303 have held that attorneys may be holders in due course only to the extent that they have actually performed legal services prior to acquiring a negotiable instrument. See [Citations: Pennsylvania, Florida, Massachusetts]. We agree.

This retainer was a contract for future legal services. Under section 3-303(a)(1), it was a “promise of performance,” not yet performed. Thus, no value was received, and Carter is not a holder in due course.

Furthermore, in this case, no evidence was presented in the trial court that Carter performed any legal services for Country Grain prior to receiving the checks. Without an evidentiary basis for finding that Carter received the checks for services performed, the trial court correctly found that Carter failed to prove that it was a holder in due course. [Citations]

### Conclusion

Because we have decided that Carter did not take the checks for value under section 3-303(a) of the UCC, we need not address its other arguments.

The judgment of the circuit court of Peoria County is affirmed.

Holdridge, J., dissenting.

I respectfully dissent. In a contractual relationship between attorney and client, the payment of a fee or retainer creates the relationship, and once that relationship is created the contract is no longer executory. [Citation] Carter's agreement to enter into an attorney-client relationship with Country Grain was the value exchanged for the checks endorsed over to the firm. Thus, the general rule cited by the majority that "an executory promise is not value" does not apply to the case at bar. On that basis I would hold that the trial court erred in determining that Carter was not entitled to the check proceeds and I therefore dissent.

### CASE QUESTIONS

1. How did Carter & Grimsley obtain the two checks drawn by Omni?
2. Why—apparently—did Omni stop payments on the checks?
3. Why did the court determine that Carter was not an HDC?
4. Who is it that must have performed here in order for Carter to have been an HDC, Country Grain or Carter?
5. How could making a retainer payment to an attorney be considered anything other than payment on an executory contract, as the dissent argues?

### The "Good Faith and Reasonable Commercial Standards" Requirement

Buckeye Check Cashing, Inc. v. Camp

825 N.E.2d 644 (Ohio App. 2005)

Donovan, J.

Defendant-appellant Shawn Sheth appeals from a judgment of the Xenia Municipal Court in favor of plaintiff-appellee Buckeye Check Cashing, Inc. (“Buckeye”). Sheth contends that the trial court erred in finding that Buckeye was a holder in due course of a postdated check drawn by Sheth and therefore was entitled to payment on the instrument despite the fact that Sheth had issued a stop-payment order to his bank.

In support of this assertion, Sheth argues that the trial court did not use the correct legal standard in granting holder-in-due-course status to Buckeye. In particular, Sheth asserts that the trial court used the pre-1990 Uniform Commercial Code (“UCC”) definition of “good faith” as it pertains to holder-in-due-course status, which defined it as “honesty in fact.” The definition of “good faith” was extended by the authors of the UCC in 1990 to also mean “the observance of reasonable commercial standards of fair dealing.” The post-1990 definition was adopted by the Ohio legislature in 1994.

Sheth argues that while Buckeye would prevail under the pre-1990, “honesty in fact” definition of “good faith,” it failed to act in a commercially reasonable manner when it chose to cash the postdated check drawn by Sheth. The lower court...adjudged Buckeye to be a holder in due course and, therefore, entitled to payment. We conclude that the trial court used the incorrect “good faith” standard when it granted holder-in-due-course status to Buckeye because Buckeye did not act in a commercially reasonable manner when it cashed the postdated check drawn by Sheth. Because we accept Sheth’s sole assignment of error, the judgment of the trial court is reversed.

On or about October 12, 2003, Sheth entered into negotiations with James A. Camp for Camp to provide certain services to Sheth by October 15, 2003. To that end, Sheth issued Camp a check for \$1,300. The check was postdated to October 15, 2003.

On October 13, 2003, Camp negotiated the check to Buckeye and received a payment of \$1,261.31. Apparently fearing that Camp did not intend to fulfill his end of the contract, Sheth contacted his bank on October 14, 2003, and issued a stop-payment order on the check. Unaware of the stop-payment order, Buckeye deposited the check with its own bank on October 14, 2003, believing that the check would reach Sheth’s bank by October 15, 2003. Because the stop-payment order was in effect, the check was ultimately dishonored by Sheth’s bank. After an unsuccessful attempt to obtain payment directly from Sheth, Buckeye brought suit.

Sheth’s sole assignment of error is as follows:

“The trial court erred by applying the incorrect legal standard in granting holder in due course status to the plaintiff-appellee because the plaintiff-appellee failed to follow commercially reasonable standards in electing to cash the check that gives rise to this dispute.”

[UCC 3-302] outlines the elements required to receive holder-in-due-course status. The statute states:

...‘holder in due course’ means the holder of an instrument if both of the following apply:

“(1) The instrument when issued or negotiated to the holder does not bear evidence of forgery or alteration that is so apparent, or is otherwise so irregular or incomplete as to call into question its authenticity;

“(2) The holder took the instrument under all of the following circumstances:

(a) For value;

(b) **In good faith;**

(c) Without notice that the instrument is overdue or has been dishonored or that there is an uncured default with respect to payment of another instrument issued as part of the same series;

(d) Without notice that the instrument contains an unauthorized signature or has been altered;

(e) Without notice of any claim to the instrument as described in [3-306];

(f) Without notice that any party has a defense or claim in recoupment described in [UCC 3-305(a); emphasis added].

At issue in the instant appeal is whether Buckeye acted in “good faith” when it chose to honor the postdated check originally drawn by Sheth....UCC 1-201, defines “good faith” as “honesty in fact and the observance of reasonable commercial standards of fair dealing.” Before the Ohio legislature amended UCC 1-201 in 1994, that section did not define “good faith”; the definition of “good faith” as “honesty in fact” in UCC 1-201 was the definition that applied[.]...

“Honesty in fact” is defined as the absence of bad faith or dishonesty with respect to a party’s conduct within a commercial transaction. [Citation] Under that standard, absent fraudulent behavior, an otherwise innocent party was assumed to have acted in good faith. The “honesty in fact” requirement, also known as the “pure heart and empty head” doctrine, is a subjective test under which a holder had to subjectively believe he was negotiating an instrument in good faith for him to become a holder in due course. Maine [Citation, 1999].

In 1994, however, the Ohio legislature amended the definition of “good faith” to include not only the subjective “honesty in fact” test, but also an objective test: “the observance of reasonable commercial standards of fair dealing.” Ohio UCC 1-201(20). A holder in due course must now satisfy both a subjective and an objective test of good faith. What constitutes “reasonable commercial standards of fair dealing” for parties claiming holder-in-due-course status, however, has not heretofore been defined in the state of Ohio.

In support of his contention that Buckeye is not a holder in due course, Sheth cites a decision from the Supreme Court of Maine, [referred to above] in which the court provided clarification with respect to the objective prong of the “good faith” analysis:

“The fact finder must therefore determine, first, whether the conduct of the holder comported with industry or ‘commercial’ standards applicable to the transaction and second, whether those standards were reasonable standards intended to result in fair dealing. Each of those determinations must be made in the context of the specific transaction at hand. If the fact finder’s conclusion on each point is ‘yes,’ the holder will be determined to have acted in good faith even if, in the individual transaction at issue, the result appears unreasonable. Thus, a holder may be accorded holder in due course where it acts pursuant to those reasonable commercial standards of fair dealing—even if it is negligent—but may lose that status, even where it complies with commercial standards, if those standards are not reasonably related to achieving fair dealing.” [Citation]

Check cashing is an unlicensed and unregulated business in Ohio. [Citation] Thus, there are no concrete commercial standards by which check-cashing businesses must operate. Moreover, Buckeye argues that its own internal operating policies do not require that it verify the availability of funds, nor does Buckeye apparently have any guidelines with respect to the acceptance of postdated checks. Buckeye asserts that cashing a postdated check does not prevent a holder from obtaining holder-in-due-course status and cites several cases in support of this contention. All of the cases cited by Buckeye, however, were decided prior to the UCC’s addition of the objective prong to the definition of “good faith.”

Under a purely subjective “honesty in fact” analysis, it is clear that Buckeye accepted the check from Camp in good faith and would therefore achieve holder-in-due-course status. When the objective prong of the good faith test is applied, however, we find that Buckeye did not conduct itself in a commercially reasonable manner. While not going so far as to say that cashing a postdated check prevents a holder from obtaining holder-in-due-course status in every instance, the presentation of a postdated check should put the check cashing entity on notice that the check might not be good. Buckeye accepted the postdated check at its own peril. Some attempt at verification should be made before a check-cashing business cashes a postdated check. Such a failure to act does not constitute taking an instrument in good faith under the current objective test of “reasonable commercial standards” enunciated in [the UCC].

We conclude that in deciding to amend the good faith requirement to include an objective component of “reasonable commercial standards,” the Ohio legislature intended to place a duty on the holders of certain instruments to act in a responsible manner in order to obtain holder-in-due-course status. When Buckeye decided to cash the postdated check presented by Camp, it did so without making any attempt to verify its validity. This court in no way seeks to curtail the free negotiability of commercial instruments. However, the nature of certain instruments, such as the postdated check in this case, renders it necessary for appellee Buckeye to take minimal steps to protect its interests. That was not done. Buckeye was put on notice that the check was not good until October 15, 2003. “Good faith,” as it is defined in the UCC and the Ohio Revised Code, requires that a holder demonstrate not only honesty in fact but also that the holder act in a commercially reasonable manner. Without taking any steps to discover whether the postdated check issued by Sheth was valid, Buckeye failed to act in a commercially reasonable manner and therefore was not a holder in due course.

Based upon the foregoing, Sheth’s single assignment of error is sustained, the judgment of the Xenia Municipal Court is reversed, and this matter is remanded to that court for further proceedings in accordance with law and consistent with this opinion.

Judgment reversed, and cause remanded.

## CASE QUESTIONS

1. Who was Camp? Why did Sheth give him a check? Why is the case titled *Buckeye v. Camp*?
2. How does giving someone a postdated check offer the drawer any protection? How does it give rise to any “notice that the check might not be good”?
3. If Camp had taken the check to Sheth’s bank to cash it, what would have happened?
4. What difference did the court discern between the pre-1990 UCC Article 3 and the post-1990 Article 3 (that Ohio adopted in 1994)?

### The Shelter Rule

Triffin v. Somerset Valley Bank

777 A.2d 993 (N.J. Ct. App. 2001)

Cuff, J.

This case concerns the enforceability of dishonored checks against the issuer of the checks under Article 3 of the Uniform Commercial Code (UCC), as implemented in New Jersey[.]

Plaintiff [Robert J. Triffin] purchased, through assignment agreements with check cashing companies, eighteen dishonored checks, issued by defendant Hauser Contracting Company (Hauser Co.). Plaintiff then filed suit...to enforce Hauser Co.’s liability on the checks. The trial court granted plaintiff’s motion for summary judgment. Hauser Co. appeals the grant of summary judgment....We affirm.

In October 1998, Alfred M. Hauser, president of Hauser Co., was notified by Edwards Food Store in Raritan and the Somerset Valley Bank (the Bank), that several individuals were cashing what appeared to be Hauser Co. payroll checks. Mr. Hauser reviewed the checks, ascertained that the checks were counterfeits and contacted the Raritan Borough and Hillsborough Police Departments. Mr. Hauser concluded that the checks were counterfeits because none of the payees were employees of Hauser Co., and because he did not write the checks or authorize anyone to sign those checks on his behalf. At that time, Hauser Co. employed Automatic Data Processing, Inc. (ADP) to provide payroll services and a facsimile signature was utilized on all Hauser Co. payroll checks.



Mr. Hauser executed affidavits of stolen and forged checks at the Bank, stopping payment on the checks at issue. Subsequently, the Bank received more than eighty similar checks valued at \$25,000 all drawn on Hauser Co.'s account.

Plaintiff is in the business of purchasing dishonored negotiable instruments. In February and March 1999, plaintiff purchased eighteen dishonored checks from four different check cashing agencies, specifying Hauser Co. as the drawer. The checks totaled \$8,826.42. Pursuant to assignment agreements executed by plaintiff, each agency stated that it cashed the checks for value, in good faith, without notice of any claims or defenses to the checks, without knowledge that any of the signatures were unauthorized or forged, and with the expectation that the checks would be paid upon presentment to the bank upon which the checks were drawn. All eighteen checks bore a red and green facsimile drawer's signature stamp in the name of Alfred M. Hauser. All eighteen checks were marked by the Bank as "stolen check" and stamped with the warning, "do not present again." ...

Plaintiff then filed this action against the Bank, Hauser Co.,...Plaintiff contended that Hauser Co. was negligent in failing to safeguard both its payroll checks and its authorized drawer's facsimile stamp, and was liable for payment of the checks.

The trial court granted plaintiff's summary judgment motion, concluding that no genuine issue of fact existed as to the authenticity of the eighteen checks at issue. Judge Hoens concluded that because the check cashing companies took the checks in good faith, plaintiff was a holder in due course as assignee. Judge Hoens also found that because the checks appeared to be genuine, Hauser Co. was required, but had failed, to show that plaintiff's assignor had any notice that the checks were not validly drawn....

Hauser Co. argues that summary judgment was improperly granted because the court failed to properly address Hauser Co.'s defense that the checks at issue were invalid negotiable instruments and therefore erred in finding plaintiff was a holder in due course.

As a threshold matter, it is evident that the eighteen checks meet the definition of a negotiable instrument [UCC 3-104]. Each check is payable to a bearer for a fixed amount, on demand, and does not state any other undertaking by the person promising payment, aside from the payment of money. In addition, each check appears to have been signed by Mr. Hauser, through the use of a facsimile stamp, permitted by the UCC to take the place of a manual signature. [Section 3-401(b) of the UCC] provides that a "signature may be made manually or by means of a device or machine...with present intention to authenticate a writing." It is uncontroverted

by Hauser Co. that the facsimile signature stamp on the checks is identical to Hauser Co.'s authorized stamp.

Hauser Co., however, contends that the checks are not negotiable instruments because Mr. Hauser did not sign the checks, did not authorize their signing, and its payroll service, ADP, did not produce the checks. Lack of authorization, however, is a separate issue from whether the checks are negotiable instruments. Consequently, given that the checks are negotiable instruments, the next issue is whether the checks are unenforceable by a holder in due course, because the signature on the checks was forged or unauthorized.

[Sections 3-203 and 3-302 of the UCC] discuss the rights of a holder in due course and the rights of a transferee of a holder in due course. Section 3-302 establishes that a person is a holder in due course if:

- (1) the instrument when issued or negotiated to the holder does not bear such apparent evidence of forgery or alteration or is not otherwise so irregular or incomplete as to call into question its authenticity; and
- (2) the holder took the instrument for value, in good faith, without notice that the instrument is overdue or has been dishonored or that there is an uncured default with respect to payment of another instrument issued as part of the same series, without notice that the instrument contains an unauthorized signature or has been altered, without notice of any claim to the instrument described in 3-306, and without notice that any party has a defense or claim in recoupment described in subsection a. of 3-305.

Section 3-203 deals with transfer of instruments and provides:

- a. An instrument is transferred when it is delivered by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument.
- b. Transfer of an instrument, whether or not the transfer is a negotiation, vests in the transferee any right of the transferor to enforce the instrument, including any right as a holder in due course, but the transferee cannot acquire rights of a holder in due course by a transfer, directly or indirectly, from a holder in due course if the transferee engaged in fraud or illegality affecting the instrument....

Under subsection (b) a holder in due course that transfers an instrument transfers those rights as a holder in due course to the purchaser. The policy is to assure the holder in due course a free market for the instrument.

The record indicates that plaintiff has complied with the requirements of both sections 3-302 and 3-203. Each of the check cashing companies from whom plaintiff purchased the dishonored checks were holders in due course. In support of his summary judgment motion, plaintiff submitted an affidavit from each company; each company swore that it cashed the checks for value, in good faith, without notice of any claims or defenses by any party, without knowledge that any of the signatures on the checks were unauthorized or fraudulent, and with the expectation that the checks would be paid upon their presentment to the bank upon which the checks were drawn. Hauser Co. does not dispute any of the facts sworn to by the check cashing companies.

The checks were then transferred to plaintiff in accordance with section 3-303, vesting plaintiff with holder in due course status. Each company swore that it assigned the checks to plaintiff in exchange for consideration received from plaintiff. Plaintiff thus acquired the check cashing companies' holder in due course status when the checks were assigned to plaintiff. Moreover, pursuant to section 3-403(a)'s requirement that the transfer must have been made for the purpose of giving the transferee the right to enforce the instrument, the assignment agreements expressly provided plaintiff with that right, stating that "all payments [assignor] may receive from any of the referenced Debtors...shall be the exclusive property of [assignee]." Again, Hauser Co. does not dispute any facts relating to the assignment of the checks to plaintiff.

Hauser Co. contends, instead, that the checks are per se invalid because they were fraudulent and unauthorized. Presumably, this argument is predicated on section 3-302. This section states a person is not a holder in due course if the instrument bears "apparent evidence of forgery or alteration" or is otherwise "so irregular or incomplete as to call into question its authenticity."

In order to preclude liability from a holder in due course under section 3-302, it must be apparent on the face of the instrument that it is fraudulent. The trial court specifically found that Hauser Co. had provided no such evidence, stating that Hauser Co. had failed to show that there was anything about the appearance of the checks to place the check cashing company on notice that any check was not valid. Specifically, with respect to Hauser Co.'s facsimile signature on the checks, the court stated that the signature was identical to Hauser Co.'s authorized facsimile signature. Moreover, each of the check cashing companies certified that they had no knowledge that the signatures on the checks were fraudulent or that there were

any claims or defenses to enforcement of the checks. Hence, the trial court's conclusion that there was no apparent evidence of invalidity was not an abuse of discretion and was based on a reasonable reading of the record.

To be sure, section 3-308(a) does shift the burden of establishing the validity of the signature to the plaintiff, but only if the defendant specifically denies the signature's validity in the pleadings. The section states:

In an action with respect to an instrument, the authenticity of, and authority to make, each signature on the instrument is admitted unless specifically denied in the pleadings. If the validity of a signature is denied in the pleadings, the burden of establishing validity is on the person claiming validity, but the signature is presumed to be authentic and authorized unless the action is to enforce the liability of the purported signer and the signer is dead or incompetent at the time of trial of the issue of validity of the signature.

Examination of the pleadings reveals that Hauser Co. did not specifically deny the factual assertions in plaintiff's complaint.

Hence, the trial court's conclusion that there was no apparent evidence of invalidity was not an abuse of discretion and was based on a reasonable reading of the record.

In conclusion, we hold that Judge Hoens properly granted summary judgment. There was no issue of material fact as to: (1) the status of the checks as negotiable instruments; (2) the status of the check cashing companies as holders in due course; (3) the status of plaintiff as a holder in due course; and (4) the lack of apparent evidence on the face of the checks that they were forged, altered or otherwise irregular. Moreover, Hauser Co.'s failure to submit some factual evidence indicating that the facsimile signature was forged or otherwise unauthorized left unchallenged the UCC's rebuttable presumption that a signature on an instrument is valid. Consequently, the trial court properly held, as a matter of law, that plaintiff was a holder in due course and entitled to enforce the checks. Affirmed.

## CASE QUESTIONS

1. Why did the plaintiff, Mr. Triffin, obtain possession of the dishonored checks? Regarding the plaintiff, consider this:  
<http://caselaw.findlaw.com/nj-supreme-court/1332248.html>.
2. Section 4-401 of the UCC says nobody is liable on an instrument unless the person signed it, and Section 4-403(a) provides that “an unauthorized signature is ineffective” (except as the signature of the unauthorized person), so how could Hauser Co. be liable at all? And why did the court never discuss plaintiff’s contention that the defendant “was negligent in failing to safeguard both its payroll checks and its authorized drawer’s facsimile stamp”?
3. Why didn’t the Hauser Co. specifically deny the authenticity of the signatures?
4. Obviously, the plaintiff must have known that there was something wrong with the checks when he bought them from the check-cashing companies: they had been dishonored and were marked “Stolen, do not present again.” Did he present them again?
5. While the UCC does not require that the transferee of an instrument acted in good faith in order to collect on the instrument as an HDC (though he can’t have participated in any scam), it disallows a person from being an HDC if he takes an instrument with notice of dishonor. Surely the plaintiff had notice of that. What does the UCC require that transformed Mr. Triffin—via the shelter rule—into a person with the rights of an HDC?
6. If the plaintiff had not purchased the checks from the check-cashing companies, who would have taken the loss here?
7. What recourse does the defendant, Hauser Co., have now?
8. Authors’ comment: How this scam unfolded is suggested in the following segment of an online guide to reducing financial transaction fraud.

Recommendations: It is clear from this case that if a thief can get check stock that looks genuine, your company can be held liable for losses that may occur from those counterfeit checks. Most companies buy check stock from vendors that sell the identical check stock entirely blank to other companies, totally uncontrolled, thus aiding the forgers. Many companies opt for these checks because they are less expensive than controlled, high security checks (excluding legal fees and holder in due course judgments). Forgers buy the check stock, and using a \$99

scanner and Adobe Illustrator, create counterfeit checks that cannot be distinguished from the account holder's original checks. This is how legal exposure to a holder in due course claim can be and is created. Companies should use checks uniquely designed and manufactured for them, or buy from vendors such as SAFEChecks (<http://www.safechecks.com>) that customize every company's check and never sells check stock entirely blank without it first being customized for the end user. Frank Abagnale and Greg Litster, *Holder in Due Course and Check Fraud*, TransactionDirectory.com.

## 24.4 Summary and Exercises

### Summary

A holder is a holder in due course (HDC) if he takes the instrument without reason to question its authenticity on account of obvious facial irregularities, for value, in good faith, and without notice that it is overdue or has been dishonored, or that it contains a forgery or alteration, or that that any person has any defense against it or claim to it. The HDC takes the paper free of most defenses; an ordinary holder takes the paper as an assignee, acquiring only the rights of the assignor.

Value is not the same as consideration; hence, a promise will not satisfy this criterion until it has been performed. The HDC must have given something of value other than a promise to give.

Good faith means (1) honesty in fact in the conduct or transaction concerned and (2) the observance of reasonable commercial standards of fair dealing. Honesty in fact is a subjective test, but the observance of reasonable commercial standards is objective.

Notice is not limited to receipt of an explicit statement of defenses; a holder may be given notice through inferences that should be drawn from the character of the instrument. Thus an incomplete instrument, one that bears marks of forgery, or one that indicates it is overdue may give notice on its face. Certain facts do not necessarily give notice of defense or claim: that the instrument is antedated or postdated, that the instrument was negotiated in return for an executory promise, that any party has signed for accommodation, that an incomplete instrument has been completed, that any person negotiating the instrument is or was a fiduciary, or that there has been default in payment of interest or principal.

A person who could not have become an HDC directly (e.g., because he had notice of a defense or claim) may become so if he takes as transferee from an HDC as long as he was not a party to any fraud or illegality affecting the instrument or had not previously been a holder with notice of a defense or claim. This is the shelter rule.

Holder in due course are not immune from all defenses. A real, as opposed to a personal, defense may be asserted against the HDC. Personal defenses include fraud in the inducement, failure of consideration, nonperformance of a condition precedent, and the like. Real defenses consist of infancy, acts that would make a contract void (such as duress), fraud in the execution, forgery, and discharge in bankruptcy. A 1976 trade regulation rule of the Federal Trade Commission abolishes the holder-in-due-course rule for consumer transactions.

## EXERCISES

1. Mike signed and delivered a note for \$9,000 to Paul Payee in exchange for Paul's tractor. Paul transferred the note to Hilda, who promised to pay \$7,500 for it. After Hilda had paid Paul \$5,000 of the promised \$7,500, Hilda learned that Mike had a defense: the tractor was defective. How much, if anything, can Hilda collect from Mike on the note, and why?
2. In Exercise 1, if Hilda had paid Paul \$7,500 and then learned of Mike's defense, how much—if any of the amount—could she collect from Mike?
3. Tex fraudulently sold a boat, to which he did not have title, to Sheryl for \$30,000 and received, as a deposit from her, a check in the amount of \$5,000. He deposited the check in his account at First Bank and immediately withdrew \$3,000 of the proceeds. When Sheryl discovered that Tex had no title, she called her bank (the drawee) and stopped payment on the check. Tex, in the meantime, disappeared. First Bank now wishes to collect the \$3,000 from Sheryl, but she claims it is not an HDC because it did not give value for the check in that the payment to Tex was conditional: the bank retained the right to collect from Tex if it could not collect on the check. Is Sheryl correct? Explain.
4. Corporation draws a check payable to First Bank. The check is given to an officer of Corporation (known to Bank), who is instructed to deliver it to Bank in payment of a debt owed by Corporation to Bank. Instead, the officer, intending to defraud Corporation, delivers the check to Bank in payment of his personal debt. Bank has received funds of Corporation that have been used for the personal benefit of the officer. Corporation asserts a claim to the proceeds of the check against Bank. Is Bank an HDC of the check?
5. Contractor contracted with Betty Baker to install a new furnace in Baker's business. Baker wrote a check for \$8,000 (the price quoted by Contractor) payable to Furnace Co., which Contractor delivered to Furnace Co. in payment of his own debt to it. Furnace Co. knew nothing of what went on between Contractor and Baker. When Contractor did not complete the job, Baker stopped payment on the check. Furnace Co. sued Baker, who defended by claiming failure of consideration. Is this a good defense against Furnace Co.?
6. Benson purchased a double-paned, gas-filled picture window for his house from Wonder Window, making a \$200 deposit and signing an installment contract, which is here set out in its entirety:



October 3, 2012

I promise to pay to Wonder Window or order the sum of \$1,000 in five equal installments of \$200.

[Signed] Benson

Wonder Window negotiated the installment contract to Devon, who took the instrument for value, in good faith, without notice of any claim or defense of any party, and without question of the instrument's authenticity. After Benson made three payments, the window fogged up inside and was unacceptable. Benson wants his money back from Wonder Window, and he wants to discontinue further payments. Can he do that? Explain.

7. The Turmans executed a deed of trust note (a note and mortgage) dated November 12, 2012, for \$100,000 payable to Ward's Home Improvement, Inc. The note was consideration for a contract: Ward was to construct a home on the Turmans' property. The same day, Ward executed a separate written assignment of the note to Robert L. Pomerantz, which specifically used the word "assigns." Ward did not endorse the note to Pomerantz or otherwise write on it. Ward did not complete the house; to do so would require the expenditure of an additional \$42,000. Pomerantz maintained he is a holder in due course of the \$100,000 note and demanded payment from the Turmans. Does he get paid? Explain. *Turman v. Ward's Home Imp., Inc.*, 1995 WL 1055769, Va. Cir. Ct. (1995).

## SELF-TEST QUESTIONS

1. Which defeats a person from being an HDC?
  - a. She takes the paper in return for a promise by the maker or drawer to perform a service in the future.
  - b. She subjectively takes it in good faith, but most people would recognize the deal as suspect.
  - c. The instrument contains a very clever, almost undetectable forged signature.
  - d. The instrument was postdated.
  - e. All these are grounds to defeat the HDC status.
  
2. Personal defenses are
  - a. good against all holders
  - b. good against holders but not HDCs
  - c. good against HDCs but not holders
  - d. not good against any holder, HDC or otherwise
  - e. sometimes good against HDCs, depending on the facts
  
3. Fraud in the inducement is a \_\_\_\_\_ defense.
  - a. real
  - b. personal
  
4. A person would not be an HDC if she
  - a. was notified that payment on the instrument had been refused
  - b. knew that one of the prior indorsers had been discharged
  - c. understood that the note was collateral for a loan
  - d. purchased the note at a discount
  
5. Rock Industries agreed to sell Contractor gravel to repair an airport drain field. Contractor was uncertain how many loads of gravel would be needed, so he drew a check made out to “Rock Industries” as the payee but left the amount blank, to be filled in on the job site when the last load of gravel was delivered. Five truckloads, each carrying ten tons of gravel, were required, with

gravel priced at \$20 per ton. Thus Contractor figured he'd pay for fifty tons, or \$1,000, but Rock Industries had apparently filled in the amount as \$1,400 and negotiated it to Fairchild Truck Repair. Fairchild took it in good faith for an antecedent debt. Contractor will

- a. be liable to Fairchild, but only for \$1,000
- b. be liable to Fairchild for \$1,400
- c. not be liable to Fairchild because the check was materially altered
- d. not be liable to Fairchild because it did not give "value" for it to Rock Industries

#### SELF-TEST ANSWERS

- 1. a
- 2. b
- 3. b
- 4. a
- 5. b

## Chapter 25

### Liability and Discharge

#### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The liability of an agent who signs commercial paper
2. What contract liability is imposed when a person signs commercial paper
3. What warranty liability is imposed upon a transferor
4. What happens if there is payment or acceptance by mistake
5. How parties are discharged from liability on commercial paper

In [Chapter 22 "Nature and Form of Commercial Paper"](#), [Chapter 23 "Negotiation of Commercial Paper"](#), and [Chapter 24 "Holder in Due Course and Defenses"](#), we focused on the methods and consequences of negotiating commercial paper when all the proper steps are followed. For example, a maker gives a negotiable note to a payee, who properly negotiates the paper to a third-party holder in due course. As a result, this third party is entitled to collect from the maker, unless the latter has a real defense.

In this chapter, we begin by examining a question especially important to management: personal liability for signing company notes and checks. Then we look at the two general types of liability—contract and warranty—introduced in [Chapter 23 "Negotiation of Commercial Paper"](#). We conclude the chapter by reviewing the ways in which parties are discharged from liability.

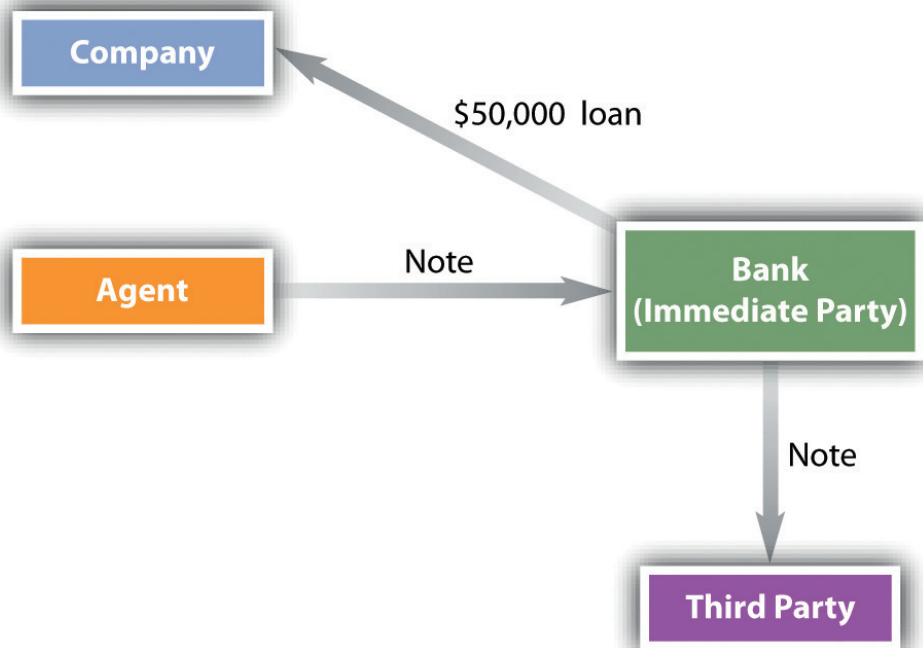
## 25.1 Liability Imposed by Signature: Agents, Authorized and Unauthorized

### LEARNING OBJECTIVES

1. Recognize what a signature is under Article 3 of the Uniform Commercial Code.
2. Understand how a person's signature on an instrument affects liability if the person is an agent, or a purported agent, for another.

The liability of an agent who signs commercial paper is one of the most frequently litigated issues in this area of law. For example, Igor is an agent (treasurer) of Frank N. Stein, Inc. Igor signs a note showing that the corporation has borrowed \$50,000 from First Bank. The company later becomes bankrupt. The question: Is Igor personally liable on the note? The unhappy treasurer might be sued by the bank—the immediate party with whom he dealt—or by a third party to whom the note was transferred (see [Figure 25.1 "Signature by Representative"](#)).

Figure 25.1 *Signature by Representative*



There are two possibilities regarding an agent who signs commercial paper: the agent was authorized to do so, or the agent was not authorized to do so. First, though, what is a signature?

### **A “Signature” under the Uniform Commercial Code**

Section 3-401 of the Uniform Commercial Code (UCC) provides fairly straightforwardly that “a signature can be made (i) manually or by means of a device or machine, and (ii) by the use of any name, including any trade or assumed name, or by any word, mark, or symbol executed or adopted by a person with the present intention to authenticate a writing.”

### **Liability of an Agent Who Has Authority to Sign**

Agents often sign instruments on behalf of their principals, and—of course—because a corporation’s existence is a legal fiction (you can’t go up and shake hands with General Motors), corporations can only act through their agents.

#### **The General Rule**

Section 3-402(a) of the UCC provides that a person acting (or purporting to act) as an agent who signs an instrument binds the principal to the same extent that the principal would be bound if the signature were on a simple contract. The drafters of the UCC here punt to the common law of agency: if, under agency law, the principal would be bound by the act of the agent, the signature is the authorized signature of the principal. And the general rule in agency law is that the agent is not liable if he signs his own name and makes clear he is doing so as an agent. In our example, Igor should sign as follows: “Frank N. Stein, Inc., by Igor, Agent.” Now it is clear under agency law that the corporation is liable and Igor is not. Uniform Commercial Code, Section 3-402(b)(1). Good job, Igor.

#### **Incorrect Signatures**

The problems arise where the agent, although authorized, signs in an incorrect way. There are three possibilities: (1) the agent signs only his own name—“Igor”; (2) the agent signs both names but without indication of any agency—“Frank N. Stein, Inc., / Igor” (the signature is ambiguous—are both parties to be liable, or is Igor merely an agent?); (3) the agent signs as agent but doesn’t identify the principal—“Igor, Agent.”

The UCC provides that in each case, the agent is liable to a holder in due course (HDC) who took the instrument without notice that the agent wasn’t intended to be

liable on the instrument. As to any other person (holder or transferee), the agent is liable unless she proves that the original parties to the instrument did not intend her to be liable on it. Section 3-402(c) says that, as to a *check*, if an agent signs his name without indicating agency status but the check has the principal's identification on it (that would be in the upper left corner), the authorized agent is not liable.

### **Liability of an “Agent” Who Has No Authority to Sign**

A person who has no authority to sign an instrument cannot really be an “agent” because by definition an agent is a person or entity authorized to act on behalf of and under the control of another in dealing with third parties. Nevertheless, unauthorized persons not infrequently purport to act as agents: either they are mistaken or they are crooks. Are their signatures binding on the “principal”?

#### **The General Rule**

An unauthorized signature is not binding; it is—as the UCC puts it—“ineffective except as the signature of the unauthorized signer.” Uniform Commercial Code, Section 3-403. So if Crook signs a Frank N. Stein, Inc., check with the name “Igor,” the only person liable on the check is Crook.

#### **The Exceptions**

There are two exceptions. Section 4-403(a) of the UCC provides that an unauthorized signature may be ratified by the principal, and Section 3-406 says that if negligence contributed to an instrument's alteration or forgery, the negligent person cannot assert lack of authority against an HDC or a person who in good faith pays or takes the instrument for value or for collection. This is the situation where Principal leaves the rubber signature stamp lying about and Crook makes mischief with it, making out a check to Payee using the stamp. But if Payee herself failed to exercise reasonable care in taking a suspicious instrument, both Principal and Payee could be liable, based on comparative negligence principles. Uniform Commercial Code, Section 3-406(b).

### KEY TAKEAWAY

Under the UCC, a “signature” is any writing or mark used by a person to indicate that a writing is authentic. Agents often sign on behalf of principals, and when the authorized agent makes clear that she is so signing—by naming the principal and signing her name as “agent”—the principal is liable, not the agent. But when the agent signs incorrectly, the UCC says, in general, that the agent is personally liable to an HDC who takes the paper without notice that the agent is not intended to be liable. Unauthorized signatures (forgeries) are ineffective as to the principal: they are effective as the forger’s signature, unless the principal or the person paying on the instrument has been negligent in contributing to, or in failing to notice, the forgery, in which case comparative negligence principles are applied.

### EXERCISES

1. Able signs his name on a note with an entirely illegible squiggle. Is that a valid signature?
2. Under what circumstances is an agent clearly not personally liable on an instrument?
3. Under what circumstances is a forgery effective as to the person whose name is forged?



## 25.2 Contract Liability of Parties

### LEARNING OBJECTIVE

1. Understand that a person who signs commercial paper incurs contract liability.
2. Recognize the two types of such liability: primary and secondary.
3. Know the conditions that must be met before secondary liability attaches.

Two types of liability can attach to those who deal in commercial paper: contract liability and warranty liability. Contract liability is based on a party's signature on the paper. For contract liability purposes, signing parties are divided into two categories: primary parties and secondary parties.

We discuss here the liability of various parties. You may recall the discussion in [Chapter 22 "Nature and Form of Commercial Paper"](#) about accommodation parties. An *accommodation party* signs a negotiable instrument in order to lend his name to another party to the instrument. The Uniform Commercial Code (UCC) provides that such a person “may sign the instrument as maker, drawer, acceptor, or indorser” and that in whatever capacity the person signs, he will be liable in that capacity. Uniform Commercial Code, Section 3-419.

### Liability of Primary Parties

Two parties are primarily liable: the maker of a note and the acceptor of a draft. They are required to pay by the terms of the instrument itself, and their liability is unconditional.

#### Maker

By signing a promissory note, the maker promises to pay the instrument—that's the maker's contract and, of course, the whole point to a note. The obligation is owed to a person entitled to enforce the note or to an indorser that paid the note. Uniform Commercial Code, Section 3-412.

### Acceptor

Recall that *acceptance* is the drawee's signed engagement to honor a draft as presented. The drawee's signature on the draft is necessary and sufficient to accept, and if that happens, the drawee as acceptor is primarily liable. The acceptance must be written on the draft by some means—any means is good. The signature is usually accompanied by some wording, such as “accepted,” “good,” “I accept.” When a bank *certifies* a check, that is the drawee bank's acceptance, and the bank as acceptor becomes liable to the holder; the drawer and all indorsers prior to the bank's acceptance are discharged. So the holder—whether a payee or an indorsee—can look only to the bank, not to the drawer, for payment. Uniform Commercial Code, Section 3-414(b). If the drawee varies the terms when accepting the draft, it is liable according to the terms as varied. Uniform Commercial Code, Section 3-413(a)(iii).

### Liability of Secondary Parties

Unlike primary liability, secondary liability is conditional, arising only if the primarily liable party fails to pay. The parties for whom these conditions are significant are the drawers and the indorsers. By virtue of UCC Sections 3-414 and 3-415, drawers and indorsers engage to pay the amount of an unaccepted draft to any subsequent holder or indorser who takes it up, again, *if* (this is the conditional part) the (1) the instrument is dishonored and, in some cases, (2) notice of dishonor is given to the drawer or indorser.

### Drawer's Liability

If Carlos writes (more properly “draws”) a check to his landlord for \$700, Carlos does not expect the landlord to turn around and approach him for the money: Carlos's bank—the drawee—is supposed to pay from Carlos's account. But if the bank dishonors the check—most commonly because of insufficient funds to pay it—then Carlos is liable to pay according to the instrument's terms when he wrote the check or, if it was incomplete when he wrote it, according to its terms when completed (subject to some limitations). Uniform Commercial Code, Section 3-414. Under the pre-1997 UCC, Carlos's liability was conditioned not only upon dishonor but also upon notice of dishonor; however, under the revised UCC, notice is not required for the drawer to be liable unless the draft has been accepted and the acceptor is not a bank. Most commonly, if a check bounces, the person who wrote it is liable to make it good.

The drawer of a noncheck draft may disclaim her contractual liability on the instrument by drawing “without recourse.” Uniform Commercial Code, Section 3-414(d).

### Indorser's Liability

Under UCC Section 3-415, an indorser promises to pay on the instrument according to its terms if it is dishonored or, if it was incomplete when indorsed, according to its terms when completed. The liability here is conditioned upon the indorser's receipt of *notice of dishonor* (with some exceptions, noted in [Section 25.2 "Contract Liability of Parties"](#) on contract liability of parties. Indorsers may disclaim contractual liability by indorsing "without recourse." Uniform Commercial Code, Section 3-415(b).

### Conditions Required for Liability

We have alluded to the point that secondary parties do not become liable unless the proper conditions are met—there are conditions precedent to liability (i.e., things have to happen before liability “ripens”).

### Conditions for Liability in General

The conditions are slightly different for two classes of instruments. For an unaccepted draft, the drawer's liability is conditioned on (1) presentment and (2) dishonor. For an accepted draft on a nonbank, or for an indorser, the conditions are (1) presentment, (2) dishonor, and (3) notice of dishonor.

### Presentment

**Presentment**<sup>1</sup> occurs when a person entitled to enforce the instrument (creditor) demands *payment* from the maker, drawee, or acceptor, or when a person entitled to enforce the instrument (again, the creditor) demands *acceptance* of a draft from the drawee. Uniform Commercial Code, Section 3-501.

The common-law tort that makes a person who wrongfully takes another's property liable for that taking is **conversion**<sup>2</sup>—it's the civil equivalent of theft. The UCC provides that “the law applicable to conversion of personal property applies to instruments.” Uniform Commercial Code, Section 3-420. Conversion is relevant here because if an instrument is presented for payment or acceptance and the person to whom it is presented refuses to pay, accept, or return it, the instrument is converted. An instrument is also converted if a person pays an instrument on a forged indorsement: a bank that pays a check on a forged indorsement has converted the instrument and is liable to the person whose indorsement was forged. There are various permutations on the theme of conversion; here is one example from the Official Comment:

1. A holder's demand for payment from a payor.
2. Wrongful possession or disposition of another's property as if it were one's own.

A check is payable to the order of A. A indorses it to B and puts it into an envelope addressed to B. The envelope is never delivered to B. Rather, Thief steals the envelope, forges B's indorsement to the check and obtains payment. Because the check was never delivered to B, the indorsee, B has no cause of action for conversion, but A does have such an action. A is the owner of the check. B never obtained rights in the check. If A intended to negotiate the check to B in payment of an obligation, that obligation was not affected by the conduct of Thief. B can enforce that obligation. Thief stole A's property not B's. Uniform Commercial Code, Section 3-420, Official Comment 1.

### Dishonor

**Dishonor**<sup>3</sup> generally means failure by the obligor to pay on the instrument when presentment for payment is made (but return of an instrument because it has not been properly indorsed does not constitute dishonor). The UCC at Section 3-502 has (laborious) rules governing what constitutes dishonor and when dishonor occurs for a note, an unaccepted draft, and an unaccepted documentary draft. (A documentary draft is a draft to be presented for acceptance or payment if specified documents, certificates, statements, or the like are to be received by the drawee or other payor before acceptance or payment of the draft.)

### Notice of Dishonor

Again, when acceptance or payment is refused after presentment, the instrument is said to be dishonored. The holder has a right of recourse against the drawers and indorsers, but he is usually supposed to give notice of the dishonor. Section 3-503(a) of the UCC requires the holder to give notice to a party before the party can be charged with liability, unless such notice is excused, but the UCC exempts notice in a number of circumstances (Section 3-504, discussed in [Section 25.2 "Contract Liability of Parties"](#) on contract liability). The UCC makes giving notice pretty easy: it permits any party who may be compelled to pay the instrument to notify any party who may be liable on it (but each person who is to be charged with liability must actually be notified); notice of dishonor may "be given by any commercially reasonable means including an oral, written, or electronic communication"; and no specific form of notice is required—it is "sufficient if it reasonably identifies the instrument and indicates that the instrument has been dishonored or has not been paid or accepted." Uniform Commercial Code, Section 3-503(b). Section 3-503(c) sets out time limits when notice of dishonor must be given for collecting banks and for other persons. An oral notice is unwise because it might be difficult to prove. Usually, notice of dishonor is given when the instrument is returned with a stamp ("NSF"—the dreaded "nonsufficient funds"), a ticket, or a memo.

3. Refusal to pay or accept an instrument when it is presented.

Suppose—you'll want to graph this out—Ann signs a note payable to Betty, who indorses it to Carl, who in turn indorses it to Darlene. Darlene indorses it to Earl, who presents it to Ann for payment. Ann refuses. Ann is the only primary party, so if Earl is to be paid he must give notice of dishonor to one or more of the secondary parties, in this case, the indorsers. He knows that Darlene is rich, so he notifies only Darlene. He may collect from Darlene but not from the others. If Darlene wishes to be reimbursed, she may notify Betty (the payee) and Carl (a prior indorser). If she fails to notify either of them, she will have no recourse. If she notifies both, she may recover from either. Carl in turn may collect from Betty, because Betty already will have been notified. If Darlene notifies only Carl, then she may collect only from him, but he must notify Betty or he cannot be reimbursed. Suppose Earl notified only Betty. Then Carl and Darlene are discharged. Why? Earl cannot proceed against them because he did not notify them. Betty cannot proceed against them because they indorsed subsequent to her and therefore were not contractually obligated to her. However, if, mistakenly believing that she could collect from either Carl or Darlene, Betty gave each notice within the time allowed to Earl, then he would be entitled to collect from one of them if Betty failed to pay, because they would have received notice. It is not necessary to receive notice from one to whom you are liable; Section 3-503(b) says that notice may be given by any person, so that notice operates for the benefit of all others who have rights against the obligor.

There are some deadlines for giving notice: on an instrument taken for collection, a bank must give notice before midnight on the next banking day following the day on which it receives notice of dishonor; a nonbank must give notice within thirty days after the day it received notice; and in all other situations, the deadline is thirty days after the day dishonor occurred. Uniform Commercial Code, Section 3-503(c).

### **Waived or Excused Conditions**

Presentment and notice of dishonor have been discussed as conditions precedent for imposing liability upon secondarily liable parties (again, drawers and indorsers). But the UCC provides circumstances in which such conditions may be waived or excused.

#### **Presentment Waived or Excused**

Under UCC Section 3-504(a), presentment is excused if (1) the creditor cannot with reasonable diligence present the instrument; (2) the maker or acceptor has repudiated the obligation to pay, is dead, or is in insolvency proceedings; (3) no presentment is necessary by the instrument's terms; (4) the drawer or indorsers waived presentment; (5) the drawer instructed the drawee not to pay or accept; or (6) the drawee was not obligated to the drawer to pay the draft.

### Notice of Dishonor Excused

Notice of dishonor is not required if (1) the instrument's terms do not require it or (2) the debtor waived the notice of dishonor. Moreover, a waiver of presentment is also a waiver of notice of dishonor. Delay in giving the notice is excused, too, if it is caused by circumstances beyond the control of the person giving notice and she exercised reasonable diligence when the cause of delay stopped. Uniform Commercial Code, Section 3-504.

In fact, in real life, presentment and notice of dishonor don't happen very often, at least as to notes. Going back to presentment for a minute: the UCC provides that the "party to whom presentment is made [the debtor] may require exhibition of the instrument,...reasonable identification of the person demanding payment,...[and] a signed receipt [from the creditor (among other things)]" (Section 3-501). This all makes sense: for example, certainly the prudent contractor paying on a note for his bulldozer wants to make sure the creditor actually still has the note (hasn't negotiated it to a third party) and is the correct person to pay, and getting a signed receipt when you pay for something is always a good idea. "Presentment" here is listed as a condition of liability, but in fact, most of the time there is no presentment at all:

[I]t's a fantasy. Every month millions of homeowners make payments on the notes that they signed when they borrowed money to buy their houses. Millions of college graduates similarly make payments on their student loan notes. And millions of drivers and boaters pay down the notes that they signed when they borrowed money to purchase automobiles or vessels. [Probably] none of these borrowers sees the notes that they are paying. There is no "exhibition" of the instruments as section 3-501 [puts it]. There is no showing of identification. In some cases...there is no signing of a receipt for payment. Instead, each month, the borrowers simply mail a check to an address that they have been given. Gregory E. Maggs, "A Complaint about Payment Law Under the U.C.C.: What You See Is Often Not What You Get," *Ohio State Law Journal* 68, no. 201, no. 207 (2007), <http://ssrn.com/abstract=1029647>.

The Official Comment to UCC Section 5-502 says about the same thing:

In the great majority of cases presentment and notice of dishonor are waived with respect to notes. In most cases a formal demand for payment to the maker of the note is not contemplated. Rather, the maker is expected to send payment to the holder of the note on the date or dates on which payment is due. If payment is not made when due, the holder usually makes a demand for payment, but in the normal case in which presentment is waived, demand is irrelevant and the holder can proceed against indorsers when payment is not received.

### KEY TAKEAWAY

People who sign commercial paper become liable on the instrument by contract: they contract to honor the instrument. There are two types of liability: primary and secondary. The primarily liable parties are makers of notes and drawees of drafts (your bank is the drawee for your check), and their liability is unconditional. The secondary parties are drawers and indorsers. Their liability is conditional: it arises if the instrument has been presented for payment or collection by the primarily liable party, the instrument has been dishonored, and notice of dishonor is provided to the secondarily liable parties. The presentment and notice of dishonor are often unnecessary to enforce contractual liability.

### EXERCISES

1. What parties have primary liability on a negotiable instrument?
2. What parties have secondary liability on a negotiable instrument?
3. Secondary liability is conditional. What are the conditions precedent to liability?
4. What conditions may be waived or excused, and how?

## 25.3 Warranty Liability of Parties

### LEARNING OBJECTIVES

1. Understand that independent of contract liability, parties to negotiable instruments incur warranty liability.
2. Know what warranties a person makes when she transfers an instrument.
3. Know what warranties a person makes when he presents an instrument for payment or acceptance.
4. Understand what happens if a bank pays or accepts a check by mistake.

### Overview of Warranty Liability

We discussed the contract liability of primary and secondary parties, which applies to those who sign the instrument. Liability arises a second way, too—by warranty. A negotiable instrument is a type of property that is sold and bought, just the way an automobile is, or a toaster. If you buy a car, you generally expect that it will, more or less, work the way cars are supposed to work—that’s the implied warranty of merchantability. Similarly, when an instrument is transferred from A to B for consideration, the transferee (B) expects that the instrument will work the way such instruments are supposed to work. If A transfers to B a promissory note made by Maker, B figures that when the time is right, she can go to Maker and get paid on the note. So A makes some implied warranties to B—transfer warranties. And when B presents the instrument to Maker for payment, Maker assumes that B as the indorsee from A is entitled to payment, that the signatures are genuine, and the like. So B makes some implied warranties to Maker—presentment warranties. Usually, claims of breach of warranty arise in cases involving forged, altered, or stolen instruments, and they serve to allocate the loss to the person in the best position to have avoided the loss, putting it on the person (or bank) who dealt with the wrongdoer. We take up both transfer and presentment warranties.

### Transfer Warranties

Transfer warranties are important because—as we’ve seen—contract liability is limited to those who have actually signed the instrument. Of course, secondary liability will provide a holder with sufficient grounds for recovery against a previous indorser who did not qualify his indorsement. But sometimes there is no indorsement, and sometimes the indorsement is qualified. Sometimes, also, the holder fails to make timely presentment or notice of dishonor, thereby discharging



a previous indorsee. In such cases, the transferee-holder can still sue a prior party on one or more of the five implied warranties.

A person who receives consideration for transferring an instrument makes the five warranties listed in UCC Section 3-416. The warranty may be sued on by the immediate transferee or, if the transfer was by indorsement, by any subsequent holder who takes the instrument in good faith. The warranties thus run with the instrument. They are as follows:

1. *The transferor is entitled to enforce the instrument.* The transferor warrants that he is—or would have been if he weren't transferring it—entitled to enforce the instrument. As UCC Section 3-416, Comment 2, puts it, this “is in effect a warranty that there are no unauthorized or missing indorsements that prevent the transferor from making the transferee a person entitled to enforce the instrument.” Suppose Maker makes a note payable to Payee; Thief steals the note, forges Payee's indorsement, and sells the note. Buyer is not a holder because he is not “a person in possession of an instrument drawn, issued, or indorsed to him, or to his order, or to bearer, or in blank,” so he is not entitled to enforce it. “Person entitled to enforce” means (i) the holder, (ii) a non-holder in possession of the instrument who has the rights of a holder [because of the shelter rule]” (UCC, Section 3-301). Buyer sells the note to Another Party, who can hold Buyer liable for breach of the warranty: he was not entitled to enforce it.
2. *All signatures on the instrument are authentic and authorized.* This warranty would be breached, too, in the example just presented.
3. *The instrument has not been altered.*
4. *The instrument is not subject to a defense or claim in recoupment of any party that can be asserted against the warrantor.* “Recoupment” means to hold back or deduct part of what is due to another. The Official Comment to UCC Section 3-416 observes, “[T]he transferee does not undertake to buy an instrument that is not enforceable in whole or in part, unless there is a contrary agreement. Even if the transferee takes as a holder in due course who takes free of the defense or claim in recoupment, the warranty gives the transferee the option of proceeding against the transferor rather than litigating with the obligor on the instrument the issue of the holder-in-due-course status of the transferee.”
5. *The warrantor has no knowledge of any insolvency proceeding commenced with respect to the maker or acceptor or, in the case of an unaccepted draft, the drawer.* The UCC Official Comment here provides the following: “The transferor does not warrant against difficulties of collection, impairment of the credit of the obligor or even insolvency [only knowledge of insolvency]. The transferee is expected to determine

such questions before taking the obligation. If insolvency proceedings...have been instituted against the party who is expected to pay and the transferor knows it, the concealment of that fact amounts to a fraud upon the transferee, and the warranty against knowledge of such proceedings is provided accordingly.”Uniform Commercial Code, Section 3-416, Official Comment 4.

## **Presentment Warranties**

A payor paying or accepting an instrument in effect takes the paper from the party who presents it to the payor, and that party has his hand out. In doing so, the presenter makes certain implied promises to the payor, who is about to fork over cash (or an acceptance). The UCC distinguishes between warranties made by one who presents an unaccepted draft for payment and warranties made by one who presents other instruments for payment. The warranties made by the presenter are as follows.Uniform Commercial Code, Section 3-417.

### **Warranties Made by One Who Presents an Unaccepted Draft**

1. *The presenter is entitled to enforce the draft or to obtain payment or acceptance.* This is “in effect a warranty that there are no unauthorized or missing indorsements.”Uniform Commercial Code, Section 3-417, Comment 2. Suppose Thief steals a check drawn by Drawer to Payee and forges Payee’s signature, then presents it to the bank. If the bank pays it, the bank cannot charge Drawer’s account because it has not followed Drawer’s order in paying to the wrong person (except in the case of an imposter or fictitious payee). It can, though, go back to Thief (fat chance it can find her) on the claim that she breached the warranty of no unauthorized indorsement.
2. *There has been no alteration of the instrument.* If Thief takes a check and changes the amount from \$100 to \$1,000 and the bank pays it, the bank can recover from Thief \$900, the difference between the amount paid by the bank and the amount Drawer (customer) authorized the bank to pay.Uniform Commercial Code, Sections 3-417(2) and (b). If the drawee accepts the draft, the same rules apply.
3. *The presenter has no knowledge that the signature of the drawer is unauthorized.* If the presenter doesn’t know Drawer’s signature is forged and the drawee pays out on a forged signature, the drawee bears the loss. (The bank would be liable for paying out over the forged drawer’s signature: that’s why it has the customer’s signature on file.)

These rules apply—again—to warranties made by the presenter to a drawee paying out on an unaccepted draft. The most common situation would be where a person has a check made out to her and she gets it cashed at the drawer's bank.

### **Warranties Made by One Who Presents Something Other Than an Unaccepted Draft**

In all other cases, there is only one warranty made by the presenter: that he or she is a person entitled to enforce the instrument or obtain payment on it.

This applies to the presentment of accepted drafts, to the presentment of dishonored drafts made to the drawer or an indorser, and to the presentment of notes. For example, Maker makes a note payable to Payee; Payee indorses the note to Indorsee, Indorsee indorses and negotiates the note to Subsequent Party. Subsequent Party presents the note to Maker for payment. The Subsequent Party warrants to Maker that she is entitled to obtain payment. If she is paid and is *not* entitled to payment, Maker can sue her for breach of that warranty. If the reason she isn't entitled to payment is because Payee's signature was forged by Thief, then Maker can go after Thief: the UCC says that "the person obtaining payment [Subsequent Party] and a prior transferor [Thief] warrant to the person making payment in good faith [Maker] that the warrantor [Subsequent Party] is entitled to enforce the instrument." Uniform Commercial Code, Section 3-417(d). Or, again, Drawer makes the check out to Payee; Payee attempts to cash or deposit the check, but it is dishonored. Payee presents the check to Drawer to make it good: Payee warrants he is entitled to payment on it.

Warranties cannot be disclaimed in the case of checks (because, as UCC Section 3-417, Comment 7, puts it, "it is not appropriate to allow disclaimer of warranties appearing on checks that normally will not be examined by the payor bank"—they're machine read). But a disclaimer of warranties is permitted as to other instruments, just as disclaimers of warranty are usually OK under general contract law. The reason presentment warranties 2 and 3 don't apply to makers and drawers (they apply to drawees) is because makers and drawers are going to know their own signatures and the terms of the instruments; indorsers already warranted the wholesomeness of their transfer (transfer warranties), and acceptors should examine the instruments when they accept them.

### **Payment by Mistake**

Sometimes a drawee pays a draft (most familiarly, again, a bank pays a check) or accepts a draft by mistake. The UCC says that if the mistake was in thinking that there was no stop-payment order on it (when there was), or that the drawer's

signature was authorized (when it was not), or that there were sufficient funds in the drawer's account to pay it (when there were not), "the drawee may recover the amount paid...or in the case of acceptance, may revoke the acceptance." Uniform Commercial Code, Section 3-418. Except—and it's a big exception—such a recovery of funds does not apply "against a person who took the instrument in good faith and for value." Uniform Commercial Code, Section 3-418(c). The drawee in that case would have to go after the forger, the unauthorized signer, or, in the case of insufficient funds, the drawer. Example: Able draws a check to Baker. Baker deposits the check in her bank account, and Able's bank mistakenly pays it even though Able doesn't have enough money in his account to cover it. Able's bank cannot get the money back from Baker: it has to go after Able. To rephrase, in most cases, the remedy of restitution will not be available to a bank that pays or accepts a check because the person receiving payment of the check will have given value for it in good faith.

#### KEY TAKEAWAY

A transferor of a negotiable instrument warrants to the transferee five things: (1) entitled to enforce, (2) authentic and authorized signatures, (3) no alteration, (4) no defenses, and (5) no knowledge of insolvency. If the transfer is by delivery, the warranties run only to the immediate transferee; if by indorsement, to any subsequent good-faith holder. Presenters who obtain payment of an instrument and all prior transferors make three presenter's warranties: (1) entitled to enforce, (2) no alteration, (3) genuineness of drawer's signature. These warranties run to any good-faith payor or acceptor. If a person pays or accepts a draft by mistake, he or she can recover the funds paid out unless the payee took the instrument for value and in good faith.

#### EXERCISES

1. What does it mean to say that the transferor of a negotiable instrument warrants things to the transferee, and what happens if the warranties are breached? What purpose do the warranties serve?
2. What is a presenter, and to whom does such a person make warranties?
3. Under what circumstances would suing for breach of warranties be useful compared to suing on the contract obligation represented by the instrument?
4. Why are the rules governing mistaken payment not very often useful to a bank?

## 25.4 Discharge

### LEARNING OBJECTIVE

1. Understand how the obligations represented by commercial paper may be discharged.

### Overview

Negotiable instruments eventually die. The obligations they represent are discharged (terminated) in two general ways: (1) according to the rules stated in Section 3-601 of the Uniform Commercial Code (UCC) or (2) by an act or agreement that would discharge an obligation to pay money under a simple contract (e.g., declaring bankruptcy).

### Discharge under the Uniform Commercial Code

The UCC provides a number of ways by which an obligor on an instrument is discharged from liability, but notwithstanding these several ways, under Section 3-601, no discharge of any party provided by the rules presented in this section operates against a subsequent holder in due course unless she has notice when she takes the instrument.

#### Discharge in General

##### Discharge by Payment

A person primarily liable discharges her liability on an instrument to the extent of payment by paying or otherwise satisfying the holder, and the discharge is good even if the payor knows that another has claim to the instrument. However, discharge does not operate if the payment is made in bad faith to one who unlawfully obtained the instrument (and UCC Section 3-602(b) lists two other exceptions).

##### Discharge by Tender

A person who tenders full payment to a holder on or after the date due discharges any subsequent liability to pay interest, costs, and attorneys' fees (but not liability for the face amount of the instrument). If the holder refuses to accept the tender, any party who would have had a right of recourse against the party making the

tender is discharged. Mario makes a note payable to Carol, who indorses it to Ed. On the date the payment is due, Mario (the maker) tenders payment to Ed, who refuses to accept the payment; he would rather collect from Carol. Carol is discharged: had she been forced to pay as indorser in the event of Mario's refusal, she could have looked to him for recourse. Since Mario did tender, Ed can no longer look to Carol for payment. Uniform Commercial Code, Section 3-603(b).

### **Discharge by Cancellation and Renunciation**

The holder may discharge any party, even without consideration, by marking the face of the instrument or the indorsement in an unequivocal way, as, for example, by intentionally canceling the instrument or the signature by destruction or mutilation or by striking out the party's signature. The holder may also renounce his rights by delivering a signed writing to that effect or by surrendering the instrument itself. Uniform Commercial Code, Section 3-604.

### **Discharge by Material and Fraudulent Alteration**

Under UCC Section 3-407, if a holder materially and fraudulently alters an instrument, any party whose contract is affected by the change is discharged. A payor bank or drawee paying a fraudulently altered instrument or a person taking it for value, in good faith, and without notice of the alteration, may enforce rights with respect to the instrument according to its original terms or, if the incomplete instrument was altered by unauthorized completion, according to its terms as completed.

- Example 1: Marcus makes a note for \$100 payable to Pauline. Pauline fraudulently raises the amount to \$1,000 without Marcus's negligence and negotiates it to Ned, who qualifies as a holder in due course (HDC). Marcus owes Ned \$100.
- Example 2: Charlene writes a check payable to Lumber Yard and gives it to Contractor to buy material for a deck replacement. Contractor fills it in for \$1,200: \$1,000 for the decking and \$200 for his own unauthorized purposes. Lumber Yard, if innocent of any wrongdoing, could enforce the check for \$1,200, and Charlene must go after Contractor for the \$200.

### **Discharge by Certification**

As we have noted, where a drawee certifies a draft for a holder, the drawer and all prior indorsers are discharged.

### **Discharge by Acceptance Varying a Draft**

If the holder assents to an acceptance varying the terms of a draft, the obligation of the drawer and any indorsers who do not expressly assent to the acceptance is discharged. Uniform Commercial Code, Section 3-410.

### **Discharge of Indorsers and Accommodation Parties**

The liability of indorsers and accommodation parties is discharged under the following three circumstances. Uniform Commercial Code, Section 3-605.

#### **Extension of Due Date**

If the holder agrees to an extension of the due date of the obligation of the obligor, the extension discharges an indorser or accommodation party having a right of recourse against the obligor to the extent the indorser or accommodation party proves that the extension caused her loss with respect to the right of recourse.

#### **Material Modification of Obligation**

If the holder agrees to a material modification of the obligor's obligation, other than an extension of the due date, the modification discharges the obligation of an indorser or accommodation party having a right of recourse against the obligor to the extent the modification causes her loss with respect to the right of recourse.

#### **Impairment of Collateral**

If the obligor's duty to pay is secured by an interest in collateral and the holder impairs the value of the interest in collateral, the obligation of an indorser or accommodation party having a right of recourse against the obligor is discharged to the extent of the impairment.

The following explanatory paragraph from UCC Section 3-605, Official Comment 1, may be helpful:

Bank lends \$10,000 to Borrower who signs a note under which she (in suretyship law, the "Principal Debtor") agrees to pay Bank on a date stated. But Bank insists that an accommodation party also become liable to pay the note (by signing it as a co-maker or by indorsing the note). In suretyship law, the accommodation party is a "Surety." Then Bank agrees to a modification of the rights and obligations between it and Principal Debtor, such as agreeing that she may pay the note at some date after the due date, or that she may discharge her \$10,000 obligation to

pay the note by paying Bank \$3,000, or the Bank releases collateral she gave it to secure the note. Surety is discharged if changes like this are made by Bank (the creditor) without Surety's consent to the extent Surety suffers loss as a result. Section 3-605 is concerned with this kind of problem with Principal Debtor and Surety. But it has a wider scope: it also applies to indorsers who are not accommodation parties. Unless an indorser signs without recourse, the indorser's liability under section 3-415(a) is that of a surety. If Bank in our hypothetical case indorsed the note and transferred it to Second Bank, Bank has rights given to an indorser under section 3-605 if it is Second Bank that modifies rights and obligations of Borrower.

### **Discharge by Reacquisition**

Suppose a prior party reacquires the instrument. He may—but does not automatically—cancel any indorsement unnecessary to his title and may also reissue or further negotiate the instrument. Any intervening party is thereby discharged from liability to the reacquiring party or to any subsequent holder not in due course. If an intervening party's indorsement is cancelled, she is not liable even to an HDC. Uniform Commercial Code, Section 3-207.

### **Discharge by Unexcused Delay in Presentment or Notice of Dishonor**

If notice of dishonor is not excused under UCC Section 3-504, failure to give it discharges drawers and indorsers.

#### **KEY TAKEAWAY**

The potential liabilities arising from commercial paper are discharged in several ways. Anything that would discharge a debt under common contract law will do so. More specifically as to commercial paper, of course, payment discharges the obligation. Other methods include tender of payment, cancellation or renunciation, material and fraudulent alteration, certification, acceptance varying a draft, reacquisition, and—in some cases—unexcused delay in giving notice of presentment or dishonor. Indorsers and accommodation parties' liability may be discharged by the same means that a surety's liability is discharged, to the extent that alterations in the agreement between the creditor and the holder would be defenses to a surety because right of recourse is impaired to the surety.



## EXERCISES

1. What is the most common way that obligations represented by commercial paper are discharged?
2. Parents loan Daughter \$6,000 to attend college, and she gives them a promissory note in return. At her graduation party, Parents ceremoniously tear up the note. Is Daughter's obligation terminated?
3. Juan signs Roberta's note to Creditor as an accommodation party, agreeing to serve in that capacity for two years. At the end of that term, Roberta has not paid Creditor, who—without Juan's knowledge—gives Roberta an extra six months to pay. She fails to do so. Does Creditor still have recourse against Juan?

## 25.5 Cases

### **Breach of Presentment Warranties and Conduct Precluding Complaint about Such Breach**

Bank of Nichols Hills v. Bank of Oklahoma

196 P.3d 984 (Okla. Civ. App. 2008)

Gabbard, J.

Plaintiff, Bank of Nichols Hills (BNH), appeals a trial court judgment for Defendant, Bank of Oklahoma (BOK), regarding payment of a forged check. The primary issue on appeal is whether BOK presented sufficient proof to support the trial court's finding that the [UCC] § 3-406 preclusion defense applied. We find that it did, and affirm.

#### **Facts**

Michael and Stacy Russell owned a mobile home in Harrah, Oklahoma. The home was insured by Oklahoma Farm Bureau Mutual Insurance Company (Farm Bureau). The insurance policy provided that in case of loss, Farm Bureau "will pay you unless another payee is named on the Declarations page," that "Loss shall be payable to any mortgagee named in the Declarations," and that one of Farm Bureau's duties was to "protect the mortgagee's interests in the insured building." The Declarations page of the policy listed Conseco Finance as the mortgagee. Conseco had a mortgage security interest in the home.

In August 2002, a fire completely destroyed the mobile home. The Russells submitted an insurance claim to Farm Bureau. Farm Bureau then negotiated a \$69,000 settlement with the Russells, issued them a check in this amount payable to them and Conseco jointly, and mailed the check to the Russells. Neither the Russells nor Farm Bureau notified Conseco of the loss, the settlement, or the mailing of the check.

The check was drawn on Farm Bureau's account at BNH. The Russells deposited the check into their account at BOK. The check contains an endorsement by both Russells, and a rubber stamp endorsement for Conseco followed by a signature of a Donna Marlatt and a phone number. It is undisputed that Conseco's endorsement

was forged. Upon receipt, BOK presented the check to BNH. BNH paid the \$69,000 check and notified Farm Bureau that the check had been paid from its account.

About a year later, Conseco learned about the fire and the insurance payoff. Conseco notified Farm Bureau that it was owed a mortgage balance of more than \$50,000. Farm Bureau paid off the balance and notified BNH of the forgery. BNH reimbursed Farm Bureau the amount paid to Conseco. BNH then sued BOK.

Both banks relied on the Uniform Commercial Code. BNH asserted that under § 4-208, BOK had warranted that all the indorsements on the check were genuine. BOK asserted an affirmative defense under § 3-406, alleging that Farm Bureau's own negligence contributed to the forgery. After a non-jury trial, the court granted judgment to BOK, finding as follows:

- Conseco's endorsement was a forgery, accomplished by the Russells;
- Farm Bureau was negligent in the manner and method it used to process the claim and pay the settlement without providing any notice or opportunity for involvement in the process to Conseco;
- Farm Bureau's negligence substantially contributed to the Russells' conduct in forging Conseco's endorsement; and
- BOK proved its affirmative defense under § 3-406 by the greater weight of the evidence.

From this judgment, BNH appeals.

### **Analysis**

It cannot be disputed that BOK breached its presentment warranty to BNH under § 4-208. Section 4-208 provides as follows: "(a) If an unaccepted draft is presented [in this case, by BOK] to the drawee [BNH] for payment or acceptance and the drawee pays or accepts the draft, (i) the person obtaining payment or acceptance, at the time of presentment, and (ii) a previous transferor of the draft, at the time of transfer, warrant to the drawee that pays or accepts the draft in good faith, that: (1) The warrantor is, or was, at the time the warrantor transferred the draft, a person entitled to enforce the draft or authorized to obtain payment or acceptance of the draft on behalf of a person entitled to enforce the draft; (2) The draft has not been altered; and (3) The warrantor has no knowledge that the signature of the purported drawer of the draft is unauthorized. (b) A drawee making payment may recover from a warrantor damages for breach of warranty.... (c) If a drawee asserts a claim for breach of warranty under subsection (a) of this section based on an unauthorized indorsement of the draft or an alteration of the draft, the warrantor may defend by proving that...the drawer [here, Farm Bureau] is precluded under

Section 3-406 or 4-406 of this title from asserting against the drawee the unauthorized indorsement or alteration.” Thus the primary issue raised is whether BOK established a preclusion defense under 3-406 [that BNH is precluded from complaining about BOK’s breach of presentment warranty because of its own negligence].(a) A person whose failure to exercise ordinary care substantially contributes to an alteration of an instrument or to the making of a forged signature on an instrument is precluded from asserting the alteration or the forgery against a person who, in good faith, pays the instrument or takes it for value or for collection. BNH asserts that the evidence fails to establish this defense because the mailing of its check to and receipt by the insured “is at most an event of opportunity and has nothing to do with the actual forgery.”

Section 3-406 requires less stringent proof than the “direct and proximate cause” test for general negligence. The parties do not address Section 3-406(b), which states that the person asserting preclusion may be held partially liable under comparative negligence principles for failing to exercise ordinary care in paying or taking the check. They also do not address any possible negligence by either bank in accepting the forged check without confirming the legitimacy of Consec’s indorsement. Conduct is a contributing cause of an alteration or forgery if it is a substantial factor in bringing it about, or makes it “easier for the wrongdoer to commit his wrong.” The UCC Comment to § 3-406 notes that the term has the meaning as used by the Pennsylvania court in *Thompson* [Citation].

In *Thompson*, an independent logger named Albers obtained blank weighing slips, filled them out to show fictitious deliveries of logs for local timber owners, delivered the slips to the company, accepted checks made payable to the timber owners, forged the owners’ signatures, and cashed the checks at the bank. When the company discovered the scheme, it sued the bank and the bank raised § 3-406 as a defense. The court specifically found that the company’s negligence did not have to be the direct and proximate cause of the bank’s acceptance of the forged checks. Instead, the defense applied because the company left blank logging slips readily accessible to haulers, the company had given Albers whole pads of blank slips, the slips were not consecutively numbered, haulers were allowed to deliver both the original and duplicate slips to the company’s office, and the company regularly entrusted the completed checks to the haulers for delivery to the payees without the payees’ consent. The court noted:

While none of these practices, in isolation, might be sufficient to charge the plaintiff [the company] with negligence within the meaning of § 3-406, the company’s course of conduct, viewed in its entirety, is surely sufficient to support the trial judge’s determination that it substantially contributed to the making of the unauthorized signatures....[T]hat conduct was ‘no different than had the plaintiff

simply given Albers a series of checks signed in blank for his unlimited, unrestrictive use.’

The UCC Comment to § 3-406 gives three examples of conduct illustrating the defense. One example involves an employer who leaves a rubber stamp and blank checks accessible to an employee who later commits forgery; another example involves a company that issues a ten dollar check but leaves a blank space after the figure which allows the payee to turn the amount into ten thousand dollars; and the third example involves an insurance company that mails a check to one policyholder whose name is the same as another policyholder who was entitled to the check. In each case, the company’s negligence substantially contributed to the alterations or forgeries by making it easier for the wrongdoer to commit the malfeasance.

In the present case, we find no negligence in Farm Bureau’s delivery of the check to the Russells. There is nothing in the insurance policy that prohibits the insurer from making the loss-payment check jointly payable to the Russells and Conseco. Furthermore, under § 3-420, if a check is payable to more than one payee, delivery to one of the payees is deemed to be delivery to all payees. The authority cited by BOK, in which a check was delivered to one joint payee who then forged the signature of the other, involve cases where the drawer knew or should have known that the wrongdoer was not entitled to be a payee in the first place. See [Citations].

We also find no negligence in Farm Bureau’s violation of its policy provisions requiring the protection of the mortgage holder. Generally, violation of contract provisions and laxity in the conduct of the business affairs of the drawer do not per se establish negligence under this section. See [Citations].

However, evidence was presented that the contract provision merely reflected an accepted and customary commercial standard in the insurance industry. Failure to conform to the reasonable commercial standards of one’s business has been recognized by a number of courts as evidence of negligence. See, e.g., [Citations].

Here, evidence was presented that Farm Bureau did not act in a commercially reasonable manner or in accordance with reasonable commercial standards of its business when it issued the loss check to the insured without notice to the mortgagee. BOK’s expert testified that it is standard practice in the industry to notify the lender of a loss this size, in order to avoid exactly the result that occurred here. Mortgagees often have a greater financial stake in an insurance policy than do the mortgagors. That was clearly true in this case. While there was opinion testimony to the contrary, the trial court was entitled to conclude that Farm Bureau did not act in a commercially reasonable manner and that this failure was

negligence which substantially contributed to the forgery, as contemplated by § 3-406.

We find the trial court's judgment supported by the law and competent evidence. Accordingly, the trial court's decision is affirmed. Affirmed.

### CASE QUESTIONS

1. How did BOK breach its presentment warranty to BNH?
2. What part of the UCC did BOK point to as why it should not be liable for that breach?
3. In what way was Farm Bureau Mutual Insurance Co. negligent in this case, and what was the consequence?

### Presentment, Acceptance, Dishonor, and Warranties

Messing v. Bank of America

821 A.2d 22 (Md. 2003)

At some point in time prior to 3 August 2000, Petitioner, as a holder, came into possession of a check in the amount of Nine Hundred Seventy-Six Dollars (\$976.00) (the check) from Toyson J. Burruss, the drawer, doing business as Prestige Auto Detail Center. Instead of depositing the check into his account at his own bank, Petitioner elected to present the check for payment at a branch of Mr. Burruss' bank, Bank of America, the drawee. Petitioner's choice could be viewed as an attempt at risk shifting. Petitioner, an attorney, may have known that he could have suffered a fee charged by his own bank if he deposited a check into his own account and then the bank on which it was drawn returned it for insufficient funds, forged endorsement, alteration, or the like. Petitioner's action, viewed against that backdrop, would operate as a risk-shifting strategy, electing to avoid the risk of a returned-check fee by presenting in person the check for acceptance at the drawee bank. On 3 August 2000, Petitioner approached a teller at Bank of America...in Baltimore City and asked to cash the check. The teller, by use of a computer, confirmed the availability of funds on deposit, and placed the check into the computer's printer slot. The computer stamped certain data on the back of the check, including the time, date, amount of the check, account number, and teller number. The computer also effected a hold on the amount of \$976.00 in the customer's account. The teller gave the check back to the Petitioner, who endorsed it. The teller then asked for Petitioner's identification. Petitioner presented his

driver's license and a major credit card. The teller took the indorsed check from Petitioner and manually inscribed the driver's license information and certain credit card information on the back of the check.

At some point during the transaction, the teller counted out \$976.00 in cash from her drawer in anticipation of completing the transaction. She asked if the Petitioner was a customer of Bank of America. The Petitioner stated that he was not. The teller returned the check to Petitioner and requested, consistent with bank policy when cashing checks for non-customers, that Petitioner place his thumbprint on the check. [The thumbprint identification program was designed by various banking and federal agencies to reduce check fraud.] Petitioner refused and the teller informed him that she would be unable to complete the transaction without his thumbprint.

...Petitioner presented the check to the branch manager and demanded that the check be cashed notwithstanding Petitioner's refusal to place his thumbprint on the check. The branch manager examined the check and returned it to the Petitioner, informing him that, because Petitioner was a non-customer, Bank of America would not cash the check without Petitioner's thumbprint on the instrument....Petitioner left the bank with the check in his possession....

Rather than take the check to his own bank and deposit it there, or returning it to Burruss, the drawer, as dishonored and demanding payment, Petitioner,...[sued] Bank of America (the Bank)...Petitioner claimed that the Bank had violated the Maryland Uniform Commercial Code (UCC) and had violated his personal privacy when the teller asked Petitioner to place an "inkless" thumbprint on the face of the check at issue....

...[T]he Circuit Court heard oral arguments..., entered summary judgment in favor of the Bank, dismissing the Complaint with prejudice. [The special appeals court affirmed. The Court of Appeals—this court—accepted the appeal.]

[Duty of Bank on Presentment and Acceptance]

Petitioner argues that he correctly made "presentment" of the check to the Bank pursuant to § 3-111 and § 3-501(a), and demands that, as the person named on the instrument and thus entitled to enforce the check, the drawee Bank pay him....In a continuation, Petitioner contends that the teller, by placing the check in the slot of her computer, and the computer then printing certain information on the back of the check, accepted the check as defined by § 3-409(a)....Thus, according to Petitioner, because the Bank's computer printed information on the back of the

check, under § 3-401(b) the Bank “signed” the check, said “signature” being sufficient to constitute acceptance under § 3-409(a).

Petitioner’s remaining arguments line up like so many dominos. According to Petitioner, having established that under his reading of § 3-409(a) the Bank accepted the check, Petitioner advances that the Bank is obliged to pay him, pursuant to § 3-413(a)...Petitioner extends his line of reasoning by arguing that the actions of the Bank amounted to a conversion under § 3-420,...Petitioner argues that because the Bank accepted the check, an act which, according to Petitioner, discharged the drawer, he no longer had enforceable rights in the check and only had a right to the proceeds. Petitioner’s position is that the Bank exercised unauthorized dominion and control over the proceeds of the check to the complete exclusion of the Petitioner after the Bank accepted the check and refused to distribute the proceeds, counted out by the teller, to him.

We turn to the Bank’s obligations, or lack thereof, with regard to the presentment of a check by someone not its customer. Bank argues, correctly, that it had no duty to the Petitioner, a non-customer and a stranger to the Bank, and that nothing in the Code allows Petitioner to force Bank of America to act as a depository bank...

Absent a special relationship, a non-customer has no claim against a bank for refusing to honor a presented check. [Citations] This is made clear by § 3-408, which states:

A check or other draft does not of itself operate as an assignment of funds in the hands of the drawee available for its payment, and the drawee is not liable on the instrument until the drawee accepts it.

Once a bank accepts a check, under § 3-409, it is obliged to pay on the check under § 3-413. Thus, the relevant question in terms of any rights Petitioner had against the Bank [regarding presentment] turns not on the reasonableness of the thumbprint identification, but rather upon whether the Bank accepted the check when presented as defined by § 3-409. As will be seen *infra* [below] the question of the thumbprint identification is relevant only to the issue of whether the Bank’s refusal to pay the instrument constituted dishonor under § 3-502, a determination which has no impact in terms of any duty allegedly owed by the Bank to the Petitioner.

The statute clearly states that acceptance becomes effective when the presenter is notified of that fact. The facts demonstrate that at no time did the teller notify Petitioner that the Bank would pay on the check. Rather, the facts show that:



[T]he check was given back to [Petitioner] by the teller so that he could put his thumbprint signature on it, not to notify or give him rights on the purported acceptance. After appellant declined to put his thumbprint signature on the check, he was informed by both the teller and the branch manager that it was against bank policy to honor the check without a thumbprint signature. Indignant, [Petitioner] walked out of the bank with the check.

As the intermediate appellate court correctly pointed out, the negotiation of the check is in the nature of a contract, and there can be no agreement until notice of acceptance is received. As a result, there was never acceptance as defined by § 3-409(a), and thus the Bank, pursuant to § 3-408 never was obligated to pay the check under § 3-413(a). Thus, the answer to Petitioner's second question [Did the lower court err in finding the Bank did not accept the...check at issue, as "acceptance" is defined in UCC Section 3-409?] is "no."

"Conversion" under § 3-420.

Because it never accepted the check, Bank of America argues that the intermediate appellate court also correctly concluded that the Bank did not convert the check or its proceeds under § 3-420. Again, we must agree. The Court of Special Appeals stated:

"Conversion," we have held, "requires not merely temporary interference with property rights, but the exercise of unauthorized dominion and control to the complete exclusion of the rightful possessor." [Citation] At no time did [Respondent] exercise "unauthorized dominion and control [over the check] to the complete exclusion of the rightful possessor," [Petitioner].

[Petitioner] voluntarily gave the check to [Respondent's] teller. When [Petitioner] indicated to the teller that he was not an account holder, she gave the check back to him for a thumbprint signature in accordance with bank policy. After being informed by both [Respondent's] teller and branch manager that it was [Respondent's] policy not to cash a non-account holder's check without a thumbprint signature, [Petitioner] left the bank with the check in hand.

Because [Petitioner] gave the check to the teller, [Respondent's] possession of that check was anything but "unauthorized," and having returned the check, within minutes of its receipt, to [Petitioner] for his thumbprint signature, [Respondent] never exercised "dominion and control [over it] to the complete exclusion of the rightful possessor," [Petitioner]. In short, there was no conversion.

D. “Reasonable Identification” under § 3-501(b)(2)(ii) and “Dishonor” under § 3-502

We now turn to the issue of whether the Bank’s refusal to accept the check as presented constituted dishonor under § 3-501 and § 3-502 as Petitioner contends. Petitioner’s argument that Bank of America dishonored the check under § 3-502(d) fails because that section applies to dishonor of an accepted draft. We have determined, *supra*, [above] that Bank of America never accepted the draft. Nevertheless, the question remains as to whether Bank of America dishonored the draft under § 3-502(b)...

(2) Upon demand of the person to whom presentment is made, the person making presentment must (i) exhibit the instrument, (ii) give reasonable identification...

(3) Without dishonoring the instrument, the party to whom presentment is made may (i) return the instrument for lack of a necessary indorsement, or (ii) refuse payment or acceptance for failure of the presentment to comply with the terms of the instrument, an agreement of the parties, or other applicable law or rule.

The question is whether requiring a thumbprint constitutes a request for “reasonable identification” under § 3-501(b)(2)(ii). If it is “reasonable,” then under § 3-501(b)(3)(ii) the refusal of the Bank to accept the check from Petitioner did not constitute dishonor. If, however, requiring a thumbprint is not “reasonable” under § 3-501(b)(2)(ii), then the refusal to accept the check may constitute dishonor under § 3-502(b)(2). The issue of dishonor is arguably relevant because Petitioner has no cause of action against any party, including the drawer, until the check is dishonored.

Respondent Bank of America argues that its relationship with its customer is contractual, [Citations] and that in this case, its contract with its customer, the drawer, authorizes the Bank’s use of the Thumbprint Signature Program as a reasonable form of identification.

According to Respondent, this contractual agreement allowed it to refuse to accept the check, without dishonoring it pursuant to § 3-501(b)(3)(ii), because the Bank’s refusal was based upon the presentment failing to comply with “an agreement of the parties.” The intermediate appellate court agreed. We, however, do not.

...Bank and its customer cannot through their contract define the meaning of the term “reasonable” and impose it upon parties who are not in privity with that contract. Whether requiring a thumbprint constitutes “reasonable identification” within the meaning of § 3-501(b)(2)(ii) is therefore a broader policy consideration,

and not, as argued in this case, simply a matter of contract. We reiterate that the contract does not apply to Petitioner and, similarly, does not give him a cause of action against the Bank for refusing to accept the check. This also means that the Bank cannot rely on the contract as a defense against the Petitioner, on the facts presented here, to say that it did not dishonor the check.

Petitioner, as noted, argues that requiring a thumbprint violates his privacy, and further argues that a thumbprint is not a reasonable form of identification because it does not prove contemporaneously the identity of an over the counter presenter at the time presentment is made. According to Petitioner, the purpose of requiring “reasonable identification” is to allow the drawee bank to determine that the presenter is the proper person to be paid on the instrument. Because a thumbprint does not provide that information at the time presentment and payment are made, Petitioner argues that a thumbprint cannot be read to fall within the meaning of “reasonable identification” for the purposes of § 3-501(b)(2)(ii).

Bank of America argues that the requirement of a thumbprint has been upheld, in other non-criminal circumstances, not to be an invasion of privacy, and is a reasonable and necessary industry response to the growing problem of check fraud. The intermediate appellate court agreed, pointing out that the form of identification was not defined by the statute, but that the Code itself recognized a thumbprint as a form of signature, § 1-201(39), and observing that requiring thumbprint or fingerprint identification has been found to be reasonable and not to violate privacy rights in a number of non-criminal contexts....

We agree with [Petitioner] that a thumbprint cannot be used, in most instances, to confirm the identity of a non-account checkholder at the time that the check is presented for cashing, as his or her thumbprint is usually not on file with the drawee at that time. We disagree, however, with [Petitioner’s] conclusion that a thumbprint signature is therefore not “reasonable identification” for purposes of § 3-501(b)(2).

Nowhere does the language of § 3-501(b)(2) suggest that “reasonable identification” is limited to information [Bank] can authenticate at the time presentment is made. Rather, all that is required is that the “person making presentment must...give reasonable identification.” § 3-501(b)(2). While providing a thumbprint signature does not necessarily confirm identification of the checkholder at presentment—unless of course the drawee bank has a duplicate thumbprint signature on file—it does assist in the identification of the checkholder should the check later prove to be bad. It therefore serves as a powerful deterrent to those who might otherwise attempt to pass a bad check. That one method provides identification at the time of presentment and the other identification after the

check may have been honored, does not prevent the latter from being “reasonable identification” for purposes of § 3-501(b)(2) [Citation].

[So held the lower courts.] We agree, and find this conclusion to be compelled, in fact, by our State’s Commercial Law Article.

The reason has to do with warranties. The transfer of a check for consideration creates both transfer warranties (§ 3-416(a) and (c)) and presentment warranties (§ 3-417(a) and (e)) which cannot be disclaimed. The warranties include, for example, that the payee is entitled to enforce the instrument and that there are no alterations on the check. The risk to banks is that these contractual warranties may be breached, exposing the accepting bank to a loss because the bank paid over the counter on an item which was not properly payable....In such an event, the bank would then incur the expense to find the presenter, to demand repayment, and legal expenses to pursue the presenter for breach of his warranties.

In short, when a bank cashes a check over the counter, it assumes the risk that it may suffer losses for counterfeit documents, forged endorsements, or forged or altered checks. Nothing in the Commercial Law Article forces a bank to assume such risks. *See* [Citations] To the extent that banks are willing to cash checks over the counter, with reasonable identification, such willingness expands and facilitates the commercial activities within the State....

Because the reduction of risk promotes the expansion of commercial practices, we... conclude that a bank’s requirement of a thumbprint placed upon a check presented over the counter by a non-customer is reasonable. [Citations] As the intermediate appellate court well documented, the Thumbprint Program is part of an industry wide response to the growing threat of check fraud. Prohibiting banks from taking reasonable steps to protect themselves from losses could result in banks refusing to cash checks of non-customers presented over the counter at all, a result which would be counter to the direction of § 1-102(2)(b).

As a result of this conclusion, Bank of America in the present case did not dishonor the check when it refused to accept it over the counter. Under § 3-501(b)(3)(ii), Bank of America “refused payment or acceptance for failure of the presentment to comply with...other applicable law or rule.” The rule not complied with by the Petitioner-presenter was § 3-502(b)(2)(ii), in that he refused to give what we have determined to be reasonable identification. Therefore, there was no dishonor of the check by Bank of America’s refusal to accept it. The answer to Petitioner’s third question is therefore “no,” [Did Bank dishonor the check?].

Judgment of the court of special appeals affirmed; costs to be paid by petitioner.

Eldridge, J., concurring in part and dissenting in part.

I cannot agree with the majority's holding that, after the petitioner presented his driver's license and a major credit card, it was "reasonable" to require the petitioner's thumbprint as identification.

Today, honest citizens attempting to cope in this world are constantly being required to show or give drivers' licenses, photo identification cards, social security numbers, the last four digits of social security numbers, mothers' "maiden names," 16 digit account numbers, etc. Now, the majority takes the position that it is "reasonable" for banks and other establishments to require, in addition, thumbprints and fingerprints. Enough is enough. The most reasonable thing in this case was petitioner's "irritation with the Bank of America's Thumbprint Signature Program." Chief Judge Bell has authorized me to state that he joins this concurring and dissenting opinion.

### CASE QUESTIONS

1. Petitioner claimed (a) he made a valid presentment, (b) Bank accepted the instrument, (c) Bank dishonored the acceptance, and (d) Bank converted the money and owes it to him. What did the court say about each assertion?
2. There was no dispute that there was enough money in the drawer's account to pay the check, so why didn't Petitioner just deposit it in his own account (then he wouldn't have been required to give a thumbprint)?
3. What part of UCC Article 3 became relevant to the question of whether it was reasonable for Bank to demand Petitioner's thumbprint?
4. How do the presentment and transfer warranties figure into the majority opinion?
5. What did the dissenting judges find fault with in the majority's opinion? What result would have obtained if the minority side had prevailed?

### **Breach of Transfer Warranties and the Bank's Obligation to Act in Good Faith**

PNC Bank v. Robert L. Martin

2010 WL 3271725, U.S. Dist. Ct. (Ky. 2010)

Coffman, J.

This matter is before the court on plaintiff PNC Bank's motion for summary judgment. The court will grant the motion as to liability and damages, because the defendant, Robert L. Martin, fails to raise any genuine issue of material fact, and the evidence establishes that Martin breached his transfer warranties and account agreement with PNC....

### **I. Background**

Martin, an attorney, received an e-mail message on August 16, 2008, from a person who called himself Roman Hidotashi. Hidotashi claimed that he was a representative of Chipang Lee Song Manufacturing Company and needed to hire a lawyer to collect millions of dollars from past-due accounts of North American customers. Martin agreed to represent the company.

On September 8, 2008, Martin received a check for \$290,986.15 from a purported Chipang Lee Song Manufacturing Company customer, even though Martin had yet to commence any collections work. The check, which was drawn on First Century Bank USA, arrived in an envelope with a Canadian postmark and no return address. The check was accompanied by an undated transmittal letter. Martin endorsed the check and deposited it in his client trust account at PNC. Martin then e-mailed Hidotashi, reported that he had deposited the check, and stated that he would await further instructions.

Hidotashi responded to Martin's e-mail message on September 9, 2008. Hidotashi stated that he had an "immediate need for funds" and instructed Martin to wire \$130,600 to a bank account in Tokyo. Martin went to PNC's main office in Louisville the next morning and met with representative Craig Friedman. According to Martin, Friedman advised that the check Martin deposited had cleared. Martin instructed Friedman to wire \$130,600 to the Tokyo account.

Martin returned to PNC later the same day. According to Martin, Friedman accessed Martin's account information and said, "I don't understand this. The check was cleared yesterday. Let me go find out what is going on." Friedman returned with PNC vice president and branch manager Sherry Jennewein, who informed Martin that the check was fraudulent. According to Martin, Jennewein told him that she wished he had met with her instead of Friedman because she never would have authorized the wire transfer.

First Century Bank, on which the check was drawn, dishonored the check. PNC charged Martin's account for \$290,986.15. PNC, however, could not recover the \$130,600 the bank had wired to the Tokyo account. Martin's account, as a result, was left overdrawn by \$124,313.01.

PNC commenced this action. PNC asserts one count for Martin's alleged breach of the transfer warranties provided in Kentucky's version of the Uniform Commercial Code and one count for breach of Martin's account agreement. PNC moves for summary judgment on both counts.

## **II. Discussion**

### **A. Breach of transfer warranties**

PNC is entitled to summary judgment on its breach-of-transfer-warranties claim because the undisputed facts establish Martin's liability.

Transfer warranties trigger when a person transfers an instrument for consideration. UCC § 3-416(a)). A transfer, for purposes of the statute, occurs when an instrument is delivered by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument. § 3-203(a). Martin transferred an instrument to PNC when he endorsed the check and deposited it in his account, thereby granting PNC the right to enforce the check. [Citation] Consideration, for purposes of the statute, need only be enough to support a simple contract. [Citation] Martin received consideration from PNC because PNC made the funds provisionally available before confirming whether First Century Bank would honor the check.

As a warrantor, Martin made a number of representations to PNC, including representations that he was entitled to enforce the check and that all signatures on the check were authentic and authorized. [UCC] § 3-416(a). Martin breached his warranties twofold. First, he was not entitled to enforce the check because the check was a counterfeit and, as a result, Martin had nothing to enforce. Second, the drawer's signature was not authentic because the check was a counterfeit.

Martin does not dispute these facts. Instead, Martin argues, summary judgment is inappropriate because Friedman and Jennewein admitted that PNC made a mistake when Friedman said that he thought the check cleared and Jennewein said that she never would have authorized the wire transfer. Friedman's and Jennewein's statements are immaterial facts. The transfer warranties placed the risk of loss on Martin, regardless of whether PNC, Martin, or both of them were at fault. [Citation] Martin, in any event, fails to support Friedman's and Jennewein's statements with

firsthand deposition testimony or affidavits, so the statements do not qualify as competent evidence. [Citation]

Martin claims that the risk of loss falls on the bank. But the cases Martin cites in support of that proposition suffer from two defects. First, all but one of the cases were decided before the Kentucky General Assembly adopted the Uniform Commercial Code. Martin fails to argue, much less demonstrate, that his cases are good law. Second, Martin's cases are inapposite even if they are good law. [UCC] § 3-416(a) addresses whether a transferor or transferee bears the risk of loss. Martin's cases address who bears the risk of loss as between other players: a drawee bank and a collecting agent [Citation]; a drawer and a drawee bank [Citation]; and an execution creditor and drawee bank [Citation—all of these cases are from 1910–1930]. The one modern case that Martin cites is also inapposite because the case involves a drawer and a drawee bank. [Citation]

In sum, the court must grant summary judgment in PNC's favor on the breach-of-transfer-warranties claim because the parties do not contest any material facts, which establish Martin's liability.

## **B. Breach of Contract**

PNC is also entitled to summary judgment on its breach-of-contract claim because the undisputed facts establish Martin's liability.

To support its allegation that a contract existed, PNC filed copies of Martin's account agreement and Martin's accompanying signature card. Under the agreement's terms, Martin agreed to bind himself to the agreement by signing the signature card. Martin does not dispute that the account agreement was a binding contract, and he does not dispute the account agreement's terms.

Martin's account agreement authorized PNC to charge Martin's account for the value of any item returned to PNC unpaid or any item on which PNC did not receive payment. If PNC's charge-back created an overdraft, Martin was required to pay PNC the amount of the overdraft immediately.

The scam of which Martin was a victim falls squarely within the charge-back provision of the account agreement. The check was returned to PNC unpaid. PNC charged Martin's account, leaving it with an overdraft. Martin was obliged to pay PNC immediately.



As with the breach-of-transfer-warranties claim, Martin cannot defend against the breach-of-contract claim by arguing that PNC made a mistake. The account agreement authorized PNC to charge back Martin's account "even if the amount of the item has already been made available to you." The account agreement, as a result, placed the risk of loss on Martin. Any mistake on PNC's part was immaterial because PNC always had the right to charge back Martin's account. [Citation]

### **C. Martin's Counterclaims**

Martin has asserted counterclaims for violations of various Uniform Commercial Code provisions; negligence and failure to exercise ordinary care; negligent misrepresentation; breach of contract and breach of the implied covenants of good faith and fair dealing; detrimental reliance; conversion; and negligent retention and supervision. Martin argues that "[t]o the extent that either party should be entitled to summary judgment in this case, it would be Martin with respect to his counterclaims against PNC." Martin, however, has not moved for summary judgment on his counterclaims, and the court does not address them on PNC's motion.

### **D. Damages**

PNC's recovery under both theories of liability is contingent on PNC's demonstrating that it acted in good faith. PNC may recover for breach of the transfer warranties only if it took the check in good faith. § 3-416(b). Moreover, PNC must satisfy the implied covenant of good faith and fair dealing, which Kentucky law incorporates in the account agreement. [Citation] Good faith, under both theories, means honesty in fact and the observance of reasonable commercial standards of fair dealing. That means "contracts impose on the parties thereto a duty to do everything necessary to carry them out." [Citation]

The undisputed evidence establishes that PNC acted in good faith. PNC accepted deposit of Martin's check, attempted to present the check for payment at First Century Bank, and charged back Martin's account when the check was dishonored. Martin cannot claim that PNC lacked good faith and fair dealing when PNC took actions permitted under the contract. [Citation] Although PNC might have had the ability to investigate the authenticity of the check before crediting Martin's account, PNC bore no such obligation because Martin warranted that the check was authentic. [UCC] § 3-416(a). Friedman's and Jennewein's statements do not impute a lack of good faith to PNC, even if Martin could support the statements with competent evidence. The Uniform Commercial Code and the account agreement place the risk of loss on Martin, even if PNC made a mistake.

Martin suggests that an insurance carrier might have already reimbursed PNC for the loss. Martin, however, presents no evidence of reimbursement, which PNC, presumably, would have disclosed in discovery.

PNC, therefore, may recover from Martin the overdraft value of \$124,313.01, which is the loss PNC suffered as a result of Martin's breach of the transfer warranties and breach of contract. [UCC] § 3-416(b)...

### III. Conclusion

For the foregoing reasons, IT IS ORDERED that PNC's motion for summary judgment is granted...to the extent that...PNC is permitted to recover \$124,313.01 from Martin....

#### CASE QUESTIONS

1. How did Martin come to have an overdraft of \$124,313.01 in his account?
2. Under what UCC provision did the court hold Martin liable for this amount?
3. The contract liability the court discusses was *not* incurred by Martin on account of his signature on the check (though he did indorse it); what was the contract liability?
4. If the bank had not taken the check in good faith (honesty in fact and observing reasonable commercial standards), what would the consequence have been, and why?
5. Is a reader really constrained here to say that Mr. Martin got totally scammed, or was his behavior reasonable under the circumstances?

## 25.6 Summary and Exercises

### Summary

As a general rule, one who signs a note as maker or a draft as drawer is personally liable unless he or she signs in a representative capacity and either the instrument or the signature shows that the signing has been made in a representative capacity. Various rules govern the permutations of signatures when an agent and a principal are involved.

The maker of a note and the acceptor of a draft have primary contract liability on the instruments. Secondarily liable are drawers and indorsers. Conditions precedent to secondary liability are presentment, dishonor, and notice of dishonor. Under the proper circumstances, any of these conditions may be waived or excused.

Presentment is a demand for payment made on the maker, acceptor, or drawee, or a demand for acceptance on the drawee. Presentment must be made (1) at the time specified in the instrument unless no time is specified, in which case it must be at the time specified for payment, or (2) within a reasonable time if a sight instrument.

Dishonor occurs when acceptance or payment is refused after presentment, at which time a holder has the right of recourse against secondary parties if he has given proper notice of dishonor.

A seller-transferor of any commercial paper gives five implied warranties, which become valuable to a holder seeking to collect in the event that there has been no indorsement or the indorsement has been qualified. These warranties are (1) good title, (2) genuine signatures, (3) no material alteration, (4) no defenses by other parties to the obligation to pay the transferor, and (5) no knowledge of insolvency of maker, acceptor, or drawer.

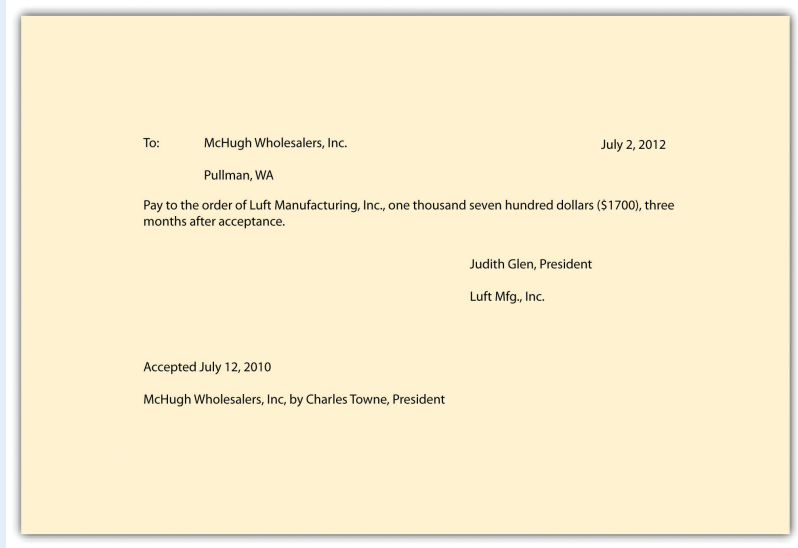
A holder on presentment makes certain warranties also: (1) entitled to enforce the instrument, (2) no knowledge that the maker's or drawer's signature is unauthorized, and (3) no material alteration.

Among the ways in which the parties may be discharged from their contract to honor the instrument are the following: (1) payment or satisfaction, (2) tender of payment, (3) cancellation and renunciation, (4) impairment of recourse or of collateral, (5) reacquisition, (6) fraudulent and material alteration, (7) certification, (8) acceptance varying a draft, and (9) unexcused delay in presentment or notice of dishonor.

## EXERCISES

1. Howard Corporation has the following instrument, which it purchased in good faith and for value from Luft Manufacturing, Inc.

Figure 25.2



Judith Glen indorsed the instrument on the back in her capacity as president of Luft when it was transferred to Howard on July 15, 2012.

- a. Is this a note or a draft?
  - b. What liability do McHugh and Luft have to Howard? Explain.
2. An otherwise valid negotiable bearer note is signed with the forged signature of Darby. Archer, who believed he knew Darby's signature, bought the note in good faith from Harding, the forger. Archer transferred the note without indorsement to Barker, in partial payment of a debt. Barker then sold the note to Chase for 80 percent of its face amount and delivered it without indorsement. When Chase presented the note for payment at maturity, Darby refused to honor it, pleading forgery. Chase gave proper notice of dishonor to Barker and to Archer.
    - a. Can Chase hold Barker liable? Explain.

- b. Can Chase hold Archer liable? Explain.
  - c. Can Chase hold Harding liable? Explain.
3. Marks stole one of Bloom's checks, already signed by Bloom and made payable to Duval, drawn on United Trust Company. Marks forged Duval's signature on the back of the check and cashed it at Check Cashing Company, which in turn deposited it with its bank, Town National. Town National proceeded to collect on the check from United. None of the parties was negligent. Who will bear the loss, assuming Marks cannot be found?
4. Robb stole one of Markum's blank checks, made it payable to himself, and forged Markum's signature on it. The check was drawn on the Unity Trust Company. Robb cashed the check at the Friendly Check Cashing Company, which in turn deposited it with its bank, the Farmer's National. Farmer's National proceeded to collect on the check from Unity. The theft and forgery were quickly discovered by Markum, who promptly notified Unity. None of the parties mentioned was negligent. Who will bear the loss, assuming the amount cannot be recovered from Robb? Explain.
5. Pat stole a check made out to the order of Marks, forged the name of Marks on the back, and made the instrument payable to herself. She then negotiated the check to Harrison for cash by signing her own name on the back of the instrument in Harrison's presence. Harrison was unaware of any of the facts surrounding the theft or forged indorsement and presented the check for payment. Central County Bank, the drawee bank, paid it. Disregarding Pat, who will bear the loss? Explain.
6. American Music Industries, Inc., owed Disneyland Records over \$340,000. As evidence of the debt, Irv Schwartz, American's president, issued ten promissory notes, signing them himself. There was no indication they were obligations of the corporation, American Music Industries, Inc., or that Irv Schwartz signed them in a representative capacity, but Mr. Schwartz asserted that Disneyland knew the notes were corporate obligations, not his personally. American paid four of the notes and then defaulted, and Disneyland sued him personally on the notes. He asserted he should be allowed to prove by parol evidence that he was not supposed to be liable. Is he personally liable? Explain. *Schwartz v. Disneyland Vista Records*, 383 So.2d 1117 (Fla. App. 1980).
7. Alice Able hired Betty Baker as a bookkeeper for her seamstress shop. Baker's duties included preparing checks for Able to sign and reconciling the monthly bank statements. Baker made out several checks to herself, leaving a large space to the left of the amount written, which Able noticed when she signed the checks. Baker took the signed

checks, altered the amount by adding a zero to the right of the original amount, and cashed them at First Bank, the drawee. Able discovered the fraud, Baker was sent to prison, and Able sued First Bank, claiming it was liable for paying out on altered instruments. What is the result?

8. Christina Reynolds borrowed \$16,000 from First Bank to purchase a used Ford automobile. Bank took a note and a secured interest in the car (the car is collateral for the loan). It asked for further security, so Christina got her sister Juanita to sign the note as an accommodation maker. Four months later, Christina notified Bank that she wished to sell the Ford for \$14,000 in order to get a four-wheel drive Jeep, and Bank released its security interest. When Christina failed to complete payment on the note for the Ford, Bank turned to Juanita. What, if anything, does Juanita owe?

## SELF-TEST QUESTIONS

1. Drawers and indorsers have
  - a. primary contract liability
  - b. secondary liability
  - c. no liability
  - d. none of the above
  
2. Conditions(s) needed to establish secondary liability include
  - a. presentment
  - b. dishonor
  - c. notice of dishonor
  - d. all of the above
  
3. A demand for payment made on a maker, acceptor, or drawee is called
  - a. protest
  - b. notice
  - c. presentment
  - d. certification
  
4. An example of an implied warranty given by a seller of commercial paper includes a warranty
  - a. of good title
  - b. that there are no material alterations
  - c. that signatures are genuine
  - d. covering all of the above
  
5. Under UCC Article 3, discharge may result from
  - a. cancellation
  - b. impairment of collateral
  - c. fraudulent alteration
  - d. all of the above

**SELF-TEST ANSWERS**

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



## Chapter 26

### Legal Aspects of Banking

#### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. Banks' relationships with their customers for payment or nonpayment of checks;
2. Electronic funds transfers and how the Electronic Fund Transfer Act affects the bank-consumer relationship;
3. What a wholesale funds transfer is and the scope of Article 4A;
4. What letters of credit are and how they are used.

To this point we have examined the general law of commercial paper as found in Article 3 of the UCC. Commercial paper—notwithstanding waves of digital innovation—still passes through bank collection processes by the ton every day, and Article 3 applies to this flow. But there is also a separate article in the UCC, Article 4, “Bank Deposits and Collections.” In case of conflict with Article 3 rules, those of Article 4 govern.

A discussion of government regulation of the financial services industry is beyond the scope of this book. Our focus is narrower: the laws that govern the operations of the banking system with respect to its depositors and customers. Although histories of banking dwell on the relationship between banks and the national government, the banking law that governs the daily operation of checking accounts is state based—Article 4 of the UCC. The enormous increase in noncheck banking has given rise to the Electronic Fund Transfer Act, a federal law.

## 26.1 Banks and Their Customers

### LEARNING OBJECTIVES

1. Understand how checks move, both traditionally and electronically.
2. Know how Article 4 governs the relationship between a bank and its customers.

### The Traditional Bank Collection Process The Traditional System in General

Once people mostly paid for things with cash: actual bills. That is obviously not very convenient or safe: a lost ten-dollar bill is almost certainly gone, and carrying around large quantities of cash is dangerous (probably only crooks do much of that). Today a person might go for weeks without reaching for a bill (except maybe to get change for coins to put in the parking meter). And while it is indisputable that electronic payment is replacing paper payment, the latter is still very significant. Here is an excerpt from a Federal Reserve Report on the issue:

In 2008, U.S. consumers had more payment instruments to choose from than ever before: four types of paper instruments—cash, check, money order, and travelers checks; three types of payment cards—debit, credit, and prepaid; and two electronic instruments—online banking bill payment (OBBP) and electronic bank account deductions (EBAD) using their bank account numbers. The average consumer had 5.1 of the nine instruments in 2008, and used 4.2 instruments in a typical month. Consumers made 52.9 percent of their monthly payments with a payment card. More consumers now have debit cards than credit cards (80.2 percent versus 78.3 percent), and consumers use debit cards more often than cash, credit cards, or checks individually. However, paper instruments are still popular and account for 36.5 percent of consumer payments. Most consumers have used newer electronic payments at some point, but these only account for 9.7 percent of consumer payments. Security and ease of use are the characteristics of payment instruments that consumers rate as most important. Kevin Foster, et al., *The 2008 Survey of Consumer Payment Choice*, Federal Reserve Bank of Boston, Public Policy Discussion Paper No. 09-10, p. 2 (April 2010), <http://www.bos.frb.org/economic/ppdp/2009/ppdp0910.pdf>.

Americans still wrote some thirty billion checks in 2006. Scott Schuh, *Overview of the Survey of Consumer Payment Choice (SCPC) Program*, Federal Reserve Bank of Boston, p.

5 (May 2010). <http://www.bos.frb.org/economic/cprc/presentations/2010/Schuh050610.pdf>. You can readily imagine how complex the bank collection process must be to cope with such a flood of paper. Every check written must eventually come back to the bank on which it is drawn, after first having been sent to the landlord, say, to pay rent, then to the landlord's bank, and from there through a series of intermediate banks and collection centers.

### Terminology

To trace the traditional check-collection process, it is necessary to understand the terminology used. The bank upon which a check is written is the **payor bank**<sup>1</sup> (the drawee bank). The **depository bank**<sup>2</sup> is the one the payee deposits the check into. Two terms are used to describe the various banks that may handle the check after it is written: collecting banks and intermediary banks. All banks that handle the check—except the payor bank—are **collecting banks**<sup>3</sup> (including the depository bank); **intermediary banks**<sup>4</sup> are all the collecting banks except the payor and depository banks. A bank can take on more than one role: Roger in Seattle writes a check on his account at Seattle Bank and mails it to Julia in Los Angeles in payment for merchandise; Julia deposits it in her account at Bank of L.A. Bank of L.A. is a depository bank and a collecting bank. Any other bank through which the check travels (except the two banks already mentioned) is an intermediary bank.

### Collection Process between Customers of the Same Bank

If the depository bank is also the payor bank (about 30% of all checks), the check is called an “on-us” item and UCC 4-215(e)(2) provides that—if the check is not dishonored—it is available by the payee “at the opening of the bank’s second banking day following receipt of the item.” Roger writes a check to Matthew, both of whom have accounts at Seattle Bank; Matthew deposits the check on Monday. On Wednesday the check is good for Matthew (he may have been given “provisional credit” before then, as discussed below, the bank could subtract the money from his account if Roger didn’t have enough to cover the check).

### Collection Process between Customers of Different Banks

Roger in Seattle writes a check on Seattle Bank payable to Julia in L.A. Julia deposits it in her account at L.A. Bank, the depository bank. L.A. Bank must somehow present the check to Seattle Bank either directly or through intermediary banks. If the collecting banks (again, all of them except Seattle Bank) act before the midnight deadline following receipt, they have acted “seasonably” according to UCC 4-202. When the payor bank—Seattle Bank—gets the check it must pay it, unless the check is dishonored or returned (UCC 4-302).

1. The bank upon which a check is drawn; the drawee.
2. The bank into which a check is deposited by its payee.
3. A bank that collects the amount of a check for its customer from the payor bank.
4. A bank that handles checks, but not including payor and depository banks.

## Physical Movement of Checks

The physical movement of checks—such as it still occurs—is handled by three possible systems.

The Federal Reserve System’s regional branches process checks for banks holding accounts with them. The Feds charge for the service, and prior to 2004 it regularly included check collection, air transportation of checks to the Reserve Bank (hired out to private contractors) and ground transportation delivery of checks to paying banks. Reserve Banks handle about 27 percent of US checks, but the air service is decreasing with “Check 21,” a federal law discussed below, that allows electronic transmission of checks.

**Correspondent banks**<sup>5</sup> are banks that have formed “partnerships” with other banks in order to exchange checks and payments directly, bypassing the Federal Reserve and its fees. Outside banks may go through a correspondent bank to exchange checks and payments with one of its partners.

Correspondent banks may also form a **clearinghouse corporation**<sup>6</sup>, in which members exchange checks and payments in bulk, instead of on a check-by-check basis, which can be inefficient considering that each bank might receive thousands of checks in a day. The clearinghouse banks save up the checks drawn on other members and exchange them on a daily basis. The net payments for these checks are often settled through Fedwire, a Federal Reserve Board electronic funds transfer (EFT) system that handles large-scale check settlement among US banks. Correspondent banks and clearinghouse corporations make up the private sector of check clearing, and together they handle about 43 percent of US checks.

## The Electronic System: Check 21 Act

### Rationale for the “Check Clearing for the 21st Century Act”

After the events of September 11, 2001, Congress felt with renewed urgency that banks needed to present and clear checks in a way not dependent upon the physical transportation of the paper instruments by air and ground, in case such transportation facilities were disrupted. The federal Check Clearing for the 21st Century Act (Public Law 108-100)—more commonly referred to as “Check 21 Act”—became effective in 2004.

### Basic Idea of Check 21 Act

Check 21 Act provides the legal basis for the electronic transportation of check data. A bank scans the check. The data on the check is already encoded in

5. Those banks that form a partnership to exchange checks among themselves, bypassing the Federal Reserve and its fees.

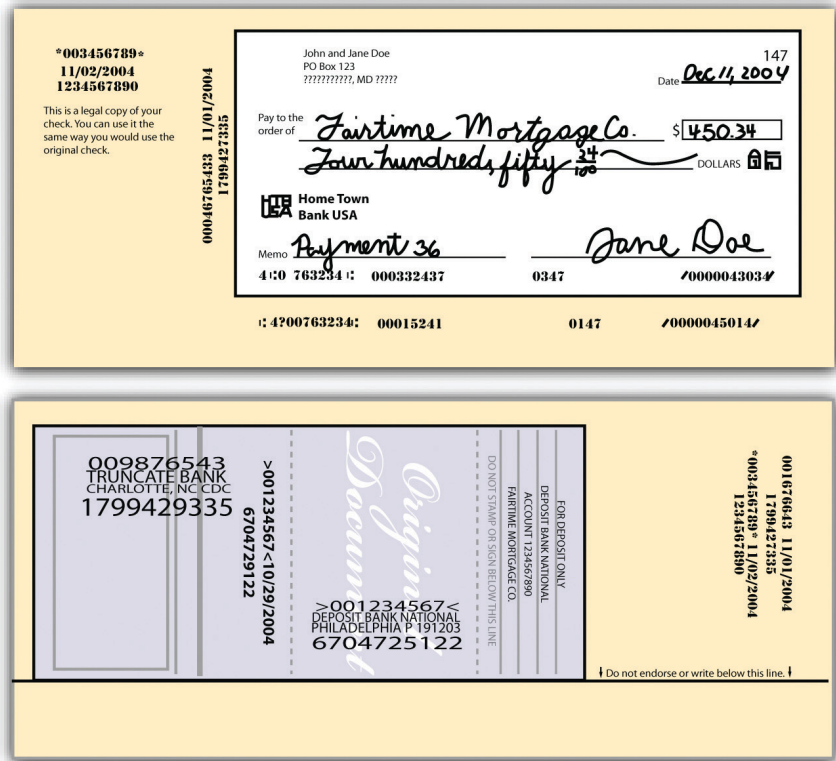
6. An office where banks exchange checks and drafts and settle accounts, owned by the member banks participating.

electronically readable numbers and the data, now separated (“truncated”) from the paper instrument (which may be destroyed), is transmitted for processing. “The Act authorizes a new negotiable instrument, called a **substitute check**<sup>7</sup>, to replace the original check. A substitute check is a paper reproduction of the original check that is suitable for automated processing in the same manner as the original check. The Act permits banks to provide substitute checks in place of original checks to subsequent parties in the check processing stream....Any financial institution in the check clearing process can truncate the original check and create a substitute check. United States Treasury, *The Check Clearing for the 21st Century Act: Frequently Asked Questions*, October 2004, [http://www.justice.gov/ust/eo/private\\_trustee/library/chapter07/docs/check21/Check21FAQs-final.pdf](http://www.justice.gov/ust/eo/private_trustee/library/chapter07/docs/check21/Check21FAQs-final.pdf). However, in the check collection process it is not required that the image be converted to a substitute check: the electronic image itself may suffice.

For example, suppose Roger in Seattle writes a check on Seattle Bank payable to Julia in L.A. and mails it to her. Julia deposits it in her account at L.A. Bank, the depository bank. L.A. Bank truncates the check (again, scans it and destroys the original) and transmits the data to Seattle Bank for presentation and payment. If for any reason Roger, or any appropriate party, wants a paper version, a substitute check will be created (see [Figure 26.1 "Substitute Check Front and Back"](#)). Most often, though, that is not necessary: Roger does not receive the actual cancelled checks he wrote in his monthly statement as he did formerly. He receives instead a statement listing paid checks he’s written and a picture of the check (not a substitute check) is available to him online through his bank’s website. Or he may receive his monthly statement itself electronically, with pictures of the checks he wrote available with a mouse click. Roger may also dispense with mailing the check to Julia entirely, as noted in the discussion of electronic funds transfers.

7. A paper reproduction of an electronically copied check the image of which is transferred if requested, instead of the paper check.

Figure 26.1 *Substitute Check Front and Back*



Front and back of a substitute check (not actual size).

Images from Federal Reserve Board: [http://www.federalreserve.gov/pubs/check21/consumer\\_guide](http://www.federalreserve.gov/pubs/check21/consumer_guide)

Substitute checks are legal negotiable instruments. The act provides certain warranties to protect recipients of substitute checks that are intended to protect recipients against losses associated with the check substitution process. One of these warranties provides that “[a] bank that transfers, presents, or returns a substitute check...for which it receives consideration warrants...that...[t]he substitute check meets the requirements of legal equivalence” (12 CFR § 229.52(a)(1)). The Check 21 Act does not replace existing state laws regarding such instruments. The Uniform Commercial Code still applies, and we turn to it next.

Two notable consequences of the Check 21 Act are worth mentioning. The first is that a check may be presented to the payor bank for payment very quickly, perhaps in less than an hour: the customer’s “float” time is abbreviated. That means be sure you have enough money in your account to cover the checks that you write. The second consequence of Check 21 Act is that it is now possible for anybody—you at

home or the merchant from whom you are buying something—to scan a check and deposit it instantly. “Remote deposit capture” allows users to transmit a scanned image of a check for posting and clearing using a web-connected computer and a check scanner. The user clicks to send the deposit to the desired existing bank account. Many merchants are using this system: that’s why if you write a check at the hardware store you may see it scanned and returned immediately to you. The digital data are transmitted, and the scanned image may be retrieved, if needed, as a “substitute check.”

## **UCC Article 4: Aspects of Bank Operations**

### **Reason for Article 4**

Over the years, the states had begun to enact different statutes to regulate the check collection process. Eighteen states adopted the American Bankers Association Bank Collection Code; many others enacted Deferred Posting statutes. Not surprisingly, a desire for uniformity was the principal reason for the adoption of UCC Article 4. Article 4 absorbed many of the rules of the American Bankers Association Code and of the principles of the Deferred Posting statutes, as well as court decisions and common customs not previously codified.

### **Banks Covered**

Article 4 covers three types of banks: depository banks, payor banks, and collecting banks. These terms—already mentioned earlier—are defined in UCC Section 4-105. A depository bank is the first bank to which an item is transferred for collection. Section 4-104 defines “item” as “an instrument or a promise or order to pay money handled by a bank for collection or payment[,],...not including a credit or debit card slip.” A payor bank is any bank that must pay a check because it is drawn on the bank or accepted there—the drawee bank (a depository bank may also be a payor bank). A collecting bank is any bank except the payor bank that handles the item for collection.

### **Technical Rules**

Detailed coverage of Parts 2 and 3 of Article 4, the substantive provisions, is beyond the scope of this book. However, Article 4 answers several specific questions that bank customers most frequently ask.

1. What is the effect of a “pay any bank” indorsement? The moment these words are indorsed on a check, only a bank may acquire the rights of a holder. This restriction can be lifted whenever (a) the check has been

returned to the customer initiating collection or (b) the bank specially indorses the check to a person who is not a bank (4-201).

2. May a depository bank supply a missing indorsement? It may supply any indorsement of the customer necessary to title unless the check contains words such as “payee’s indorsement required.” If the customer fails to indorse a check when depositing it in his account, the bank’s notation that the check was deposited by a customer or credited to his account takes effect as the customer’s indorsement. (Section 4-205(1)).
3. Are any warranties given in the collection process? Yes. They are identical to those provided in Article 3, except that they apply only to customers and collecting banks (4-207(a)). The customer or collecting bank that transfers an item and receives a settlement or other consideration warrants (1) he is entitled to enforce the item; (2) all signatures are authorized authentic; (3) the item has not been altered; (4) the item is not subject to a defense or claim in recoupment; (5) he has no knowledge of insolvency proceedings regarding the maker or acceptor or in the case of an unaccepted draft, the drawer. These warranties cannot be disclaimed as to checks.
4. Does the bank have the right to a charge-back against a customer’s account, or refund? The answer turns on whether the settlement was provisional or final. A settlement is the proper crediting of the amount ordered to be paid by the instrument. Someone writes you a check for \$1,000 drawn on First Bank, and you deposit it in Second Bank. Second Bank will make a “provisional settlement” with you—that is, it will provisionally credit your account with \$1,000, and that settlement will be final when First Bank debits the check writer’s account and credits Second Bank with the funds. Under Section 4-212(1), as long as the settlement was still provisional, a collecting bank has the right to a “charge-back” or refund if the check “bounces” (is dishonored). However, if settlement was final, the bank cannot claim a refund.

What determines whether settlement is provisional or final? Section 4-213(1) spells out four events (whichever comes first) that will convert a payor bank’s provisional settlement into final settlement: When it (a) pays the item in cash; (b) settles without reserving a right to revoke and without having a right under statute, clearinghouse rule, or agreement with the customer; finishes posting the item to the appropriate account; or (d) makes provisional settlement and fails to revoke the settlement in the time and manner permitted by statute, clearinghouse rule, or agreement. All clearinghouses have rules permitting revocation of settlement within certain time periods. For example an item cleared before 10 a.m. may be returned and the settlement revoked before 2 p.m. From this section it should be



apparent that a bank generally can prevent a settlement from becoming final if it chooses to do so.

## **Relationship with Customers**

The relationship between a bank and its customers is governed by UCC Article 4. However, Section 4-103(1) permits the bank to vary its terms, except that no bank can disclaim responsibility for failing to act in good faith or to exercise ordinary care. Most disputes between bank and customer arise when the bank either pays or refuses to pay a check. Under several provisions of Article 4, the bank is entitled to pay, even though the payment may be adverse to the customer's interest.

### **Common Issues Arising between Banks and Their Customers**

#### **Payment of Overdrafts**

Suppose a customer writes a check for a sum greater than the amount in her account. May the bank pay the check and charge the customer's account? Under Section 4-401(1), it may. Moreover, it may pay on an altered check and charge the customer's account for the original tenor of the check, and if a check was completed it may pay the completed amount and charge the customer's account, assuming the bank acted in good faith without knowledge that the completion was improper.

#### **Payment of Stale Checks**

Section 4-404 permits a bank to refuse to pay a check that was drawn more than six months before being presented. Banks ordinarily consider such checks to be "stale" and will refuse to pay them, but the same section gives them the option to pay if they choose. A corporate dividend check, for example, will be presumed to be good more than six months later. The only exception to this rule is for certified checks, which must be paid whenever presented, since the customer's account was charged when the check was certified.

#### **Payment of Deceased's or Incompetent's Checks**

Suppose a customer dies or is adjudged to be incompetent. May the bank honor her checks? Section 4-405 permits banks to accept, pay, and collect an item as long as it has no notice of the death or declaration of incompetence, and has no reasonable opportunity to act on it. Even after notice of death, a bank has ten days to pay or certify checks drawn on or prior to the date of death unless someone claiming an interest in the account orders it to refrain from doing so.

### Stop Payment Orders

Section 4-403 expressly permits the customer to order the bank to “stop payment” on any check payable for her account, assuming the stop order arrives in enough time to reasonably permit the bank to act on it. An oral stop order is effective for fourteen days; a follow-up written confirmation within that time is effective for six months and can be renewed in writing. But if a stop order is not renewed, the bank will not be liable for paying the check, even one that is quite stale (e.g., *Granite Equipment Leasing Corp. v. Hempstead Bank*, 326 N.Y.S. 2d 881 (1971)).

### Wrongful Dishonor

If a bank wrongfully dishonors an item, it is liable to the customer for all damages that are a direct consequence of (“proximately caused by”) the dishonor. The bank’s liability is limited to the damages actually proved; these may include damages for arrest and prosecution. See [Section 26.4 "Cases"](#) under “Bank’s Liability for Paying over Customer’s ‘Stop Payment’ Order” (*Meade v. National Bank of Adams County*).

### Customers’ Duties

In order to hold a bank liable for paying out an altered check, the customer has certain duties under Section 4-406. Primarily, the customer must act promptly in examining her statement of account and must notify the bank if any check has been altered or her signature has been forged. If the customer fails to do so, she cannot recover from the bank for an altered signature or other term if the bank can show that it suffered a loss because of the customer’s slowness. Recovery may also be denied when there has been a series of forgeries and the customer did not notify the bank within two weeks after receiving the first forged item. See [Section 26.4 "Cases"](#) under “Customer’s Duty to Inspect Bank Statements” (the *Planters Bank v. Rogers* case).

These rules apply to a payment made with ordinary care by the bank. If the customer can show that the bank negligently paid the item, then the customer may recover from the bank, regardless of how dilatory the customer was in notifying the bank—with two exceptions: (1) from the time she first sees the statement and item, the customer has one year to tell the bank that her signature was unauthorized or that a term was altered, and (2) she has three years to report an unauthorized indorsement.

## The Expedited Funds Availability Act In General

In addition to UCC Article 4 (again, state law), the federal Expedited Funds Availability Act—also referred to as “Regulation CC” after the Federal Reserve regulation that implements it—addresses an aspect of the relationship between a bank and its customers. It was enacted in 1988 in response to complaints by consumer groups about long delays before customers were allowed access to funds represented by checks they had deposited. It has nothing to do with electronic transfers, although the increasing use of electronic transfers does speed up the system and make it easier for banks to comply with Regulation CC.

### The Act’s Provisions

The act provides that when a customer deposits a cashier’s check, certified check, or a check written on an account in the same bank, the funds must be available by the next business day. Funds from other local checks (drawn on institutions within the same Federal Reserve region) must be available within two working days, while there is a maximum five-day wait for funds from out-of-town checks. In order for these time limits to be effective, the customer must endorse the check in a designated space on the back side. The FDIC sets out the law at its website: <http://www.fdic.gov/regulations/laws/rules/6500-3210.html>.

### KEY TAKEAWAY

The bank collection process is the method by which checks written on one bank are transferred by the collecting bank to a clearing house. Traditionally this has been a process of physical transfer by air and ground transportation from the depository bank to various intermediary banks to the payor bank where the check is presented. Since 2004 the Check 21 Act has encouraged a trend away from the physical transportation of checks to the electronic transportation of the check’s data, which is truncated (stripped) from the paper instrument and transmitted. However, if a paper instrument is required, a “substitute check” will recreate it. The UCC’s Article 4 deals generally with aspects of the bank-customer relationship, including warranties on payment or collection of checks, payment of overdrafts, stop orders, and customers’ duties to detect irregularities. The Expedited Funds Availability Act is a federal law governing customer’s access to funds in their accounts from deposited checks.

## EXERCISES

1. Describe the traditional check-collection process from the drawing of the check to its presentation for payment to the drawee (payor) bank
2. Describe how the Check 21 Act has changed the check-collection process.
3. Why was Article 4 developed, and what is its scope of coverage?

## 26.2 Electronic Funds Transfers

### LEARNING OBJECTIVES

1. Understand why electronic fund transfers have become prevalent.
2. Recognize some typical examples of EFTs.
3. Know that the EFT Act of 1978 protects consumers, and recognize what some of those protections—and liabilities—are.
4. Understand when financial institutions will be liable for violating the act, and some of the circumstances when the institutions will not be liable.

### Background to Electronic Fund Transfers

#### In General

Drowning in the yearly flood of billions of checks, eager to eliminate the “float” that a bank customer gets by using her money between the time she writes a check and the time it clears, and recognizing that better customer service might be possible, financial institutions sought a way to computerize the check collection process. What has developed is electronic fund transfer (EFT), a system that has changed how customers interact with banks, credit unions, and other financial institutions. Paper checks have their advantages, but their use is decreasing in favor of EFT.

In simplest terms, EFT is a method of paying by substituting an electronic signal for checks. A “debit card,” inserted in the appropriate terminal, will authorize automatically the transfer of funds from your checking account, say, to the account of a store whose goods you are buying.

#### Types of EFT

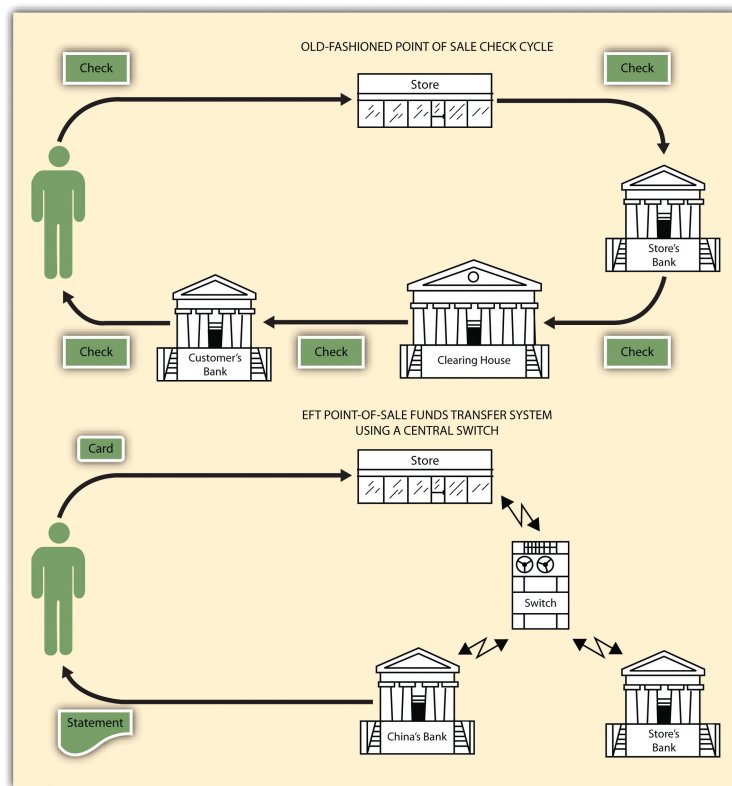
You are of course familiar with some forms of EFT:

- The automated teller machine (ATM) permits you to electronically transfer funds between checking and savings accounts at your bank with a plastic ID card and a personal identification number (PIN), and to obtain cash from the machine.

- Telephone transfers or computerized transfers allow customers to access the bank's computer system and direct it to pay bills owed to a third party or to transfer funds from one account to another.
- Point of sale terminals located in stores let customers instantly debit their bank accounts and credit the merchant's account.
- Preauthorized payment plans permit direct electronic deposit of paychecks, Social Security checks, and dividend checks.
- Preauthorized withdrawals from customers' bank accounts or credit card accounts allow paperless payment of insurance premiums, utility bills, automobile or mortgage payments, and property tax payments.

The "short circuit" that EFT permits in the check processing cycle is illustrated in Figure 26.2 "How EFT Replaces Checks".

Figure 26.2 How EFT Replaces Checks



Unlike the old-fashioned check collection process, EFT is virtually instantaneous: at one instant a customer has a sum of money in her account; in the next, after insertion of a plastic card in a machine or the transmission of a coded message by telephone or computer, an electronic signal automatically debits her bank checking account and posts the amount to the bank account of the store where she is making

a purchase. No checks change hands; no paper is written on. It is quiet, odorless, smudge proof. But errors are harder to trace than when a paper trail exists, and when the system fails (“our computer is down”) the financial mess can be colossal. Obviously some sort of law is necessary to regulate EFT systems.

## Electronic Fund Transfer Act of 1978

### Purpose

Because EFT is a technology consisting of several discrete types of machines with differing purposes, its growth has not been guided by any single law or even set of laws. The most important law governing consumer transactions is the **Electronic Fund Transfer Act of 1978**<sup>8</sup>, FDIC, “Electronic Fund Transfer Act of 1978,” <http://www.fdic.gov/regulations/laws/rules/6500-1350.html>. whose purpose is “to provide a basic framework establishing the rights, liabilities, and responsibilities of participants in electronic fund transfer systems. The primary objective of [the statute], however, is the provision of individual consumer rights.” This federal statute has been implemented and supplemented by the Federal Reserve Board’s Regulation E, Comptroller of the Currency guidelines on EFT, and regulations of the Federal Home Loan Bank Board. (Wholesale transactions are governed by UCC Article 4A, which is discussed later in this chapter.)

The EFT Act of 1978 is primarily designed to disclose the terms and conditions of electronic funds transfers so the customer knows the rights, costs and liabilities associated with EFT, but it does not embrace every type of EFT system. Included are “point-of-sale transfers, automated teller machine transactions, direct deposits or withdrawal of funds, and transfers initiated by telephone or computer” (EFT Act Section 903(6)). Not included are such transactions as wire transfer services, automatic transfers between a customer’s different accounts at the same financial institution, and “payments made by check, draft, or similar paper instrument at electronic terminals” (Reg. E, Section 205.2(g)).

### Consumer Protections Afforded by the Act

Four questions present themselves to the mildly wary consumer facing the advent of EFT systems: (1) What record will I have of my transaction? (2) How can I correct errors? (3) What recourse do I have if a thief steals from my account? (4) Can I be required to use EFT? The EFT Act, as implemented by Regulation E, answers these questions as follows.

8. Federal law that provides a basic framework establishing the rights, liabilities, and responsibilities of participants in electronic fund transfer systems.

1. Proof of transaction. The electronic terminal itself must be equipped to provide a receipt of transfer, showing date, amount, account number, and certain other information. Perhaps more importantly, the bank or

other financial institution must provide you with a monthly statement listing all electronic transfers to and from the account, including transactions made over the computer or telephone, and must show to whom payment has been made.

2. **Correcting errors.** You must call or write the financial institution whenever you believe an error has been made in your statement. You have sixty days to do so. If you call, the financial institution may require you to send in written information within ten days. The financial institution has forty-five days to investigate and correct the error. If it takes longer than ten days, however, it must credit you with the amount in dispute so that you can use the funds while it is investigating. The financial institution must either correct the error promptly or explain why it believes no error was made. You are entitled to copies of documents relied on in the investigation.
3. **Recourse for loss or theft.** If you notify the issuer of your EFT card within two business days after learning that your card (or code number) is missing or stolen, your liability is limited to \$50. If you fail to notify the issuer in this time, your liability can go as high as \$500. More daunting is the prospect of loss if you fail within sixty days to notify the financial institution of an unauthorized transfer noted on your statement: after sixty days of receipt, your liability is unlimited. In other words, a thief thereafter could withdraw all your funds and use up your line of credit and you would have no recourse against the financial institution for funds withdrawn after the sixtieth day, if you failed to notify it of the unauthorized transfer.
4. **Mandatory use of EFT.** Your employer or a government agency can compel you to accept a salary payment or government benefit by electronic transfer. But no creditor can insist that you repay outstanding loans or pay off other extensions of credit electronically. The act prohibits a financial institution from sending you an EFT card “valid for use” unless you specifically request one or it is replacing or renewing an expired card. The act also requires the financial institution to provide you with specific information concerning your rights and responsibilities (including how to report losses and thefts, resolve errors, and stop payment of preauthorized transfers). A financial institution may send you a card that is “not valid for use” and that you alone have the power to validate if you choose to do so, after the institution has verified that you are the person for whom the card was intended.

### **Liability of the Financial Institution**

The financial institution’s failure to make an electronic fund transfer, in accordance with the terms and conditions of an account, in the correct amount or in a timely



manner when properly instructed to do so by the consumer makes it liable for all damages proximately caused to the consumer, except where

- 1) the consumer's account has insufficient funds;
- 2) the funds are subject to legal process or other encumbrance restricting such transfer;
- 3) such transfer would exceed an established credit limit;
- 4) an electronic terminal has insufficient cash to complete the transaction; or
- 5) a circumstance beyond its control, where it exercised reasonable care to prevent such an occurrence, or exercised such diligence as the circumstances required.

#### **Enforcement of the Act**

A host of federal regulatory agencies oversees enforcement of the act. These include the Comptroller of the Currency (national banks), Federal Reserve District Bank (state member banks), Federal Deposit Insurance Corporation regional director (nonmember insured banks), Federal Home Loan Bank Board supervisory agent (members of the FHLB system and savings institutions insured by the Federal Savings & Loan Insurance Corporation), National Credit Union Administration (federal credit unions), Securities & Exchange Commission (brokers and dealers), and the Federal Trade Commission (retail and department stores) consumer finance companies, all nonbank debit card issuers, and certain other financial institutions. Additionally, consumers are empowered to sue (individually or as a class) for actual damages caused by any EFT system, plus penalties ranging from \$100 to \$1,000. Section 26.4 "Cases", under "Customer's Duty to Inspect Bank Statements" (*Commerce Bank v. Brown*), discusses the bank's liability under the act.

### KEY TAKEAWAY

Eager to reduce paperwork for both themselves and for customers, and to speed up the check collection process, financial institutions have for thirty years been moving away from paper checks and toward electronic fund transfers. These EFTs are ubiquitous, including ATMs, point-of-sale systems, direct deposits and withdrawals and online banking of various kinds. Responding to the need for consumer protection, Congress adopted the Electronic Fund Transfers Act, effective in 1978. The act addresses many common concerns consumers have about using electronic fund transfer systems, sets out liability for financial institutions and customers, and provides an enforcement mechanism.

### EXERCISES

1. Why have EFTs become very common?
2. What major issues are addressed by the EFTA?
3. If you lose your credit card, what is your liability for unauthorized charges?

## 26.3 Wholesale Transactions and Letters of Credit

### LEARNING OBJECTIVES

1. Understand what a “wholesale transaction” is; recognize that UCC Article 4A governs such transactions, and recognize how the Article addresses three common issues.
2. Know what a “letter of credit” (LC) is, the source of law regarding LCs, and how such instruments are used.

### Wholesale Funds Transfers

Another way that money is transferred is by commercial fund transfers or **wholesale funds transfers**<sup>9</sup>, which is by far the largest segment of the US payment system measured in amounts of money transferred. It is trillions of dollars a day. Wholesale transactions are the transfers of funds between businesses or financial institutions.

### Background and Coverage

It was in the development of commercial “wholesale wire transfers” of money in the nineteenth and early twentieth centuries that businesses developed the processes enabling the creation of today’s consumer electronic funds transfers. Professor Jane Kaufman Winn described the development of uniform law governing commercial funds transfers:

Although funds transfers conducted over funds transfer facilities maintained by the Federal Reserve Banks were subject to the regulation of the Federal Reserve Board, many funds transfers took place over private systems, such as the Clearing House for Interbank Payment Systems (“CHIPS”). The entire wholesale funds transfer system was not governed by a clear body of law until U.C.C. Article 4A was promulgated in 1989 and adopted by the states shortly thereafter. The Article 4A drafting process resulted in many innovations, even though it drew heavily on the practices that had developed among banks and their customers during the 15 years before the drafting committee was established. While a consensus was not easy to achieve, the community of interests shared by both the banks and their customers permitted the drafting process to find workable compromises on many thorny issues. Jane Kaufman Winn, *Clash of the Titans: Regulating the Competition between Established and Emerging Electronic Payment Systems*,

9. Transfers of large sums of money—tens of millions of dollars—between businesses or financial institutions.

<http://www.law.washington.edu/Directory/docs/Winn/Clash%20of%20the%20Titans.htm>.

All states and US territories have adopted Article 4A. Consistent with other UCC provisions, the rights and obligations under Article 4A may be varied by agreement of the parties. Article 4A does not apply if any step of the transaction is governed by the Electronic Fund Transfer Act. Although the implication may be otherwise, the rules in Article 4A apply to any funds transfer, not just electronic ones (i.e., transfers by mail are covered, too). Certainly, however, electronic transfers are most common, and—as the Preface to Article 4A notes—a number of characteristics of them influenced the Code’s rules. These transactions are characterized by large amounts of money—multimillions of dollars; the parties are sophisticated businesses or financial institutions; funds transfers are completed in one day, they are highly efficient substitutes for paper delivery; they are usually low cost—a few dollars for the funds transfer charged by the sender’s bank.

### **Operation of Article 4A**

The UCC “Prefatory Note” to Article 4A observes that “the funds transfer that is covered by Article 4A is not a complex transaction.” To illustrate the operation of Article 4A, assume that Widgets International has an account with First Bank. In order to pay a supplier, Supplies Ltd., in China, Widgets instructs First Bank to pay \$6 million to the account of Supplies Ltd. in China Bank. In the terminology of Article 4A, Widgets’ instruction to its bank is a “payment order.” Widgets is the “sender” of the payment order, First Bank is the “receiving bank,” and Supplies Ltd. is the “beneficiary” of the order.

When First Bank performs the purchase order by instructing China Bank to credit the account of Supplies Limited, First Bank becomes a sender of a payment order, China Bank becomes a receiving bank, and Supplies Ltd. is still the beneficiary. This transaction is depicted in [Figure 26.3 "Funds Transfer"](#). In some transactions there may also be one or more “intermediary banks” between First and Second Bank.

### Frequently Occurring Legal Issues in Funds Transfers

Three legal issues that frequently arise in funds transfer litigation are addressed in Article 4A and might be mentioned here.

#### Responsibility for Unauthorized Payments

First, who is responsible for unauthorized payment orders? The usual practice is for banks and their customers to agree to security procedures for the verification of payment orders. If a bank establishes a commercially reasonable procedure, complies with that procedure, and acts in good faith and according to its agreement with the customer, the customer is bound by an unauthorized payment order. There is, however, an important exception to this rule. A customer will not be liable when the order is from a person unrelated to its business operations.

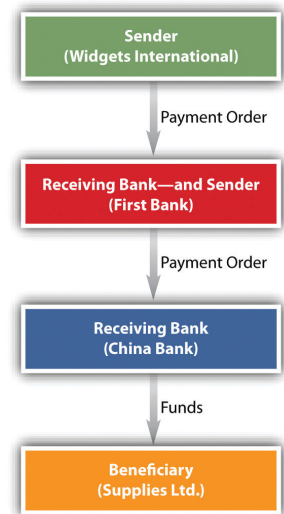
#### Error by Sender

Second, who is responsible when the sender makes a mistake—for instance, in instructing payment greater than what was intended? The general rule is that the sender is bound by its own error. But in cases where the error would have been discovered had the bank complied with its security procedure, the receiving bank is liable for the excess over the amount intended by the sender, although the bank is allowed to recover this amount from the beneficiary.

#### Bank Mistake in Transferring Funds

Third, what are the consequences when the bank makes a mistake in transferring funds? Suppose, for example, that Widgets (in the previous situation) instructed payment of \$2 million but First Bank in turn instructed payment of \$20 million. First Bank would be entitled to only \$2 million from Widgets and would then attempt to recover the remaining \$18 million from Supplies Ltd. If First Bank had instructed payment to the wrong beneficiary, Widgets would have no liability and the bank would be responsible for recovering the entire payment. Unless the parties agree otherwise, however, a bank that improperly executes a payment order is not liable for consequential damages.

Figure 26.3 Funds Transfer



## Letters of Credit

Because international trade involves risks not usually encountered in domestic trade—government control of exports, imports, and currency; problems in verifying goods' quality and quantity; disruptions caused by adverse weather, war; and so on—merchants have over the years devised means to minimize these risks, most notably the letter of credit (“LC”). Here are discussed the definition of letters of credit, the source of law governing them, how they work as payments for exports and as payments for imports.

### Definition

A **letter of credit**<sup>10</sup> is a statement by a bank (or other financial institution) that it will pay a specified sum of money to specific persons if certain conditions are met. Or, to rephrase, it is a letter issued by a bank authorizing the bearer to draw a stated amount of money from the issuing bank (or its branches, or other associated banks or agencies). Originally, a letter of credit was quite literally that—a letter addressed by the buyer's bank to the seller's bank stating that the former could vouch for their good customer, the buyer, and that it would pay the seller in case of the buyer's default. An LC is issued by a bank on behalf of its creditworthy customers, whose application for the credit has been approved by that bank.

### Source of Law

Letters of credit are governed by both international and US domestic law.

### International Law

Many countries (including the United States) have bodies of law governing letters of credit. Sophisticated traders will agree among themselves by which body of law they choose to be governed. They can agree to be bound by the UCC, or they may decide they prefer to be governed by the Uniform Customs and Practice for Commercial Documentary Credits (UCP), a private code devised by the Congress of the International Chamber of Commerce. Suppose the parties do not stipulate a body of law for the agreement, and the various bodies of law conflict, what then? Julius is in New York and Rochelle is in Paris; does French law or New York law govern? The answer will depend on the particulars of the dispute. An American court must determine under the applicable principles of the law of “conflicts of law” whether New York or French law applies.

10. A statement by a bank (or other financial institution) that it will pay a specified sum of money to specific persons if certain conditions are met.

## Domestic Law

The principal body of law applicable to the letter of credit in the United States is Article 5 of the UCC. Section 5-103 declares that Article 5 “applies to letters of credit and to certain rights and obligations arising out of transactions involving letters of credit.” The Official Comment to 5-101 observes, “A letter of credit is an idiosyncratic form of undertaking that supports performance of an obligation incurred in a separate financial, mercantile, or other transaction or arrangement.” And—as is the case in other parts of the Code—parties may, within some limits, agree to “variation by agreement in order to respond to and accommodate developments in custom and usage that are not inconsistent with the essential definitions and mandates of the statute.” Although detailed consideration of Article 5 is beyond the scope of this book, a distinction between guarantees and letters of credit should be noted: Article 5 applies to the latter and not the former.

## Letters of Credit as Payment for Exports

The following discussion presents how letters of credit work as payment for exports, and a sample letter of credit is presented at [Figure 26.4 "A Letter of Credit"](#).

Figure 26.4 *A Letter of Credit*

**MORGAN GUARANTY TRUST COMPANY**  
**OF NEW YORK**  
 INTERNATIONAL BANKING DIVISION  
 23 WALL STREET, NEW YORK, N.Y. 10015 March 5, 20\*

Smith Tool Co. Inc.  
 29 Bleecker Street  
 New York, N.Y. 10012

On all communications please refer to  
**NUMBER IC - 152647**

Dear Sirs:

We are instructed to advise you of the establishment by  
 Bank of South America, Puerto Cabello, Venezuela .....  
 of their IRREVOCABLE Credit No. 19845 .....  
 in your favor, for the account of John Doe, Puerto Cabello, Venezuela .....  
 for U.S. \$3,000.00 (THREE THOUSAND U.S. DOLLARS) .....  
 available upon presentation to us of your drafts at sight on us, accompanied by:

Commercial Invoice in triplicate, describing the merchandise as indicated below

Consular Invoice in triplicate, all signed and stamped by the Consul of Venezuela

Negotiable Insurance Policy and/or Underwriter's Certificate, endorsed in blank, covering marine and war risks

Full set of straight ocean steamer Bills of Lading, showing consignment to the Bank of South America, Puerto Cabello, stamped by Venezuelan Consul and marked "Freight Prepaid," evidencing shipment of UNA MAQUINA DE SELLAR LATAS, C.I.F. Puerto Cabello, from United States Port to PuertoCabello, Venezuela

Except as otherwise expressly stated herein, this credit is subject to the Uniform Customs and Practice for Documentary Credits (1975 revision), International Chamber of Commerce Publication No. 500

The above bank engages with you that all drafts drawn under and in compliance with the terms of this advice will be duly honored if presented to our Commercial Credits Department, 18 Broad Street, New York, N.Y. 10015, on or before March 31, 20\* on which date this credit expires.

We confirm the foregoing and undertake that all drafts drawn and presented in accordance with its terms will be duly honored.

Yours very truly,  
 Authorized Signature

Immediately upon receipt, please examine this instrument and if its terms are not clear to you or if you need any assistance in respect to your availment of it, we would welcome your communicating with us. Documents should be presented promptly and not later than 3 P.M.

Julius desires to sell fine quality magic wands and other stage props to Rochelle's Gallery in Paris. Rochelle agrees to pay by letter of credit—she will, in effect, get her bank to inform Julius that he will get paid if the goods are right. She does so by “opening” a letter of credit at her bank—the issuing bank—the Banque de Rue de Houdini where she has funds in her account, or good credit. She tells the bank the terms of sale, the nature and quantity of the goods, the amount to be paid, the documents she will require as proof of shipment, and an expiration date. Banque de Rue de Houdini then directs its correspondent bank in the United States, First Excelsior Bank, to inform Julius that the letter of credit has been opened: Rochelle is good for it. For Julius to have the strongest guarantee that he will be paid, Banque de Rou de Houdini can ask First Excelsior to confirm the letter of credit, thus binding both Banque de Rue de Houdini and Excelsior to pay according to the terms of the letter.

Once Julius is informed that the letter of credit has been issued and confirmed, he can proceed to ship the goods and draw a draft to present (along with the required documents such as commercial invoice, bill of lading, and insurance policy) to First Excelsior, which is bound to follow exactly its instructions from Banque de Rue de Houdini. Julius can present the draft and documents directly, through correspondent banks, or by a representative at the port from which he is shipping the goods. On presentation, First Excelsior may forward the documents to Banque de Rue de Houdini for approval and when First Excelsior is satisfied it will take the draft and pay Julius immediately on a sight draft or will stamp the draft “accepted” if it is a time draft (payable in thirty, sixty, or ninety days). Julius can discount an accepted time draft or hold it until it matures and cash it in for the full amount. First Excelsior will then forward the draft through international banking channels to Banque de Rue de Houdini to debit Rochelle's account.

### **As Payment for Imports**

US importers—buyers—also can use the letter of credit to pay for goods bought from abroad. The importer's bank may require that the buyer put up collateral to guarantee it will be reimbursed for payment of the draft when it is presented by the seller's agents. Since the letter of credit ordinarily will be irrevocable, the bank will be bound to pay the draft when presented (assuming the proper documents are attached), regardless of deficiencies ultimately found in the goods. The bank will hold the bill of lading and other documents and could hold up transfer of the goods until the importer pays, but that would saddle the bank with the burden of disposing of the goods if the importer failed to pay. If the importer's credit rating is sufficient, the bank could issue a trust receipt. The goods are handed over to the importer before they are paid for, but the importer then becomes trustee of the goods for the bank and must hold the proceeds for the bank up to the amount owed



**KEY TAKEAWAY**

Wholesale funds transfers are a mechanism by which businesses and financial institutions can transmit large sums of money—millions of dollars—between each other, usually electronically, from and to their clients' accounts. Article 4A of the UCC governs these transactions. A letter of credit is a promise by a buyer's bank that upon presentation of the proper paperwork it will pay a specified sum to the identified seller. Letters of credit are governed by domestic and international law.

## 26.4 Cases

### **Bank's Liability for Paying over Customer's "Stop Payment" Order**

Meade v. National Bank of Adams County

2002 WL 31379858 (Ohio App. 2002)

Kline, J.

The National Bank of Adams County appeals the Adams County Court's judgment finding that it improperly paid a check written by Denton Meade, and that Meade incurred \$3,800 in damages as a result of that improper payment....

#### **I.**

Denton Meade maintained a checking account at the Bank. In 2001, Meade entered into an agreement with the Adams County Lumber Company to purchase a yard barn for \$2,784 and paid half the cost as a deposit. On the date of delivery, Friday, March 9, 2001, Meade issued a check to the Lumber Company for the remaining amount he owed on the barn, \$1,406.79.

Meade was not satisfied with the barn. Therefore, at 5:55 p.m. on March 9, 2001, Meade called the Bank to place a stop payment order on his check. Jacqueline Evans took the stop payment order from Meade. She received all the information and authorization needed to stop payment on the check at that time.

Bank employees are supposed to enter stop payments into the computer immediately after taking them. However, Evans did not immediately enter the stop payment order into the computer because it was 6:00 p.m. on Friday, and the Bank closes at 6:00 p.m. on Fridays. Furthermore, the Bank's policy provides that any matters that are received after 2:00 p.m. on a Friday are treated as being received on the next business day, which was Monday, March 12, 2001 in this instance.

On the morning of Saturday, March 10, 2001, Greg Scott, an officer of the Lumber Company, presented the check in question for payment at the Bank. The Bank paid the check. On Monday, the Bank entered Meade's stop payment into the computer and charged Meade a \$15 stop payment fee. Upon realizing that it already paid the

check, on Tuesday the Bank credited the \$15 stop payment fee back to Meade's account. On Thursday, the Bank deducted the amount of the check, \$1,406.79, from Meade's account.

In the meanwhile, Meade contacted Greg Scott at the Lumber Company regarding his dissatisfaction with the barn. Scott sent workers to repair the barn on Saturday, March 10 and on Monday, March 12. However, Meade still was not satisfied. In particular, he was unhappy with the runners supporting the barn. Although his order with the Lumber Company specifically provided for 4 x 6" runner boards, the Lumber Company used 2 x 6" boards. The Lumber Company "laminated" the two by six-inch boards to make them stronger. However, carpenter Dennis Baker inspected the boards and determined that the boards were not laminated properly.

Meade hired Baker to repair the barn. Baker charged Meade approximately three hundred dollars to make the necessary repairs. Baker testified that properly laminated two by six-inch boards are just as strong as four by six-inch boards.

Meade filed suit against the Bank in the trial court seeking \$5,000 in damages. The Bank filed a motion for summary judgment, which the trial court denied. At the subsequent jury trial the court permitted Meade to testify, over the Bank's objections, to the amount of his court costs, attorney fees, and deposition costs associated with this case. The Bank filed motions for directed verdict at the close of Meade's case and at the close of evidence, which the trial court denied.

The jury returned a general verdict finding the Bank liable to Meade in the amount of \$3,800. The Bank filed motions for a new trial and for judgment notwithstanding the verdict, which the trial court denied. The Bank now appeals, asserting the following five assignments of error....

## II.

In its first assignment of error, the Bank contends that the trial court erred in denying its motion for summary judgment. Specifically, the Bank asserts that Meade did not issue the stop payment order within a reasonable time for the Bank to act upon it, and therefore that the trial court should have granted summary judgment in favor of the Bank.

Summary judgment is appropriate only when it has been established: (1) that there is no genuine issue as to any material fact; (2) that the moving party is entitled to judgment as a matter of law; and (3) that reasonable minds can come to only one conclusion, and that conclusion is adverse to the nonmoving party. [Citation]

[UCC 4-403(A)] provides that a customer may stop payment on any item drawn on the customer's account by issuing an order to the bank that describes the item with reasonable certainty and is received by the bank "at a time and in a manner that affords the bank a reasonable opportunity to act on it before any action by the bank with respect to the item." What constitutes a reasonable time depends upon the facts of the case. See *Chute v. Bank One of Akron*, (1983) [Citation]

In *Chute*, Bank One alleged that its customer, Mr. Chute, did not give it a reasonable opportunity to act upon his stop payment order when he gave an oral stop payment at one Bank One branch office, and a different Bank One branch office paid the check the following day. In ruling that Bank One had a reasonable opportunity to act upon Mr. Chute's order before it paid the check, the court considered the teller's testimony that stop payment orders are entered onto the computer upon receipt, where they are virtually immediately accessible to all Bank One tellers.

In this case, as in *Chute*, Meade gave notice one day, and the Bank paid the check the following day. Additionally, in this case, the same branch that took the stop payment order also paid the check. Moreover, Evans testified that the Bank's policy for stop payment orders is to enter them into the computer immediately, and that Meade's stop payment order may have shown up on the computer on Saturday if she had entered it on Friday. Based on this information, and construing the facts in the light most favorable to Meade, reasonable minds could conclude that Meade provided the Bank with the stop payment order within time for the Bank to act upon the stop payment order. Accordingly, we overrule the Bank's first assignment of error.

### III.

In its second assignment of error, the Bank contends that the trial court erred in permitting Meade to testify regarding the amount he spent on court costs, attorney fees, and taking depositions. Meade contends that because he incurred these costs as a result of the Bank paying his check over a valid stop payment order, the costs are properly recoverable.

As a general rule, the costs and expenses of litigation, other than court costs, are not recoverable in an action for damages. [Citations]

In this case, the statute providing for damages, [UCC 4-403(c)], provides that a customer's recoverable loss for a bank's failure to honor a valid stop payment order "may include damages for dishonor of subsequent items \* \* \*." The statute does not provide for recouping attorney fees and costs. Meade did not allege that the Bank acted in bad faith or that he is entitled to punitive damages. Additionally, although

Meade argues that the Bank caused him to lose his bargaining power with the Lumber Company, Meade did not present any evidence that he incurred attorney fees or costs by engaging in litigation with the Lumber Company.

Absent statutory authority or an allegation of bad faith, attorney fees are improper in a compensatory damage award....Therefore, the trial court erred in permitting the jury to hear evidence regarding Meade's expenditures for his attorney fees and costs. Accordingly, we sustain the Bank's second assignment of error....

#### IV.

In its third assignment of error, the Bank contends that the trial court erred when it overruled the Bank's motion for a directed verdict. The Bank moved for a directed verdict both at the conclusion of Meade's case and at the close of evidence.

The Bank first asserts that the record does not contain sufficient evidence to show that Meade issued a stop payment order that provided it with a reasonable opportunity to act as required by [the UCC]. Meade presented evidence that he gave the Bank his stop payment order prior to 6:00 p.m. on Friday, and that the Bank paid the check the following day....We find that this constitutes sufficient evidence that Meade communicated the stop payment order to the Bank in time to allow the Bank a reasonable opportunity to act upon it.

The Bank also asserts that the record does not contain sufficient evidence that Meade incurred some loss resulting from its payment of the check. Pursuant to [UCC 4-403(c)] "[t]he burden of establishing the fact and amount of loss resulting from the payment of an item contrary to a stop payment order or order to close an account is on the customer." Establishing the fact and amount of loss, "the customer must show some loss other than the mere debiting of the customer's account." [Citation]

...Baker testified that he charged Meade between two hundred-eighty and three hundred dollars to properly laminate the runners and support the barn. Based upon these facts, we find that the record contains sufficient evidence that Meade sustained some loss beyond the mere debiting of his account as a result of the Bank paying his check. Accordingly, we overrule the Bank's third assignment of error.

#### V.

...In its final assignment of error, the Bank contends that the trial court erred in denying its motions for judgment notwithstanding the verdict and for a new trial....

[U]nlike our consideration of the Bank's motions for a directed verdict, in considering the Bank's motion for judgment notwithstanding the verdict, we also must consider whether the amount of the jury's award is supported by sufficient evidence. The Bank contends the jury's general verdict, awarding Meade \$3,800, is not supported by evidence in the record.

A bank customer seeking damages for the improper payment of a check over a valid stop payment order carries the burden of proving "the fact and amount of loss." [UCC 4-403(C).] To protect banks and prevent unjust enrichment to customers, the mere debiting of the customer's account does not constitute a loss. [Citation]

In this case, the Bank's payment of Meade's \$1,406.79 check to the Lumber Company discharged Meade's debt to the Lumber Company in the same amount. Therefore, the mere debiting of \$1,406.79 from Meade's account does not constitute a loss.

Meade presented evidence that he incurred \$300 in repair costs to make the barn satisfactory. Meade also notes that he never got the four by six-inch runners he wanted. However, Meade's carpenter, Baker, testified that since he properly laminated the two by six-inch runners, they are just as strong or stronger than the four by six-inch runners would have been.

Meade also presented evidence of his costs and fees. However, as we determined in our review of the Bank's second assignment of error, only the court may award costs and fees, and therefore this evidence was improperly admitted. Thus, the evidence cannot support the damage award. Meade did not present any other evidence of loss incurred by the Bank's payment of his check....Therefore, we find that the trial court erred in declining to enter a judgment notwithstanding the verdict on the issue of damages. Upon remand, the trial court should grant in part the Bank's motion for judgment notwithstanding the verdict as it relates to damages and consider the Bank's motion for a new trial only on the issue of damages[....] Accordingly, we sustain the Banks fourth and fifth assignments of error in part.

## VI.

In conclusion, we find that the trial court did not err in denying the Bank's motions for summary judgment and for directed verdict. However, we find that the trial court erred in permitting Meade to testify as to his court costs, attorney fees and deposition costs. Additionally, we find that the trial court erred in totally denying the Bank's motion for judgment notwithstanding the verdict, as the amount of damages awarded by the jury is not supported by sufficient evidence in the record. Accordingly, we affirm the judgment of the trial court as to liability, but reverse the

judgment of the trial court as to the issue of damages, and remand this cause for further proceedings consistent with this opinion.

### CASE QUESTIONS

1. What did the bank do wrong here?
2. Why did the court deny Meade damages for his attorneys' fees?
3. Why did the court conclude that the jury-awarded damages were not supported by evidence presented at trial? What damages did the evidence support?

### Customer's Duty to Inspect Bank Statements

Union Planters Bank, Nat. Ass'n v. Rogers

912 So.2d 116 (Miss. 2005)

Waller, J.

This appeal involves an issue of first impression in Mississippi—the interpretation of [Mississippi's UCC 4-406], which imposes duties on banks and their customers insofar as forgeries are concerned.

#### Facts

Neal D. and Helen K. Rogers maintained four checking accounts with the Union Planters Bank in Greenville, Washington County, Mississippi....The Rogers were both in their eighties when the events which gave rise to this lawsuit took place.Neal Rogers died prior to the institution of this lawsuit. Helen Rogers died after Union Planters filed this appeal. We have substituted Helen's estate as appellee. After Neal became bedridden, Helen hired Jackie Reese to help her take care of Neal and to do chores and errands.

In September of 2000, Reese began writing checks on the Rogers' four accounts and forged Helen's name on the signature line. Some of the checks were made out to "cash," some to "Helen K. Rogers," and some to "Jackie Reese." The following chart summarizes the forgeries to each account:

Account Number	Beginning	Ending	Number of Checks	Amount of Checks
54282309	11/27/2000	6/18/2001	46	\$16,635.00
0039289441	9/27/2000	1/25/2001	10	\$2,701.00
6100110922	11/29/2000	8/13/2001	29	\$9,297.00
6404000343	11/20/2000	8/16/2001	83	\$29,765.00
Total			168	\$58,398.00

Neal died in late May of 2001. Shortly thereafter, the Rogers' son, Neal, Jr., began helping Helen with financial matters. Together they discovered that many bank statements were missing and that there was not as much money in the accounts as they had thought. In June of 2001, they contacted Union Planters and asked for copies of the missing bank statements. In September of 2001, Helen was advised by Union Planters to contact the police due to forgeries made on her accounts. More specific dates and facts leading up to the discovery of the forgeries are not found in the record.

Subsequently, criminal charges were brought against Reese. (The record does not reveal the disposition of the criminal proceedings against Reese.) In the meantime, Helen filed suit against Union Planters, alleging conversion (unlawful payment of forged checks) and negligence. After a trial, the jury awarded Helen \$29,595 in damages, and the circuit court entered judgment accordingly. From this judgment, Union Planters appeals.

### Discussion

...II. Whether Rogers' Delay in Detecting the Forgeries Barred Suit against Union Planters.

The relationship between Rogers and Union Planters is governed by Article 4 of the Uniform Commercial Code. [UCC] 4-406(a) and (c) provide that a bank customer has a duty to discover and report "unauthorized signatures"; i.e., forgeries. [The section] reflects an underlying policy decision that furthers the UCC's "objective of promoting certainty and predictability in commercial transactions." The UCC facilitates financial transactions, benefiting both consumers and financial institutions, by allocating responsibility among the parties according to whomever is best able to prevent a loss. Because the customer is more familiar with his own



signature, and should know whether or not he authorized a particular withdrawal or check, he can prevent further unauthorized activity better than a financial institution which may process thousands of transactions in a single day....The customer's duty to exercise this care is triggered when the bank satisfies its burden to provide sufficient information to the customer. As a result, if the bank provides sufficient information, the customer bears the loss when he fails to detect and notify the bank about unauthorized transactions. [Citation]

**A. Union Planters' Duty to Provide Information under 4-406(a).**

The court admitted into evidence copies of all Union Planters statements sent to Rogers during the relevant time period. Enclosed with the bank statements were either the cancelled checks themselves or copies of the checks relating to the period of time of each statement. The evidence shows that all bank statements and cancelled checks were sent, via United States Mail, postage prepaid, to all customers at their "designated address" each month. Rogers introduced no evidence to the contrary. We therefore find that the bank fulfilled its duty of making the statements available to Rogers and that the remaining provisions of 4-406 are applicable to the case at bar....

In defense of her failure to inspect the bank statements, Rogers claims that she never received the bank statements and cancelled checks. Even if this allegation is true, since there was a series of forged checks, it is reasonable to assume that Reese intercepted the bank statements before Rogers could inspect them. However, Union Planters cannot be held liable for Reese's fraudulent concealment. It does not excuse Rogers from failing to fulfill her duties under 4-406(a) & (c) because the statute clearly states a bank discharges its duty in providing the necessary information to a customer when it "sends...to a customer a statement of account showing payment of items."...The word "receive" is absent. The customer's duty to inspect and report does not arise when the statement is received, as Rogers claims; the customer's duty to inspect and report arises when the bank sends the statement to the customer's address. A reasonable person who has not received a monthly statement from the bank would promptly ask the bank for a copy of the statement. Here, Rogers claims that she did not receive numerous statements. We find that she failed to act reasonably when she failed to take any action to replace the missing statements.

**B. Rogers' Duty to Report the Forgeries under 4-406(d).**

[Under UCC 4-406] a customer who has not promptly notified a bank of an irregularity may be precluded from bringing certain claims against the bank:

“(d) If the bank proves that the customer failed, with respect to an item, to comply with the duties imposed on the customer by subsection (c), the customer is precluded from asserting against the bank:

(1) The customer’s unauthorized signature...on the item,...

Also, when there is a series of forgeries, 406(d)(2) places additional duties on the customer, [who is precluded from asserting against the bank]:

(2) The customer’s unauthorized signature...by the same wrongdoer on any other item paid in good faith by the bank if the payment was made before the bank received notice from the customer of the unauthorized signature...and after the customer had been afforded a reasonable period of time, not exceeding thirty (30) days, in which to examine the item or statement of account and notify the bank.

Although there is no mention of a specific date, Rogers testified that she and her son began looking for the statements in late May or early June of 2001, after her husband had died....When they discovered that statements were missing, they notified Union Planters in June of 2001 to replace the statements. At this time, no mention of possible forgery was made, even though Neal, Jr., thought that “something was wrong.” In fact, Neal, Jr., had felt that something was wrong as far back as December of 2000, but failed to do anything. Neal, Jr., testified that neither he nor his mother knew that Reese had been forging checks until September of 2001. Actually, it was Union Planters that notified Rogers that there had been forgeries, as opposed to Rogers’ discovering the forgeries herself.

Rogers is therefore precluded from making claims against Union Planters because (1) under 4-406(a), Union Planters provided the statements to Rogers, and (2) under 4-406(d)(2), Rogers failed to notify Union Planters of the forgeries within 30 days of the date she should have reasonably discovered the forgeries....

### **Conclusion**

The circuit court erred in denying Union Planters’ motion for JNOV because, under 4-406, Rogers is precluded from recovering amounts paid by Union Planters on any of the forged checks because she failed to timely detect and notify the bank of the unauthorized transactions and because she failed to show that Union Planters failed to use ordinary care in its processing of the forged checks. Therefore, we reverse the circuit court’s judgment and render judgment here that Rogers take nothing and that the complaint and this action are finally dismissed with prejudice. Reversed.

## CASE QUESTIONS

1. If a bank pays out over a forged drawer's signature one time, and the customer (drawer) reports the forgery to the bank within thirty days, why does the bank take the loss?
2. Who forged the checks?
3. Why did Mrs. Rogers think she should not be liable for the forgeries?
4. In the end, who probably really suffered the loss here?

### Customer's Duty to Inspect Bank Statements

Commerce Bank of Delaware v. Brown

2007 WL 1207171 (Del. Com. Pl. 2007)

#### I. Procedural Posture

Plaintiff, Commerce Bank/Delaware North America ("Commerce") initially filed a civil complaint against defendant Natasha J. Brown ("Brown") on October 28, 2005. Commerce seeks judgment in the amount of \$4,020.11 plus costs and interest and alleges that Brown maintained a checking account with Commerce and has been unjustly enriched by \$4,020.11....

The defendant, Brown...denied all allegations of the complaint. As an affirmative defense Brown claims the transaction for which plaintiff seeks to recover a money judgment were made by means of an ATM Machine using a debit card issued by the defendant. On January 16, 2005 Brown asserts that she became aware of the fraudulent transactions and timely informed the plaintiff of the facts on January 16, 2005. Brown asserts that she also requested Commerce in her answer to investigate the matter and to close her account. Based upon these facts, Brown asserts a maximum liability on her own part from \$50.00 to \$500.00 in accordance with the Electronic Fund Transfer Act ("EFTA") 15 U.S.C. § 1693(g) and regulation (e), 12 CFR 205.6. [Commerce Bank withdrew its complaint at trial, leaving only the defendant's counter-claim in issue.]

Defendant Brown asserts [that] defendant failed to investigate and violated EFTA and is therefore liable to the plaintiff for money damages citing [EFTA].

## II. The Facts

Brown was the only witness called at trial. Brown is twenty-seven years old and has been employed by Wilmington Trust as an Administrative Assistant for the past three years. Brown previously opened a checking account with Commerce and was issued a debit/ATM card by Commerce which was in her possession in December 2004. Brown, on or about January 14, 2005 went to Commerce to charge a \$5.00 debit to the card at her lunch-break was informed that there was a deficiency balance in the checking account. Brown went to the Talleyville branch of Commerce Bank and spoke with “Carla” who agreed to investigate these unauthorized charges, as well as honor her request to close the account. Defendant’s Exhibit No.: 1 is a Commerce Bank electronic filing and/or e-mail which details a visit by defendant on January 16, 2005 to report her card loss. The “Description of Claim” indicates as follows:

Customer came into speak with a CSR “Carla Bernard” on January 16, 2005 to report her card loss. At this time her account was only showing a negative \$50.00 balance. She told Ms. Bernard that this was not her transaction and to please close this account. Ms. Bernard said that she would do this and that there would be an investigation on the unauthorized transactions. It was at this time also that she had Ms. Bernard change her address. In the meantime, several transactions posted to the account causing a balance of negative \$3,948.11 and this amount has since been charged off on 1/27/05. Natasha Brown never received any notification of this until she received a letter from one of our collection agencies. She is now here to get this resolved.

On the back of defendant’s Exhibit No.: 1 were 26 separate unauthorized transactions at different mercantile establishments detailing debits with the pin number used on Brown’s debit card charged to Commerce Bank. The first charge was \$501.75 on January 13, 2005....Brown asserts at trial that she therefore timely gave notice to Commerce to investigate and requested Commerce to close the debit checking account on January 16, 2005.

At trial Brown also testified she “never heard” from Commerce again until she received a letter in December 2005 citing a \$4,000.00 deficiency balance....

On cross-examination Brown testified she received a PIN number from Commerce and “gave the PIN number to no other person.” In December 2004 she resided with Charles Williams, who is now her husband. Brown testified on cross-examination that she was the only person authorized as a PIN user and no one else knew of the card, ‘used the card,’ or was provided orally or in writing of the PIN number. Brown spoke with Carla Bernard at the Commerce Bank at the Talleyville branch. Although

Brown did not initially fill out a formal report, she did visit Commerce on January 16, 2005 the Talleyville branch and changed her address with Carla. Brown does not recall the last time she ever received a statement from Commerce Bank on her checking account. Brown made no further purchases with the account and she was unaware of all the “incidents of unauthorized debit charges on her checking account” until she was actually sued by Commerce Bank in the Court of Common Pleas.

### III. The Law

15 U.S.C. § 1693(g). Consumer Liability:

(a) Unauthorized electronic fund transfers; limit. A consumer shall be liable for any unauthorized electronic fund transfer....In no event, however, shall a consumer’s liability for an unauthorized transfer exceed the lesser of—

(1) \$ 50; or

(2) the amount of money or value of property or services obtained in such unauthorized electronic fund transfer prior to the time the financial institution is notified of, or otherwise becomes aware of, circumstances which lead to the reasonable belief that an unauthorized electronic fund transfer involving the consumer’s account has been or may be affected. Notice under this paragraph is sufficient when such steps have been taken as may be reasonably required in the ordinary course of business to provide the financial institution with the pertinent information, whether or not any particular officer, employee, or agent of the financial institution does in fact receive such information.

15 U.S.C. § 1693(m) Civil Liability:

(a) [A]ction for damages; amount of award....[A]ny person who fails to comply with any provision of this title with respect to any consumer, except for an error resolved in accordance with section 908, is liable to such consumer in an amount equal to the sum of—

(1) any actual damage sustained by such consumer as a result of such failure;

(2) in the case of an individual action, an amount not less than \$ 100 nor greater than \$ 1,000; or...

(3) in the case of any successful action to enforce the foregoing liability, the costs of the action, together with a reasonable attorney's fee as determined by the court.

12 C.F.R. § 205.6 Liability of consumer for unauthorized transfers.

(b) Limitations on amount of liability. A consumer's liability for an unauthorized electronic fund transfer or a series of related unauthorized transfers shall be determined as follows:

(1) Timely notice given. If the consumer notifies the financial institution within two business days after learning of the loss or theft of the access device, the consumer's liability shall not exceed the lesser of \$ 50 or the amount of unauthorized transfers that occur before notice to the financial institution.

(2) Timely notice not given. If the consumer fails to notify the financial institution within two business days after learning of the loss or theft of the access device, the consumer's liability shall not exceed the lesser of \$ 500 or the sum of:

(i) \$ 50 or the amount of unauthorized transfers that occur within the two business days, whichever is less; and

(ii) The amount of unauthorized transfers that occur after the close of two business days and before notice to the institution, provided the institution establishes that these transfers would not have occurred had the consumer notified the institution within that two-day period.

#### **IV. Opinion and Order**

The Court finds based upon the testimony presented herein that defendant in her counter-claim has proven by a preponderance of evidence damages in the amount of \$1,000.00 plus an award of attorney's fees. Clearly, Commerce failed to investigate the unauthorized charges pursuant to 15 U.S.C. § 1693(h). Nor did Commerce close the account as detailed in Defendant's Exhibit No. 1. Instead, Commerce sued Brown and then withdrew its claim at trial. The Court finds \$50.00 is the appropriate liability for Brown for the monies charged on her account as set forth within the above statute because she timely notified, in person, Commerce on January 16, 2005. Brown also requested Commerce to close her checking account. Based upon the trial record, defendant has proven by a preponderance of the evidence damages of \$1,000.00 as set forth in the above statute, 15 U.S.C. § 1693(m).

### CASE QUESTIONS

1. Why—apparently—did the bank withdraw its complaint against Brown at the time of trial?
2. Why does the court mention Ms. Brown's occupation, and that she was at the time of the incident living with the man who was—at the time of trial—her husband?
3. What is the difference between the United States Code (USC) and the *Code of Federal Regulations* (CFR), both of which are cited by the court?
4. What did the bank do wrong here?
5. What damages did Ms. Brown suffer for which she was awarded \$1,000? What else did she get by way of an award that is probably more important?

## 26.5 Summary and Exercises

### Summary

Traditionally when a customer wrote a check (on the payor bank) and the payee deposited it into his account (at the depository bank), the check was physically routed by means of ground and air transportation to the various intermediary banks until it was physically presented to the payor bank for final settlement. The federal Check 21 Act (2004) promotes changes in this process by allowing banks to process electronic images of customers' checks instead of the actual paper instrument: the data on the check is truncated (stripped) from the instrument and the data are transmitted. The original check can be digitally recreated by the making of a "substitute check." Merchants—indeed, anyone with a check scanner and a computer—can also process electronic data from checks to debit the writer's account and credit the merchant's instantly.

In addition to Check 21 Act, the Electronic Fund Transfer Act of 1978 also facilitates electronic banking. It primarily addresses the uses of credit and debit cards. Under this law, the electronic terminal must provide a receipt of transfer. The financial institution must follow certain procedures on being notified of errors, the customer's liability is limited to \$50 if a card or code number is wrongfully used and the institution has been notified, and an employer or government agency can compel acceptance of salary or government benefits by EFT.

Article 4 of the UCC—state law, of course—governs a bank's relationship with its customers. It permits a bank to pay an overdraft, to pay an altered check (charging the customer's account for the original tenor of the check), to refuse to pay a six-month-old check, to pay or collect an item of a deceased person (if it has no notice of death) and obligates it to honor stop payment orders. A bank is liable to the customer for damages if it wrongfully dishonors an item. The customer also has duties; primarily, the customer must inspect each statement of account and notify the bank promptly if the checks have been altered or signatures forged. The federal Expedited Funds Availability Act requires that, within some limits, banks make customers' funds available quickly.

Wholesale funds transactions, involving tens of millions of dollars, were originally made by telegraph ("wire transfers"). The modern law governing such transactions is, in the United States, UCC Article 4A.

A letter of credit is a statement by a bank or other financial institution that it will pay a specified sum of money to specified persons when certain conditions are met. Its purpose is to facilitate nonlocal sales transactions by ensuring that the buyer will not get access to the goods until the seller has proper access to the buyer's money. In the US letters of credit are governed by UCC Article 5, and in international transactions they may be covered by a different internationally recognized law.



## EXERCISES

1. On March 20, Al gave Betty a check for \$1,000. On March 25, Al gave Carl a check for \$1,000, which Carl immediately had certified. On October 24, when Al had \$1,100 in his account, Betty presented her check for payment and the bank paid her \$1,000. On October 25, Carl presented his check for payment and the bank refused to pay because of insufficient funds. Were the bank's actions proper?
2. Winifred had a balance of \$100 in her checking account at First Bank. She wrote a check payable to her landlord in the amount of \$400. First Bank cashed the check and then attempted to charge her account. May it? Why?
3. Assume in Exercise 2 that Winifred had deposited \$4,000 in her account a month before writing the check to her landlord. Her landlord altered the check by changing the amount from \$400 to \$4,000 and then cashed the check at First Bank. May the bank charge Winifred's account for the check? Why?
4. Assume in Exercise 2 that Winifred had deposited \$5,000 in her account a month before writing the check but the bank misdirected her deposit, with the result that her account showed a balance of \$100. Believing the landlord's check to be an overdraft, the bank refused to pay it. Was the refusal justified? Why?
5. Assume in Exercise 2 that, after sending the check to the landlord, Winifred decided to stop payment because she wanted to use the \$300 in her account as a down payment on a stereo. She called First Bank and ordered the bank to stop payment. Four days later the bank mistakenly paid the check. Is the bank liable to Winifred? Why?
6. Assume in Exercise 5 that the landlord negotiated the check to a holder in due course, who presented the check to the bank for payment. Is the bank required to pay the holder in due course after the stop payment order? Why?
7. On Wednesday, August 4, Able wrote a \$1,000 check on his account at First Bank. On Saturday, August 7, the check was cashed, but the Saturday activity was not recorded by the bank until Monday, August 9. On that day at 8:00 a.m., Able called in a stop payment order on the check and he was told the check had not cleared; at 9:00 he went to the bank and obtained a printed notice confirming the stop payment, but shortly thereafter the Saturday activity was recorded—Able's account had been debited. He wants the \$1,000 recredited. Was the stop payment order effective? Explain.
8. Alice wrote a check to Carl's Contracting for \$190 on April 23, 2011. Alice was not satisfied with Carl's work. She called, leaving a message for him to return the call to discuss the matter with her. He did not do so, but

when she reconciled her checks upon receipt of her bank statement, she noticed the check to Carl did not appear on the April statement. Several months went by. She figured Carl just tore the check up instead of bothering to resolve any dispute with her. The check was presented to Alice's bank for payment on March 20, 2012, and Alice's bank paid it. May she recover from the bank?

9. Fitting wrote a check in the amount of \$800. Afterwards, she had second thoughts about the check and contacted the bank about stopping payment. A bank employee told her a stop payment order could not be submitted until the bank opened the next day. She discussed with the employee what would happen if she withdrew enough money from her account that when the \$800 check was presented, there would be insufficient funds to cover it. The employee told her that in such a case the bank would not pay the check. Fitting did withdraw enough money to make the \$800 an overdraft, but the bank paid it anyway, and then sued her for the amount of the overdraft. Who wins and why? *Continental Bank v. Fitting*, 559 P.2d 218 (1977).
10. Plaintiff's executive secretary forged plaintiff's name on number checks by signing his name and by using a rubber facsimile stamp of his signature: of fourteen checks that were drawn on her employer's account, thirteen were deposited in her son's account at the defendant bank, and one was deposited elsewhere. Evidence at trial was presented that the bank's system of comparing its customer's signature to the signature on checks was the same as other banks in the area. Plaintiff sued the bank to refund the amount of the checks paid out over a forged drawer's signature. Who wins and why? *Read v. South Carolina National Bank*, 335 S.E.2d 359 (S.C., 1965).
11. On Tuesday morning, Reggie discovered his credit card was not in his wallet. He realized he had not used it since the previous Thursday when he'd bought groceries. He checked his online credit card account register and saw that some \$1,700 had been charged around the county on his card. He immediately notified his credit union of the lost card and unauthorized charges. For how much is Reggie liable?

## SELF-TEST QUESTIONS

1. Article 4 of the UCC permits a bank to pay
  - a. an overdraft
  - b. an altered check
  - c. an item of a deceased person if it has no notice of death
  - d. all of the above
  
2. The type of banks covered by Article 4 include
  - a. depository banks
  - b. payor banks
  - c. both of the above
  - d. none of the above
  
3. A bank may
  - a. refuse to pay a check drawn more than six months before being presented
  - b. refuse to pay a check drawn more than sixty days before being presented
  - c. not refuse to pay a check drawn more than six months before being presented
  - d. do none of the above
  
4. Forms of electronic fund transfer include
  - a. automated teller machines
  - b. point of sale terminals
  - c. preauthorized payment plans
  - d. all of the above

**SELF-TEST ANSWERS**

1. d
2. c
3. a
4. d

# Chapter 27

## Consumer Credit Transactions

### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. How consumers enter into credit transactions and what protections they are afforded when they do
2. What rights consumers have after they have entered into a consumer transaction
3. What debt collection practices third-party collectors may pursue

This chapter and the three that follow are devoted to debtor-creditor relations. In this chapter, we focus on the consumer credit transaction. Chapter 28 "Secured Transactions and Suretyship" and Chapter 29 "Mortgages and Nonconsensual Liens" explore different types of security that a creditor might require. Chapter 30 "Bankruptcy" examines debtors' and creditors' rights under bankruptcy law.

The amount of consumer debt, or **household debt**<sup>1</sup>, owed by Americans to mortgage lenders, stores, automobile dealers, and other merchants who sell on credit is difficult to ascertain. One reads that the average household *credit card* debt (not including mortgages, auto loans, and student loans) in 2009 was almost \$16,000. Ben Woolsey and Matt Schulz, *Credit Card Statistics, Industry Statistics, Debt Statistics*, August 24, 2010, <http://www.creditcards.com/credit-card-news/credit-card-industry-facts-personal-debt-statistics-1276.php>. This is "calculated by dividing the total revolving debt in the U.S. (\$852.6 billion as of March 2010 data, as listed in the Federal Reserve's May 2010 report on consumer credit) by the estimated number of households carrying credit card debt (54 million)." Or maybe it was \$10,000. Deborah Fowles, "Your Monthly Credit Card Minimum Payments May Double," About.com Financial Planning, <http://financialplan.about.com/od/creditcarddebt/a/CCMinimums.htm>. Or maybe it was \$7,300. Index Credit Cards, *Credit Card Debt*, February 9, 2010, <http://www.indexcreditcards.com/creditcarddebt>. But probably focusing on the *average* household debt is not very helpful: 55 percent of households have no credit card debt at all, and the *median* debt is \$1,900. Liz Pulliam Weston, "The Big Lie about Credit Card Debt," *MSN Money*, July 30, 2007.

1. Debt owed by consumers.

In 2007, the total household debt owed by Americans was \$13.3 trillion, according to the Federal Reserve Board. That is really an incomprehensible number: suffice it to say, then, that the availability of credit is an important factor in the US economy, and not surprisingly, a number of statutes have been enacted over the years to protect consumers both before and after signing credit agreements.

The statutes tend to fall within three broad categories. First, several statutes are especially important when a consumer enters into a credit transaction. These include laws that regulate credit costs, the credit application, and the applicant's right to check a credit record. Second, after a consumer has contracted for credit, certain statutes give a consumer the right to cancel the contract and correct billing mistakes. Third, if the consumer fails to pay a debt, the creditor has several traditional debt collection remedies that today are tightly regulated by the government.

## 27.1 Entering into a Credit Transaction

### LEARNING OBJECTIVES

1. Understand what statutes regulate the cost of credit, and the exceptions.
2. Know how the cost of credit is expressed in the Truth in Lending Act.
3. Recognize that there are laws prohibiting discrimination in credit granting.
4. Understand how consumers' credit records are maintained and may be corrected.

### The Cost of Credit

Lenders, whether banks or retailers, are not free to charge whatever they wish for credit. **Usury**<sup>2</sup> laws establish a maximum rate of lawful interest. The penalties for violating usury laws vary from state to state. The heaviest penalties are loss of both principal and interest, or loss of a multiple of the interest the creditor charged. The courts often interpret these laws stringently, so that even if the impetus for a usurious loan comes from the borrower, the contract can be avoided, as demonstrated in *Matter of Dane's Estate* ([Section 27.3 "Cases"](#)).

Some states have eliminated interest rate limits altogether. In other states, usury law is riddled with exceptions, and indeed, in many cases, the exceptions have pretty much eaten up the general rule. Here are some common exceptions:

- Business loans. In many states, businesses may be charged any interest rate, although some states limit this exception to incorporated businesses.
- Mortgage loans. Mortgage loans are often subject to special usury laws. The allowable interest rates vary, depending on whether a first mortgage or a subordinate mortgage is given, or whether the loan is insured or provided by a federal agency, among other variables.
- Second mortgages and home equity loans by licensed consumer loan companies.
- Credit card and other retail installment debt. The interest rate for these is governed by the law of the state where the credit card company does business. (That's why the giant Citibank, otherwise headquartered in New York City, runs its credit card division out of South Dakota, which has no usury laws for credit cards.)

2. Charging interest in excess of the legal limit.

- Consumer leasing.
- “Small loans” such as payday loans and pawnshop loans.
- Lease-purchases on personal property. This is the lease-to-own concept.
- Certain financing of mobile homes that have become real property or where financing is insured by the federal government.
- Loans a person takes from her tax-qualified retirement plan.
- Certain loans from stockbrokers and dealers.
- Interest and penalties on delinquent property taxes.
- Deferred payment of purchase price (layaway loans).
- Statutory interest on judgments.

And there are others. Moreover, certain charges are not considered interest, such as fees to record documents in a public office and charges for services such as title examinations, deed preparation, credit reports, appraisals, and loan processing. But a creditor may not use these devices to cloak what is in fact a usurious bargain; it is not the form but the substance of the agreement that controls.

As suggested, part of the difficulty here is that governments at all levels have for a generation attempted to promote consumption to promote production; production is required to maintain politically acceptable levels of employment. If consumers can get what they want on credit, consumerism increases. Also, certainly, tight limits on interest rates cause creditors to deny credit to the less creditworthy, which may not be helpful to the lower classes. That’s the rationale for the usury exceptions related to pawnshop and payday loans.

## Disclosure of Credit Costs

Setting limits on what credit costs—as usury laws do—is one thing. Disclosing the cost of credit is another.

### The Truth in Lending Act

Until 1969, lenders were generally free to disclose the cost of money loaned or credit extended in any way they saw fit—and they did. Financing and credit terms varied widely, and it was difficult and sometimes impossible to understand what the true cost was of a particular loan, much less to comparison shop. After years of failure, consumer interests finally persuaded Congress to pass a national law requiring disclosure of credit costs in 1968. Officially called the Consumer Credit Protection Act, Title I of the law is more popularly known as the **Truth in Lending Act**<sup>3</sup> (TILA). The act only applies to *consumer* credit transactions, and it only protects natural-person debtors—it does not protect business organization debtors.

3. A federal act ensuring that every individual who has need for consumer credit is given full disclosure of the terms and cost of the credit.



The act provides what its name implies: lenders must inform borrowers about significant terms of the credit transaction. The TILA does not establish maximum interest rates; these continue to be governed by state law. The two key terms that must be disclosed are the finance charge and the annual percentage rate. To see why, consider two simple loans of \$1,000, each carrying interest of 10 percent, one payable at the end of twelve months and the other in twelve equal installments. Although the actual charge in each is the same—\$100—the interest rate is not. Why? Because with the first loan you will have the use of the full \$1,000 for the entire year; with the second, for much less than the year because you must begin repaying part of the principal within a month. In fact, with the second loan you will have use of only about half the money for the entire year, and so the actual rate of interest is closer to 15 percent. Things become more complex when interest is compounded and stated as a monthly figure, when different rates apply to various portions of the loan, and when processing charges and other fees are stated separately. The act regulates open-end credit (revolving credit, like charge cards) and closed-end credit (like a car loan—extending for a specific period), and—as amended later—it regulates consumer leases and credit card transactions, too.

Figure 27.1 Credit Disclosure Form

Big Wheel Auto Alice Green

<b>ANNUAL PERCENTAGE RATE</b> <small>The cost of your credit as a yearly rate</small>	<b>FINANCE CHARGE</b> <small>The dollar amount the credit will cost you</small>	<b>Amount Financed</b> <small>The amount of credit provided to you or on your behalf</small>	<b>Total of Payments</b> <small>The amount you will have paid after you have made all your payments as scheduled</small>	<b>Total Sale Price</b> <small>The total cost of your purchase on credit, including your down-payment of</small>
14.84%	\$1496.80	\$6107.50	\$7604.30	\$1500 \$9104.30

You have the right to receive at this time an itemization of the Amount Financed  
 I want an itemization     I do not want an itemization

Your payment schedule will be:

Number of Payments	Amount of Payments	When Payments Are Due
36	\$211.23	Monthly beginning 6-1-11

**Insurance**  
 Credit life insurance and credit disability insurance are not required to obtain credit, and will not be provided unless you sign and agree to pay the additional cost

Type	Premium	Signature
Credit Life	\$120	I want credit life insurance <span style="float: right;">Signature <u>Alice Green</u></span>
Credit Disability		I want credit disability insurance <span style="float: right;">Signature _____</span>
Credit Life and Disability		I want credit life and disability insurance <span style="float: right;">Signature _____</span>

Security: You are giving a security interest in:  
 the goods being purchased.

Filing fees \$ 12.50    Nonfiling insurance \$ \_\_\_\_\_

Late Charge: If a payment is late, you will be charged \$10.

Prepayment: If you pay off early, you  
 may  will not have to pay a penalty.  
 may  will not be entitled to a refund of part of the finance charge.

See your contract documents for any additional information about nonpayment, default, any required repayment in full before the scheduled date, and prepayment refunds and penalties.

I have received a copy of this statement.  
 Signature Alice Green    Date 6-1-11  
e means an estimate

By requiring that the finance charge and the annual percentage rate be disclosed on a uniform basis, the TILA makes understanding and comparison of loans much easier. The **finance charge**<sup>4</sup> is the total of all money paid for credit; it includes the interest paid over the life of the loan and all processing charges. The annual percentage rate is the true rate of interest for money or credit actually available to the borrower. The annual percentage rate must be calculated using the total finance charge (including all extra fees). See [Figure 27.1 "Credit Disclosure Form"](#) for an example of a disclosure form used by creditors.

### **Consumer Leasing Act of 1988**

The Consumer Leasing Act (CLA) amends the TILA to provide similar full disclosure for consumers who lease automobiles or other goods from firms whose business it is to lease such goods, if the goods are valued at \$25,000 or less and the lease is for four months or more. All material terms of the lease must be disclosed in writing.

### **Fair Credit and Charge Card Disclosure**

In 1989, the Fair Credit and Charge Card Disclosure Act went into effect. This amends the TILA by requiring credit card issuers to disclose in a uniform manner the annual percentage rate, annual fees, grace period, and other information on credit card applications.

### **Credit Card Accountability, Responsibility, and Disclosure Act of 2009**

The 1989 act did make it possible for consumers to know the costs associated with credit card use, but the card companies' behavior over 20 years convinced Congress that more regulation was required. In 2009, Congress passed and President Obama signed the Credit Card Accountability, Responsibility, and Disclosure Act of 2009 (the Credit Card Act). It is a further amendment of the TILA. Some of the salient parts of the act are as follows:

- Restricts all interest rate increases during the first year, with some exceptions. The purpose is to abolish "teaser" rates.
- Increases notice for rate increase on future purchases to 45 days.
- Preserves the ability to pay off on the old terms, with some exceptions.
- Limits fees and penalty interest and requires statements to clearly state the required due date and late payment penalty.
- Requires fair application of payments. Amounts in excess of the minimum payment must be applied to the highest interest rate (with some exceptions).
- Provides sensible due dates and time to pay.

4. The total cost of credit a customer must pay on a consumer loan, including interest.

- Protects young consumers. Before issuing a card to a person under the age of twenty-one, the card issuer must obtain an application that contains either the signature of a cosigner over the age of twenty-one or information indicating an independent means of repaying any credit extended.
- Restricts card issuers from providing tangible gifts to students on college campuses in exchange for filling out a credit card application.
- Requires colleges to publicly disclose any marketing contracts made with a card issuer.
- Requires enhanced disclosures.
- Requires issuers to disclose the period of time and the total interest it will take to pay off the card balance if only minimum monthly payments are made.
- Establishes gift card protections. Consumers Union, “Upcoming Credit Card Protections,” <http://www.creditcardreform.org/pdf/dodd-summary-509.pdf>.

The Federal Reserve Board is to issue implementing rules.

Creditors who violate the TILA are subject to both criminal and civil sanctions. Of these, the most important are the civil remedies open to consumers. If a creditor fails to disclose the required information, a customer may sue to recover twice the finance charge, plus court costs and reasonable attorneys’ fees, with some limitations. As to the Credit Card Act of 2009, the issuing companies were not happy with the reforms. Before the law went into effect, the companies—as one commentator put it—unleashed a “frenzy of retaliation,” Liz Pulliam Weston, “Credit Card Lenders Go on a Rampage,” *MSN Money*, November 25, 2009. by repricing customer accounts, changing fixed rates to variable rates, lowering credit limits, and increasing fees.

### **State Credit Disclosure Laws**

The federal TILA is not the only statute dealing with credit disclosures. A uniform state act, the Uniform Consumer Credit Code, as amended in 1974, is now on the books in twelve US jurisdictions, States adopting the Uniform Consumer Credit Code are the following: Colorado, Idaho, Indiana, Iowa, Kansas, Maine, Oklahoma, South Carolina, Utah, Wisconsin, Wyoming, and Guam. Cornell University Law School, “Uniform Laws.” <http://www.law.cornell.edu/uniform/vol7.html#concc>. though its effect on the development of modern consumer credit law has been significant beyond the number of states adopting it. It is designed to protect consumers who buy goods and services on credit by simplifying, clarifying, and updating legislation governing consumer credit and usury.

## Getting Credit

Disclosure of credit costs is a good thing. After discovering how much credit will cost, a person might decide to go for it: get a loan or a credit card. The potential creditor, of course, should want to know if the applicant is a good risk; that requires a credit check. And somebody who knows another person's creditworthiness has what is usually considered confidential information, the possession of which is subject to abuse, and thus regulation.

## Equal Credit Opportunity Act

Through the 1960s, banks and other lending and credit-granting institutions regularly discriminated against women. Banks told single women to find a cosigner for loans. Divorced women discovered that they could not open store charge accounts because they lacked a prior credit history, even though they had contributed to the family income on which previous accounts had been based. Married couples found that the wife's earnings were not counted when they sought credit; indeed, families planning to buy homes were occasionally even told that the bank would grant a mortgage if the wife would submit to a hysterectomy! In all these cases, the premise of the refusal to treat women equally was the unstated—and usually false—belief that women would quit work to have children or simply to stay home.

By the 1970s, as women became a major factor in the labor force, Congress reacted to the manifest unfairness of the discrimination by enacting (as part of the Consumer Credit Protection Act) the Equal Credit Opportunity Act (ECOA) of 1974. The act prohibits any creditor from discriminating “against any applicant on the basis of sex or marital status with respect to any aspect of a credit transaction.” In 1976, Congress broadened the law to bar discrimination (1) on the basis of race, color, religion, national origin, and age; (2) because all or a part of an applicant's income is from a public assistance program; or (3) because an applicant has exercised his or her rights under the Consumer Credit Protection Act.

Under the ECOA, a creditor may not ask a credit applicant to state sex, race, national origin, or religion. And unless the applicant is seeking a joint loan or account or lives in a community-property state, the creditor may not ask for a statement of marital status or, if you have voluntarily disclosed that you are married, for information about your spouse, nor may one spouse be required to cosign if the other is deemed independently creditworthy. All questions concerning plans for children are improper. In assessing the creditworthiness of an applicant, the creditor must consider all sources of income, including regularly received alimony and child support payments. And if credit is refused, the creditor must, on

demand, tell you the specific reasons for rejection. See *Rosa v. Park West Bank & Trust Co.* in [Section 27.3 "Cases"](#) for a case involving the ECOA.

The Home Mortgage Disclosure Act, 1975, and the Community Reinvestment Act (CRA), 1977, get at another type of discrimination: redlining. This is the practice by a financial institution of refusing to grant home loans or home-improvement loans to people living in low-income neighborhoods. The act requires that financial institutions within its purview report annually by transmitting information from their Loan Application Registers to a federal agency. From these reports it is possible to determine what is happening to home prices in a particular area, whether investment in one neighborhood lags compared with that in others, if the racial or economic composition of borrowers changed over time, whether minorities or women had trouble accessing mortgage credit, in what kinds of neighborhoods subprime loans are concentrated, and what types of borrowers are most likely to receive subprime loans, among others. “Armed with hard facts, users of all types can better execute their work: Advocates can launch consumer education campaigns in neighborhoods being targeted by subprime lenders, planners can better tailor housing policy to market conditions, affordable housing developers can identify gentrifying neighborhoods, and activists can confront banks with poor lending records in low income communities.” Kathryn L.S. Pettit and Audrey E. Droesch, “A Guide to Home Mortgage Disclosure Act Data,” The Urban Institute, December 2008, [http://www.urban.org/uploadedpdf/1001247\\_hdma.pdf](http://www.urban.org/uploadedpdf/1001247_hdma.pdf). Under the CRA, federal regulatory agencies examine banking institutions for CRA compliance and take this information into consideration when approving applications for new bank branches or for mergers or acquisitions.

### **Fair Credit Reporting Act of 1970: Checking the Applicant’s Credit Record**

It is in the interests of all consumers that people who would be bad credit risks not get credit: if they do and they default (fail to pay their debts), the rest of us end up paying for their improvidence. Because credit is such a big business, a number of support industries have grown up around it. One of the most important is the credit-reporting industry, which addresses this issue of checking creditworthiness. Certain companies—**credit bureau**<sup>5</sup>s—collect information about borrowers, holders of credit cards, store accounts, and installment purchasers. For a fee, this information—currently held on tens of millions of Americans—is sold to companies anxious to know whether applicants are creditworthy. If the information is inaccurate, it can lead to rejection of a credit application that should be approved, and it can wind up in other files where it can live to do more damage. In 1970, Congress enacted, as part of the Consumer Credit Protection Act, the Fair Credit Reporting Act (FCRA) to give consumers access to their credit files in order to correct errors.

5. A private firm that maintains consumer credit data files and provides credit information to authorized users for a fee.

Under this statute, an applicant denied credit has the right to be told the name and address of the credit bureau (called “consumer reporting agency” in the act) that prepared the report on which the denial was based. (The law covers reports used to screen insurance and job applicants as well as to determine creditworthiness.) The agency must list the nature and substance of the information (except medical information) and its sources (unless they contributed to an investigative-type report). A credit report lists such information as name, address, employer, salary history, loans outstanding, and the like. An investigative-type report is one that results from personal interviews and may contain nonfinancial information, like drinking and other personal habits, character, or participation in dangerous sports. Since the investigators rely on talks with neighbors and coworkers, their reports are usually subjective and can often be misleading and inaccurate.

The agency must furnish the consumer the information free if requested within thirty days of rejection and must also specify the name and address of anyone who has received the report within the preceding six months (two years if furnished for employment purposes).

If the information turns out to be inaccurate, the agency must correct its records; if investigative material cannot be verified, it must be removed from the file. Those to whom it was distributed must be notified of the changes. When the agency and the consumer disagree about the validity of the information, the consumer’s version must be placed in the file and included in future distributions of the report. After seven years, any adverse information must be removed (ten years in the case of bankruptcy). A person is entitled to one free copy of his or her credit report from each of the three main national credit bureaus every twelve months. If a reporting agency fails to correct inaccurate information in a reasonable time, it is liable to the consumer for \$1,000 plus attorneys’ fees.

Under the FCRA, any person who obtains information from a credit agency under false pretenses is subject to criminal and civil penalties. The act is enforced by the Federal Trade Commission. See *Rodgers v. McCullough* in [Section 27.3 "Cases"](#) for a case involving use of information from a credit report.

### KEY TAKEAWAY

Credit is an important part of the US economy, and there are various laws regulating its availability and disclosure. Usury laws prohibit charging excessive interest rates, though the laws are riddled with exceptions. The disclosure of credit costs is regulated by the Truth in Lending Act of 1969, the Consumer Leasing Act of 1988, the Fair Credit and Charge Card Disclosure Act of 1989, and the Credit Card Accountability, Responsibility, and Disclosure Act of 2009 (these latter three are amendments to the TILA). Some states have adopted the Uniform Consumer Credit Code as well. Two major laws prohibit invidious discrimination in the granting of credit: the Equal Credit Opportunity Act of 1974 and the Home Mortgage Disclosure Act of 1975 (addressing the problem of redlining). The Fair Credit Reporting Act of 1970 governs the collection and use of consumer credit information held by credit bureaus.

### EXERCISES

1. The penalty for usury varies from state to state. What are the two typical penalties?
2. What has the TILA done to the use of *interest* as a term to describe how much credit costs, and why?
3. What is redlining?
4. What does the Fair Credit Reporting Act do, in general?

## 27.2 Consumer Protection Laws and Debt Collection Practices

### LEARNING OBJECTIVES

1. Understand that consumers have the right to cancel some purchases made on credit.
2. Know how billing mistakes may be corrected.
3. Recognize that professional debt collectors are governed by some laws restricting certain practices.

### Cancellation Rights

Ordinarily, a contract is binding when signed. But consumer protection laws sometimes provide an escape valve. For example, a Federal Trade Commission (FTC) regulation gives consumers three days to cancel contracts made with door-to-door salespersons. Under this cooling-off provision, the cancellation is effective if made by midnight of the third business day after the date of the purchase agreement. The salesperson must notify consumers of this right and supply them with two copies of a cancellation form, and the sales agreement must contain a statement explaining the right. The purchaser cancels by returning one copy of the cancellation form to the seller, who is obligated either to pick up the goods or to pay shipping costs. The three-day cancellation privilege applies only to sales of twenty-five dollars or more made either in the home or away from the seller's place of business; it does not apply to sales made by mail or telephone, to emergency repairs and certain other home repairs, or to real estate, insurance, or securities sales.

The Truth in Lending Act (TILA) protects consumers in a similar way. For certain big-ticket purchases (such as installations made in the course of major home improvements), sellers sometimes require a mortgage (which is subordinate to any preexisting mortgages) on the home. The law gives such customers three days to rescind the contract. Many states have laws similar to the FTC's three-day cooling-off period, and these may apply to transactions not covered by the federal rule (e.g., to purchases of less than twenty-five dollars and even to certain contracts made at the seller's place of business).



## Correcting Billing Mistakes

### Billing Mistakes

In 1975, Congress enacted the **Fair Credit Billing Act**<sup>6</sup> as an amendment to the Consumer Credit Protection Act. It was intended to put to an end the phenomenon, by then a standard part of any comedian's repertoire, of the many ways a computer could insist that you pay a bill, despite errors and despite letters you might have written to complain. The act, which applies only to open-end credit and not to installment sales, sets out a procedure that creditors and customers must follow to rectify claimed errors. The customer has sixty days to notify the creditor of the nature of the error and the amount. Errors can include charges not incurred or those billed with the wrong description, charges for goods never delivered, accounting or arithmetic errors, failure to credit payments or returns, and even charges for which you simply request additional information, including proof of sale. During the time the creditor is replying, you need not pay the questioned item or any finance charge on the disputed amount.

The creditor has thirty days to respond and ninety days to correct your account or explain why your belief that an error has been committed is incorrect. If you do turn out to be wrong, the creditor is entitled to all back finance charges and to prompt payment of the disputed amount. If you persist in disagreeing and notify the creditor within ten days, it is obligated to tell all credit bureaus to whom it sends notices of delinquency that the bill continues to be disputed and to tell you to whom such reports have been sent; when the dispute has been settled, the creditor must notify the credit bureaus of this fact. Failure of the creditor to follow the rules, an explanation of which must be provided to each customer every six months and when a dispute arises, bars it from collecting the first fifty dollars in dispute, plus finance charges, even if the creditor turns out to be correct.

### Disputes about the Quality of Goods or Services Purchased

While disputes over the quality of goods are not "billing errors," the act does apply to unsatisfactory goods or services purchased by credit card (except for store credit cards); the customer may assert against the credit card company any claims or defenses he or she may have against the seller. This means that under certain circumstances, the customer may withhold payments without incurring additional finance charges. However, this right is subject to three limitations: (1) the value of the goods or services charged must be in excess of fifty dollars, (2) the goods or services must have been purchased either in the home state or within one hundred miles of the customer's current mailing address, and (3) the consumer must make a good-faith effort to resolve the dispute before refusing to pay. If the consumer does refuse to pay, the credit card company would acquiesce: it would credit her account for the disputed amount, pass the loss down to the merchant's bank, and that bank

6. A federal law (1975) to protect consumers from unfair billing practices and to provide a mechanism for addressing billing errors in open-end credit accounts, such as credit card or charge card accounts.

would debit the merchant's account. The merchant would then have to deal with the consumer directly.

## Debt Collection Practices

Banks, financial institutions, and retailers have different incentives for extending credit—for some, a loan is simply a means of making money, and for others, it is an inducement to buyers. But in either case, credit is a risk because the consumer may default; the creditor needs a means of collecting when the customer fails to pay. Open-end credit is usually given without collateral. The creditor can, of course, sue, but if the consumer has no assets, collection can be troublesome. Historically, three different means of recovering the debt have evolved: garnishment, wage assignment, and confession of judgment.

### Garnishment

**Garnishment**<sup>7</sup> is a legal process by which a creditor obtains a court order directing the debtor's employer (or any party who owes money to the debtor) to pay directly to the creditor a certain portion of the employee's wages until the debt is paid. Until 1970, garnishment was regulated by state law, and its effects could be devastating—in some cases, even leading to suicide. In 1970, Title III of the Consumer Credit Protection Act asserted federal control over garnishment proceedings for the first time. The federal wage-garnishment law limits the amount of employee earnings that may be withheld in any one pay date to the lesser of 25 percent of disposable (after-tax) earnings or the amount by which disposable weekly earnings exceed thirty times the highest current federal minimum wage. The federal law covers everyone who receives personal earnings, including wages, salaries, commissions, bonuses, and retirement income (though not tips), but it allows courts to garnish above the federal maximum in cases involving support payments (e.g., alimony), in personal bankruptcy cases, and in cases where the debt owed is for state or federal tax.

The federal wage-garnishment law also prohibits an employer from firing any worker solely because the worker's pay has been garnished for one debt (multiple garnishments may be grounds for discharge). The penalty for violating this provision is a \$1,000 fine, one-year imprisonment, or both. But the law does not say that an employee fired for having one debt garnished may sue the employer for damages. In a 1980 case, the Fifth Circuit Court of Appeals denied an employee the right to sue, holding that the statute places enforcement exclusively in the hands of the federal secretary of labor. *Smith v. Cotton Brothers Baking Co., Inc.*, 609 F.2d 738 (5th Cir. 1980).

7. The attachment or seizure of personal wages through a court-assisted process.

The 1970 federal statute is not the only limitation on the garnishment process. Note that the states can also still regulate garnishment so long as the state regulation is not in conflict with federal law: North Carolina, Pennsylvania, South Carolina, and Texas prohibit most garnishments, unless it is the government doing the garnishment. And there is an important constitutional limitation as well. Many states once permitted a creditor to garnish the employee's wage even before the case came to court: a simple form from the clerk of the court was enough to freeze a debtor's wages, often before the debtor knew a suit had been brought. In 1969, the US Supreme Court held that this prejudgment garnishment procedure was unconstitutional. *Sniadach v. Family Finance Corp.*, 395 U.S. 337 (1969).

### Wage Assignment

A **wage assignment**<sup>8</sup> is an agreement by an employee that a creditor may take future wages as security for a loan or to pay an existing debt. With a wage assignment, the creditor can collect directly from the employer. However, in some states, wage assignments are unlawful, and an employer need not honor the agreement (indeed, it would be liable to the employee if it did). Other states regulate wage assignments in various ways—for example, by requiring that the assignment be a separate instrument, not part of the loan agreement, and by specifying that no wage assignment is valid beyond a certain period of time (two or three years).

### Confession of Judgment

Because suing is at best nettlesome, many creditors have developed forms that allow them to sidestep the courthouse when debtors have defaulted. As part of the original credit agreement, the consumer or borrower waives his right to defend himself in court by signing a **confession of judgment**<sup>9</sup>. This written instrument recites the debtor's agreement that a court order be automatically entered against him in the event of default. The creditor's lawyer simply takes the confession of judgment to the clerk of the court, who enters it in the judgment book of the court without ever consulting a judge. Entry of the judgment entitles the creditor to attach the debtor's assets to satisfy the debt. Like prejudgment garnishment, a confession of judgment gives the consumer no right to be heard, and it has been banned by statute or court decisions in many states.

8. A clause in a loan contract that allows the lender to obtain the borrower's wages in the case of a default.

9. A written agreement in which the defendant in a lawsuit admits liability and accepts the amount of agreed-upon damages that must be paid to the plaintiff.

### Fair Debt Collection Practices Act of 1977

Many stores, hospitals, and other organizations attempt on their own to collect unpaid bills, but thousands of merchants, professionals, and small businesses rely on collection agencies to recover accounts receivable. The debt collection business employed some 216,000 people in 2007 and collected over \$40 billion in

debt.PricewaterhouseCoopers LLP, *Value of Third-Party Debt Collection to the U.S. Economy in 2007: Survey And Analysis*, June 2008, <http://www.acainternational.org/files.aspx?p=/images/12546/pwc2007-final.pdf>. For decades, some of these collectors used harassing tactics: posing as government agents or attorneys, calling at the debtor's workplace, threatening physical harm or loss of property or imprisonment, using abusive language, publishing a deadbeats list, misrepresenting the size of the debt, and telling friends and neighbors about the debt. To provide a remedy for these abuses, Congress enacted, as part of the Consumer Credit Protection Act, the Fair Debt Collection Practices Act (FDCPA) in 1977.

This law regulates the manner by which third-party collection agencies conduct their business. It covers collection of all personal, family, and household debts by collection agencies. It does not deal with collection by creditors themselves; the consumer's remedy for abusive debt collection by the creditor is in tort law.

Under the FDCPA, the third-party collector may contact the debtor only during reasonable hours and not at work if the debtor's employer prohibits it. The debtor may write the collector to cease contact, in which case the agency is prohibited from further contact (except to confirm that there will be no further contact). A written denial that money is owed stops the bill collector for thirty days, and he can resume again only after the debtor is sent proof of the debt. Collectors may no longer file suit in remote places, hoping for default judgments; any suit must be filed in a court where the debtor lives or where the underlying contract was signed. The use of harassing and abusive tactics, including false and misleading representations to the debtor and others (e.g., claiming that the collector is an attorney or that the debtor is about to be sued when that is not true), is prohibited. Unless the debtor has given the creditor her cell phone number, calls to cell phones (but not to landlines) are not allowed. Federal Communications Commission, "In the Matter of Rules and Regulations Implementing the Telephone Consumer Protection Act of 1991," [http://fjallfoss.fcc.gov/edocs\\_public/attachmatch/FCC-07-232A1.txt](http://fjallfoss.fcc.gov/edocs_public/attachmatch/FCC-07-232A1.txt). (This document shows up best with Adobe Acrobat.) In any mailings sent to the debtor, the return address cannot indicate that it is from a debt collection agency (so as to avoid embarrassment from a conspicuous name on the envelope that might be read by third parties).

Communication with third parties about the debt is not allowed, except when the collector may need to talk to others to trace the debtor's whereabouts (though the collector may not tell them that the inquiry concerns a debt) or when the collector contacts a debtor's attorney, if the debtor has an attorney. The federal statute gives debtors the right to sue the collector for damages for violating the statute and for causing such injuries as job loss or harm to reputation.

### KEY TAKEAWAY

Several laws regulate practices after consumer credit transactions. The FTC provides consumers with a three-day cooling-off period for some in-home sales, during which time the consumer-purchaser may cancel the sale. The TILA and some state laws also have some cancellation provisions. Billing errors are addressed by the Fair Credit Billing Act, which gives consumers certain rights. Debt collection practices such as garnishment, wage assignments, and confessions of judgment are regulated (and in some states prohibited) by federal and state law. Debt collection practices for third-party debt collectors are constrained by the Fair Debt Collection Practices Act.

### EXERCISES

1. Under what circumstances may a consumer have three days to avoid a contract?
2. How does the Fair Credit Billing Act resolve the problem that occurs when a consumer disputes a bill and “argues” with a computer about it?
3. What is the constitutional problem with garnishment as it was often practiced before 1969?
4. If Joe of Joe’s Garage wants to collect on his own the debts he is owed, he is not constrained by the FDCPA. What limits are there on his debt collection practices?

## 27.3 Cases

### Usury

Matter of Dane's Estate

390 N.Y.S.2d 249 (N.Y.A.D. 1976)

MAHONEY, J.

On December 17, 1968, after repeated requests by decedent [Leland Dane] that appellant [James Rossi] loan him \$10,500 [about \$64,000 in 2010 dollars] the latter drew a demand note in that amount and with decedent's consent fixed the interest rate at 7 1/2% Per annum, the then maximum annual interest permitted being 7 1/4%. Decedent executed the note and appellant gave him the full amount of the note in cash....[The estate] moved for summary judgment voiding the note on the ground that it was a usurious loan, the note having been previously rejected as a claim against the estate. The [lower court] granted the motion, voided the note and enjoined any prosecution on it thereafter. Appellant's cross motion to enforce the claim was denied.

New York's usury laws are harsh, and courts have been reluctant to extend them beyond cases that fall squarely under the statutes [Citation]. [New York law] makes any note for which more than the legal rate of interests is 'reserved or taken' or 'agreed to be reserved or taken' void. [The law] commands cancellation of a note in violation of [its provisions]. Here, since both sides concede that the note evidences the complete agreement between the parties, we cannot aid appellant by reliance upon the presumption that he did not make the loan at a usurious rate [Citation]. The terms of the loan are not in dispute. Thus, the note itself establishes, on its face, clear evidence of usury. There is no requirement of a specific intent to violate the usury statute. A general intent to charge more than the legal rate as evidenced by the note, is all that is needed. If the lender intends to take and receive a rate in excess of the legal percentage at the time the note is made, the statute condemns the act and mandates its cancellation [Citation]. The showing, as here, that the note reserves to the lender an illegal rate of interest satisfies respondents' burden of proving a usurious loan.

Next, where the rate of interest on the face of a note is in excess of the legal rate, it cannot be argued that such a loan may be saved because the borrower prompted the loan or even set the rate. The usury statutes are for the protection of the

borrower and [their] purpose would be thwarted if the lender could avoid its consequences by asking the borrower to set the rate. Since the respondents herein asserted the defense of usury, it cannot be said that the decedent waived the defense by setting or agreeing to the 7 1/2% Rate of interest.

Finally, equitable considerations cannot be indulged when, as here, a statute specifically condemns an act. The statute fixes the law, and it must be followed.

The order should be affirmed, without costs.

### CASE QUESTIONS

1. What is the consequence to the lender of charging usurious rates in New York?
2. The rate charged here was one-half of one percent in excess of the allowable limit. Who made the note, the borrower or the lender? That makes no difference, but should it?
3. What “equitable considerations” were apparently raised by the creditor?

### Discrimination under the ECOA

Rosa v. Park West Bank & Trust Co.

214 F.3d 213, C.A.1 (Mass. 2000)

Lynch, J.

Lucas Rosa sued the Park West Bank & Trust Co. under the Equal Credit Opportunity Act (ECOA), 15 U.S.C. §§ 1691–1691f, and various state laws. He alleged that the Bank refused to provide him with a loan application because he did not come dressed in masculine attire and that the Bank’s refusal amounted to sex discrimination under the Act. The district court granted the Bank’s motion to dismiss the ECOA claim...

#### I.

According to the complaint, which we take to be true for the purpose of this appeal, on July 21, 1998, Mr. Lucas Rosa came to the Bank to apply for a loan. A biological male, he was dressed in traditionally feminine attire. He requested a loan application from Norma Brunelle, a bank employee. Brunelle asked Rosa for

identification. Rosa produced three forms of photo identification: (1) a Massachusetts Department of Public Welfare Card; (2) a Massachusetts Identification Card; and (3) a Money Stop Check Cashing ID Card. Brunelle looked at the identification cards and told Rosa that she would not provide him with a loan application until he “went home and changed.” She said that he had to be dressed like one of the identification cards in which he appeared in more traditionally male attire before she would provide him with a loan application and process his loan request.

## II.

Rosa sued the Bank for violations of the ECOA and various Massachusetts antidiscrimination statutes. Rosa charged that “[b]y requiring [him] to conform to sex stereotypes before proceeding with the credit transaction, [the Bank] unlawfully discriminated against [him] with respect to an aspect of a credit transaction on the basis of sex.” He claims to have suffered emotional distress, including anxiety, depression, humiliation, and extreme embarrassment. Rosa seeks damages, attorney’s fees, and injunctive relief.

Without filing an answer to the complaint, the Bank moved to dismiss....The district court granted the Bank’s motion. The court stated:

[T]he issue in this case is not [Rosa’s] sex, but rather how he chose to dress when applying for a loan. Because the Act does not prohibit discrimination based on the manner in which someone dresses, Park West’s requirement that Rosa change his clothes does not give rise to claims of illegal discrimination. Further, even if Park West’s statement or action were based upon Rosa’s sexual orientation or perceived sexual orientation, the Act does not prohibit such discrimination.

*Price Waterhouse v. Hopkins* (U.S. Supreme Court, 1988), which Rosa relied on, was not to the contrary, according to the district court, because that case “neither holds, nor even suggests, that discrimination based merely on a person’s attire is impermissible.”

On appeal, Rosa says that the district court “fundamentally misconceived the law as applicable to the Plaintiff’s claim by concluding that there may be no relationship, as a matter of law, between telling a bank customer what to wear and sex discrimination.” ...The Bank says that Rosa loses for two reasons. First, citing cases pertaining to gays and transsexuals, it says that the ECOA does not apply to crossdressers. Second, the Bank says that its employee genuinely could not identify Rosa, which is why she asked him to go home and change.



### III.

...In interpreting the ECOA, this court looks to Title VII case law, that is, to federal employment discrimination law....The Bank itself refers us to Title VII case law to interpret the ECOA.

The ECOA prohibits discrimination, “with respect to any aspect of a credit transaction[,] on the basis of race, color, religion, national origin, sex or marital status, or age.” 15 U.S.C. § 1691(a). Thus to prevail, the alleged discrimination against Rosa must have been “on the basis of...sex.” See [Citation.] The ECOA’s sex discrimination prohibition “protects men as well as women.”

While the district court was correct in saying that the prohibited bases of discrimination under the ECOA do not include style of dress or sexual orientation, that is not the discrimination alleged. It is alleged that the Bank’s actions were taken, in whole or in part, “on the basis of... [the appellant’s] sex.” The Bank, by seeking dismissal under Rule 12(b)(6), subjected itself to rigorous standards. We may affirm dismissal “only if it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations.” [Citations] Whatever facts emerge, and they may turn out to have nothing to do with sex-based discrimination, we cannot say at this point that the plaintiff has no viable theory of sex discrimination consistent with the facts alleged.

The evidence is not yet developed, and thus it is not yet clear why Brunelle told Rosa to go home and change. It may be that this case involves an instance of disparate treatment based on sex in the denial of credit. See [Citation]; (“Disparate treatment’...is the most easily understood type of discrimination. The employer simply treats some people less favorably than others because of their...sex.”); [Citation] (invalidating airline’s policy of weight limitations for female “flight hostesses” but not for similarly situated male “directors of passenger services” as impermissible disparate treatment); [Citation] (invalidating policy that female employees wear uniforms but that similarly situated male employees need wear only business dress as impermissible disparate treatment); [Citation] (invalidating rule requiring abandonment upon marriage of surname that was applied to women, but not to men). It is reasonable to infer that Brunelle told Rosa to go home and change because she thought that Rosa’s attire did not accord with his male gender: in other words, that Rosa did not receive the loan application because he was a man, whereas a similarly situated woman would have received the loan application. That is, the Bank may treat, for credit purposes, a woman who dresses like a man differently than a man who dresses like a woman. If so, the Bank concedes, Rosa may have a claim. Indeed, under *Price Waterhouse*, “stereotyped remarks [including statements about dressing more ‘femininely’] can certainly be evidence that gender played a part.” [Citation.] It is also reasonable to infer, though, that Brunelle

refused to give Rosa the loan application because she thought he was gay, confusing sexual orientation with cross-dressing. If so, Rosa concedes, our precedents dictate that he would have no recourse under the federal Act. See [Citation]. It is reasonable to infer, as well, that Brunelle simply could not ascertain whether the person shown in the identification card photographs was the same person that appeared before her that day. If this were the case, Rosa again would be out of luck. It is reasonable to infer, finally, that Brunelle may have had mixed motives, some of which fall into the prohibited category.

It is too early to say what the facts will show; it is apparent, however, that, under some set of facts within the bounds of the allegations and non-conclusory facts in the complaint, Rosa may be able to prove a claim under the ECOA....

We reverse and remand for further proceedings in accordance with this opinion.

### CASE QUESTIONS

1. Could the bank have denied Mr. Rosa a loan because he was gay?
2. If a woman had applied for loan materials dressed in traditionally masculine attire, could the bank have denied her the materials?
3. The Court offers up at least three possible reasons why Rosa was denied the loan application. What were those possible reasons, and which of them would have been valid reasons to deny him the application?
4. To what federal law does the court look in interpreting the application of the ECOA?
5. Why did the court rule in Mr. Rosa's favor when the facts as to why he was denied the loan application could have been interpreted in several different ways?

### Uses of Credit Reports under the FCRA

Rodgers v. McCullough

296 F.Supp.2d 895 (W.D. Tenn. 2003)

#### Background

This case concerns Defendants' receipt and use of Christine Rodgers' consumer report. The material facts do not seem to be disputed. The parties agree that Ms. Rodgers gave birth to a daughter, Meghan, on May 4, 2001. Meghan's father is

Raymond Anthony. Barbara McCullough, an attorney, represented Mr. Anthony in a child custody suit against Ms. Rodgers in which Mr. Anthony sought to obtain custody and child support from Ms. Rodgers. Ms. McCullough received, reviewed, and used Ms. Rodgers' consumer report in connection with the child custody case.

On September 25, 2001, Ms. McCullough instructed Gloria Christian, her secretary, to obtain Ms. Rodgers' consumer report. Ms. McCullough received the report on September 27 or 28 of 2001. She reviewed the report in preparation for her examination of Ms. Rodgers during a hearing to be held in juvenile court on October 23, 2001. She also used the report during the hearing, including attempting to move the document into evidence and possibly handing it to the presiding judge.

The dispute in this case centers around whether Ms. McCullough obtained and used Ms. Rodgers' consumer report for a purpose permitted under the Fair Credit Reporting Act (the "FCRA"). Plaintiff contends that Ms. McCullough, as well as her law firm, Wilkes, McCullough & Wagner, a partnership, and her partners, Calvin J. McCullough and John C. Wagner, are liable for the unlawful receipt and use of Ms. Rodgers' consumer report in violation 15 U.S.C. §§ 1681 o (negligent failure to comply with the FCRA) and 1681n (willful failure to comply with the FCRA or obtaining a consumer report under false pretenses). Plaintiff has also sued Defendants for the state law tort of unlawful invasion of privacy....

### **Analysis**

Plaintiff has moved for summary judgment on the questions of whether Defendants failed to comply with the FCRA (i.e. whether Defendants had a permissible purpose to obtain Ms. Rodgers' credit report), whether Defendants' alleged failure to comply was willful, and whether Defendants' actions constituted unlawful invasion of privacy. The Court will address the FCRA claims followed by the state law claim for unlawful invasion of privacy.

#### **A. Permissible Purpose under the FCRA**

Pursuant to the FCRA, "A person shall not use or obtain a consumer report for any purpose unless (1) the consumer report is obtained for a purpose for which the consumer report is authorized to be furnished under this section...." [Citation.] Defendants do not dispute that Ms. McCullough obtained and used Ms. Rodgers' consumer report.

[The act] provides a list of permissible purposes for the receipt and use of a consumer report, of which the following subsection is at issue in this case:

[A]ny consumer reporting agency may furnish a consumer report under the following circumstances and no other:...

(3) To a person which it has reason to believe-

(A) intends to use the information in connection with a credit transaction involving the consumer on whom the information is to be furnished and involving the extension of credit to, or review or collection of an account of, the consumer...

[Citation.] Defendants concede that Ms. McCullough's receipt and use of Ms. Rodgers' consumer report does not fall within any of the other permissible purposes enumerated in [the act].

Ms. Rodgers requests summary judgment in her favor on this point, relying on the plain text of the statute, because she was not in arrears on any child support obligation at the time Ms. McCullough requested the consumer report, nor did she owe Ms. McCullough's client any debt. She notes that Mr. Anthony did not have custody of Meghan Rodgers and that an award of child support had not even been set at the time Ms. McCullough obtained her consumer report.

Defendants maintain that Ms. McCullough obtained Ms. Rodgers' consumer report for a permissible purpose, namely to locate Ms. Rodgers' residence and set and collect child support obligations. Defendants argue that 15 U.S.C. § 1681b(a)(3)(A) permits the use of a credit report in connection with "collection of an account" and, therefore, Ms. McCullough was permitted to use Ms. Rodgers' credit report in connection with the collection of child support. Defendants also admit that Ms. McCullough used the credit report to portray Ms. Rodgers as irresponsible, financially unstable, and untruthful about her residence and employment history to the Juvenile Court. Defendants do not allege that these constitute permissible purposes under the FCRA.

The cases Defendants have cited in response to the motion for summary judgment are inapplicable to the present facts. In each case cited by Defendants, the person who obtained a credit report did so in order to collect on an *outstanding* judgment or an *outstanding* debt. *See, e.g.,* [Citation] (finding that collection of a judgment of arrears in child support is a permissible purpose under [the act]; [Citation] (holding that defendant had a permissible purpose for obtaining a consumer report where plaintiff owed an outstanding debt to the company).

However, no such outstanding debt or judgment existed in this case. At the time Ms. McCullough obtained Ms. Rodgers' consumer report, Ms. Rodgers' did not owe

money to either Ms. McCullough or her client, Mr. Anthony. Defendants have provided no evidence showing that Ms. McCullough believed Ms. Rodgers owed money to Mr. Anthony at the time she requested the credit report. Indeed, Mr. Anthony had not even been awarded custody of Meghan Rodgers at the time Ms. McCullough obtained and used the credit report. Ms. McCullough acknowledged each of the facts during her deposition. Moreover, in response to Plaintiff's request for admissions, Ms. McCullough admitted that she did not receive the credit report for the purpose of collecting on an account from Ms. Rodgers.

The evidence before the Court makes clear that Ms. McCullough was actually attempting, on behalf of Mr. Anthony, to secure custody of Meghan Rodgers and obtain a future award of child support payments from Ms. Rodgers by portraying Ms. Rodgers as irresponsible to the court. These are not listed as permissible purposes under [FCRA]. Defendants have offered the Court no reason to depart from the plain language of the statute, which clearly does not permit an individual to obtain a consumer report for the purposes of obtaining child custody and instituting child support payments. Moreover, the fact that the Juvenile Court later awarded custody and child support to Mr. Anthony does not retroactively provide Ms. McCullough with a permissible purpose for obtaining Ms. Rodgers' consumer report. Therefore, the Court GRANTS Plaintiff's motion for partial summary judgment on the question of whether Defendants had a permissible purpose to obtain Ms. Rodgers' credit report.

### **B. Willful Failure to Comply with the FCRA**

Pursuant to [the FCRA], "Any person who willfully fails to comply with any requirement imposed under this subchapter with respect to any consumer is liable to that consumer" for the specified damages.

"To show willful noncompliance with the FCRA, [the plaintiff] must show that [the defendant] 'knowingly and intentionally committed an act in conscious disregard for the rights of others,' but need not show 'malice or evil motive.'" [Citation.] "Under this formulation the defendant must commit the act that violates the Fair Credit Reporting Act with knowledge that he is committing the act and with intent to do so, and he must also be conscious that his act impinges on the rights of others." "The statute's use of the word 'willfully' imports the requirement that the defendant know his or her conduct is unlawful." [Citation.] A defendant can not be held civilly liable under [the act] if he or she obtained the plaintiff's credit report "under what is believed to be a proper purpose under the statute but which a court...later rules to be impermissible legally under [Citation]."

Ms. McCullough is an attorney who signed multiple service contracts with Memphis Consumer Credit Association indicating that the primary purpose for which credit information would be ordered was “to collect judgments.” Ms. McCullough also agreed in these service contracts to comply with the FCRA. Her deposition testimony indicates that she had never previously ordered a consumer report for purposes of calculating child support. This evidence may give rise to an inference that Ms. McCullough was aware that she did not order Ms. Rodgers’ consumer report for a purpose permitted under the FCRA.

Defendants argue in their responsive memorandum that if Ms. McCullough had suspected that she had obtained Ms. Rodgers’ credit report in violation of the FCRA, it is unlikely that she would have attempted to present the report to the Juvenile Court as evidence during the custody hearing for Meghan Rodgers. Ms. McCullough also testified that she believed she had a permissible purpose for obtaining Ms. Rodgers’ consumer report (i.e. to set and collect child support obligations).

Viewing the evidence in the light most favorable to the nonmoving party, Defendants have made a sufficient showing that Ms. McCullough may not have understood that she lacked a permissible purpose under the FCRA to obtain and use Ms. Rodgers’ credit report.

If Ms. McCullough was not aware that her actions might violate the FCRA at the time she obtained and used Ms. Rodgers’ credit report, she would not have willfully failed to comply with the FCRA. The question of Ms. McCullough’s state of mind at the time she obtained and used Ms. Rodgers’ credit report is an issue best left to a jury. [Citation] (“state of mind is typically not a proper issue for resolution on summary judgment”). The Court DENIES Plaintiff’s motion for summary judgment on the question of willfulness under [the act].

### **C. Obtaining a Consumer Report under False Pretenses or Knowingly without a Permissible Purpose**

...For the same reasons the Court denied Plaintiff’s motion for summary judgment on the question of willfulness, the Court also DENIES Plaintiff’s motion for summary judgment on the question of whether Ms. McCullough obtained and used Ms. Rodgers’ credit report under false pretenses or knowingly without a permissible purpose.

[Discussion of the invasion of privacy claim omitted.]

Conclusion

For the foregoing reasons, the Court GRANTS Plaintiff's Motion for Partial Summary Judgment Regarding Defendants' Failure to Comply with the Fair Credit Reporting Act [having no permissible purpose]. The Court DENIES Plaintiff's remaining motions for partial summary judgment.

### CASE QUESTIONS

1. Why did the defendant, McCullough, order her secretary to obtain Ms. Rodgers's credit report? If Ms. McCullough is found liable, why would her law firm partners also be liable?
2. What "permissible purpose" did the defendants contend they had for obtaining the credit report? Why did the court determine that purpose was not permissible?
3. Why did the court deny the plaintiff's motion for summary judgment on the question of whether the defendant "willfully" failed to comply with the act? Is the plaintiff out of luck on that question, or can it be litigated further?

## 27.4 Summary and Exercises

### Summary

Consumers who are granted credit have long received protection through usury laws (laws that establish a maximum interest rate). The rise in consumer debt in recent years has been matched by an increase in federal regulation of consumer credit transactions. The Truth in Lending Act requires disclosure of credit terms; the Equal Credit Opportunity Act prohibits certain types of discrimination in the granting of credit; the Fair Credit Reporting Act gives consumers access to their credit dossiers and prohibits unapproved use of credit-rating information. After entering into a credit transaction, a consumer has certain cancellation rights and may use a procedure prescribed by the Fair Credit Billing Act to correct billing errors. Traditional debt collection practices—garnishment, wage assignments, and confession of judgment clauses—are now subject to federal regulation, as are the practices of collection agencies under the Fair Debt Collection Practices Act.



## EXERCISES

1. Carlene Consumer entered into an agreement with Rent to Buy, Inc., to rent a computer for \$20 per week. The agreement also provided that if Carlene chose to rent the computer for fifty consecutive weeks, she would own it. She then asserted that the agreement was not a lease but a sale on credit subject to the Truth in Lending Act, and that Rent to Buy, Inc., violated the act by failing to state the annual percentage rate. Is Carlene correct?
2. Carlos, a resident of Chicago, was on a road trip to California when he heard a noise under the hood of his car. He took the car to a mechanic for repair. The mechanic overhauled the power steering unit and billed Carlos \$600, which he charged on his credit card. Later that day—Carlos having driven about fifty miles—the car made the same noise, and Carlos took it to another mechanic, who diagnosed the problem as a loose exhaust pipe connection at the manifold. Carlos was billed \$300 for this repair, with which he was satisfied. Carlos returned to Chicago and examined his credit card statement. What rights has he as to the \$600 charge on his card?
3. Ken was the owner of Scrimshaw, a company that manufactured and sold carvings made on fossilized ivory. He applied for a loan from Bank. Bank found him creditworthy, but seeking additional security for repayment, it required his wife, Linda, to sign a guaranty as well. During a subsequent recession, demand for scrimshaw fell, and Ken's business went under. Bank filed suit against both Ken and Linda. What defense has Linda?
4. The FCRA requires that credit-reporting agencies "follow reasonable procedures to assure maximum possible accuracy of the information." In October of 1989, Renie Guimond became aware of, and notified the credit bureau Trans Union about, inaccuracies in her credit report: that she was married (and it listed a Social Security number for this nonexistent spouse), that she was also known as Ruth Guimond, and that she had a Saks Fifth Avenue credit card. About a month later, Trans Union responded to Guimond's letter, stating that the erroneous information had been removed. But in March of 1990, Trans Union again published the erroneous information it purportedly had removed. Guimond then requested the source of the erroneous information, to which Trans Union responded that it could not disclose the identity of the source because it did not know its source. The disputed information was eventually removed from Guimond's file in October 1990. When Guimond sued, Trans Union defended that she had no claim because no credit was denied to her as a result of the inaccuracies in her credit file.

The lower court dismissed her case; she appealed. To what damages, if any, is Guimond entitled?

5. Plaintiff incurred a medical debt of \$160. She received two or three telephone calls from Defendant, the collection agency; each time she denied any money owing. Subsequently she received this letter:

You have shown that you are unwilling to work out a friendly settlement with us to clear the above debt. Our field investigator has now been instructed to make an investigation in your neighborhood and to personally call on your employer.

The immediate payment of the full amount, or a personal visit to this office, will spare you this embarrassment.

The top of the letter notes the creditor's name and the amount of the alleged debt. The letter was signed by a "collection agent." The envelope containing that letter presented a return address that included Defendant's full name: "Collection Accounts Terminal, Inc." What violations of the Fair Debt Collection Practices Act are here presented?

6. Eric and Sharaveen Rush filed a claim alleging violations of the Fair Credit Reporting Act arising out of an allegedly erroneous credit report prepared by a credit bureau from information, in part, from Macy's, the department store. The error causes the Rushes to be denied credit. Macy's filed a motion to dismiss. Is Macy's liable? Discuss.

## SELF-TEST QUESTIONS

1. An example of a loan that is a common exception to usury law is
  - a. a business loan
  - b. a mortgage loan
  - c. an installment loan
  - d. all of the above
  
2. Under the Fair Credit Reporting Act, an applicant denied credit
  - a. has a right to a hearing
  - b. has the right to be told the name and address of the credit bureau that prepared the credit report upon which denial was based
  - c. always must pay a fee for information regarding credit denial
  - d. none of the above
  
3. Garnishment of wages
  - a. is limited by federal law
  - b. involves special rules for support cases
  - c. is a legal process where a creditor obtains a court order directing the debtor's employer to pay a portion of the debtor's wages directly to the creditor
  - d. involves all of the above
  
4. A wage assignment is
  - a. an example of garnishment
  - b. an example of confession of judgment
  - c. an exception to usury law
  - d. an agreement that a creditor may take future wages as security for a loan
  
5. The Truth-in-Truth in Lending Act requires disclosure of
  - a. the annual percentage rate
  - b. the borrower's race

- c. both of the above
- d. neither of the above

### SELF-TEST ANSWERS

1. d
2. b
3. d
4. d
5. a

## Chapter 28

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# Secured Transactions and Suretyship

### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The basic concepts of secured transactions
2. The property subject to the security interest
3. Creation and perfection of the security interest
4. Priorities for claims on the security interest
5. Rights of creditors on default
6. The basic concepts of suretyship
7. The relationship between surety and principal
8. Rights among cosureties

## 28.1 Introduction to Secured Transactions

### LEARNING OBJECTIVES

1. Recognize, most generally, the two methods by which debtors' obligations may be secured.
2. Know the source of law for personal property security.
3. Understand the meaning of *security interest* and other terminology necessary to discuss the issues.
4. Know what property is subject to the security interest.
5. Understand how the security interest is created—"attached"—and perfected.

### The Problem of Security

Creditors want assurances that they will be repaid by the debtor. An oral promise to pay is no security at all, and—as it is oral—it is difficult to prove. A **signature loan**<sup>1</sup> is merely a written promise by the debtor to repay, but the creditor stuck holding a promissory note with a signature loan only—while he may sue a defaulting debtor—will get nothing if the debtor is insolvent. Again, that's no security at all. Real security for the creditor comes in two forms: by agreement with the debtor or by operation of law without an agreement.

### By Agreement with the Debtor

Security obtained through agreement comes in three major types: (1) personal property security (the most common form of security); (2) suretyship—the willingness of a third party to pay if the primarily obligated party does not; and (3) mortgage of real estate.

### By Operation of Law

Security obtained through operation of law is known as a **lien**<sup>2</sup>. Derived from the French for "string" or "tie," a *lien* is the legal hold that a creditor has over the property of another in order to secure payment or discharge an obligation.

1. A loan for which no collateral is pledged.

2. An encumbrance upon property to secure payment.

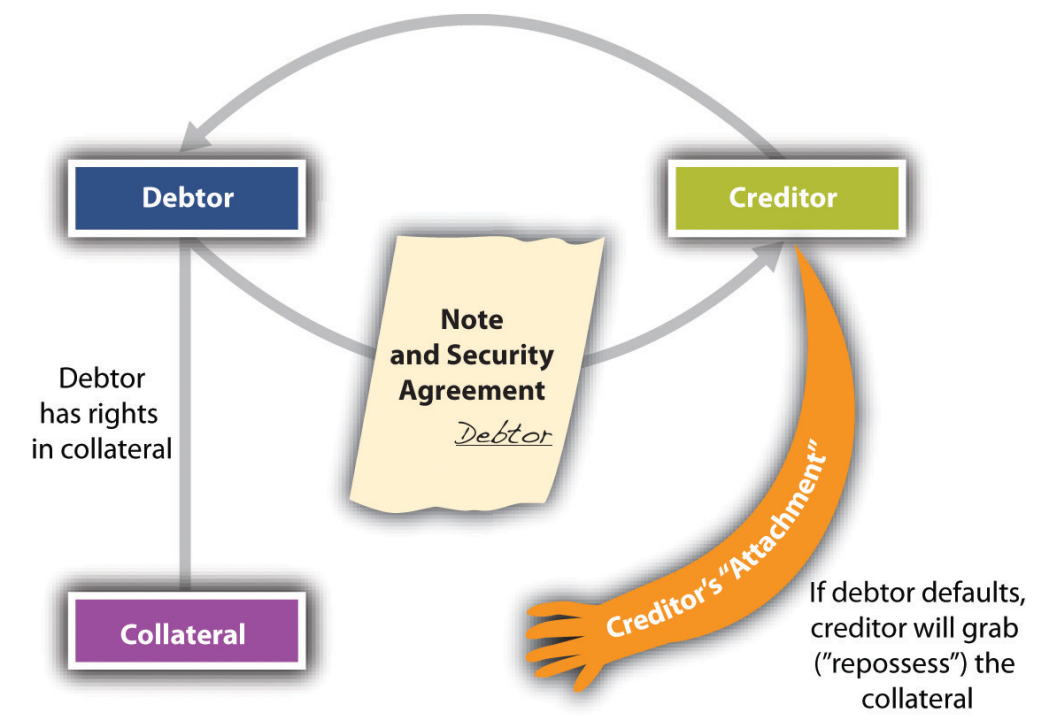
In this chapter, we take up security interests in personal property and suretyship. In the next chapter, we look at mortgages and nonconsensual liens.

## Basics of Secured Transactions

The law of secured transactions consists of five principal components: (1) the nature of property that can be the subject of a security interest; (2) the methods of creating the security interest; (3) the perfection of the security interest against claims of others; (4) priorities among secured and unsecured creditors—that is, who will be entitled to the secured property if more than one person asserts a legal right to it; and (5) the rights of creditors when the debtor defaults. After considering the source of the law and some key terminology, we examine each of these components in turn.

Here is the simplest (and most common) scenario: Debtor borrows money or obtains credit from Creditor, signs a note and security agreement putting up collateral, and promises to pay the debt or, upon Debtor's default, let Creditor (secured party) take possession of (repossess) the collateral and sell it. Figure 28.1 "The Grasping Hand" illustrates this scenario—the grasping *hand* is Creditor's reach for the collateral, but the hand will not close around the collateral and take it (repossess) unless Debtor defaults.

Figure 28.1 *The Grasping Hand*



## Source of Law and Definitions

### Source of Law

Article 9 of the Uniform Commercial Code (UCC) governs security interests in personal property. The UCC defines the scope of the article (here slightly truncated): Uniform Commercial Code, Section 9-109.

This chapter applies to the following:

1. A transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract;
2. An agricultural lien;
3. A sale of accounts, chattel paper, payment intangibles, or promissory notes;
4. A consignment...

### Definitions

As always, it is necessary to review some definitions so that communication on the topic at hand is possible. The secured transaction always involves a debtor, a secured party, a security agreement, a security interest, and collateral.

Article 9 applies to any transaction “that creates a security interest.” The UCC in Section 1-201(35) defines **security interest**<sup>3</sup> as “an interest in personal property or fixtures which secures payment or performance of an obligation.”

**Security agreement**<sup>4</sup> is “an agreement that creates or provides for a security interest.” It is the contract that sets up the debtor’s duties and the creditor’s rights in event the debtor defaults. Uniform Commercial Code, Section 9-102(a)(73).

3. Right in personal property to secure payment or performance of an obligation.

4. Agreement that grants a security interest.

5. Property given as security for a debt.

6. The security interest held by the seller of collateral to secure payment of all or part of the price.

**Collateral**<sup>5</sup> “means the property subject to a security interest or agricultural lien.” Uniform Commercial Code, Section 9-102(12).

**Purchase-money security interest**<sup>6</sup> (PMSI) is the simplest form of security interest. Section 9-103(a) of the UCC defines “purchase-money collateral” as “goods or software that secures a purchase-money obligation with respect to that collateral.” A PMSI arises where the debtor gets credit to buy goods and the creditor takes a secured interest in those goods. Suppose you want to buy a big hardbound textbook on credit at your college bookstore. The manager refuses to extend you credit outright but says she will take back a PMSI. In other words, she will retain a security interest in the book itself, and if you don’t pay, you’ll have to return the



book; it will be repossessed. Contrast this situation with a counteroffer you might make: because she tells you not to mark up the book (in the event that she has to repossess it if you default), you would rather give her some other collateral to hold—for example, your gold college signet ring. Her security interest in the ring is not a PMSI but a pledge; a PMSI must be an interest in the particular goods purchased. A PMSI would also be created if you borrowed money to buy the book and gave the lender a security interest in the book.

Whether a transaction is a lease or a PMSI is an issue that frequently arises. The answer depends on the facts of each case. However, a security interest is created if (1) the lessee is obligated to continue payments for the term of the lease; (2) the lessee cannot terminate the obligation; and (3) one of several economic tests, which are listed in UCC Section 1-201 (37), is met. For example, one of the economic tests is that “the lessee has an option to become owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.”

The issue of lease versus security interest gets litigated because of the requirements of Article 9 that a security interest be perfected in certain ways (as we will see). If the transaction turns out to be a security interest, a lessor who fails to meet these requirements runs the risk of losing his property to a third party. And consider this example. Ferrous Brothers Iron Works “leases” a \$25,000 punch press to Millie’s Machine Shop. Under the terms of the lease, Millie’s must pay a yearly rental of \$5,000 for five years, after which time Millie’s may take title to the machine outright for the payment of \$1. During the period of the rental, title remains in Ferrous Brothers. Is this “lease” really a security interest? Since ownership comes at nominal charge when the entire lease is satisfied, the transaction would be construed as one creating a security interest. What difference does this make? Suppose Millie’s goes bankrupt in the third year of the lease, and the trustee in bankruptcy wishes to sell the punch press to satisfy debts of the machine shop. If it were a true lease, Ferrous Brothers would be entitled to reclaim the machine (unless the trustee assumed the lease). But if the lease is really intended as a device to create a security interest, then Ferrous Brothers can recover its collateral only if it has otherwise complied with the obligations of Article 9—for example, by recording its security interest, as we will see.

Now we return to definitions.

**Debtor**<sup>7</sup> is “a person (1) having an interest in the collateral other than a security interest or a lien; (2) a seller of accounts, chattel paper, payment intangibles, or promissory notes; or (3) a consignee.” Uniform Commercial Code, Section 9-102(a)(28).

7. One who owes money or a duty of performance to another.

**Obligor**<sup>8</sup> is “a person that, with respect to an obligation secured by a security interest in or an agricultural lien on the collateral, (i) owes payment or other performance of the obligation, (ii) has provided property other than the collateral to secure payment or other performance of the obligation, or (iii) is otherwise accountable in whole or in part for payment or other performance of the obligation.” Uniform Commercial Code, Section 9-102 (59). Here is example 1 from the Official Comment to UCC Section 9-102: “Behnfeltdt borrows money and grants a security interest in her Miata to secure the debt. Behnfeltdt is a debtor and an obligor.”

Behnfeltdt is a debtor because she has an interest in the car—she owns it. She is an obligor because she owes payment to the creditor. Usually the debtor is the obligor.

A *secondary obligor* is “an obligor to the extent that: (A) [the] obligation is secondary; or (b) [the person] has a right of recourse with respect to an obligation secured by collateral against the debtor, another obligor, or property of either.” Uniform Commercial Code, Section 9-102(a)(71). The secondary obligor is a guarantor (surety) of the debt, obligated to perform if the primary obligor defaults. Consider example 2 from the Official Comment to Section 9-102: “Behnfeltdt borrows money and grants a security interest in her Miata to secure the debt. Bruno cosigns a negotiable note as maker. As before, Behnfeltdt is the debtor and an obligor. As an accommodation party, Bruno is a secondary obligor. Bruno has this status even if the note states that her obligation is a primary obligation and that she waives all suretyship defenses.”

Again, usually the debtor is the obligor, but consider example 3 from the same Official Comment: “Behnfeltdt borrows money on an unsecured basis. Bruno cosigns the note and grants a security interest in her Honda to secure her [Behnfeltdt’s] obligation. Inasmuch as Behnfeltdt does not have a property interest in the Honda, Behnfeltdt is not a debtor. Having granted the security interest, Bruno is the debtor. Because Behnfeltdt is a principal obligor, she is not a secondary obligor. Whatever the outcome of enforcement of the security interest against the Honda or Bruno’s secondary obligation, Bruno will look to Behnfeltdt for her losses. The enforcement will not affect Behnfeltdt’s aggregate obligations.”

8. One who owes an obligation.

9. The creditor who has a security interest in a debtor’s collateral.

10. A security device by which a mortgagee takes security interest in personal property of the mortgagor; mostly superseded by other security arrangements under UCC Article 9.

**Secured party**<sup>9</sup> is “a person in whose favor a security interest is created or provided for under a security agreement,” and it includes people to whom accounts, chattel paper, payment intangibles, or promissory notes have been sold; consignors; and others under Section 9-102(a)(72).

**Chattel mortgage**<sup>10</sup> means “a debt secured against items of personal property rather than against land, buildings and fixtures.” Commercial Brokers, Inc.,

“Glossary of Real Estate Terms,” <http://www.cbire.com/index.cfm/fuseaction/terms.list/letter/C/contentid/32302EC3-81D5-47DF-A9CBA32FAE38B22A>.

## **Property Subject to the Security Interest**

Now we examine what property may be put up as security—collateral. Collateral is—again—property that is subject to the security interest. It can be divided into four broad categories: goods, intangible property, indispensable paper, and other types of collateral.

### **Goods**

Tangible property as collateral is goods. *Goods* means “all things that are movable when a security interest attaches. The term includes (i) fixtures, (ii) standing timber that is to be cut and removed under a conveyance or contract for sale, (iii) the unborn young of animals, (iv) crops grown, growing, or to be grown, even if the crops are produced on trees, vines, or bushes, and (v) manufactured homes. The term also includes a computer program embedded in goods.”Uniform Commercial Code, Section 9-102(44). Goods are divided into several subcategories; six are taken up here.

### **Consumer Goods**

These are “goods used or bought primarily for personal, family, or household purposes.”Uniform Commercial Code, Section 9-102(a)(48).

### **Inventory**

“Goods, other than farm products, held by a person for sale or lease or consisting of raw materials, works in progress, or material consumed in a business.”Uniform Commercial Code, Section 9-102(a)(48).

### **Farm Products**

“Crops, livestock, or other supplies produced or used in farming operations,” including aquatic goods produced in aquaculture.Uniform Commercial Code, Section 9-102(a)(34).

### **Equipment**

This is the residual category, defined as “goods other than inventory, farm products, or consumer goods.”Uniform Commercial Code, Section 9-102(a)(33).

### **Fixtures**

These are “goods that have become so related to particular real property that an interest in them arises under real property law.” Uniform Commercial Code, Section 9-102(a)(41). Examples would be windows, furnaces, central air conditioning, and plumbing fixtures—items that, if removed, would be a cause for significant reconstruction.

### **Accession**

These are “goods that are physically united with other goods in such a manner that the identity of the original goods is lost.” Uniform Commercial Code, Section 9-102(a)(1). A new engine installed in an old automobile is an accession.

### **Intangible Property**

Two types of collateral are neither goods nor indispensable paper: accounts and general intangibles.

#### **Accounts**

This type of intangible property includes accounts receivable (the right to payment of money), insurance policy proceeds, energy provided or to be provided, winnings in a lottery, health-care-insurance receivables, promissory notes, securities, letters of credit, and interests in business entities. Uniform Commercial Code, Section 9-102(a)(2). Often there is something in writing to show the existence of the right—such as a right to receive the proceeds of somebody else’s insurance payout—but the writing is merely evidence of the right. The paper itself doesn’t have to be delivered for the transfer of the right to be effective; that’s done by assignment.

#### **General Intangibles**

General intangibles refers to “any personal property, including things in action, other than accounts, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction.” General intangibles include payment intangibles and software. Uniform Commercial Code, Section 9-102(42).

### **Indispensable Paper**

This oddly named category is the middle ground between goods—stuff you can touch—and intangible property. It’s called “indispensable” because although the right to the value—such as a warehouse receipt—is embodied in a written paper, the paper itself is indispensable for the transferee to access the value. For example, suppose Deborah Debtor borrows \$3,000 from Carl Creditor, and Carl takes a security interest in four designer chairs Deborah owns that are being stored in a warehouse. If Deborah defaults, Carl has the right to possession of the warehouse receipt: he takes it to the warehouse and is entitled to take the chairs and sell them to satisfy the obligation. The warehouse will not let Carl have the chairs without the warehouse receipt—it’s indispensable paper. There are four kinds of indispensable paper.

### **Chattel Paper**

*Chattel* is another word for goods. Chattel paper is a record (paper or electronic) that demonstrates both “a monetary obligation and a security interest either in certain goods or in a lease on certain goods.” Uniform Commercial Code, Section 9-102(11). The paper represents a valuable asset and can itself be used as collateral. For example, Creditor Car Company sells David Debtor an automobile and takes back a note and security agreement (this is a purchase-money security agreement; the note and security agreement is chattel paper). The chattel paper is not yet collateral; the automobile is. Now, though, Creditor Car Company buys a new hydraulic lift from Lift Co., and grants Lift Co. a security interest in Debtor’s chattel paper to secure Creditor Car’s debt to Lift Co. The chattel paper is now collateral. Chattel paper can be tangible (actual paper) or electronic.

### **Documents**

This category includes documents of title—bills of lading and warehouse receipts are examples.

### **Instruments**

An “instrument” here is “a negotiable instrument (checks, drafts, notes, certificates of deposit) or any other writing that evidences a right to the payment of a monetary obligation, is not itself a security agreement or lease, and is of a type that in the ordinary course of business is transferred by delivery with any necessary indorsement or assignment.” “Instrument” does not include (i) investment property, (ii) letters of credit, or (iii) writings that evidence a right to payment arising out of the use of a credit or charge card or information contained on or for use with the card. Uniform Commercial Code, Section 9-102(a)(47).

### Investment Property

This includes securities (stock, bonds), security accounts, commodity accounts, and commodity contracts. Uniform Commercial Code, Section 9-102(a)(49). Securities may be certified (represented by a certificate) or uncertified (not represented by a certificate). Uniform Commercial Code, Section 8-102(a)(4) and (a)(18).

### Other Types of Collateral

Among possible other types of collateral that may be used as security is the **floating lien**<sup>11</sup>. This is a security interest in property that was not in the possession of the debtor when the security agreement was executed. The floating lien creates an interest that floats on the river of present and future collateral and proceeds held by—most often—the business debtor. It is especially useful in loans to businesses that sell their collateralized inventory. Without the floating lien, the lender would find its collateral steadily depleted as the borrowing business sells its products to its customers. Pretty soon, there'd be no security at all. The floating lien includes the following:

- *After-acquired property*. This is property that the debtor acquires after the original deal was set up. It allows the secured party to enhance his security as the debtor (obligor) acquires more property subject to collateralization.
- *Sale proceeds*. These are proceeds from the disposition of the collateral. Carl Creditor takes a secured interest in Deborah Debtor's sailboat. She sells the boat and buys a garden tractor. The secured interest attaches to the garden tractor.
- *Future advances*. Here the security agreement calls for the collateral to stand for both present and future advances of credit without any additional paperwork.

Here are examples of future advances:

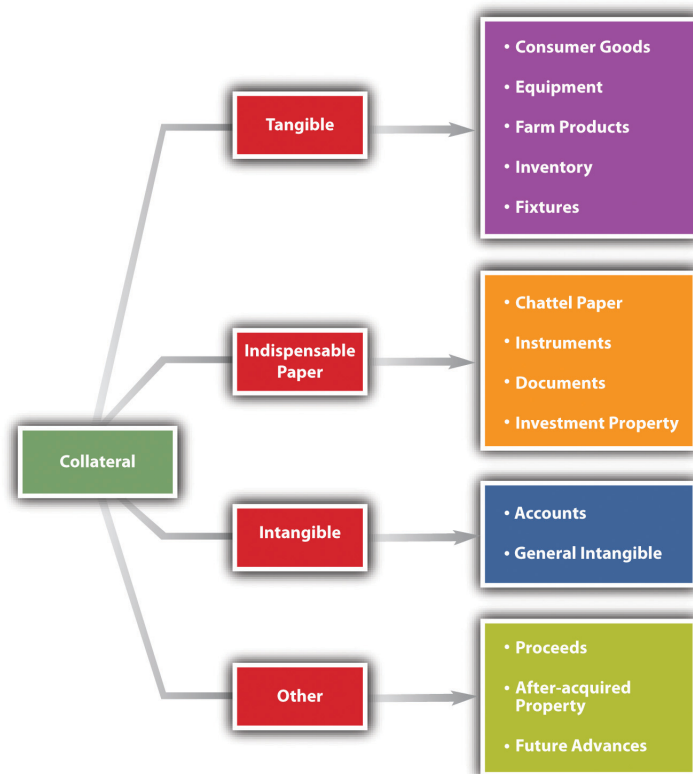
- Example 1: A debtor enters into a security agreement with a creditor that contains a future advances clause. The agreement gives the creditor a security interest in a \$700,000 inventory-picking robot to secure repayment of a loan made to the debtor. The parties contemplate that the debtor will, from time to time, borrow more money, and when the debtor does, the machine will stand as collateral to secure the further indebtedness, without new paperwork.
- Example 2: A debtor signs a security agreement with a bank to buy a car. The security agreement contains a future advances clause. A

11. A lien that is expanded to cover any additional property that is acquired by the debtor while the debt is outstanding.

few years later, the bank sends the debtor a credit card. Two years go by: the car is paid for, but the credit card is in default. The bank seizes the car. “Whoa!” says the debtor. “I paid for the car.” “Yes,” says the bank, “but it was collateral for all future indebtedness you ran up with us. Check out your loan agreement with us and UCC Section 9-204(c), especially Comment 5.”

See [Figure 28.2 "Tangibles and Intangibles as Collateral"](#).

Figure 28.2 Tangibles and Intangibles as Collateral



### Attachment of the Security Interest In General

**Attachment**<sup>12</sup> is the term used to describe when a security interest becomes enforceable against the debtor with respect to the collateral. In [Figure 28.1 "The Grasping Hand"](#), "Attachment" is the outreached hand that is prepared, if the debtor defaults, to grasp the collateral. Uniform Commercial Code, Section 9-203(a).

12. The process by which a security interest becomes enforceable against the debtor with respect to the collateral.

### **Requirements for Attachment**

There are three requirements for attachment: (1) the secured party gives value; (2) the debtor has rights in the collateral or the power to transfer rights in it to the secured party; (3) the parties have a security agreement “authenticated” (signed) by the debtor, or the creditor has possession of the collateral.

### **Creditor Gives Value**

The creditor, or secured party, must give “value” for the security interest to attach. The UCC, in Section 1-204, provides that

a person gives ‘value’ for rights if he acquires them

(1) in return for a binding commitment to extend credit or for the extension of immediately available credit whether or not drawn upon and whether or not a charge-back is provided for in the event of difficulties in collection; or

(2) as security for or in total or partial satisfaction of a pre-existing claim; or

(3) by accepting delivery pursuant to a pre-existing contract for purchase; or

(4) generally, in return for any consideration sufficient to support a simple contract.

Suppose Deborah owes Carl \$3,000. She cannot repay the sum when due, so she agrees to give Carl a security interest in her automobile to the extent of \$3,000 in return for an extension of the time to pay. That is sufficient value.

### **Debtor’s Rights in Collateral**

The debtor must have rights in the collateral. Most commonly, the debtor owns the collateral (or has some ownership interest in it). The rights need not necessarily be the immediate right to possession, but they must be rights that can be conveyed. Uniform Commercial Code, Section 9-203(b)(2). A person can’t put up as collateral property she doesn’t own.



### Security Agreement (Contract) or Possession of Collateral by Creditor

The debtor most often signs the written security agreement, or contract. The UCC says that “the debtor [must have] authenticated a security agreement that provides a description of the collateral....” “Authenticating” (or “signing,” “adopting,” or “accepting”) means to sign or, in recognition of electronic commercial transactions, “to execute or otherwise adopt a symbol, or encrypt or similarly process a record...with the present intent of the authenticating person to identify the person and adopt or accept a record.” The “record” is the modern UCC’s substitution for the term “writing.” It includes information electronically stored or on paper. Uniform Commercial Code, Section 9-102, Official Comment 9. Here is a free example of a security agreement online: Docstoc, “Free Business Templates—Sample Open-Ended Security Agreement,” <http://www.docstoc.com/docs/271920/Free-Business-Templates—Sample-Open-Ended-Security-Agreement>.

The “authenticating record” (the signed security agreement) is *not* required in some cases. It is not required if the debtor makes a **pledge**<sup>13</sup> of the collateral—that is, delivers it to the creditor for the creditor to possess. For example, upon a creditor’s request of a debtor for collateral to secure a loan of \$3,000, the debtor offers up his stamp collection. The creditor says, “Fine, have it appraised (at your expense) and show me the appraisal. If it comes in at \$3,000 or more, I’ll take your stamp collection and lock it in my safe until you’ve repaid me. If you don’t repay me, I’ll sell it.” A creditor could take possession of any goods and various kinds of paper, tangible or intangible. In commercial transactions, it would be common for the creditor to have possession of—actually or virtually—certified securities, deposit accounts, electronic chattel paper, investment property, or other such paper or electronic evidence of value. Uniform Commercial Code, Section 9-203(b)(3)(B-D).

Again, [Figure 28.1 "The Grasping Hand"](#) diagrams the attachment, showing the necessary elements: the creditor gives value, the debtor has rights in collateral, and there is a security agreement signed (authenticated) by the debtor. If the debtor defaults, the creditor’s “hand” will grab (repossess) the collateral.

### Perfection of the Security Interest

As between the debtor and the creditor, attachment is fine: if the debtor defaults, the creditor will repossess the goods and—usually—sell them to satisfy the outstanding obligation. But unless an additional set of steps is taken, the rights of the secured party might be subordinated to the rights of other secured parties, certain lien creditors, bankruptcy trustees, and buyers who give value and who do not know of the security interest. **Perfection**<sup>14</sup> is the secured party’s way of announcing the security interest to the rest of the world. It is the secured party’s claim on the collateral.

13. The delivery of goods to a creditor as security for the debt.

14. The process by which a secured party announces to the world her secured interest in particular goods.

There are five ways a creditor may perfect a security interest: (1) by filing a financing statement, (2) by taking or retaining possession of the collateral, (3) by taking control of the collateral, (4) by taking control temporarily as specified by the UCC, or (5) by taking control automatically.

### Perfection by Filing

“Except as otherwise provided...a financing statement must be filed to perfect all security agreements.”Uniform Commercial Code, Section 9-310(a).

### The Financing Statement

A **financing statement**<sup>15</sup> is a simple notice showing the creditor’s general interest in the collateral. It is what’s filed to establish the creditor’s “dibs.”

### Contents of the Financing Statement

It may consist of the security agreement itself, as long as it contains the information required by the UCC, but most commonly it is much less detailed than the security agreement: it “indicates merely that a person may have a security interest in the collateral[.]...Further inquiry from the parties concerned will be necessary to disclose the full state of affairs.”Uniform Commercial Code, Section 9-502, Official Comment 2. The financing statement must provide the following information:

- The debtor’s name. Financing statements are indexed under the debtor’s name, so getting that correct is important. Section 9-503 of the UCC describes what is meant by “name of debtor.”
- The secured party’s name.
- An “indication” of what collateral is covered by the financing statement.Uniform Commercial Code, Section 9-502(a). It may describe the collateral or it may “indicate that the financing statement covers all assets or all personal property” (such generic references are not acceptable in the security agreement but are OK in the financing statement).Uniform Commercial Code, Section 9-504. If the collateral is real-property-related, covering timber to be cut or fixtures, it must include a description of the real property to which the collateral is related.Uniform Commercial Code, Section 9-502(b).

15. Filing of a notice in the appropriate state office to perfect a security interest.

The form of the financing statement may vary from state to state, but see [Figure 28.3 "UCC-1 Financing Statement"](#) for a typical financing statement. Minor errors or omissions on the form will not make it ineffective, but the debtor’s signature is

required unless the creditor is authorized by the debtor to make the filing without a signature, which facilitates paperless filing. Uniform Commercial Code, Section 9-506; Uniform Commercial Code, Section, 9-502, Comment 3.

Figure 28.3 UCC-1 Financing Statement

This UCC-1 FINANCING STATEMENT is presented for filing pursuant to the WASHINGTON UNIFORM COMMERCIAL CODE, chapter 62A.9 RCW, to perfect a security interest in the below named collateral.

**PLEASE TYPE FORM** Filing fee: \$12.00.

1. DEBTOR(S) (see instruction #2)  
 PERSONAL (see instruction #2) (name, middle name and address)  
 BUSINESS (legal business name and address)

2. FOR OFFICE USE ONLY - DO NOT WRITE IN THIS BOX

TRADE NAME, DBA, AKA:

3. SECURED PARTY(IES) (name and address)

4. ASSIGNEE(S) OF SECURED PARTY(IES) if applicable (name and address)

5. SECURED PARTY CONTACT PERSON: \_\_\_\_\_ Phone: \_\_\_\_\_

6. CHECK ONLY IF APPLICABLE: (For definitions of TRANSMITTING UTILITY AND PRODUCTS OF COLLATERAL, see instruction sheet.)  
 Debtor is a Transmitting Utility  Products of Collateral are also covered

7. THIS FINANCING STATEMENT covers the following collateral: (Attach additional 8-1/2"x 11" sheet(s) if needed)

8. RETURN ACKNOWLEDGEMENT COPY TO: (name and address)

9. FILE WITH:  
 UNIFORM COMMERCIAL CODE  
 DEPARTMENT OF LICENSING  
 P.O. BOX 9660  
 OLYMPIA, WA 98507-9660  
 (206) 753-2523

MAKE CHECKS PAYABLE TO THE DEPARTMENT OF LICENSING

10. FOR OFFICE USE ONLY - IMAGES TO BE FILMED

11. If collateral is described below, this statement may be signed by the Secured Party instead of the Debtor. Please check the appropriate box, complete the adjacent lines and Item 13. If collateral is:  
 a.  already subject to a security interest in another jurisdiction when it was brought into this state or when the debtor's location was changed to this state. (complete adjacent lines 1 and 2)  
 b.  proceeds of the original collateral described above in which a security interest was perfected. (complete adjacent lines 1 and 2)  
 c.  listed on a filing which has lapsed. (complete adjacent lines 1 and 2)  
 d.  acquired after a change of name, identity, or corporate structure of the debtor(s). (complete adjacent lines 1, 2 and 3)

12. DEBTOR NAME(S) AND SIGNATURE(S):  
 TYPE NAME(S) OF DEBTOR(S) AS IT APPEARS IN BOX 1.  
 SIGNATURE(S) OF DEBTOR(S)  
 SIGNATURE(S) OF DEBTOR(S)

13. SECURED PARTY NAME(S) AND SIGNATURE(S) ARE REQUIRED IF BOX 11 HAS BEEN COMPLETED.  
 TYPE NAME(S) OF SECURED PARTY(IES) AS IT APPEARS IN BOX 3 OR 4.  
 SIGNATURE(S) OF SECURED PARTY(IES)  
 SIGNATURE(S) OF SECURED PARTY(IES)

FORM APPROVED FOR USE IN THE STATE OF WASHINGTON (8/7/93)  
 (WASHINGTON UCC-1)  
 COPY 1 - FILING OFFICER-INDEX

### Duration of the Financing Statement

Generally, the financing statement is effective for five years; a **continuation statement**<sup>16</sup> may be filed within six months before the five-year expiration date, and it is good for another five years. Uniform Commercial Code, Section 9-515. Manufactured-home filings are good for thirty years. When the debtor's obligation is satisfied, the secured party files a **termination statement**<sup>17</sup> if the collateral was consumer goods; otherwise—upon demand—the secured party sends the debtor a termination statement. Uniform Commercial Code, Section 9-513.

### Debtor Moves out of State

The UCC also has rules for continued perfection of security interests when the debtor—whether an individual or an association (corporation)—moves from one state to another. Generally, an interest remains perfected until the earlier of when

- 16. An amendment of a financing statement that identifies, by its file number, the initial financing statement to which it relates and that indicates that it is a continuation statement for, or that it is filed to continue the effectiveness of, the identified financing statement.
- 17. The notice from a creditor that the debtor's obligations are discharged.

the perfection would have expired or for four months after the debtor moves to a new jurisdiction. Uniform Commercial Code, Section 9-316.

### **Where to File the Financing Statement**

For most real-estate-related filings—ore to be extracted from mines, agricultural collateral, and fixtures—the place to file is with the local office that files mortgages, typically the county auditor’s office. Uniform Commercial Code, Section 9-501. For other collateral, the filing place is as duly authorized by the state. In some states, that is the office of the Secretary of State; in others, it is the Department of Licensing; or it might be a private party that maintains the state’s filing system. Uniform Commercial Code, Section 9-501(a)(2). The filing should be made in the state where the debtor has his or her primary residence for individuals, and in the state where the debtor is organized if it is a registered organization. Uniform Commercial Code, Section 9-307(b). The point is, creditors need to know where to look to see if the collateral offered up is already encumbered. In any event, filing the statement in more than one place can’t hurt. The filing office will provide instructions on how to file; these are available online, and electronic filing is usually available for at least some types of collateral.

### **Exemptions**

Some transactions are exempt from the filing provision. The most important category of exempt collateral is that covered by state certificate of title laws. For example, many states require automobile owners to obtain a certificate of title from the state motor vehicle office. Most of these states provide that it is not necessary to file a financing statement in order to perfect a security interest in an automobile. The reason is that the motor vehicle regulations require any security interests to be stated on the title, so that anyone attempting to buy a car in which a security interest had been created would be on notice when he took the actual title certificate. Uniform Commercial Code, Section 9-303.

### **Temporary Perfection**

The UCC provides that certain types of collateral are automatically perfected but only for a while: “A security interest in certificated securities, or negotiable documents, or instruments is perfected without filing or the taking of possession for a period of twenty days from the time it attaches to the extent that it arises for new value given under an authenticated security agreement.” Uniform Commercial Code, Section 9-312(e). Similar temporary perfection covers negotiable documents or goods in possession of a bailee, and when a security certificate or instrument is delivered to the debtor for sale, exchange, presentation, collection, enforcement, renewal, or registration. Uniform Commercial Code, Section 9-312(f) and (g). After

the twenty-day period, perfection would have to be by one of the other methods mentioned here.

### Perfection by Possession

A secured party may perfect the security interest by possession where the collateral is negotiable documents, goods, instruments, money, tangible chattel paper, or certified securities. Uniform Commercial Code, Section 9-313. This is a pledge of assets (mentioned in the example of the stamp collection). No security agreement is required for perfection by possession.

A variation on the theme of pledge is **field warehousing**<sup>18</sup>. When the pawnbroker lends money, he takes possession of the goods—the watch, the ring, the camera. But when large manufacturing concerns wish to borrow against their inventory, taking physical possession is not necessarily so easy. The bank does not wish to have shipped to its Wall Street office several tons of copper mined in Colorado. Bank employees perhaps could go west to the mine and take physical control of the copper, but banks are unlikely to employ people and equipment necessary to build a warehouse on the spot. Thus this so-called field pledge is rare.

More common is the field warehouse. The field warehouse can take one of two forms. An independent company can go to the site and put up a temporary structure—for example, a fence around the copper—thus establishing physical control of the collateral. Or the independent company can lease the warehouse facilities of the debtor and post signs indicating that the goods inside are within its sale custody. Either way, the goods are within the physical possession of the field warehouse service. The field warehouse then segregates the goods secured to the particular bank or finance company and issues a warehouse receipt to the lender for those goods. The lender is thus assured of a security interest in the collateral.

### Perfection by Control

“A security interest in investment property, deposit accounts, letter-of-credit rights, or electronic chattel paper may be perfected by control of the collateral.” Uniform Commercial Code, Section 9-314. “Control” depends on what the collateral is. If it’s a checking account, for example, the bank with which the deposit account is maintained has “control”: the bank gets a security interest automatically because, as Official Comment 3 to UCC Section 9-104 puts it, “all actual and potential creditors of the debtor are always on notice that the bank with which the debtor’s deposit account is maintained may assert a claim against the deposit account.” “Control” of electronic chattel paper of investment property, and of letter-of-credit rights is detailed in Sections 9-105, 9-106, and 9-107. Obtaining

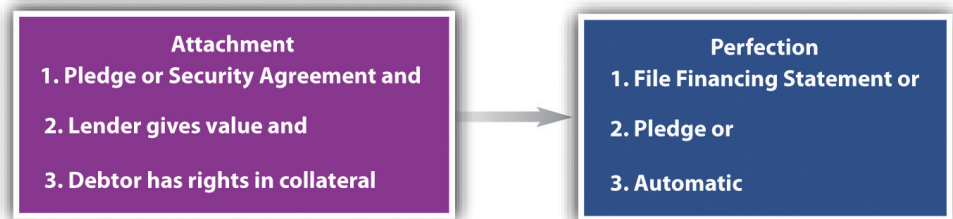
18. Mortgage arrangement in which a lender secures its loan with a lien on items stored in a warehouse or at the debtor’s place of business, with access to the items controlled by the lender, who releases goods as they are paid for by the borrower.

“control” means that the creditor has taken whatever steps are necessary, given the manner in which the items are held, to place itself in a position where it can have the items sold, without further action by the owner. Uniform Commercial Code, Section 8-106, Official Comment 1.

### Automatic Perfection

The fifth mechanism of perfection is addressed in Section 9-309 of the UCC: there are several circumstances where a security interest is perfected upon mere attachment. The most important here is **automatic perfection**<sup>19</sup> of a purchase-money security interest given in consumer goods. If a seller of consumer goods takes a PMSI in the goods sold, then perfection of the security interest is automatic. But the seller may file a financing statement and faces a risk if he fails to file and the consumer debtor sells the goods. Under Section 9-320(b), a buyer of consumer goods takes free of a security interest, even though perfected, if he buys without knowledge of the interest, pays value, and uses the goods for his personal, family, or household purposes—unless the secured party had first filed a financing statement covering the goods.

Figure 28.4 Attachment and Perfection



19. Perfection by mere attachment.

### KEY TAKEAWAY

A creditor may be secured—allowed to take the debtor’s property upon debtor’s default—by agreement between the parties or by operation of law. The law governing agreements for personal property security is Article 9 of the UCC. The creditor’s first step is to attach the security interest. This is usually accomplished when the debtor, in return for value (a loan or credit) extended from the creditor, puts up as collateral some valuable asset in which she has an interest and authenticates (signs) a security agreement (the contract) giving the creditor a security interest in collateral and allowing that the creditor may take it if the debtor defaults. The UCC lists various kinds of assets that can be collateralized, ranging from tangible property (goods), to assets only able to be manifested by paper (indispensable paper), to intangible assets (like patent rights). Sometimes no security agreement is necessary, mostly if the creditor takes possession of the collateral. After attachment, the prudent creditor will want to perfect the security interest to make sure no other creditors claim an interest in the collateral. Perfection is most often accomplished by filing a financing statement in the appropriate place to put the world on notice of the creditor’s interest. Perfection can also be achieved by a pledge (possession by the secured creditor) or by “control” of certain assets (having such control over them as to be able to sell them if the debtor defaults). Perfection is automatic temporarily for some items (certified securities, instruments, and negotiable documents) but also upon mere attachment to purchase-money security interests in consumer goods.

## EXERCISES

1. Why is a creditor ill-advised to be unsecured?
2. Elaine bought a computer for her use as a high school teacher, the school contributing one-third of its cost. Elaine was compelled to file for bankruptcy. The computer store claimed it had perfected its interest by mere attachment, and the bankruptcy trustee claimed the computer as an asset of Elaine's bankruptcy estate. Who wins, and why?
3. What is the general rule governing where financing statements should be filed?
4. If the purpose of perfection is to alert the world to the creditor's claim in the collateral, why is perfection accomplishable by possession alone in some cases?
5. Contractor pawned a power tool and got a \$200 loan from Pawnbroker. Has there been a perfection of a security interest?



## 28.2 Priorities

### LEARNING OBJECTIVES

1. Understand the general rule regarding who gets priority among competing secured parties.
2. Know the immediate exceptions to the general rule—all involving PMSIs.
3. Understand the basic ideas behind the other exceptions to the general rule.

**Priorities:** this is the money question. Who gets what when a debtor defaults? Depending on how the priorities in the collateral were established, even a secured creditor may walk away with the collateral or with nothing. Here we take up the general rule and the exceptions.

### General Rule

The general rule regarding priorities is, to use a quotation attributed to a Southern Civil War general, the one who wins “gets there firstest with the mostest.” The first to do the best job of perfecting wins. The Uniform Commercial Code (UCC) creates a race of diligence among competitors.

### Application of the Rule

If both parties have perfected, the first to perfect wins. If one has perfected and one attached, the perfected party wins. If both have attached without perfection, the first to attach wins. If neither has attached, they are unsecured creditors. Let’s test this general rule against the following situations:

1. Rosemary, without having yet lent money, files a financing statement on February 1 covering certain collateral owned by Susan—Susan’s fur coat. Under UCC Article 9, a filing may be made before the security interest attaches. On March 1, Erika files a similar statement, also without having lent any money. On April 1, Erika loans Susan \$1,000, the loan being secured by the fur coat described in the statement she filed on March 1. On May 1, Rosemary also loans Susan \$1,000, with the same fur coat as security. Who has priority? Rosemary does, since she filed first, even though Erika actually first extended the loan, which was perfected when made (because she had already filed). This result is

dictated by the rule even though Rosemary may have known of Erika's interest when she subsequently made her loan.

2. Susan cajoles both Rosemary and Erika, each unknown to the other, to loan her \$1,000 secured by the fur coat, which she already owns and which hangs in her coat closet. Erika gives Susan the money a week after Rosemary, but Rosemary has not perfected and Erika does not either. A week later, they find out they have each made a loan against the same coat. Who has priority? Whoever perfects first: the rule creates a race to the filing office or to Susan's closet. Whoever can submit the financing statement or actually take possession of the coat first will have priority, and the outcome does not depend on knowledge or lack of knowledge that someone else is claiming a security interest in the same collateral. But what of the rule that in the absence of perfection, whichever security interest first attached has priority? This is "thought to be of merely theoretical interest," says the UCC commentary, "since it is hard to imagine a situation where the case would come into litigation without [either party] having perfected his interest." And if the debtor filed a petition in bankruptcy, neither unperfected security interest could prevail against the bankruptcy trustee.

To rephrase: An attached security interest prevails over other unsecured creditors (unsecured creditors lose to secured creditors, perfected or unperfected). If both parties are secured (have attached the interest), the first to perfect wins. Uniform Commercial Code, Section 9-322(a)(2). If both parties have perfected, the first to have perfected wins. Uniform Commercial Code, Section 9-322(a)(1).

### **Exceptions to the General Rule**

There are three immediate exceptions to the general rule, and several other exceptions, all of which—actually—make some straightforward sense even if it sounds a little complicated to explain them.

#### **Immediate Exceptions**

We call the following three exceptions "immediate" ones because they allow junior filers immediate priority to take their collateral before the debtor's other creditors get it. They all involve purchase-money security interests (PMSIs), so if the debtor defaults, the creditor repossesses the very goods the creditor had sold the debtor.

(1) *Purchase-money security interest in goods (other than inventory or livestock)*. The UCC provides that "a perfected purchase-money security interest in goods other than

inventory or livestock has priority over a conflicting security interest in the same goods...if the purchase-money security interest is perfected when debtor receives possession of the collateral or within 20 days thereafter.”Uniform Commercial Code, Section 9-324(a). The Official Comment to this UCC section observes that “in most cases, priority will be over a security interest asserted under an after-acquired property clause.”

Suppose Susan manufactures fur coats. On February 1, Rosemary advances her \$10,000 under a security agreement covering all Susan’s machinery and containing an after-acquired property clause. Rosemary files a financing statement that same day. On March 1, Susan buys a new machine from Erika for \$5,000 and gives her a security interest in the machine; Erika files a financing statement within twenty days of the time that the machine is delivered to Susan. Who has priority if Susan defaults on her loan payments? Under the PMSI rule, Erika has priority, because she had a PMSI. Suppose, however, that Susan had not bought the machine from Erika but had merely given her a security interest in it. Then Rosemary would have priority, because her filing was prior to Erika’s.

What would happen if this kind of PMSI in noninventory goods (here, equipment) did not get priority status? A prudent Erika would not extend credit to Susan at all, and if the new machine is necessary for Susan’s business, she would soon be out of business. That certainly would not inure to the benefit of Rosemary. It is, mostly, to Rosemary’s advantage that Susan gets the machine: it enhances Susan’s ability to make money to pay Rosemary.

(2) *Purchase-money security interest in inventory.* The UCC provides that a perfected PMSI in inventory has priority over conflicting interests in the same inventory, provided that the PMSI is perfected when the debtor receives possession of the inventory, the PMSI-secured party sends an authenticated notification to the holder of the conflicting interest and that person receives the notice within five years before the debtor receives possession of the inventory, and the notice states that the person sending it has or expects to acquire a PMSI in the inventory and describes the inventory.Uniform Commercial Code, Section 9-324(b). The notice requirement is aimed at protecting a secured party in the typical situation in which incoming inventory is subject to a prior agreement to make advances against it. If the original creditor gets notice that new inventory is subject to a PMSI, he will be forewarned against making an advance on it; if he does not receive notice, he will have priority. It is usually to the earlier creditor’s advantage that her debtor is able to get credit to “floor” (provide) inventory, without selling which, of course, the debtor cannot pay back the earlier creditor.

(3) *Purchase-money security interest in fixtures.* Under UCC Section 9-334(e), a perfected security interest in fixtures has priority over a mortgage if the security interest is a PMSI and the security interest is perfected by a fixture filing before the goods become fixtures or within twenty days after. A mortgagee is usually a bank (the mortgagor is the owner of the real estate, subject to the mortgagee's interest). The bank's mortgage covers the real estate and fixtures, even fixtures added after the date of the mortgage (after-acquired property clause). In accord with the general rule, then, the mortgagee/bank would normally have priority if the mortgage is recorded first, as would a fixture filing if made before the mortgage was recorded. But with the exception noted, the bank's interest is subordinate to the fixture-seller's later-perfected PMSI. Example: Susan buys a new furnace from Heating Co. to put in her house. Susan gave a bank a thirty-year mortgage on the house ten years before. Heating Co. takes back a PMSI and files the appropriate financing statement before or within twenty days of installation. If Susan defaults on her loan to the bank, Heating Co. would take priority over the bank. And why not? The mortgagee has, in the long run, benefited from the improvement and modernization of the real estate. (Again, there are further nuances in Section 9-334 beyond our scope here.) A non-PMSI in fixtures or PMSIs perfected more than twenty days after goods become a fixture loses out to prior recorded interests in the realty.

### Other Exceptions

We have noted the three immediate exceptions to the general rule that “the firstest with the mostest” prevails. There are some other exceptions.

Think about how these other exceptions might arise: who might want to take property subject to a security agreement (not including thieves)? That is, Debtor gives Creditor a security interest in, say, goods, while retaining possession. First, *buyers* of various sorts might want the goods if they paid for them; they usually win. Second, *lien creditors* might want the goods (a **lien creditor**<sup>20</sup> is one whose claim is based on operation of law—involuntarily against Debtor, and including a trustee in bankruptcy—as opposed to one whose claim is based on agreement); lien creditors may be statutory (landlords, mechanics, bailees) or judicial. Third, a *bankruptcy trustee* representing Debtor's creditors (independent of the trustee's role as a lien creditor) might want to take the goods to sell and satisfy Debtor's obligations to the creditors. Fourth, unsecured creditors; fifth, secured creditors; and sixth, secured and perfected creditors. We will examine some of the possible permutations but are compelled to observe that this area of law has many fine nuances, not all of which can be taken up here.

20. A creditor who is secured by a lien.

First we look at buyers who take priority over, or free of, unperfected security interests. Buyers who take delivery of many types of collateral covered by an

*unperfected* security interest win out over the hapless secured party who failed to perfect if they give value and don't know of the security interest or agricultural lien. Uniform Commercial Code, Section 9-317(b). A buyer who doesn't give value or who knows of the security interest will not win out, nor will a buyer prevail if the seller's creditor files a financing statement before or within twenty days after the debtor receives delivery of the collateral.

Now we look at buyers who take priority over *perfected* security interests. Sometimes people who buy things even covered by a perfected security interest win out (the perfected secured party loses).

- *Buyers in the ordinary course of business.* “A buyer in the ordinary course of business, other than [one buying farm products from somebody engaged in farming] takes free of a security interest created by the buyer's seller, even if the security interest is perfected and the buyer knows [it].” Uniform Commercial Code, Section 9-320(a). Here the buyer is usually purchasing inventory collateral, and it's OK if he knows the inventory is covered by a security interest, but it's not OK if he knows “that the sale violates a term in an agreement with the secured party.” Uniform Commercial Code, Section 9-320, Comment 3. It would not be conducive to faith in commercial transactions if buyers of inventory generally had to worry whether their seller's creditors were going to repossess the things the buyers had purchased in good faith. For example (based on example 1 to the same comment, UCC 9-320, Official Comment 3), Manufacturer makes appliances and owns manufacturing equipment covered by a perfected security agreement in favor of Lender. Manufacturer sells the equipment to Dealer, whose business is buying and selling used equipment; Dealer, in turn, sells the stuff to Buyer, a buyer in the ordinary course. Does Buyer take free of the security interest? No, because Dealer didn't create it; Manufacturer did.
- Buyers of consumer goods purchased for personal, family, or household use take free of security interests, even if perfected, so long as they buy without knowledge of the security interest, for value, for their own consumer uses, and before the filing of a financing statement covering the goods. This—again—is the rub when a seller of consumer goods perfects by “mere attachment” (automatic perfection) and the buyer of the goods turns around and sells them. For example, Tom buys a new refrigerator from Sears, which perfects by mere attachment. Tom has cash flow problems and sells the fridge to Ned, his neighbor. Ned doesn't know about Sears's security interest and pays a reasonable amount for it. He puts it in his kitchen for home use. Sears cannot repossess the fridge from Ned. If it wanted to protect

itself fully, Sears would have filed a financing statement; then Ned would be out the fridge when the repo men came. Uniform Commercial Code, Section 9-320(b). The “value” issue is interestingly presented in the *Nicolosi* case (Section 28.5 “Cases”).

- *Buyers of farm products.* The UCC itself does not protect buyers of farm products from security interests created by “the person engaged in farming operations who is in the business of selling farm products,” and the result was that sometimes the buyer had to pay twice: once to the farmer and again to the lender whom the farmer didn’t pay. As a result, Congress included in its 1985 Farm Security Act, 7 USC 1631, Section 1324, this language: “A buyer who in the ordinary course of business buys a farm product from a seller engaged in farming operations shall take free of a security interest created by the seller, even though the security interest is perfected; and the buyer knows of the existence of such interest.”

There are some other exceptions, beyond our scope here.

### **Lien Creditors**

Persons (including bankruptcy trustees) who become lien creditors *before* the security interest is perfected win out—the unperfected security interest is subordinate to lien creditors. Persons who become lien creditors *after* the security interest is perfected lose (subject to some nuances in situations where the lien arises between attachment by the creditor and the filing, and depending upon the type of security interest and the type of collateral). Uniform Commercial Code, Section 9-317(a)(2)(B) and 9-317(e). More straightforwardly, perhaps, a lien securing payment or performance of an obligation for services or materials furnished with respect to goods by a person in the ordinary course of business has priority over other security interests (unless a statute provides otherwise). Uniform Commercial Code, Section 9-333. This is the bailee or “material man” (one who supplies materials, as to build a house) with a lien situation. Garage Mechanic repairs a car in which Owner has previously given a perfected security interest to Bank. Owner doesn’t pay Bank. Bank seeks to repossess the car from Mechanic. It will have to pay the Mechanic first. And why not? If the car was not running, Bank would have to have it repaired anyway.

### **Bankruptcy Trustee**

To what extent can the bankruptcy trustee take property previously encumbered by a security interest? It depends. If the security interest was not perfected at the time of filing for bankruptcy, the trustee can take the collateral.<sup>11</sup> United States Code, Section 544 (Bankruptcy Act). If it was perfected, the trustee can’t take it,

subject to rules on preferential transfers: the Bankruptcy Act provides that the trustee can avoid a transfer of an interest of the debtor in property—including a security interest—(1) to or for the benefit of a creditor, (2) on or account of an antecedent debt, (3) made while the debtor was insolvent, (4) within ninety days of the bankruptcy petition date (or one year, for “insiders”—like relatives or business partners), (5) which enables the creditor to receive more than it would have in the bankruptcy. United States Code, Section 547. There are further bankruptcy details beyond our scope here, but the short of it is that sometimes creditors who think they have a valid, enforceable security interest find out that the bankruptcy trustee has snatched the collateral away from them.

*Deposit accounts perfected by control.* A security interest in a deposit account (checking account, savings account, money-market account, certificate of deposit) takes priority over security interests in the account perfected by other means, and under UCC Section 9-327(3), a bank with which the deposit is made takes priority over all other conflicting security agreements. Uniform Commercial Code, Section 9-327(1). For example, a debtor enters into a security agreement with his sailboat as collateral. The creditor perfects. The debtor sells the sailboat and deposits the proceeds in his account with a bank; normally, the creditor’s interest would attach to the proceeds. The debtor next borrows money from the bank, and the bank takes a security interest in the debtor’s account by control. The debtor defaults. Who gets the money representing the sailboat’s proceeds? The bank does. The rationale: “this...enables banks to extend credit to their depositors without the need to examine [records] to determine whether another party might have a security interest in the deposit account.” Uniform Commercial Code, Section 9-328, Official Comment 3 and 4.

### KEY TAKEAWAY

Who among competing creditors gets the collateral if the debtor defaults? The general rule on priorities is that the first to secure most completely wins: if all competitors have perfected, the first to do so wins. If one has perfected and the others have not, the one who perfects wins. If all have attached, the first to attach wins. If none have attached, they're all unsecured creditors. To this general rule there are a number of exceptions. Purchase-money security interests in goods and inventory prevail over previously perfected secured parties in the same goods and inventory (subject to some requirements); fixture financiers who file properly have priority over previously perfected mortgagees. Buyers in the ordinary course of business take free of a security interest created by their seller, so long as they don't know their purchase violates a security agreement. Buyers of consumer goods perfected by mere attachment win out over the creditor who declined to file. Buyers in the ordinary course of business of farm products prevail over the farmer's creditors (under federal law, not the UCC). Lien creditors who become such before perfection win out; those who become such after perfection usually lose. Bailees in possession and material men have priority over previous perfected claimants. Bankruptcy trustees win out over unperfected security interests and over perfected ones if they are considered voidable transfers from the debtor to the secured party. Deposit accounts perfected by control prevail over previously perfected secured parties in the same deposit accounts.

### EXERCISES

1. What is the general rule regarding priorities for the right to repossess goods encumbered by a security interest when there are competing creditors clamoring for that right?
2. Why does it make good sense to allow purchase-money security creditors in (1) inventory, (2) equipment, and (3) fixtures priority over creditors who perfected before the PMSI was perfected?
3. A buyer in the ordinary course of business is usually one buying inventory. Why does it make sense that such a buyer should take free of a security interest created by his seller?



## 28.3 Rights of Creditor on Default and Disposition after Repossession

### LEARNING OBJECTIVES

1. Understand that the creditor may sue to collect the debt.
2. Recognize that more commonly the creditor will realize on the collateral—repossess it.
3. Know how collateral may be disposed of upon repossession: by sale or by strict foreclosure.

### Rights of Creditor on Default

Upon default, the creditor must make an election: to sue, or to repossess.

### Resort to Judicial Process

After a debtor's default (e.g., by missing payments on the debt), the creditor could ignore the security interest and bring suit on the underlying debt. But creditors rarely resort to this remedy because it is time-consuming and costly. Most creditors prefer to repossess the collateral and sell it or retain possession in satisfaction of the debt.

### Repossession

Section 9-609 of the Uniform Commercial Code (UCC) permits the secured party to take possession of the collateral on default (unless the agreement specifies otherwise):

(a) After default, a secured party may (1) take possession of the collateral; and (2) without removal, may render equipment unusable and dispose of collateral on a debtor's premises.

(b) A secured party may proceed under subsection (a): (1) pursuant to judicial process; or (2) without judicial process, if it proceeds without breach of the peace.

This language has given rise to the flourishing business of professional “repo men” (and women). “Repo” companies are firms that specialize in repossession collateral. They have trained car-lock pickers, in-house locksmiths, experienced repossession

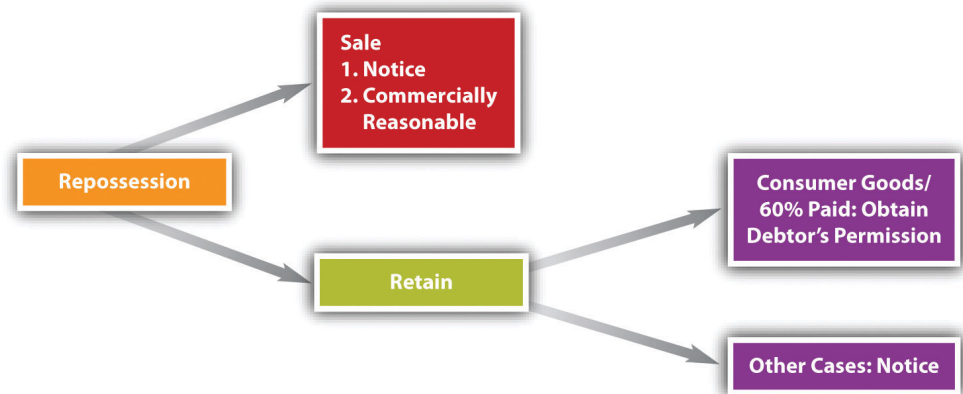
teams, damage-free towing equipment, and the capacity to deliver repossessed collateral to the client's desired destination. Some firms advertise that they have 360-degree video cameras that record every aspect of the repossession. They have "skip chasers"—people whose business it is to track down those who skip out on their obligations, and they are trained not to breach the peace. Here is an example of sophisticated online advertising for a repossession firm: SSR, "Southern & Central Coast California Repossession Services," <http://www.simonsrecovery.com/index.htm>. See *Pantoja-Cahue v. Ford Motor Credit Co.*, a case discussing repossession, in [Section 28.5 "Cases"](#).

The reference in Section 9-609(a)(2) to "render equipment unusable and dispose of collateral on a debtor's premises" gets to situations involving "heavy equipment [when] the physical removal from the debtor's plant and the storage of collateral pending disposition may be impractical or unduly expensive....Of course...all aspects of the disposition must be commercially reasonable." Uniform Commercial Code, Section 9-609(a)(2), Official Comment 6. Rendering the equipment unusable would mean disassembling some critical part of the machine—letting it sit there until an auction is set up on the premises.

The creditor's agents—the repo people—charge for their service, of course, and if possible the cost of repossession comes out of the collateral when it's sold. A debtor would be better off voluntarily delivering the collateral according to the creditor's instructions, but if that doesn't happen, "self-help"—repossession—is allowed because, of course, the debtor said it would be allowed in the security agreement, so long as the repossession can be accomplished without breach of peace. "Breach of peace" is language that can cover a wide variety of situations over which courts do not always agree. For example, some courts interpret a creditor's taking of the collateral despite the debtor's clear oral protest as a breach of the peace; other courts do not.

### **Disposition after Repossession**

After repossession, the creditor has two options: sell the collateral or accept it in satisfaction of the debt (see [Figure 28.5 "Disposition after Repossession"](#)).

Figure 28.5 *Disposition after Repossession*

### Sale

Sale is the usual method of recovering the debt. Section 9-610 of the UCC permits the secured creditor to “sell, lease, license, or otherwise dispose of any or all of the collateral in its present condition or following any commercially reasonable preparation or processing.” The collateral may be sold as a whole or in parcels, at one time or at different times. Two requirements limit the creditor’s power to resell: (1) it must send notice to the debtor and secondary obligor, and (unless consumer goods are sold) to other secured parties; and (2) all aspects of the sale must be “commercially reasonable.” Uniform Commercial Code, Section 9-611; Uniform Commercial Code, Section 9-610. Most frequently the collateral is auctioned off.

Section 9-615 of the UCC describes how the proceeds are applied: first, to the costs of the repossession, including reasonable attorney’s fees and legal expenses as provided for in the security agreement (and it will provide for that!); second, to the satisfaction of the obligation owed; and third, to junior creditors. This again emphasizes the importance of promptly perfecting the security interest: failure to do so frequently subordinates the tardy creditor’s interest to junior status. If there is money left over from disposing of the collateral—a surplus—the debtor gets that back. If there is still money owing—a deficiency—the debtor is liable for that. In Section 9-616, the UCC carefully explains how the surplus or deficiency is calculated; the explanation is required in a consumer goods transaction, and it has to be sent to the debtor after the disposition.

### Strict Foreclosure

Because resale can be a bother (or the collateral is appreciating in value), the secured creditor may wish simply to accept the collateral in full satisfaction or partial satisfaction of the debt, as permitted in UCC Section 9-620(a). This is known as **strict foreclosure**<sup>21</sup>. The debtor must consent to letting the creditor take the collateral without a sale in a “record authenticated after default,” or after default the creditor can send the debtor a proposal for the creditor to accept the collateral, and the proposal is effective if not objected to within twenty days after it’s sent.

The strict foreclosure provisions contain a safety feature for consumer goods debtors. If the debtor has paid at least 60 percent of the debt, then the creditor may not use strict foreclosure—unless the debtor signs a statement after default renouncing his right to bar strict foreclosure and to force a sale. Uniform Commercial Code, 9-620(e); Uniform Commercial Code, Section 9-624. A consumer who refuses to sign such a statement thus forces the secured creditor to sell the collateral under Section 9-610. Should the creditor fail to sell the goods within ninety days after taking possession of the goods, he is liable to the debtor for the value of the goods in a conversion suit or may incur the liabilities set forth in Section 9-625, which provides for minimum damages for the consumer debtor. Recall that the UCC imposes a duty to act in good faith and in a commercially reasonable manner, and in most cases with reasonable notification. Uniform Commercial Code, Section 1-203. See [Figure 28.5 "Disposition after Repossession"](#).

### Foreclosure on Intangible Collateral

A secured party’s repossession of inventory or equipment can disrupt or even close a debtor’s business. However, when the collateral is intangible—such as accounts receivable, general intangibles, chattel paper, or instruments—collection by a secured party after the debtor’s default may proceed without interrupting the business. Section 9-607 of the UCC provides that on default, the secured party is entitled to notify the third party—for example, a person who owes money on an account—that payment should be made to him. The secured party is accountable to the debtor for any surplus, and the debtor is liable for any deficiency unless the parties have agreed otherwise.

As always in parsing the UCC here, some of the details and nuances are necessarily omitted because of lack of space or because a more detailed analysis is beyond this book’s scope.

21. The creditor takes the collateral, discharges the debtor, and has no right to seek any deficiency.

### KEY TAKEAWAY

Upon default, the creditor may bring a lawsuit against the debtor to collect a judgment. But the whole purpose of secured transactions is to avoid this costly and time-consuming litigation. The more typical situation is that the creditor repossesses the collateral and then either auctions it off (sale) or keeps it in satisfaction of the debt (strict foreclosure). In the former situation, the creditor may then proceed against the debtor for the deficiency. In consumer cases, the creditor cannot use strict foreclosure if 60 percent of the purchase price has been paid.

### EXERCISES

1. Although a creditor could sue the debtor, get a judgment against it, and collect on the judgment, usually the creditor repossesses the collateral. Why is repossession the preferred method of realizing on the security?
2. Why is repossession allowed *so long as* it can be done without a breach of the peace?
3. Under what circumstances is strict foreclosure not allowed?

## 28.4 Suretyship

### LEARNING OBJECTIVES

1. Understand what a surety is and why sureties are used in commercial transactions.
2. Know how suretyships are created.
3. Recognize the general duty owed by the surety to the creditor, and the surety's defenses.
4. Recognize the principal obligor's duty to the surety, and the surety's rights against the surety.
5. Understand the rights among cosureties.

### Definition, Types of Sureties, and Creation of the Suretyship

#### Definition

Suretyship is the second of the three major types of consensual security arrangements noted at the beginning of this chapter (personal property security, suretyship, real property security)—and a common one. Creditors frequently ask the owners of small, closely held companies to guarantee their loans to the company, and parent corporations also frequently are guarantors of their subsidiaries' debts. The earliest sureties were friends or relatives of the principal debtor who agreed—for free—to lend their guarantee. Today most sureties in commercial transaction are insurance companies (but insurance is not the same as suretyship).

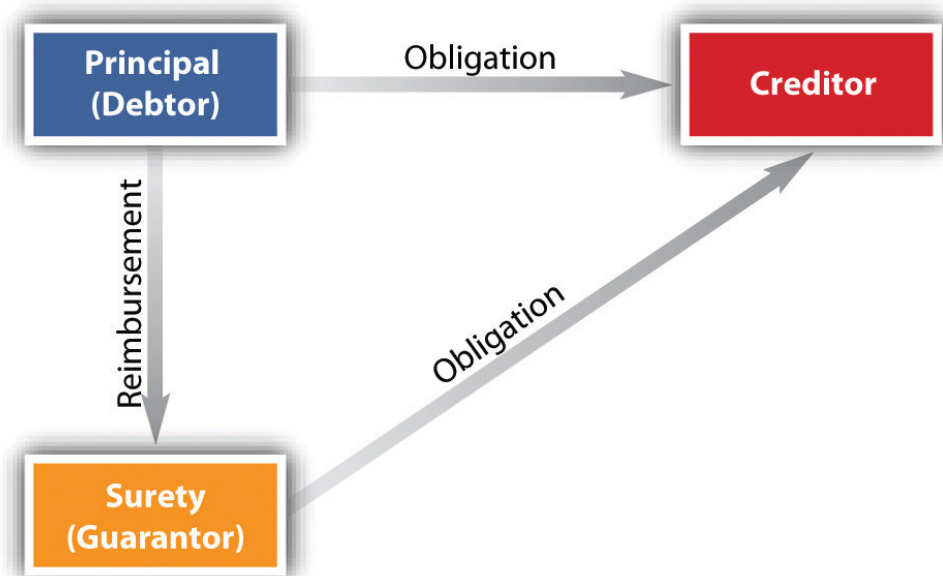
A **surety**<sup>22</sup> is one who promises to pay or perform an obligation owed by the **principal debtor**<sup>23</sup>, and, strictly speaking, the surety is primarily liable on the debt: the creditor can demand payment from the surety when the debt is due. The creditor is the person to whom the principal debtor (and the surety, strictly speaking) owes an obligation. Very frequently, the creditor requires first that the debtor put up collateral to secure indebtedness, and—in addition—that the debtor engage a surety to make extra certain the creditor is paid or performance is made. For example, David Debtor wants Bank to loan his corporation, David Debtor, Inc., \$100,000. Bank says, “Okay, Mr. Debtor, we’ll loan the corporation money, but we want its computer equipment as security, and we want you personally to guarantee the debt if the corporation can’t pay.” Sometimes, though, the surety and the principal debtor may have no agreement between each other; the surety might have struck a deal with the creditor to act as surety without the consent or knowledge of the principal debtor.

22. One who promises to act or pay upon the default of another: a guarantor.

23. The person whose debt is guaranteed by a surety.

A **guarantor**<sup>24</sup> also is one who guarantees an obligation of another, and for practical purposes, therefore, *guarantor* is usually synonymous with *surety*—the terms are used pretty much interchangeably. But here’s the technical difference: a surety is usually a party to the original contract and signs her (or his, or its) name to the original agreement along with the surety; the consideration for the principal’s contract is the same as the surety’s consideration—she is bound on the contract from the very start, and she is also expected to know of the principal debtor’s default so that the creditor’s failure to inform her of it does not discharge her of any liability. On the other hand, a guarantor usually does not make his agreement with the creditor at the same time the principal debtor does: it’s a separate contract requiring separate consideration, and if the guarantor is not informed of the principal debtor’s default, the guarantor can claim discharge on the obligation to the extent any failure to inform him prejudices him. But, again, as the terms are mostly synonymous, *surety* is used here to encompass both.

Figure 28.6 Defenses of Principal Debtor and Surety



### Types of Suretyship

Where there is an interest, public or private, that requires protection from the possibility of a default, sureties are engaged. For example, a landlord might require that a commercial tenant not only put up a security deposit but also show evidence that it has a surety on line ready to stand for three months’ rent if the tenant defaults. Often, a municipal government will want its road contractor to show it has a surety available in case, for some reason, the contractor cannot complete the project. Many states require general contractors to have bonds, purchased from

24. One who promises to pay or perform a contract obligation upon the default of another; a surety.

insurance companies, as a condition of getting a contractor's license; the insurance company is the surety—it will pay out if the contractor fails to complete work on the client's house. These are types of a **performance bond**<sup>25</sup>. A judge will often require that a criminal defendant put up a bond guaranteeing his appearance in court—that's a type of suretyship where the bail-bonder is the surety—or that a plaintiff put up a bond indemnifying the defendant for the costs of delays caused by the lawsuit—a **judicial bond**<sup>26</sup>. A bank will take out a bond on its employees in case they steal money from the bank—the bank teller, in this case, is the principal debtor (a **fidelity bond**<sup>27</sup>). However, as we will see, sureties do not anticipate financial loss like insurance companies do: the surety expects, mostly, to be repaid if it has to perform. The principal debtor goes to an insurance company and buys the bond—the suretyship policy. The cost of the premium depends on the surety company, the type of bond applied for, and the applicant's financial history. A sound estimate of premium costs is 1 percent to 4 percent, but if a surety company classifies an applicant as high risk, the premium falls between 5 percent and 20 percent of the bond amount. When the purchaser of real estate agrees to assume the seller's mortgage (promises to pay the mortgage debt), the seller then becomes a surety: unless the mortgagee releases the seller (not likely), the seller has to pay if the buyer defaults.

### Creation of the Suretyship

Suretyship can arise only through contract. The general principles of contract law apply to suretyship. Thus a person with the general capacity to contract has the power to become a surety. Consideration is required for a suretyship contract: if Debtor asks a friend to act as a surety to induce Creditor to make Debtor a loan, the consideration Debtor gives Creditor also acts as the consideration Friend gives. Where the suretyship arises *after* Creditor has already extended credit, new consideration would be required (absent application of the doctrine of promissory estoppel *American Druggists' Ins. Co. v. Shoppe*, 448 N.W.2d 103, Minn. App. (1989)). You may recall from the chapters on contracts that the promise by one person to pay or perform for the debts or defaults of another must be evidenced by a writing under the statute of frauds (subject to the "main purpose" exception).

Suretyship contracts are affected to some extent by government regulation. Under a 1985 Federal Trade Commission Credit Practices Rule, creditors are prohibited from misrepresenting a surety's liability. Creditors must also give the surety a notice that explains the nature of the obligation and the potential liability that can arise if a person cosigns on another's debt. Here is an example of the required notice: Federal Trade Commission, "Facts for Consumers: The Credit Practices Rule," <http://www.ftc.gov/bcp/edu/pubs/consumer/credit/cre12.shtm>.

25. A surety bond that ensures a property owner (as a developer or municipality) of the completion of a construction contract or payment of actual damages to the extent of the bond in the event that the contractor fails to complete it.

26. A bond filed with the court as a guarantee. For example, a party to a court action may post a judicial bond to guarantee payment of a verdict while an appeal is being considered.

27. An assurance, generally purchased by an employer, to cover employees who are entrusted with valuable property or funds.



## Duties and Rights of the Surety

### Duties of the Surety

Upon the principal debtor's default, the surety is contractually obligated to perform unless the principal herself or someone on her behalf discharges the obligation. When the surety performs, it must do so in good faith. Because the principal debtor's defenses are generally limited, and because—as will be noted—the surety has the right to be reimbursed by the debtor, debtors not infrequently claim the surety acted in bad faith by doing things like failing to make an adequate investigation (to determine if the debtor really defaulted), overpaying claims, interfering with the contact between the surety and the debtor, and making unreasonable refusals to let the debtor complete the project. The case *Fidelity and Deposit Co. of Maryland v. Douglas Asphalt Co.*, in [Section 28.5 "Cases"](#), is typical.

### Rights of the Surety

The surety has four main rights stemming from its obligation to answer for the debt or default of the principal debtor.

#### Exoneration

If, at the time a surety's obligation has matured, the principal can satisfy the obligation but refuses to do so, the surety is entitled to **exoneration**<sup>28</sup>—a court order requiring the principal to perform. It would be inequitable to force the surety to perform and then to have to seek **reimbursement**<sup>29</sup> from the principal if all along the principal is able to perform.

#### Reimbursement

If the surety must pay the creditor because the principal has defaulted, the principal is obligated to reimburse the surety. The amount required to be reimbursed includes the surety's reasonable, good-faith outlays, including interest and legal fees.

#### Subrogation

Suppose the principal's duty to the creditor is fully satisfied and that the surety has contributed to this satisfaction. Then the surety is entitled to be subrogated to the rights of the creditor against the principal. In other words, the surety stands in the creditor's shoes and may assert against the principal whatever rights the creditor could have asserted had the duty not been discharged. The right of **subrogation**<sup>30</sup> includes the right to take secured interests that the creditor obtained from the

28. Relieving of liability.

29. The right of a surety to be repaid by the principal debtor.

30. Substitution of one person for another who has a legal claim or right.

principal to cover the duty. Sarah's Pizzeria owes Martha \$5,000, and Martha has taken a security interest in Sarah's Chevrolet. Eva is surety for the debt. Sarah defaults, and Eva pays Martha the \$5,000. Eva is entitled to have the security interest in the car transferred to her.

### Contribution

Two or more sureties who are bound to answer for the principal's default and who should share between them the loss caused by the default are known as **cosureties**<sup>31</sup>. A surety who in performing its own obligation to the creditor winds up paying more than its proportionate share is entitled to **contribution**<sup>32</sup> from the cosureties.

### Defenses of the Parties

The principal and the surety may have defenses to paying.

### Defenses of the Principal

The principal debtor may avail itself of any standard contract defenses as against the creditor, including impossibility, illegality, incapacity, fraud, duress, insolvency, or bankruptcy discharge. However, the surety may contract with the creditor to be liable despite the principal's defenses, and a surety who has undertaken the suretyship with knowledge of the creditor's fraud or duress remains obligated, even though the principal debtor will be discharged. When the surety turns to the principal debtor and demands reimbursement, the latter may have defenses against the surety—as noted—for acting in bad faith.

One of the main reasons creditors want the promise of a surety is to avoid the risk that the principal debtor will go bankrupt: the debtor's bankruptcy is a defense to the debtor's liability, certainly, but that defense cannot be used by the surety. The same is true of the debtor's incapacity: it is a defense available to the principal debtor but not to the surety.

### Defenses of the Surety

Generally, the surety may exercise defenses on a contract that would have been available to the principal debtor (e.g., creditor's breach; impossibility or illegality of performance; fraud, duress, or misrepresentation by creditor; statute of limitations; refusal of creditor to accept tender or performance from either debtor or surety.) Beyond that, the surety has some defenses of its own. Common defenses raised by sureties include the following:

31. An arrangement where two or more surety companies directly participate on a bond.

32. The sharing of a loss or payment by two or more persons or sureties.

- *Release of the principal.* Whenever a creditor releases the principal, the surety is discharged, unless the surety consents to remain liable or the creditor expressly reserves her rights against the surety. The creditor's release of the surety, though, does not release the principal debtor because the debtor is liable without regard to the surety's liability.
- *Modification of the contract.* If the creditor alters the instrument sufficiently to discharge the principal, the surety is discharged as well. Likewise, when the creditor and principal modify their contract, a surety who has not consented to the modification is discharged if the surety's risk is materially increased (but not if it is decreased). Modifications include extension of the time of payment, release of collateral (this releases the surety to the extent of the impairment), change in principal debtor's duties, and assignment or delegation of the debtor's obligations to a third party. The surety may consent to modifications.
- *Creditor's failure to perfect.* A creditor who fails to file a financing statement or record a mortgage risks losing the security for the loan and might also inadvertently release a surety, but the failure of the creditor to resort first to collateral is no defense.
- *Statute of frauds.* Suretyship contracts are among those required to be evidenced by some writing under the statute of frauds, and failure to do so may discharge the surety from liability.
- *Creditor's failure to inform surety of material facts within creditor's knowledge affecting debtor's ability to perform* (e.g., that debtor has defaulted several times before).
- *General contract defenses.* The surety may raise common defenses like incapacity (infancy), lack of consideration (unless promissory estoppel can be substituted or unless no separate consideration is necessary because the surety's and debtor's obligations arise at the same time), and creditor's fraud or duress on surety. However, fraud by the principal debtor on the surety to induce the suretyship will not release the surety if the creditor extended credit in good faith; if the creditor knows of the fraud perpetrated by the debtor on the surety, the surety may avoid liability. See [Figure 28.6 "Defenses of Principal Debtor and Surety"](#).

The following are defenses of principal debtor *only*:

- Death or incapacity of principal debtor
- Bankruptcy of principal debtor
- Principal debtor's setoffs against creditor

The following are defenses of *both* principal debtor and surety:

- Material breach by creditor
- Lack of mutual assent, failure of consideration
- Creditor's fraud, duress, or misrepresentation of debtor
- Impossibility or illegality of performance
- Material and fraudulent alteration of the contract
- Statute of limitations

The following are defenses of surety *only*:

- Fraud or duress by creditor on surety
  - Illegality of suretyship contract
  - Surety's incapacity
  - Failure of consideration for surety contract (unless excused)
  - Statute of frauds
  - Acts of creditor or debtor materially affecting surety's obligations:
    - Refusal by creditor to accept tender of performance
    - Release of principal debtor without surety's consent
    - Release of surety
    - Release, surrender, destruction, or impairment of collateral
    - Extension of time on principal debtor's obligation
    - Modification of debtor's duties, place, amount, or manner of debtor's obligations

#### KEY TAKEAWAY

Creditors often require not only the security of collateral from the debtor but also that the debtor engage a surety. A contract of suretyship is a type of insurance policy, where the surety (insurance company) promises the creditor that if the principal debtor fails to perform, the surety will undertake good-faith performance instead. A difference between insurance and suretyship, though, is that the surety is entitled to reimbursement by the principal debtor if the surety pays out. The surety is also entitled, where appropriate, to exoneration, subrogation, and contribution. The principal debtor and the surety both have some defenses available: some are personal to the debtor, some are joint defenses, and some are personal to the surety.

## EXERCISES

1. Why isn't collateral put up by the debtor sufficient security for the creditor—why is a surety often required?
2. How can it be said that sureties do not anticipate financial losses like insurance companies do? What's the difference, and how does the surety avoid losses?
3. Why does the creditor's failure to perfect a security interest discharge the surety from liability? Why doesn't failure of the creditor to resort first to perfected collateral discharge the surety?
4. What is the difference between a guarantor and a surety?

## 28.5 Cases

### **Perfection by Mere Attachment; Priorities**

In re NICOLOSI

4 UCC Rep. 111 (Ohio 1966)

#### **Preliminary Statement and Issues**

This matter is before the court upon a petition by the trustee to sell a diamond ring in his possession free of liens....Even though no pleadings were filed by Rike-Kumler Company, the issue from the briefs is whether or not a valid security interest was perfected in this chattel as consumer goods, superior to the statutory title and lien of the trustee in bankruptcy.

#### **Findings of Fact**

The [debtor] purchased from the Rike-Kumler Company, on July 7, 1964, the diamond ring in question, for \$1237.35 [about \$8,500 in 2010 dollars], as an engagement ring for his fiancée. He executed a purchase money security agreement, which was not filed. Also, no financing statement was filed. The chattel was adequately described in the security agreement.

The controversy is between the trustee in bankruptcy and the party claiming a perfected security interest in the property. The recipient of the property has terminated her relationship with the [debtor], and delivered the property to the trustee.

#### **Conclusion of Law, Decision, and Order**

If the diamond ring, purchased as an engagement ring by the bankrupt, cannot be categorized as consumer goods, and therefore exempted from the notice filing requirements of the Uniform Commercial Code as adopted in Ohio, a perfected security interest does not exist.

No judicial precedents have been cited in the briefs.

Under the commercial code, collateral is divided into tangible, intangible, and documentary categories. Certainly, a diamond ring falls into the tangible category. The classes of tangible goods are distinguished by the primary use intended. Under [the UCC] the four classes [include] “consumer goods,” “equipment,” “farm products” and “inventory.”

The difficulty is that the code provisions use terms arising in commercial circles which have different semantical values from legal precedents. Does the fact that the purchaser bought the goods as a special gift to another person signify that it was not for his own “personal, family or household purposes”? The trustee urges that these special facts control under the express provisions of the commercial code.

By a process of exclusion, a diamond engagement ring purchased for one’s fiancée is not “equipment” bought or used in business, “farm products” used in farming operations, or “inventory” held for sale, lease or service contracts. When the [debtor] purchased the ring, therefore, it could only have been “consumer goods” bought “primarily for personal use.” There could be no judicial purpose to create a special class of property in derogation of the statutory principles.

Another problem is implicit, although not covered by the briefs.

By the foregoing summary analysis, it is apparent that the diamond ring, when the interest of the debtor attached, was consumer goods since it could have been no other class of goods. Unless the fiancée had a special status under the code provision protecting a bona fide buyer, without knowledge, for value, of consumer goods, the failure to file a financing statement is not crucial. No evidence has been adduced pertinent to the scienter question.

Is a promise, as valid contractual consideration, included under the term “value”? In other words, was the ring given to his betrothed in consideration of marriage (promise for a promise)? If so, and “value” has been given, the transferee is a “buyer” under traditional concepts.

The Uniform Commercial Code definition of “value”...very definitely covers a promise for a promise. The definition reads that “a person gives ‘value’ for rights if he acquires them...generally in return for any consideration sufficient to support a simple contract.”

It would seem unrealistic, nevertheless, to apply contract law concepts historically developed into the law of marriage relations in the context of new concepts developed for uniform commercial practices. They are not, in reality, the same

juristic manifold. The purpose of uniformity of the code should not be defeated by the obsessions of the code drafters to be all inclusive for secured creditors.

Even if the trustee, in behalf of the unsecured creditors, would feel inclined to insert love, romance and morals into commercial law, he is appearing in the wrong era, and possibly the wrong court.

Ordered, that the Rike-Kumler Company holds a perfected security interest in the diamond engagement ring, and the security interest attached to the proceeds realized from the sale of the goods by the trustee in bankruptcy.

### CASE QUESTIONS

1. Why didn't the jewelry store, Rike-Kumler, file a financing statement to protect its security interest in the ring?
2. How did the bankruptcy trustee get the ring?
3. What argument did the trustee make as to why he should be able to take the ring as an asset belonging to the estate of the debtor? What did the court determine on this issue?

### Repossession and Breach of the Peace

Pantoja-Cahue v. Ford Motor Credit Co.

872 N.E.2d 1039 (Ill. App. 2007)

Plaintiff Mario Pantoja-Cahue filed a six-count complaint seeking damages from defendant Ford Motor Credit Company for Ford's alleged breach of the peace and "illegal activities" in repossessing plaintiff's automobile from his locked garage....

In August 2000, plaintiff purchased a 2000 Ford Explorer from auto dealer Webb Ford. Plaintiff, a native Spanish speaker, negotiated the purchase with a Spanish-speaking salesperson at Webb. Plaintiff signed what he thought was a contract for the purchase and financing of the vehicle, with monthly installment payments to be made to Ford. The contract was in English. Some years later, plaintiff discovered the contract was actually a lease, not a purchase agreement. Plaintiff brought suit against Ford and Webb on August 22, 2003, alleging fraud. Ford brought a replevin action against plaintiff asserting plaintiff was in default on his obligations under the lease. In the late night/early morning hours of March 11-12, 2004, repossession



agents [from Doe Repossession Services] entered plaintiff's locked garage and removed the car...

Plaintiff sought damages for Ford and Doe's "unlawful activities surrounding the wrongful repossession of Plaintiff's vehicle." He alleged Ford and Doe's breaking into plaintiff's locked garage to effectuate the repossession and Ford's repossession of the vehicle knowing that title to the car was the subject of ongoing litigation variously violated section 2A-525(3) of the [Uniform Commercial] Code (count I against Ford), the [federal] Fair Debt Collection Practices Act (count II against Doe),...Ford's contract with plaintiff (count V against Ford) and section 2A-108 of the Code (count VI against Ford and Doe)....

### **Uniform Commercial Code Section 2A-525(3)**

In count I, plaintiff alleged "a breach of the peace occurred as [Ford]'s repossession agent broke into Plaintiff's locked garage in order to take the vehicle" and Ford's agent "repossessed the subject vehicle by, among other things, breaking into Plaintiff's locked garage and causing substantial damage to Plaintiff's personal property in violation of [section 2A-525(3)]":

"After a default by the lessee under the lease contract \* \* \* or, if agreed, after other default by the lessee, the lessor has the right to take possession of the goods. \* \* \*

*The lessor may proceed under subsection (2) without judicial process if it can be done without breach of the peace or the lessor may proceed by action.*" [emphasis added.]

[U]pon a lessee's default, a lessor has the right to repossess the leased goods in one of two ways: by using the judicial process or, if repossession could be accomplished without a breach of the peace, by self-help [UCC Section 2A-525(3)]. "If a breach of the peace is likely, a properly instituted civil action is the appropriate remedy." [Citation] (interpreting the term "breach of the peace" in the context of section 9-503 of the Code, which provides for the same self-help repossession as section 2A-525 but for secured creditors rather than lessors).

Taking plaintiff's well-pleaded allegations as true, Ford resorted to self-help, by employing an agent to repossess the car and Ford's agent broke into plaintiff's locked garage to effectuate the repossession. Although plaintiff's count I allegations are minimal, they are sufficient to plead a cause of action for a violation of section 2A-525(3) if breaking into a garage to repossess a car is, as plaintiff alleged, a breach of the peace. Accordingly, the question here is whether breaking into a locked

garage to effectuate a repossession is a breach of the peace in violation of section 2A-525(3).

There are no Illinois cases analyzing the meaning of the term “breach of the peace” as used in the lessor repossession context in section 2A-525(3). However, there are a few Illinois cases analyzing the term as used in section 9-503 of the Code, which contains a similar provision providing that a secured creditor may, upon default by a debtor, repossess its collateral either “(1) pursuant to judicial process; or (2) without judicial process, if it proceeds without breach of the peace.” The seminal case, and the only one of any use in resolving the issue, is *Chrysler Credit Corp. v. Koontz*, 277 Ill.App.3d 1078, 214 Ill.Dec. 726, 661 N.E.2d 1171 (1996).

In *Koontz*, Chrysler, the defendant creditor, sent repossession agents to repossess the plaintiff’s car after the plaintiff defaulted on his payments. The car was parked in the plaintiff’s front yard. The plaintiff heard the repossession in progress and ran outside in his underwear shouting “Don’t take it” to the agents. The agents did not respond and proceeded to take the car. The plaintiff argued the repossession breached the peace and he was entitled to the statutory remedy for violation of section 9-503, denial of a deficiency judgment to the secured party, Chrysler....

After a thorough analysis of the term “breach of the peace,” the court concluded the term “connotes conduct which incites or is likely to incite immediate public turbulence, or which leads to or is likely to lead to an immediate loss of public order and tranquility. Violent conduct is not a necessary element. The probability of violence at the time of or immediately prior to the repossession is sufficient.”...[The *Koontz* court] held the circumstances of the repossession did not amount to a breach the peace.

The court then considered the plaintiff’s argument that Chrysler breached the peace by repossessing the car under circumstances constituting criminal trespass to property. Looking to cases in other jurisdictions, the court determined that, “in general, a mere trespass, standing alone, does not automatically constitute a breach of the peace.” [Citation] (taking possession of car from private driveway does not, without more, constitute breach of the peace), [Citation] (no breach of the peace occurred where car repossessed from debtor’s driveway without entering “any gates, doors, or other barricades to reach” car), [Citation] (no breach of the peace occurred where car was parked partially under carport and undisputed that no door, “not even one to a garage,” on the debtor’s premises was opened, much less broken, to repossess the car), [Citation] (although secured party may not break into or enter homes or buildings or enclosed spaces to effectuate a repossession, repossession of vehicle from parking lot of debtor’s apartment building was not breach of the peace), [Citation] (repossession of car from debtor’s driveway without

entering any gates, doors or other barricades was accomplished without breach of the peace)....

Although the evidence showed the plaintiff notified Chrysler prior to the repossession that it was not permitted onto his property, the court held Chrysler's entry onto the property to take the car did not constitute a breach of the peace because there was no evidence Chrysler entered through a barricade or did anything other than drive the car away. [Citation] "Chrysler enjoyed a limited privilege to enter [the plaintiff's] property for the sole and exclusive purpose of effectuating the repossession. So long as the entry was limited in purpose (repossession), and so long as no gates, barricades, doors, enclosures, buildings, or chains were breached or cut, no breach of the peace occurred by virtue of the entry onto his property."

...[W]e come to essentially the same conclusion: where a repossession is effectuated by an actual breaking into the lessee/debtor's premises or breaching or cutting of chains, gates, barricades, doors or other barriers designed to exclude trespassers, the likelihood that a breach of the peace occurred is high.

*Davenport v. Chrysler Credit Corp.*, [Citation] (Tenn.App.1991), a case analyzing Tennessee's version of section 9-503 is particularly helpful, holding that "[a] breach of the peace is almost certain to be found if the repossession is accompanied by the unauthorized entry into a closed or locked garage." ...This is so because "public policy favors peaceful, non-trespassory repossessions when the secured party has a free right of entry" and "forced entries onto the debtor's property or into the debtor's premises are viewed as seriously detrimental to the ordinary conduct of human affairs." *Davenport* held that the creditor's repossession of a car by entering a closed garage and cutting a chain that would have prevented it from removing the car amounted to a breach of the peace, "[d]espite the absence of violence or physical confrontation" (because the debtor was not at home when the repossession occurred). *Davenport* recognized that the secured creditors' legitimate interest in obtaining possession of collateral without having to resort to expensive and cumbersome judicial procedures must be balanced against the debtors' legitimate interest in being free from unwarranted invasions of their property and privacy interests.

"Repossession is a harsh procedure and is, essentially, a delegation of the State's exclusive prerogative to resolve disputes. Accordingly, the statutes governing the repossession of collateral should be construed in a way that prevents abuse and discourages illegal conduct which might otherwise go unchallenged because of the debtor's lack of knowledge of legally proper repossession techniques" [Citation].

We agree with [this] analysis of the term “breach of the peace” in the context of repossession and hold, with regard to section 2A-525(3) of the Code, that breaking into a locked garage to effectuate a repossession may constitute a breach of the peace.

Here, plaintiff alleges more than simply a trespass. He alleges Ford, through Doe, broke into his garage to repossess the car. Given our determination that breaking into a locked garage to repossess a car may constitute a breach of the peace, plaintiff’s allegation is sufficient to state a cause of action under section 2A-525(3) of the Code. The court erred in dismissing count I of plaintiff’s second amended complaint and we remand for further proceedings.

### **Uniform Commercial Code Section 2A-108**

In count VI, plaintiff alleged the lease agreement was unconscionable because it was formed in violation of [the Illinois Consumer Fraud Statute, requiring that the customer verify that the negotiations were conducted in the consumer’s native language and that the document was translated so the customer understood it.]...Plaintiff does not quote [this] or explain how the agreement violates [it]. Instead, he quotes UCC section 2A-108 of the Code, as follows:

“With respect to a consumer lease, if the court as a matter of law finds that a lease contract or any clause of a lease contract has been induced by unconscionable conduct or that unconscionable conduct has occurred in the collection of a claim arising from a lease contract, the court may grant appropriate relief.

Before making a finding of unconscionability under subsection (1) or (2), the court, on its own motion or that of a party, shall afford the parties a reasonable opportunity to present evidence as to the setting, purpose, and effect of the lease contract or clause thereof, or of the conduct.”

He then, in “violation one” under count VI, alleges the lease was made in violation of [the Illinois Consumer Fraud Statute] because it was negotiated in Spanish but he was only given a copy of the contract in English; he could not read the contract and, as a result, Webb Ford was able to trick him into signing a lease, rather than a purchase agreement; such contract was induced by unconscionable conduct; and, because it was illegal, the contract was unenforceable.

This allegation is insufficient to state a cause of action against Ford under section 2A-108....First, Ford is an entirely different entity than Webb Ford and plaintiff does not assert otherwise. Nor does plaintiff assert that Webb Ford was acting as Ford’s

agent in inducing plaintiff to sign the lease. Plaintiff asserts no basis on which Ford can be found liable for something Webb Ford did. Second, there is no allegation as to how the contract violates [the statute], merely the legal conclusion that it does, as well as the unsupported legal conclusion that a violation of [it] is necessarily unconscionable....[Further discussion omitted.]

For the reasons stated above, we affirm the trial court's dismissal of counts IV, V and VI of plaintiff's second amended complaint. We reverse the court's dismissal of count I and remand for further proceedings. Affirmed in part and reversed in part; cause remanded.

### CASE QUESTIONS

1. Under what circumstances, if any, would breaking into a locked garage to repossess a car *not* be considered a breach of the peace?
2. The court did not decide that a breach of the peace had occurred. What would determine that such a breach had occurred?
3. Why did the court dismiss the plaintiff's claim (under UCC Article 2A) that it was unconscionable of Ford to trick him into signing a lease when he thought he was signing a purchase contract? Would that section of Article 2A make breaking into his garage unconscionable?
4. What alternatives had Ford besides taking the car from the plaintiff's locked garage?
5. If it was determined on remand that a breach of the peace had occurred, what happens to Ford?

### Defenses of the Principal Debtor as against Reimbursement to Surety

Fidelity and Deposit Co. of Maryland v. Douglas Asphalt Co.

338 Fed.Appx. 886, 11th Cir. Ct. (2009)

**Per Curium:** Latin for “by the court.” A decision of an appeals court as a whole in which no judge is identified as the specific author.

The Georgia Department of Transportation (“GDOT”) contracted with Douglas Asphalt Company to perform work on an interstate highway. After Douglas Asphalt allegedly failed to pay its suppliers and subcontractors and failed to perform under the contract, GDOT defaulted and terminated Douglas Asphalt. Fidelity and Deposit

Company of Maryland and Zurich American Insurance Company had executed payment and performance bonds in connection with Douglas Asphalt's work on the interstate, and after Douglas Asphalt's default, Fidelity and Zurich spent \$15,424,798 remedying the default.

Fidelity and Zurich, seeking to recover their losses related to their remedy of the default, brought this suit against Douglas Asphalt, Joel Spivey, and Ronnie Spivey. The Spiveys and Douglas Asphalt had executed a General Indemnity Agreement in favor of Fidelity and Zurich. They promised to reimburse the surety for its expenses and hold it harmless for further liability.

After a bench trial, the district court entered judgment in favor of Fidelity and Zurich for \$16,524,798. Douglas Asphalt and the Spiveys now appeal.

Douglas Asphalt and the Spiveys argue that the district court erred in entering judgment in favor of Fidelity and Zurich because Fidelity and Zurich acted in bad faith in three ways.

First, Douglas Asphalt and the Spiveys argue that the district court erred in not finding that Fidelity and Zurich acted in bad faith because they claimed excessive costs to remedy the default. Specifically, Douglas Asphalt and the Spiveys argue that they introduced evidence that the interstate project was 98% complete, and that only approximately \$3.6 million was needed to remedy any default. But, the district court found that the interstate project was only 90%–92% complete and that approximately \$2 million needed to be spent to correct defective work already done by Douglas Asphalt. Douglas Asphalt and the Spiveys have not shown that the district court's finding was clearly erroneous, and accordingly, their argument that Fidelity and Zurich showed bad faith in claiming that the project was only 90% complete and therefore required over \$15 million to remedy the default fails.

Second, Douglas Asphalt and the Spiveys argue that Fidelity and Zurich acted in bad faith by failing to contest the default. However, the district court concluded that the indemnity agreement required Douglas Asphalt and the Spiveys to request a contest of the default, and to post collateral security to pay any judgment rendered in the course of contesting the default. The court's finding that Douglas Asphalt and the Spiveys made no such request and posted no collateral security was not clearly erroneous, and the sureties had no independent duty to investigate a default. Accordingly, Fidelity and Zurich's failure to contest the default does not show bad faith.

Finally, Douglas Asphalt and the Spiveys argue that Fidelity and Zurich's refusal to permit them to remain involved with the interstate project, either as a contractor or consultant, was evidence of bad faith. Yet, Douglas Asphalt and the Spiveys did not direct the district court or this court to any case law that holds that the refusal to permit a defaulting contractor to continue working on a project is bad faith. As the district court concluded, Fidelity and Zurich had a contractual right to take possession of all the work under the contract and arrange for its completion. Fidelity and Zurich exercised that contractual right, and, as the district court noted, the exercise of a contractual right is not evidence of bad faith.

Finding no error, we affirm the judgment of the district court.

### CASE QUESTIONS

1. Why were Douglas Asphalt and the Spiveys supposed to pay the sureties nearly \$15.5 million?
2. What did the plaintiffs claim the defendant sureties did wrong as relates to how much money they spent to cure the default?
3. What is a "contest of the default"?
4. Why would the sureties probably *not* want the principal involved in the project?

## **28.6 Summary and Exercises**



## Summary

The law governing security interests in personal property is Article 9 of the UCC, which defines a security interest as an interest in personal property or fixtures that secures payment or performance of an obligation. Article 9 lumps together all the former types of security devices, including the pledge, chattel mortgage, and conditional sale.

Five types of tangible property may serve as collateral: (1) consumer goods, (2) equipment, (3) farm products, (4) inventory, and (5) fixtures. Five types of intangibles may serve as collateral: (1) accounts, (2) general intangibles (e.g., patents), (3) documents of title, (4) chattel paper, and (5) instruments. Article 9 expressly permits the debtor to give a security interest in after-acquired collateral.

To create an enforceable security interest, the lender and borrower must enter into an agreement establishing the interest, and the lender must follow steps to ensure that the security interest first attaches and then is perfected. There are three general requirements for attachment: (1) there must be an authenticated agreement (or the collateral must physically be in the lender's possession), (2) the lender must have given value, and (3) the debtor must have some rights in the collateral. Once the interest attaches, the lender has rights in the collateral superior to those of unsecured creditors. But others may defeat his interest unless he perfects the security interest. The three common ways of doing so are (1) filing a financing statement, (2) pledging collateral, and (3) taking a purchase-money security interest (PMSI) in consumer goods.

A financing statement is a simple notice, showing the parties' names and addresses, the signature of the debtor, and an adequate description of the collateral. The financing statement, effective for five years, must be filed in a public office; the location of the office varies among the states.

Security interests in instruments and negotiable documents can be perfected only by the secured party's taking possession, with twenty-one-day grace periods applicable under certain circumstances. Goods may also be secured through pledging, which is often done through field warehousing. If a seller of consumer goods takes a PMSI in the goods sold, then perfection is automatic and no filing is required, although the lender may file and probably should, to avoid losing seniority to a bona fide purchaser of consumer goods without knowledge of the security interest, if the goods are used for personal, family, or household purposes.

The general priority rule is "first in time, first in right." Priority dates from the earlier of two events: (1) filing a financing statement covering the collateral or (2) other perfection of the security interest. Several exceptions to this rule arise when creditors take a PMSI, among them, when a buyer in the ordinary course of business takes free of a security interest created by the seller.

On default, a creditor may repossess the collateral. For the most part, self-help private repossession continues to be lawful but risky. After repossession, the lender may sell the collateral or accept it in satisfaction of the debt. Any excess in the selling price above the debt amount must go to the debtor.

Suretyship is a legal relationship that is created when one person contracts to be responsible for the proper fulfillment of another's obligation, in case the latter (the principal debtor) fails to fulfill it. The surety may avail itself of the principal's contract defenses, but under various circumstances, defenses may be available to the one that are not available to the other. One general defense often raised by sureties is alteration of the contract. If the surety is required to perform, it has rights for reimbursement against the principal, including interest and legal fees; and if there is more than one surety, each standing for part of the obligation, one who pays a disproportionate part may seek contribution from the others.

## EXERCISES

1. Kathy Knittle borrowed \$20,000 from Bank to buy inventory to sell in her knit shop and signed a security agreement listing as collateral the entire present and future inventory in the shop, including proceeds from the sale of inventory. Bank filed no financing statement. A month later, Knittle borrowed \$5,000 from Creditor, who was aware of Bank's security interest. Knittle then declared bankruptcy. Who has priority, Bank or Creditor?
2. Assume the same facts as in Exercise 1, except Creditor—again, aware of Bank's security interest—filed a financing statement to perfect its interest. Who has priority, Bank or Creditor?
3. Harold and Wilma are married. First Bank has a mortgage on their house, and it covers after-acquired property. Because Harold has a new job requiring travel to neighboring cities, they purchase a second car for Wilma's normal household use, financed by Second Bank. They sign a security agreement; Second Bank files nothing. If they were to default on their house payments, First Bank could repossess the house; could it repossess the car, too?
4.
  - a. Kathy Knittle borrowed \$20,000 from Bank to buy inventory to sell in her knit shop and signed a security agreement listing her collateral—present and future—as security for the loan. Carlene Customer bought yarn and a tabletop loom from Knittle. Shortly thereafter, Knittle declared bankruptcy. Can Bank get the loom from Customer?
  - b. Assume that the facts are similar to those in Exercise 4a, except that the loom that Knittle sold had been purchased from Larry Loomaker, who had himself given a secured interest in it (and the other looms he manufactured) from Fine Lumber Company (FLC) to finance the purchase of the lumber to make the looms. Customer bought the loom from Knittle (unaware of Loomaker's situation); Loomaker failed to pay FLC. Why can FLC repossess the loom from Customer?
  - c. What recourse does Customer have now?
5. Creditor loaned Debtor \$30,000 with the provision that the loan was callable by Creditor with sixty days' notice to Debtor. Debtor, having been called for repayment, asked for a ninety-day extension, which Creditor assented to, provided that Debtor would put up a surety to secure repayment. Surety agreed to serve as surety. When Debtor defaulted, Creditor turned to Surety for payment. Surety asserted that

Creditor had given no consideration for Surety's promise, and therefore Surety was not bound. Is Surety correct?

6.
  - a. Mrs. Ace said to University Bookstore: "Sell the books to my daughter. I'll pay for them." When University Bookstore presented Mrs. Ace a statement for \$900, she refused to pay, denying she'd ever promised to do so, and she raised the statute of frauds as a defense. Is this a good defense?
  - b. Defendant ran a stop sign and crashed into Plaintiff's car, causing \$8,000 damage. Plaintiff's attorney orally negotiated with Defendant's insurance company, Goodhands Insurance, to settle the case. Subsequently, Goodhands denied liability and refused to pay, and it raised the statute of frauds as a defense, asserting that any promise by it to pay for its insured's negligence would have to be in writing to be enforceable under the statute's suretyship clause. Is Goodhands's defense valid?
  
7.
  - a. First Bank has a security interest in equipment owned by Kathy Knittle in her Knit Shop. If Kathy defaults on her loan and First Bank lawfully repossesses, what are the bank's options? Explain.
  - b. Suppose, instead, that First Bank had a security interest in Kathy's home knitting machine, worth \$10,000. She paid \$6,200 on the machine and then defaulted. Now what are the bank's options?

## SELF-TEST QUESTIONS

1. Creditors may obtain security
  - a. by agreement with the debtor
  - b. through operation of law
  - c. through both of the above
  - d. through neither of the above
  
2. Under UCC Article 9, when the debtor has pledged collateral to the creditor, what other condition is required for attachment of the security interest?
  - a. A written security agreement must be authenticated by the debtor.
  - b. There must be a financing statement filed by or for the creditor.
  - c. The secured party received consideration.
  - d. The debtor must have rights in the collateral.
  
3. To perfect a security interest, one may
  - a. file a financing statement
  - b. pledge collateral
  - c. take a purchase-money security interest in consumer goods
  - d. do any of the above
  
4. Perfection benefits the secured party by
  - a. keeping the collateral out of the debtor's reach
  - b. preventing another creditor from getting a secured interest in the collateral
  - c. obviating the need to file a financing statement
  - d. establishing who gets priority if the debtor defaults
  
5. Creditor filed a security interest in inventory on June 1, 2012. Creditor's interest takes priority over which of the following?
  - a. a purchaser in the ordinary course of business who bought on June 5

- b. mechanic's lien filed on May 10
- c. purchase-money security interest in after-acquired property who filed on May 15
- d. judgment lien creditor who filed the judgment on June 10

### SELF-TEST ANSWERS

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

## Chapter 29

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### Mortgages and Nonconsensual Liens

#### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The basic concepts of mortgages
2. How the mortgage is created
3. Priorities with mortgages as security devices
4. Termination of the mortgage
5. Other methods of using real estate as security
6. Nonconsensual liens

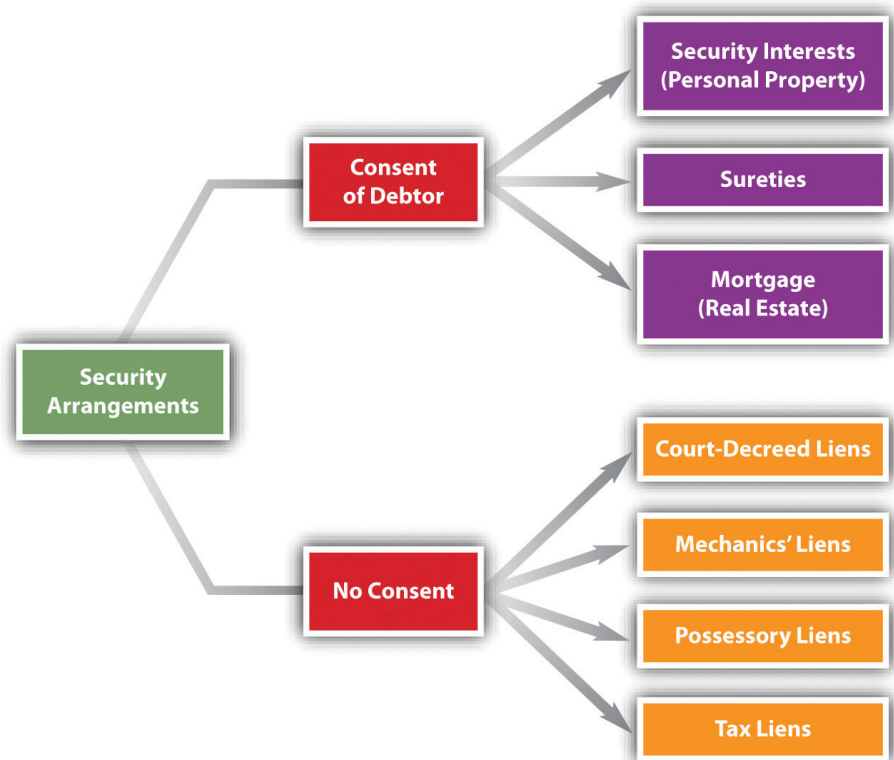
## 29.1 Uses, History, and Creation of Mortgages

### LEARNING OBJECTIVES

1. Understand the terminology used in mortgage transactions, and how mortgages are used as security devices.
2. Know a bit about the history of mortgages.
3. Understand how the mortgage is created.

Having discussed in [Chapter 28 "Secured Transactions and Suretyship"](#) security interests in personal property and suretyship—two of the three common types of consensual security arrangements—we turn now to the third type of consensual security arrangement, the mortgage. We also discuss briefly various forms of nonconsensual liens (see [Figure 29.1 "Security Arrangements"](#)).

Figure 29.1 *Security Arrangements*





## Definitions

A **mortgage**<sup>1</sup> is a means of securing a debt with real estate. A long time ago, the mortgage was considered an actual transfer of title, to become void if the debt was paid off. The modern view, held in most states, is that the mortgage is but a lien, giving the holder, in the event of default, the right to sell the property and repay the debt from the proceeds. The person giving the mortgage is the **mortgagor**<sup>2</sup>, or borrower. In the typical home purchase, that's the buyer. The buyer needs to borrow to finance the purchase; in exchange for the money with which to pay the seller, the buyer "takes out a mortgage" with, say, a bank. The lender is the **mortgagee**<sup>3</sup>, the person or institution holding the mortgage, with the right to foreclose on the property if the debt is not timely paid. Although the law of real estate mortgages is different from the set of rules in Article 9 of the Uniform Commercial Code (UCC) that we examined in [Chapter 28 "Secured Transactions and Suretyship"](#), the circumstances are the same, except that the security is real estate rather than personal property (secured transactions) or the promise of another (suretyship).

## The Uses of Mortgages

Most frequently, we think of a mortgage as a device to fund a real estate purchase: for a homeowner to buy her house, or for a commercial entity to buy real estate (e.g., an office building), or for a person to purchase farmland. But the value in real estate can be mortgaged for almost any purpose (a home equity loan): a person can take out a mortgage on land to fund a vacation. Indeed, during the period leading up to the recession in 2007–08, a lot of people borrowed money on their houses to buy things: boats, new cars, furniture, and so on. Unfortunately, it turned out that some of the real estate used as collateral was overvalued: when the economy weakened and people lost income or their jobs, they couldn't make the mortgage payments. And, to make things worse, the value of the real estate sometimes sank too, so that the debtors owed more on the property than it was worth (that's called being underwater). They couldn't sell without taking a loss, and they couldn't make the payments. Some debtors just walked away, leaving the banks with a large number of houses, commercial buildings, and even shopping centers on their hands.

1. Security in which collateral is land.
2. One who gives a mortgage; the debtor.
3. The party who holds a mortgage; the creditor (such as a bank).

## Short History of Mortgage Law

The mortgage has ancient roots, but the form we know evolved from the English land law in the Middle Ages. Understanding that law helps to understand modern mortgage law. In the fourteenth century, the mortgage was a deed that actually transferred title to the mortgagee. If desired, the mortgagee could move into the house, occupy the property, or rent it out. But because the mortgage obligated him

to apply to the mortgage debt whatever rents he collected, he seldom ousted the mortgagor. Moreover, the mortgage set a specific date (the “law day”) on which the debt was to be repaid. If the mortgagor did so, the mortgage became void and the mortgagor was entitled to recover the property. If the mortgagor failed to pay the debt, the property automatically vested in the mortgagee. No further proceedings were necessary.

This law was severe. A day’s delay in paying the debt, for any reason, forfeited the land, and the courts strictly enforced the mortgage. The only possible relief was a petition to the king, who over time referred these and other kinds of petitions to the courts of equity. At first fitfully, and then as a matter of course (by the seventeenth century), the equity courts would order the mortgagee to return the land when the mortgagor stood ready to pay the debt plus interest. Thus a new right developed: the *equitable right of redemption*, known for short as the equity of redemption. In time, the courts held that this equity of redemption was a form of property right; it could be sold and inherited. This was a powerful right: no matter how many years later, the mortgagor could always recover his land by proffering a sum of money.

Understandably, mortgagees did not warm to this interpretation of the law, because their property rights were rendered insecure. They tried to defeat the equity of redemption by having mortgagors waive and surrender it to the mortgagees, but the courts voided waiver clauses as a violation of public policy. Hence a mortgage, once a transfer of title, became a security for debt. A mortgage as such can never be converted into a deed of title.

The law did not rest there. Mortgagees won a measure of relief in the development of the **foreclosure**<sup>4</sup>. On default, the mortgagee would seek a court order giving the mortgagor a fixed time—perhaps six months or a year—within which to pay off the debt; under the court decree, failure meant that the mortgagor was forever foreclosed from asserting his right of redemption. This **strict foreclosure**<sup>5</sup> gave the mortgagee outright title at the end of the time period.

4. To shut off the owner’s interest in property and sell it upon default.

5. The creditor takes the collateral, discharges the debtor, and has no right to seek any deficiency.

6. To sell land upon buyer’s default at a public auction.

In the United States today, most jurisdictions follow a somewhat different approach: the mortgagee forecloses by forcing a public sale at auction. Proceeds up to the amount of the debt are the mortgagee’s to keep; surplus is paid over to the mortgagor. **Foreclosure by sale**<sup>6</sup> is the usual procedure in the United States. At bottom, its theory is that a mortgage is a lien on land. (Foreclosure issues are further discussed in Section 29.2 "Priority, Termination of the Mortgage, and Other Methods of Using Real Estate as Security".)

Under statutes enacted in many states, the mortgagor has one last chance to recover his property, even after foreclosure. This statutory **right of redemption**<sup>7</sup> extends the period to repay, often by one year.

## Creation of the Mortgage Statutory Regulation

The decision whether to lend money and take a mortgage is affected by several federal and state regulations.

### Consumer Credit Statutes Apply

Statutes dealing with consumer credit transactions (as discussed in [Chapter 27 "Consumer Credit Transactions"](#)) have a bearing on the mortgage, including state usury statutes, and the federal Truth in Lending Act and Equal Credit Opportunity Act.

### Real Estate Settlement Procedures Act

Other federal statutes are directed more specifically at mortgage lending. One, enacted in 1974, is the Real Estate Settlement Procedures Act (RESPA), aimed at abuses in the settlement process—the process of obtaining the mortgage and purchasing a residence. The act covers all federally related first mortgage loans secured by residential properties for one to four families. It requires the lender to disclose information about settlement costs in advance of the closing day: it prohibits the lender from “springing” unexpected or hidden costs onto the borrower. The RESPA is a US Department of Housing and Urban Development (HUD) consumer protection statute designed to help home buyers be better shoppers in the home-buying process, and it is enforced by HUD. It also outlaws what had been a common practice of giving and accepting kickbacks and referral fees. The act prohibits lenders from requiring mortgagors to use a particular company to obtain insurance, and it limits add-on fees the lender can demand to cover future insurance and tax charges.

Redlining. Several statutes are directed to the practice of **redlining**<sup>8</sup>—the refusal of lenders to make loans on property in low-income neighborhoods or impose stricter mortgage terms when they do make loans there. (The term derives from the supposition that lenders draw red lines on maps around ostensibly marginal neighborhoods.) The most important of these is the Community Reinvestment Act (CRA) of 1977.<sup>12</sup> United States Code, Section 2901. The act requires the appropriate federal financial supervisory agencies to encourage regulated financial institutions to meet the credit needs of the local communities in which they are chartered,

7. After foreclosure, for a limited period, the debtor's right to reclaim the property sold, upon paying all costs and fees.

8. The alleged practice by lenders not to lend within certain geographic areas; considered discrimination.

consistent with safe and sound operation. To enforce the statute, federal regulatory agencies examine banking institutions for CRA compliance and take this information into consideration when approving applications for new bank branches or for mergers or acquisitions. The information is compiled under the authority of the Home Mortgage Disclosure Act of 1975, which requires financial institutions within its purview to report annually by transmitting information from their loan application registers to a federal agency.

### The Note and the Mortgage Documents

The note and the mortgage documents are the contracts that set up the deal: the mortgagor gets credit, and the mortgagee gets the right to repossess the property in case of default.

#### The Note

If the lender decides to grant a mortgage, the mortgagor signs two critical documents at the closing: the note and the mortgage. We cover notes in [Chapter 22 "Nature and Form of Commercial Paper"](#). It is enough here to recall that in a note (really a type of IOU), the mortgagor promises to pay a specified principal sum, plus interest, by a certain date or dates. The note is the underlying obligation for which the mortgage serves as security. Without the note, the mortgagee would have an empty document, since the mortgage would secure nothing. Without a mortgage, a note is still quite valid, evidencing the debtor's personal obligation.

One particular provision that usually appears in both mortgages and the underlying notes is the **acceleration clause**<sup>9</sup>. This provides that if a debtor should default on any particular payment, the entire principal and interest will become due immediately at the lender's option. Why an acceleration clause? Without it, the lender would be powerless to foreclose the entire mortgage when the mortgagor defaulted but would have to wait until the expiration of the note's term. Although the acceleration clause is routine, it will not be enforced unless the mortgagee acts in an equitable and fair manner. The problem arises where the mortgagor's default was the result of some unconscionable conduct of the mortgagee, such as representing to the mortgagee that she might take a sixty-day "holiday" from having to make payments. In *Paul H. Cherry v. Chase Manhattan Mortgage Group* ([Section 29.4 "Cases"](#)), the equitable powers of the court were invoked to prevent acceleration.

9. A contract clause providing that the entire amount owing in debt becomes due if one payment is missed.

## The Mortgage

Under the statute of frauds, the mortgage itself must be evidenced by some writing to be enforceable. The mortgagor will usually make certain promises and warranties to the mortgagee and state the amount and terms of the debt and the mortgagor's duties concerning taxes, insurance, and repairs. A sample mortgage form is presented in [Figure 29.2 "Sample Mortgage Form"](#).

Figure 29.2 *Sample Mortgage Form*

Mortgage

This mortgage is made the \_\_\_ day of \_\_\_, 20\_\_\_, between the mortgagor, [name of mortgagor], at [insert residence], and [name of mortgagee], mortgagee, at [insert residence].

To secure the payment of an indebtedness of \$[numbers] [written out] dollars, to be paid on starting on the \_\_\_ day of \_\_\_, 20\_\_\_ with interest to be computed from \_\_\_ at the rate of \_\_\_% per year, and to be paid monthly, according to the promissory note of today's date, the mortgagor hereby mortgages to the mortgagee.

[address and legal description of the property].

And the mortgagor promises the mortgagee as follows:

1. That the mortgagor will pay the debt as provided.
2. That the mortgagor will keep the buildings on the premises insured against loss by fire for the benefit of the mortgagee; that s/he will assign and deliver the policies to the mortgagee; and that s/he will reimburse the mortgagee for any premiums paid for insurance made by the mortgagor's default in insuring the buildings.
3. That no building on the premises shall be removed or demolished without the consent of the mortgagee.
4. That the whole principal sum and interest shall become due at the option of the mortgagee:
  - after default in the payment of any installment of principal or of interest for \_\_\_ days;
  - or after default in the payment of any tax, water rate or assessment for \_\_\_ days, after notice and demand;
  - or after default after notice and demand either in assigning and delivering the policies insuring the buildings against loss by fire to the mortgagee;
  - or in reimbursing the mortgagee for premiums paid on such insurance, as provided here;
5. That the mortgagor will pay all taxes, assessments or water rates, and if s/he defaults, the mortgagee may pay instead.
6. That the mortgagor within \_\_\_ days upon request in person or \_\_\_ days upon request by mail will furnish a written statement, properly acknowledged, of the amount due on this mortgage and whether any offsets or defenses exist against the mortgage debt.
7. That any notice and demand or request shall be in writing and may be served in person or by mail.
9. That the mortgagor warrants the title to the premises.

As evidence of this agreement between the parties, this mortgage is signed below by them.

\_\_\_\_\_ Mortgagor.

\_\_\_\_\_ Mortgagee.

### KEY TAKEAWAY

As a mechanism of security, a mortgage is a promise by the debtor (mortgagor) to repay the creditor (mortgagee) for the amount borrowed or credit extended, with real estate put up as security. If the mortgagor doesn't pay as promised, the mortgagee may repossess the real estate. Mortgage law has ancient roots and brings with it various permutations on the theme that even if the mortgagor defaults, she may nevertheless have the right to get the property back or at least be reimbursed for any value above that necessary to pay the debt and the expenses of foreclosure. Mortgage law is regulated by state and federal statute.

### EXERCISES

1. What role did the right of redemption play in courts of equity changing the substance of a mortgage from an actual transfer of title to the mortgagee to a mere lien on the property?
2. What abuses did the federal RESPA address?
3. What are the two documents most commonly associated with mortgage transactions?

## 29.2 Priority, Termination of the Mortgage, and Other Methods of Using Real Estate as Security

### LEARNING OBJECTIVES

1. Understand why it is important that the mortgagee (creditor) record her interest in the debtor's real estate.
2. Know the basic rule of priority—who gets an interest in the property first in case of default—and the exceptions to the rule.
3. Recognize the three ways mortgages can be terminated: payment, assumption, and foreclosure.
4. Be familiar with other methods (besides mortgages) by which real property can be used as security for a creditor.

### Priorities in Real Property Security

You may recall from [Chapter 28 "Secured Transactions and Suretyship"](#) how important it is for a creditor to perfect its secured interest in the goods put up as collateral. Absent perfection, the creditor stands a chance of losing out to another creditor who took its interest in the goods subsequent to the first creditor. The same problem is presented in real property security: the mortgagee wants to make sure it has first claim on the property in case the mortgagor (debtor) defaults.

### The General Rule of Priorities

The general rule of priority is the same for real property security as for personal property security: the first in time to give notice of the secured interest is first in right. For real property, the notice is by **recording**<sup>10</sup> the mortgage. Recording is the act of giving public notice of changes in interests in real estate. Recording was created by statute; it did not exist at common law. The typical recording statute calls for a transfer of title or mortgage to be placed in a particular county office, usually the auditor, recorder, or register of deeds.

A mortgage is valid between the parties whether or not it is recorded, but a mortgagee might lose to a third party—another mortgagee or a good-faith purchaser of the property—unless the mortgage is recorded.

10. The official filing of a legal document (a mortgage or a deed) so as to inform the world of it.

## Exceptions to the General Rule

There are exceptions to the general rule; two are taken up here.

### Fixture Filing

The fixture-filing provision in Article 9 of the UCC is one exception to the general rule. As noted in [Chapter 28 "Secured Transactions and Suretyship"](#), the UCC gives priority to purchase-money security interests in fixtures if certain requirements are met.

### Future Advances

A bank might make advances to the debtor after accepting the mortgage. If the future advances are obligatory, then the first-in-time rule applies. For example: Bank accepts Debtor's mortgage (and records it) and extends a line of credit on which Debtor draws, up to a certain limit. (Or, as in the construction industry, Bank might make periodic advances to the contractors as work progresses, backed by the mortgage.) Second Creditor loans Debtor money—secured by the same property—before Debtor began to draw against the first line of credit. Bank has priority: by searching the mortgage records, Second Creditor should have been on notice that the first mortgage was intended as security for the entire line of credit, although the line was doled out over time.

However, if the future advances are not obligatory, then priority is determined by notice. For example, a bank might take a mortgage as security for an original loan and for any future loans that the bank chooses to make. A later creditor can achieve priority by notifying the bank with the first mortgage that it is making an advance. Suppose Jimmy mortgages his property to a wealthy dowager, Mrs. Calabash, in return for an immediate loan of \$20,000 and they agree that the mortgage will serve as security for future loans to be arranged. The mortgage is recorded. A month later, before Mrs. Calabash loans him any more money, Jimmy gives a second mortgage to Louella in return for a loan of \$10,000. Louella notifies Mrs. Calabash that she is loaning Jimmy the money. A month later, Mrs. Calabash loans Jimmy another \$20,000. Jimmy then defaults, and the property turns out to be worth only \$40,000. Whose claims will be honored and in what order? Mrs. Calabash will collect her original \$20,000, because it was recited in the mortgage and the mortgage was recorded. Louella will collect her \$10,000 next, because she notified the first mortgage holder of the advance. That leaves Mrs. Calabash in third position to collect what she can of her second advance. Mrs. Calabash could have protected herself by refusing the second loan.



## Termination of the Mortgage

The mortgagor's liability can terminate in three ways: payment, assumption (with a novation), or foreclosure.

### Payment

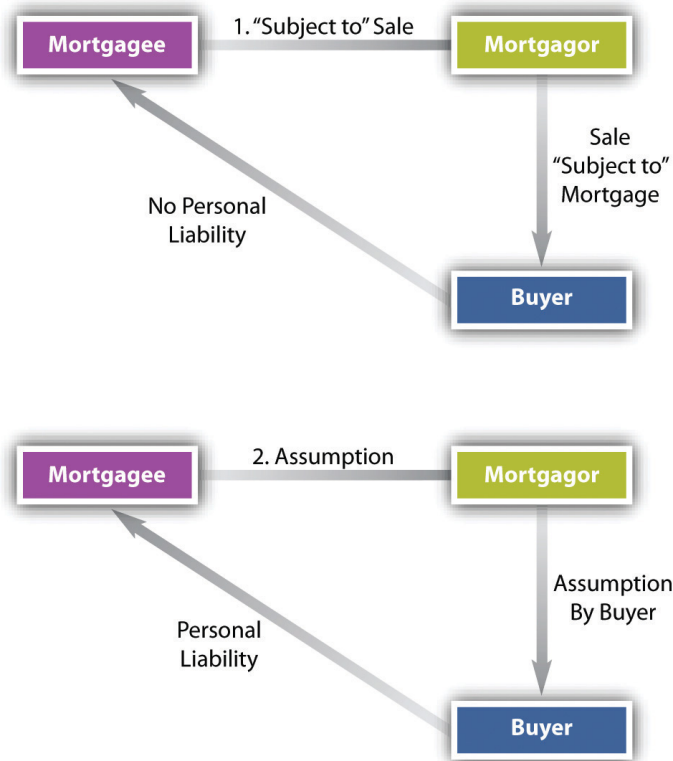
Unless they live in the home for twenty-five or thirty years, the mortgagors usually pay off the mortgage when the property is sold. Occasionally, mortgages are paid off in order to refinance. If the mortgage was taken out at a time of high interest rates and rates later drop, the homeowner might want to obtain a new mortgage at the lower rates. In many mortgages, however, this entails extra closing costs and penalties for prepaying the original mortgage. Whatever the reason, when a mortgage is paid off, the discharge should be recorded. This is accomplished by giving the mortgagor a copy of, and filing a copy of, a Satisfaction of Mortgage document. In the *Paul H. Cherry v. Chase Manhattan Mortgage Group* case ([Section 29.4 "Cases"](#)), the bank *mistakenly* filed the Satisfaction of Mortgage document, later discovered its mistake, retracted the satisfaction, accelerated the loan because the mortgagor stopped making payments (the bank, seeing no record of an outstanding mortgage, refused to accept payments), and then tried to foreclose on the mortgage, meanwhile having lost the note and mortgage besides.

### Assumption

The property can be sold without paying off the mortgage if the mortgage is assumed by the new buyer, who agrees to pay the seller's (the original mortgagor's) debt. This is a novation *if*, in approving the assumption, the bank releases the old mortgagor and substitutes the buyer as the new debtor.

The buyer need not assume the mortgage. If the buyer purchases the property without agreeing to be personally liable, this is a sale "subject to" the mortgage (see [Figure 29.3 "Subject to" Sales versus Assumption](#)). In the event of the seller's subsequent default, the bank can foreclose the mortgage and sell the property that the buyer has purchased, but the buyer is not liable for any deficiency.

Figure 29.3 “Subject to” Sales versus Assumption



What if mortgage rates are high? Can buyers assume an existing low-rate mortgage from the seller rather than be forced to obtain a new mortgage at substantially higher rates? Banks, of course, would prefer not to allow that when interest rates are rising, so they often include in the mortgage a **due-on-sale clause**<sup>11</sup>, by which the entire principal and interest become due when the property is sold, thus forcing the purchaser to get financing at the higher rates. The clause is a device for preventing subsequent purchasers from assuming loans with lower-than-market interest rates. Although many state courts at one time refused to enforce the due-on-sale clause, Congress reversed this trend when it enacted the Garn–St. Germain Depository Institutions Act in 1982.<sup>12</sup> United States Code, Section 1701-j. The act preempts state laws and upholds the validity of due-on-sale clauses. When interest rates are low, banks have no interest in enforcing such clauses, and there are ways to work around the due-on-sale clause.

### Foreclosure

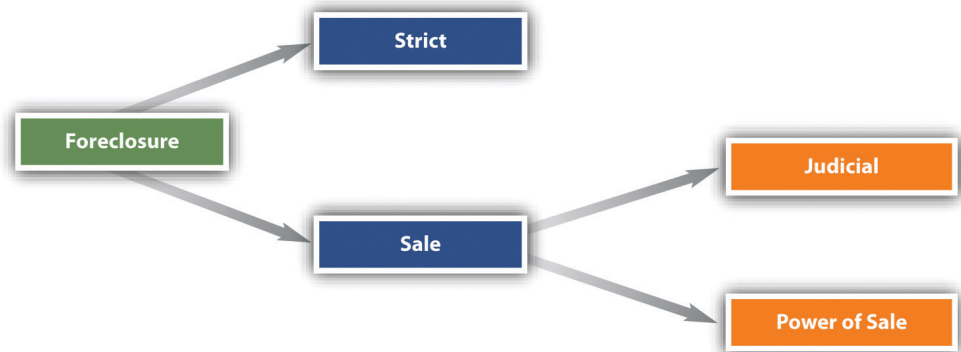
The third method of terminating the mortgage is by foreclosure when a mortgagor defaults. Even after default, the mortgagor has the right to exercise his equity of redemption—that is, to redeem the property by paying the principal and interest in

11. A contract clause requiring the entire mortgage amount be paid to the mortgagee if the property is sold; it prevents any assumption.

full. If he does not, the mortgagee may foreclose the equity of redemption. Although strict foreclosure is used occasionally, in most cases the mortgagee forecloses by one of two types of sale (see [Figure 29.4 "Foreclosure"](#)).

The first type is **judicial sale**<sup>12</sup>. The mortgagee seeks a court order authorizing the sale to be conducted by a public official, usually the sheriff. The mortgagor is entitled to be notified of the proceeding and to a hearing. The second type of sale is that conducted under a clause called a **power of sale**<sup>13</sup>, which many lenders insist be contained in the mortgage. This clause permits the mortgagee to sell the property at public auction without first going to court—although by custom or law, the sale must be advertised, and typically a sheriff or other public official conducts the public sale or auction.

Figure 29.4 Foreclosure



Once the property has been sold, it is deeded to the new purchaser. In about half the states, the mortgagor still has the right to redeem the property by paying up within six months or a year—the statutory redemption period. Thereafter, the mortgagor has no further right to redeem. If the sale proceeds exceed the debt, the mortgagor is entitled to the excess unless he has given second and third mortgages, in which case the junior mortgagees are entitled to recover their claims before the mortgagor. If the proceeds are less than the debt, the mortgagee is entitled to recover the deficiency from the mortgagor. However, some states have statutorily abolished deficiency judgments.

12. A court-ordered sale of property by a public official, such as the sheriff.

13. A term allowing the mortgagee to sell real estate upon mortgagor's default without going to court.

### Other Methods of Using Real Estate as Security

Besides the mortgage, there are other ways to use real estate as security. Here we take up two: the deed of trust and the installment or land contract.

## Deed of Trust

The **deed of trust**<sup>14</sup> is a device for securing a debt with real property; unlike the mortgage, it requires three parties: the borrower, the trustee, and the lender. Otherwise, it is at base identical to a mortgage. The borrower conveys the land to a third party, the trustee, to hold in trust for the lender until the borrower pays the debt. (The trustee's interest is really a kind of legal fiction: that person is expected to have no interest in the property.) The primary benefit to the deed of trust is that it simplifies the foreclosure process by containing a provision empowering the trustee to sell the property on default, thus doing away with the need for any court filings. The disinterested third party making sure things are done properly becomes the trustee, not a judge. In thirty states and the District of Columbia—more than half of US jurisdictions—the deed of trust is usually used in lieu of mortgages. The states using the deed of trust system are as follows: Alabama, Alaska, Arkansas, Arizona, California, Colorado, District of Columbia, Georgia, Hawaii, Idaho, Iowa, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New Hampshire, North Carolina, Oklahoma, Oregon, Rhode Island, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, West Virginia, Wisconsin, and Wyoming.

But the deed of trust may have certain disadvantages as well. For example, when the debt has been fully paid, the trustee will not release the deed of trust until she sees that all notes secured by it have been marked canceled. Should the borrower have misplaced the canceled notes or failed to keep good records, he will need to procure a surety bond<sup>14</sup> to protect the trustee in case of a mistake. This can be an expensive procedure. In many jurisdictions, the mortgage holder is prohibited from seeking a deficiency judgment if the holder chooses to sell the property through nonjudicial means.

*Alpha Imperial Building, LLC v. Schnitzer Family Investment, LLC*, [Section 29.4 "Cases"](#), discusses several issues involving deeds of trust.

## Installment or Land Contract

Under the **installment contract or land contract**<sup>15</sup>, the purchaser takes possession and agrees to pay the seller over a period of years. Until the final payment, title belongs to the seller. The contract will specify the type of deed to be conveyed at closing, the terms of payment, the buyer's duty to pay taxes and insure the premises, and the seller's right to accelerate on default. The buyer's particular concern in this type of sale is whether the seller in fact has title. The buyers can protect themselves by requiring proof of title and title insurance when the contract is signed. Moreover, the buyer should record the installment contract to protect against the seller's attempt to convey title to an innocent third-party purchaser while the contract is in effect.

14. A type of mortgage where title to the property is nominally in a trustee, who sells if the buyer defaults; it provides for a nonjudicial foreclosure.

15. The buyer makes installment payments on a real estate purchase, the title shifting when all payments are made.

The benefit to the land contract is that the borrower need not bank-qualify, so the pool of available buyers is larger, and buyers who have inadequate resources at the time of contracting but who have the expectation of a rising income in the future are good candidates for the land contract. Also, the seller gets all the interest paid by the buyer, instead of the bank getting it in the usual mortgage. The obvious disadvantage from the seller's point is that she will not get a big lump sum immediately: the payments trickle in over years (unless she can sell the contract to a third party, but that would be at a discount).

#### KEY TAKEAWAY

The general rule on priority in real property security is that the first creditor to record its interest prevails over subsequent creditors. There are some exceptions; the most familiar is that the seller of a fixture on a purchase-money security interest has priority over a previously recorded mortgagee. The mortgage will terminate by payment, assumption by a new buyer (with a novation releasing the old buyer), and foreclosure. In a judicial-sale foreclosure, a court authorizes the property's sale; in a power-of-sale foreclosure, no court approval is required. In most states, the mortgagor whose property was foreclosed is given some period of time—six months or a year—to redeem the property; otherwise, the sale is done, but the debtor may be liable for the deficiency, if any. The deed of trust avoids any judicial involvement by having the borrower convey the land to a disinterested trustee for the benefit of the lender; the trustee sells it upon default, with the proceeds (after expenses) going to the lender. Another method of real property security is a land contract: title shifts to the buyer only at the end of the term of payments.

## EXERCISES

1. A debtor borrowed \$350,000 to finance the purchase of a house, and the bank recorded its interest on July 1. On July 15, the debtor bought \$10,000 worth of replacement windows from Window Co.; Window Co. recorded its purchase-money security interest that day, and the windows were installed. Four years later, the debtor, in hard financial times, declared bankruptcy. As between the bank and Windows Co., who will get paid first?
2. Under what interest rate circumstances would banks insist on a due-on-sale clause? Under what interest rate circumstance would banks not object to a new person assuming the mortgage?
3. What is the primary advantage of the deed of trust? What is the primary advantage of the land contract?
4. A debtor defaulted on her house payments. Under what circumstances might a court *not* allow the bank's foreclosure on the property?

## 29.3 Nonconsensual Lien

### LEARNING OBJECTIVES

1. Understand the nonconsensual liens issued by courts—attachment liens and judgment liens—and how they are created.
2. Recognize other types of nonconsensual liens: mechanic's lien, possessory lien, and tax lien.

The security arrangements discussed so far—security interests, suretyship, mortgages—are all obtained by the creditor with the debtor's consent. A creditor may obtain certain liens without the debtor's consent.

### Court-Decreed Liens

Some nonconsensual liens are issued by courts.

#### Attachment Lien

An **attachment lien**<sup>16</sup> is ordered against a person's property—real or personal—to prevent him from disposing of it during a lawsuit. To obtain an attachment lien, the plaintiff must show that the defendant likely will dispose of or hide his property; if the court agrees with the plaintiff, she must post a bond and the court will issue a writ of attachment to the sheriff, directing the sheriff to seize the property. Attachments of real property should be recorded. Should the plaintiff win her suit, the court issues a writ of execution, directing the sheriff to sell the property to satisfy the judgment.

#### Judgment Lien

A **judgment lien**<sup>17</sup> may be issued when a plaintiff wins a judgment in court if an attachment lien has not already been issued. Like the attachment lien, it provides a method by which the defendant's property may be seized and sold.

16. A judicial lien imposed to preserve property during litigation.

17. A lien imposed to secure payment of a judgment owing.

## Mechanic's Lien

### Overview

The most common nonconsensual lien on real estate is the **mechanic's lien**<sup>18</sup>. A mechanic's lien can be obtained by one who furnishes labor, services, or materials to improve real estate: this is statutory, and the statute must be carefully followed. The "mechanic" here is one who works with his or her hands, not specifically one who works on machines. An automobile mechanic could not obtain a mechanic's lien on a customer's house to secure payment of work he did on her car. (The lien to which the automobile mechanic is entitled is a "possessory lien" or "artisan's lien," considered in [Section 29.3.3 "Possessory Lien"](#)) To qualify for a mechanic's lien, the claimant must file a sworn statement describing the work done, the contract made, or the materials furnished that permanently improved the real estate.

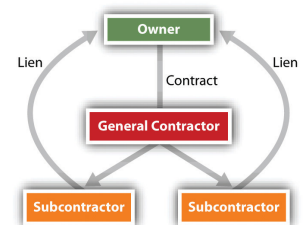
A particularly difficult problem crops up when the owner has paid the contractor, who in turn fails to pay his subcontractors. In many states, the subcontractors can file a lien on the owner's property, thus forcing the owner to pay them (see [Figure 29.5 "Subcontractors' Lien"](#))—and maybe twice. To protect themselves, owners can demand a sworn statement from general contractors listing the subcontractors used on the job, and from them, owners can obtain a waiver of lien rights before paying the general contractor.

### Procedure for Obtaining a Mechanic's Lien

Anyone claiming a lien against real estate must record a lien statement stating the amount due and the nature of the improvement. The lienor has a specified period of time (e.g., ninety days) to file from the time the work is finished. Recording as such does not give the lienor an automatic right to the property if the debt remains unpaid. All states specify a limited period of time, usually one year, within which the claimant must file suit to enforce the lien. Only if the court decides the lien is valid may the property be sold to satisfy the debt.

Difficult questions sometimes arise when a lien is filed against a landlord's property as a result of improvements and services provided to a tenant, as discussed in *F & D Elec. Contractors, Inc. v. Powder Coaters, Inc.*, [Section 29.4 "Cases"](#).

Figure 29.5 Subcontractors' Lien



### Mechanic's Liens Priorities

A mechanic's lien represents a special risk to the purchaser of real estate or to lenders who wish to take a mortgage. In most states, the mechanic's lien is given

18. A claim allowed to one who furnishes labor, services, or materials to improve property.



priority not from the date when the lien is recorded but from an earlier date—either the date the contractor was hired or the date construction began. Thus a purchaser or lender might lose priority to a creditor with a mechanic’s lien who filed after the sale or mortgage. A practical solution to this problem is to hold back part of the funds (purchase price or loan) or place them in escrow until the period for recording liens has expired.

### Possessory Lien

The most common nonconsensual lien on personal property (not real estate) is the **possessory lien**<sup>19</sup>. This is the right to continue to keep the goods on which work has been performed or for which materials have been supplied until the owner pays for the labor or materials. The possessory lien arises both under common law and under a variety of statutes. Because it is nonconsensual, the possessory lien is not covered by Article 9 of the UCC, which is restricted to consensual security interests. Nor is it governed by the law of mechanic’s liens, which are nonpossessory and relate only to work done to improve real property.

The common-law rule is that anyone who, under an express or implied contract, adds value to another’s chattel (personal property) by labor, skill, or materials has a possessory lien for the value of the services. Moreover, the lienholder may keep the chattel until her services are paid. For example, the dry cleaner shop is not going to release the wool jacket that you took in for cleaning unless you make satisfactory arrangements to pay for it, and the chain saw store won’t let you take the chain saw that you brought in for a tune-up until you pay for the labor and materials for the tune-up.

### Tax Lien

An important statutory lien is the federal **tax lien**<sup>20</sup>. Once the government assesses a tax, the amount due constitutes a lien on the owner’s property, whether real or personal. Until it is filed in the appropriate state office, others take priority, including purchasers, mechanics’ lienors, judgment lien creditors, and holders of security interests. But once filed, the tax lien takes priority over all subsequently arising liens. Federal law exempts some property from the tax lien; for example, unemployment benefits, books and tools of a trade, workers’ compensation, judgments for support of minor children, minimum amounts of wages and salary, personal effects, furniture, fuel, and provisions are exempt.

Local governments also can assess liens against real estate for failure to pay real estate taxes. After some period of time, the real estate may be sold to satisfy the tax amounts owing.

19. Lien imposed by one who has possession of goods to secure payment for improvements to them.

20. A lien imposed by the government to secure payment of taxes owing.

### KEY TAKEAWAY

There are four types of nonconsensual liens: (1) court-decreed liens are attachment liens, which prevent a person from disposing of assets pending a lawsuit, and judgment liens, which allow the prevailing party in a lawsuit to take property belonging to the debtor to satisfy the judgment; (2) mechanics' liens are authorized by statute, giving a person who has provided labor or material to a landowner the right to sell the property to get paid; (3) possessory liens on personal property allow one in possession of goods to keep them to satisfy a claim for work done or storage of them; and (4) tax liens are enforced by the government to satisfy outstanding tax liabilities and may be assessed against real or personal property.

### EXERCISES

1. The mortgagor's interests are protected in a judicial foreclosure by a court's oversight of the process; how is the mortgagor's interest protected when a deed of trust is used?
2. Why is the deed of trust becoming increasingly popular?
3. What is the rationale for the common-law possessory lien?
4. Mike Mechanic repaired Alice Ace's automobile in his shop, but Alice didn't have enough money to pay for the repairs. May Mike have a mechanic's lien on the car? A possessory lien?
5. Why does federal law exempt unemployment benefits, books and tools of a trade, workers' compensation, minimum amounts of wages and salary, personal effects, furniture, fuel, and other such items from the sweep of a tax lien?

## 29.4 Cases

### **Denial of Mortgagee's Right to Foreclose; Erroneous Filings; Lost Instruments**

Paul H. Cherry v. Chase Manhattan Mortgage Group

190 F.Supp.2d 1330 (Fed. Dist. Ct. FL 2002)

#### Background

[Paul Cherry filed a complaint suing Chase for Fair Debt Collection Practices Act violations and slander of credit.]...Chase counter-claimed for foreclosure and reestablishment of the lost note....

...Chase held a mortgage on Cherry's home to which Cherry made timely payments until August 2000. Cherry stopped making payments on the mortgage after he received a letter from Chase acknowledging his satisfaction of the mortgage. Cherry notified Chase of the error through a customer service representative. Cherry, however, received a check dated August 15, 2000, as an escrow refund on the mortgage. Chase subsequently recorded a Satisfaction of Mortgage into the Pinellas County public records on October 19, 2000. On November 14, 2000, Chase sent Cherry a "Loan Reactivation" letter with a new loan number upon which to make the payments. During this time, Cherry was placing his mortgage payments into a bank account, which subsequently were put into an escrow account maintained by his attorney. These payments were not, and have not, been tendered to Chase. As a result of the failure to tender, Chase sent Cherry an acceleration warning on November 17, 2000, and again on March 16, 2001. Chase notified the credit bureaus as to Cherry's default status and moved for foreclosure. In a letter addressed to Cherry's attorney, dated April 24, 2001, Chase's attorney advised Cherry to make the mortgage payments to Chase. Chase recorded a "vacatur, revocation, and cancellation of satisfaction of mortgage" (vacatur) [vacatur: an announcement filed in court that something is cancelled or set aside; an annulment] in the Pinellas County public records on May 3, 2001. Chase signed the vacatur on March 21, 2001, and had it notarized on March 27, 2001. Chase has also been unable to locate the original note, dated October 15, 1997, and deems it to be lost....

#### Foreclosure

Chase accelerated Cherry's mortgage debt after determining he was in a default status under the mortgage provisions. Chase claims that the right to foreclose under the note and mortgage is "absolute," [Citation], and that this Court should enforce the security interest in the mortgage though Chase made an administrative error in entering a Satisfaction of Mortgage into the public records....

#### Mortgage

...Chase relies on the Florida Supreme Court decision in *United Service Corp. v. Vi-An Const. Corp.*, [Citation] (Fla.1955), which held that a Satisfaction of Mortgage "made through a mistake may be canceled" and a mortgage reestablished as long as no other innocent third parties have "acquired an interest in the property." Generally the court looks to the rights of any innocent third parties, and if none exist, equity will grant relief to a mortgagee who has mistakenly satisfied a mortgage before fully paid. [Citation]. Both parties agree that the mortgage was released before the debt was fully paid. Neither party has presented any facts to this Court that implies the possibility nor existence of a third party interest. Although Cherry argues under *Biggs v. Smith*, 184 So. 106, 107 (1938), that a recorded satisfaction of mortgage is "prima facie evidence of extinguishment of a mortgage lien," Biggs does not apply this standard to mortgage rights affected by a mistake in the satisfaction.

Therefore, on these facts, this Court acknowledges that a vacatur is a proper remedy for Chase to correct its unilateral mistake since "equity will grant relief to those who have through mistake released a mortgage." [Citation.] Accordingly, this Court holds that an equity action is required to make a vacatur enforceable unless the parties consent to the vacatur or a similar remedy during the mortgage negotiation....

#### Tender

Cherry has not made a mortgage payment to Chase since August 2000, but claims to have made these payments into an escrow account, which he claims were paid to the escrow account because Chase recorded a satisfaction of his mortgage and, therefore, no mortgage existed. Cherry also claims that representatives of Chase rejected his initial attempts to make payments because of a lack of a valid loan number. Chase, however, correctly argues that payments made to an escrow account are not a proper tender of payment. *Matthews v. Lindsay*, [Citation] (1884) (requiring tender to be made to the court). Nor did Cherry make the required mortgage payments to the court as provided by [relevant court rules], allowing for a "deposit with the court all or any part of such sum or thing, whether that party claims all or any part of the sum or thing." Further, Chase also correctly argues that Cherry's failure to tender the payments from the escrow account or make deposits

with the court is more than just a “technical breach” of the mortgage and note. [Citation.]

Chase may, therefore, recover the entire amount of the mortgage indebtedness, unless the court finds a “limited circumstance” upon which the request may be denied. [Citation.] Although not presented by Chase in its discussion of this case, the Court may refuse foreclosure, notwithstanding that the defendant established a foreclosure action, if the acceleration was unconscionable and the “result would be inequitable and unjust.” This Court will analyze the inequitable result test and the limited circumstances by which the court may deny foreclosure.

First, this Court does not find the mortgage acceleration unconscionable by assuming *arguendo* [for the purposes of argument] that the mortgage was valid during the period that the Satisfaction of Mortgage was entered into the public records. Chase did not send the first acceleration warning until November 14, 2000, the fourth month of non-payment, followed by the second acceleration letter on March 16, 2001, the eighth month of non-payment. Although Cherry could have argued that a foreclosure action was an “inequitable” and “unjust” result after the Satisfaction of Mortgage was entered on his behalf, the result does not rise to an unconscionable level since Cherry could have properly tendered the mortgage payments to the court.

Second, the following “limited circumstances” will justify a court’s denial of foreclosure: 1) waiver of right to accelerate; 2) mortgagee estopped from asserting foreclosure because mortgagor reasonably assumed the mortgagee would not foreclose; 3) mortgagee failed to perform a condition precedent for acceleration; 4) payment made after default but prior to receiving intent to foreclose; or, 5) where there was intent to make to make timely payment, and it was attempted, or steps taken to accomplish it, but nevertheless the payment was not made due to a misunderstanding or excusable neglect, coupled with some conduct of the mortgagee which in a measure contributed to the failure to pay when due or within the grace period. [Citations.]

Chase fails to address this fifth circumstance in its motion, an apparent obfuscation of the case law before the court. This Court acknowledges that Cherry’s facts do not satisfy the first four limited circumstances. Chase at no time advised Cherry that the acceleration right was being waived; nor is Chase estopped from asserting foreclosure on the mortgage because of the administrative error, and Cherry has not relied on this error to his detriment; and since Chase sent the acceleration letter to Cherry and a request for payment to his attorney, there can be no argument that Cherry believed Chase would not foreclose. Chase has performed all conditions precedent required by the mortgage provisions prior to notice of the

acceleration; sending acceleration warnings on November 17, 2000, and March 16, 2001. Cherry also has no argument for lack of notice of intent to accelerate after default since he has not tendered a payment since July 2000, thus placing him in default of the mortgage provisions, and he admits receiving the acceleration notices.

This Court finds, however, that this claim fails squarely into the final limited circumstance regarding intent to make timely payments. Significant factual issues exist as to the intent of Cherry to make or attempt to make timely mortgage payments to Chase. Cherry claims that he attempted to make the payments, but was told by a representative of Chase that there was no mortgage loan number upon which to apply the payments. As a result, the mortgage payments were placed into an account and later into his counsel's trust account as a mortgage escrow. Although these payments should have, at a minimum, been placed with the court to ensure tender during the resolution of the mortgage dispute, Cherry did take steps to accomplish timely mortgage payments. Although Cherry, through excusable neglect or a misunderstanding as to what his rights were after the Satisfaction of Mortgage was entered, failed to tender the payments, Chase is also not without fault; its conduct in entering a Satisfaction of Mortgage into the Pinellas County public records directly contributed to Cherry's failure to tender timely payments. Cherry's attempt at making the mortgage payments, coupled with Chase's improper satisfaction of mortgage fits squarely within the limited circumstance created to justify a court's denial of a foreclosure. Equity here requires a balancing between Chase's right to the security interest encumbered by the mortgage and Cherry's attempts to make timely payments. As such, these limited circumstances exist to ensure that a foreclosure remains an action in equity. In applying this analysis, this Court finds that equity requires that Chase's request for foreclosure be denied at this juncture....

#### Reestablishment of the Lost Note and Mortgage

Chase also requests, as part of the foreclosure counterclaim, the reestablishment of the note initially associated with the mortgage, as it is unable to produce the original note and provide by affidavit evidence of its loss. Chase has complied with the [necessary statutory] requirements[.]...This Court holds the note to be reestablished and that Chase has the lawful right to enforce the note upon the issuance of this order.

This Court also agrees that Chase may reestablish the mortgage through a vacatur, revocation, and cancellation of satisfaction of mortgage. [Citation] (allowing the Equity Court to reestablish a mortgage that was improperly canceled due to a mistake). However, this Court will deem the vacatur effective as of the date of this

order. This Court leaves the status of the vacatur during the disputed period, and specifically since May 3, 2001, to be resolved in subsequent proceedings....Accordingly, it is:

ORDERED that [Chase cannot foreclose and] the request to reestablish the note and mortgage is hereby granted and effective as of the date of this order. Cherry will tender all previously escrowed mortgage payments to the Court, unless the parties agree otherwise, within ten days of this order and shall henceforth, tender future monthly payments to Chase as set out in the reestablished note and mortgage.

### CASE QUESTIONS

1. When Chase figured out that it had issued a Satisfaction of Mortgage erroneously, what did it file to rectify the error?
2. Cherry had not made any mortgage payments between the time Chase sent the erroneous Satisfaction of Mortgage notice to him and the time of the court's decision in this case. The court listed five circumstances in which a mortgagee (Chase here) might be denied the right to foreclose on a delinquent account: which one applied here? The court said Chase had engaged in "an apparent obfuscation of the case law before the court"? What obfuscation did it engage in?
3. What did Cherry do with the mortgage payments after Chase erroneously told him the mortgage was satisfied? What did the court say he should have done with the payments?

### **Mechanic's Lien Filed against Landlord for Payment of Tenant's Improvements**

F & D Elec. Contractors, Inc. v. Powder Coaters, Inc.

567 S.E.2d 842 (S.C. 2002)

#### Factual/ Procedural Background

BG Holding f/k/a Colite Industries, Inc. ("BG Holding") is a one-third owner of about thirty acres of real estate in West Columbia, South Carolina. A warehouse facility is located on the property. In September 1996, Powder Coaters, Inc. ("Powder Coaters") agreed to lease a portion of the warehouse to operate its business. Powder Coaters was engaged in the business of electrostatically painting machinery parts

and equipment and then placing them in an oven to cure. A signed lease was executed between Powder Coaters and BG Holding. Prior to signing the lease, Powder Coaters negotiated the terms with Mark Taylor, (“Taylor”) who was the property manager for the warehouse facility and an agent of BG Holding.

The warehouse facility did not have a sufficient power supply to support Powder Coaters’ machinery. Therefore, Powder Coaters contracted with F & D Electrical (“F & D”) to perform electrical work which included installing two eight foot strip light fixtures and a two hundred amp load center. Powder Coaters never paid F & D for the services. Powder Coaters was also unable to pay rent to BG Holding and was evicted in February 1997. Powder Coaters is no longer a viable company.

In January 1997, F & D filed a Notice and Certificate of Mechanic’s Lien and Affidavit of Mechanic’s Lien. In February 1997, F & D filed this action against BG Holding foreclosing on its mechanic’s lien pursuant to S.C. [statute]....

A jury trial was held on September 2nd and 3rd, 1998. At the close of F & D’s evidence, and at the close of all evidence, BG Holding made motions for directed verdicts, which were denied. The jury returned a verdict for F & D in the amount of \$8,264.00. The court also awarded F & D attorneys’ fees and cost in the amount of \$8,264.00, for a total award of \$16,528.00.

BG Holding appealed. The Court of Appeals, in a two to one decision, reversed the trial court, holding a directed verdict should have been granted to BG Holding on the grounds BG Holding did not consent to the electrical upgrade, as is required by the Mechanic’s Lien Statute. This Court granted F & D’s petition for certiorari, and the issue before this Court is:

Did the trial court err in denying BG Holding’s motion for directed verdict because the record was devoid of any evidence of owner’s consent to materialman’s performance of work on its property as required by [the S.C. statute]?

### **Law/Analysis**

F & D argues the majority of the Court of Appeals erred in holding the facts of the case failed to establish that BG Holding consented to the work performed by F & D, as is required by the [South Carolina] Mechanic’s Lien Statute. We agree....

South Carolina’s Mechanic’s Lien Statute provides:



A person to whom a debt is due for labor performed or furnished or for materials furnished and actually used in the erection, alteration, or repair of a building...by virtue of an agreement with, or *by consent of, the owner of the building or structure, or a person having authority from, or rightfully acting for, the owner* in procuring or furnishing the labor or materials shall have a lien upon the building or structure and upon the interest of the owner of the building or structure ...to secure the payment of the debt due. [emphasis added.]

Both parties in this case concede there was no express “agreement” between F & D and BG Holding. Therefore, the issue in this appeal turns on the meaning of the word “consent” in the statute, as applied in the landlord-tenant context. This is a novel issue in South Carolina.

This Court must decide who must give the consent, who must receive consent, and what type of consent (general, specific, oral, written) must be given in order to satisfy the statute. Finally, the Court must decide whether the evidence in this case shows BG Holding gave the requisite consent.

#### **A. Who Must Receive the Consent.**

The Court of Appeals’ opinion in this case contemplates the consent must be between the materialman (lien claimant) and the landlord (owner). “It is only logical...that consent under [the relevant section] must...be between the owner and the entity seeking the lien...” [Citation from Court of Appeals]. As stated previously, applying the Mechanic’s Lien Statute in the landlord-tenant context presents a novel issue. We find the consent required by the statute does not have to be between the landlord/owner and the materialman, as the Court of Appeals’ opinion indicates. A determination that the required consent must come from the owner to the materialman means the materialman can only succeed if he can prove an agreement with the owner. Such an interpretation would render meaningless the language of the statute that provides: “...by virtue of an agreement with, or by consent of the owner....”

Therefore, it is sufficient for the landlord/owner or his agent to give consent to his tenant. The landlord/owner should be able to delegate to his tenant the responsibility for making the requested improvements. The landlord/owner may not want to have direct involvement with the materialman or sub-contractors, but instead may wish to allow the tenant to handle any improvements or upgrades himself. In addition, the landlord/owner may be located far away and may own many properties, making it impractical for him to have direct involvement with the materialman. We find the landlord/owner or his agent is free to enter into a lease or agreement with a tenant which allows the tenant to direct the modifications to

the property which have been specifically consented to by the landlord/owner or his agent.

We hold a landlord/owner or his agent can give his consent to the lessee/tenant, as well as directly to the lien claimant, to make modifications to the leased premises.

### **B. What Kind of Consent Is Necessary.**

This Court has already clearly held the consent required by [the relevant section] is “something more than a mere acquiescence in a state of things already in existence. It implies an agreement to that which, but for the consent, could not exist, and which the party consenting has a right to forbid.” [Citations.] However, our Mechanics Lien Statute has never been applied in the landlord-tenant context where a third party is involved.

Other jurisdictions have addressed this issue. The Court of Appeals cited [a Connecticut case, 1987] in support of its holding. We agree with the Court of Appeals that the Connecticut court’s reasoning is persuasive, especially since Connecticut has a similar mechanics lien statute....

The Connecticut courts have stated “the consent required from the owner or one acting under the owner’s authority is more than the mere granting of permission for work to be conducted on one’s property; or the mere knowledge that work was being performed on one’s land.” Furthermore, although the Connecticut courts have stated the statute does not require an express contract, the courts have required “consent that indicates an agreement that the owner of...the land shall be, or may be, liable for the materials or labor.”...

The reasoning of [Connecticut and other states that have decided this issue] is persuasive. F & D’s brief appears to argue that mere knowledge by the landowner that the work needed to be done, coupled with the landlord’s general “permission” to perform the work, is enough to establish consent under the statute. Under this interpretation, a landlord who knew a tenant needed to improve, upgrade, or add to the leased premises would be liable to any contractor and/or subcontractor who performed work on his land. Under F & D’s interpretation the landlord would not be required to know the scope, cost, etc. of the work, but would only need to give the tenant general permission to perform upgrades or improvements.

Clearly, if the landlord/owner or his agent gives consent directly to the materialman, a lien can be established. Consent can also be given to the tenant, but the consent needs to be specific. The landlord/owner or his agent must know the

scope of the project (for instance, as the lease provided in the instant case, the landlord could approve written plans submitted by the tenant). The consent needs to be more than “mere knowledge” that the tenant will perform work on the property. There must be some kind of express or implied agreement that the landlord may be held liable for the work or material. The landlord/owner or his agent may delegate the project or work to his tenant, but there must be an express or implied agreement about the specific work to be done. A general provision in a lease which allows tenant to make repairs or improvements is not enough.

### **C. Evidence There Was No Consent**

- The record is clear that no contract, express or implied, existed between BG Holding and F & G. BG Holding had no knowledge F & G would be performing the work.
- F & G’s supervisor, David Weatherington, and Ray Dutton, the owner of F & D, both testified they never had a conversation with anyone from BG Holding. In fact, until Powder Coaters failed to pay under the contract, F & D did not know BG Holding was the owner of the building.
- Mark Taylor, BG Holding’s agent, testified he never authorized any work by F & D, nor did he see any work being performed by them on the site.
- The lease specifically provided that all work on the property was to be approved in writing by BG Holding.
- David Weatherington of F & D testified he was looking to Powder Coaters, not BG Holding, for payment.
- Powder Coaters acknowledged it was not authorized to bind BG Holding to pay for the modifications.
- The lease states, “[i]f the Lessee should make any [alterations, modification, additions, or installations], the Lessee hereby agrees to indemnify, defend, and save harmless the Lessor from any liability...”

### **D. Evidence There Was Consent**

- Bruce Houston, owner of Powder Coaters testified that during the lease negotiations, he informed Mark Taylor, BG Holding’s property manager and agent, that electrical and gas upgrading would be necessary for Powder Coaters to perform their work.
- Houston testified Mark Taylor was present at the warehouse while F & D performed their work. [However, Taylor testified he did not see F & D performing any work on the premises.]
- Houston testified he would not have entered into the lease if he was not authorized to upgrade the electrical since the existing power

source was insufficient to run the machinery needed for Powder Coaters to operate.

- Houston testified Mark Taylor, BG Holding's agent, showed him the power source for the building so Taylor could understand the extent of the work that was going to be required.
- Houston testified Paragraph 5 of the addendum to the lease was specifically negotiated. He testified the following language granted him the authority to perform the electrical upfit, so that he was not required to submit the plans to BG Holding as required by a provision in the lease: "Lessor shall allow Lessee to put Office Trailer in Building. All Utilities necessary to handle Lessee's equipment shall be paid for by the Lessee including, but not limited to electricity, water, sewer, and gas." (We note that BG Holding denies this interpretation, but insists it just requires the Lessee to pay for all utility bills.)
- Powder Coaters no longer occupies the property, and BG Holding possibly benefits from the work done.

In the instant case, there is some evidence of consent. However, it does not rise to the level required under the statute....

Viewing the evidence in the light most favorable to F & D, whether BG Holding gave their consent is a close question. However, we agree with the Court of Appeals, that F & D has not presented enough evidence to show: (1) BG Holding gave anything more than general consent to make improvements (as the lease could be interpreted to allow); or (2) BG Holding had anything more than "mere knowledge" that the work was to be done. Powder Coaters asserted the lease's addendum evidenced BG Holding's consent to perform the modifications; however, there is no evidence BG Holding expressly or implicitly agreed that it might be liable for the work. In fact, the lease between Powder Coaters and BG Holding expressly provided Powder Coaters was responsible for any alterations made to the property. Even Powder Coaters acknowledged it was not authorized to bind BG Holding....Therefore, it is impossible to see how the very general provision requiring Powder Coaters to pay for water, sewer, and gas can be interpreted to authorize Powder Coaters to perform an electrical upgrade. Furthermore, we agree with the Court of Appeals that the mere presence of BG Holding's agent at the work site is not enough to establish consent.

### **Conclusion**

We hold consent, as required by the Mechanic's Lien Statute, is something more than mere knowledge work will be or could be done on the property. The landlord/owner must do more than grant the tenant general permission to make repairs or improvements to the leased premises. The landlord/owner or his agent must give

either his tenant or the materialman express or implied consent acknowledging he may be held liable for the work.

The Court of Appeals' opinion is affirmed as modified.

### CASE QUESTIONS

1. Why did the lienor want to go after the landlord instead of the tenant?
2. Did the landlord here know that there were electrical upgrades needed by the tenant?
3. What kind of knowledge or acceptance did the court determine the landlord-owner needed to have or give before a material man could have a lien on the real estate?
4. What remedy has F & D (the material man) now?

### Deeds of Trust; Duties of Trustee

Alpha Imperial Building, LLC v. Schnitzer Family Investment, LLC, II (SFI).

2005 WL 715940, (Wash. Ct. App. 2005)

Applewick, J.

Alpha Imperial LLC challenges the validity of a non-judicial foreclosure sale on multiple grounds. Alpha was the holder of a third deed of trust on the building sold, and contests the location of the sale and the adequacy of the sale price. Alpha also claims that the trustee had a duty to re-open the sale, had a duty to the junior lienholder, chilled the bidding, and had a conflict of interest. We find that the location of the sale was proper, the price was adequate, bidding was not chilled, and that the trustee had no duty to re-open the sale, [and] no duty to the junior lienholder....We affirm.

#### Facts

Mayur Sheth and another individual formed Alpha Imperial Building, LLC in 1998 for the purpose of investing in commercial real estate. In February 2000 Alpha sold the property at 1406 Fourth Avenue in Seattle (the Property) to Pioneer Northwest, LLC (Pioneer). Pioneer financed this purchase with two loans from [defendant Schnitzer Family Investment, LLC, II (SFI)]. Pioneer also took a third loan from

Alpha at the time of the sale for \$1.3 million. This loan from Alpha was junior to the two [other] loans[.]

Pioneer defaulted and filed for bankruptcy in 2002....In October 2002 defendant Blackstone Corporation, an entity created to act as a non-judicial foreclosure trustee, issued a Trustee's Notice of Sale. Blackstone is wholly owned by defendant Witherspoon, Kelley, Davenport & Toole (Witherspoon). Defendant Michael Currin, a shareholder at Witherspoon, was to conduct the sale on January 10, 2003. Currin and Witherspoon represented SFI and 4th Avenue LLC. Sheth received a copy of the Notice of Sale through his attorney.

On January 10, 2003, Sheth and his son Abhi arrived at the Third Avenue entrance to the King County courthouse between 9:30 and 9:45 a.m. They waited for about ten minutes. They noticed two signs posted above the Third Avenue entrance. One sign said that construction work was occurring at the courthouse and 'all property auctions by the legal and banking communities will be moved to the 4th Avenue entrance of the King County Administration Building.' The other sign indicated that the Third Avenue entrance would remain open during construction. Sheth and Abhi asked a courthouse employee about the sign, and were told that all sales were conducted at the Administration Building.

Sheth and Abhi then walked to the Administration Building, and asked around about the sale of the Property. [He was told Michael Currin, one of the shareholders of Blackstone—the trustee—was holding the sale, and was advised] to call Currin's office in Spokane. Sheth did so, and was told that the sale was at the Third Avenue entrance. Sheth and Abhi went back to the Third Avenue entrance.

In the meantime, Currin had arrived at the Third Avenue entrance between 9:35 and 9:40 a.m. The head of SFI, Danny Schnitzer (Schnitzer), and his son were also present. Currin was surprised to notice that no other foreclosure sales were taking place, but did not ask at the information desk about it. Currin did not see the signs directing auctions to occur at the Administration Building. Currin conducted the auction, Schnitzer made the only bid, for \$2.1 million, and the sale was complete. At this time, the debt owed on the first two deeds of trust totaled approximately \$4.1 million. Currin then left the courthouse, but when he received a call from his assistant telling him about Sheth, he arranged to meet Sheth back at the Third Avenue entrance. When they met, Sheth told Currin that the sales were conducted at the Administration Building. Currin responded that the sale had already been conducted, and he was not required to go to the Administration Building. Currin told Sheth that the notice indicated the sale was to be at the Third Avenue entrance, and that the sale had been held at the correct location. Sheth did not ask to re-open the bidding....

Sheth filed the current lawsuit, with Alpha as the sole plaintiff, on February 14, 2003. The lawsuit asked for declaratory relief, restitution, and other damages. The trial court granted the defendants' summary judgment motion on August 8, 2003. Alpha appeals.

#### Location of the Sale

Alpha argues that the sale was improper because it was at the Third Avenue entrance, not the Administration Building. Alpha points to a letter from a King County employee stating that auctions are held at the Administration Building. The letter also stated that personnel were instructed to direct bidders and trustees to that location if asked. In addition, Alpha argues that the Third Avenue entrance was not a 'public' place, as required by [the statute], since auction sales were forbidden there. We disagree. Alpha has not shown that the Third Avenue entrance was an improper location. The evidence shows that the county had changed its policy as to where auctions would be held and had posted signs to that effect. However, the county did not exclude people from the Third Avenue entrance or prevent auctions from being held there. Street, who frequented sales, stated that auctions were being held in both locations. The sale was held where the Notice of Sale indicated it would be. In addition, Alpha has not introduced any evidence to show that the Third Avenue entrance was not a public place at the time of the sale. The public was free to come and go at that location, and the area was 'open and available for all to use.' Alpha relies on *Morton v. Resolution Trust* (S.D. Miss. 1995) to support its contention that the venue of the sale was improper. [But] *Morton* is not on point.

#### Duty to Re-Open Sale

Alpha argues that Currin should have re-opened the sale. However, it is undisputed that Sheth did not request that Currin re-open it. The evidence indicates that Currin may have known about Sheth's interest in bidding prior to the day of the sale, due to a conversation with Sheth's attorney about Sheth's desire to protect his interest in the Property. But, this knowledge did not create in Currin any affirmative duty to offer to re-open the sale.

In addition, Alpha cites no Washington authority to support the contention that Currin would have been obligated to re-open the sale if Sheth had asked him to. The decision to continue a sale appears to be fully within the discretion of the trustee: "[t]he trustee may for any cause the trustee deems advantageous, continue the sale." [Citation.] Alpha's citation to *Peterson v. Kansas City Life Ins. Co.*, Missouri (1936) to support its contention that Currin should have re-opened the sale is unavailing. In *Peterson*, the Notice of Sale indicated that the sale would be held at the 'front' door of the courthouse. But, the courthouse had four doors, and the customary door

for sales was the east door. The sheriff, acting as the trustee, conducted the sale at the east door, and then re-opened the sale at the south door, as there had been some sales at the south door. Alpha contends this shows that Currin should have re-opened the sale when learning of the Administration Building location, akin to what the sheriff did in Peterson. However, Peterson does not indicate that the sheriff had an affirmative duty to re-sell the property at the south door. This case is not on point.

### **Chilled Bidding**

Alpha contends that Currin chilled the bidding on the Property by telling bidders that he expected a full credit sale price and by holding the sale at the courthouse. Chilled bidding can be grounds for setting aside a sale. *Country Express Stores, Inc. v. Sims*, [Washington Court of Appeals] (1997). The *Country Express* court explained the two types of chilled bidding:

The first is intentional, occurring where there is collusion for the purpose of holding down the bids. The second consists of inadvertent and unintentional acts by the trustee that have the effect of suppressing the bidding. To establish chilled bidding, the challenger must establish the bidding was actually suppressed, which can sometimes be shown by an inadequate sale price.

We hold that there was no chilling. Alpha has not shown that Currin engaged in intentional chilling. There is no evidence that Currin knew about the signs indicating auctions were occurring at the Administration Building when he prepared the Notice of Sale, such that he intentionally held the sale at a location from which he knew bidders would be absent. Additionally, Currin's statement to [an interested person who might bid on the property] that a full credit sale price was expected and that the opening bid would be \$4.1 million did not constitute intentional chilling. SFI was owed \$4.1 million on the Property. SFI could thus bid up to that amount at no cost to itself, as the proceeds would go back to SFI. Currin confirmed that SFI was prepared to make a full-credit bid. [It is common for trustees to] disclose the full-credit bid amount to potential third party bidders, and for investors to lose interest when they learn of the amount of indebtedness on property. It was therefore not a misrepresentation for Currin to state \$4.1 million as the opening bid, due to the indebtedness on the Property. Currin's statements had no chilling effect—they merely informed [interested persons] of the minimum amount necessary to prevail against SFI. Thus, Currin did not intentionally chill the bidding by giving Street that information.



Alpha also argues that the chilled bidding could have been unintended by Currin.... [But the evidence is that] Currin's actions did not intentionally or unintentionally chill the bidding, and the sale will not be set aside.

### **Adequacy of the Sale Price**

Alpha claims that the sale price was 'greatly inadequate' and that the sale should thus be set aside. Alpha submitted evidence that the property had an 'as is' value of \$4.35 million in December 2002, and an estimated 2004 value of \$5.2 million. The debt owed to SFI on the property was \$4.1 million. SFI bought the property for \$2.1 million. These facts do not suggest that the sale must be set aside.

Washington case law suggests that the price the property is sold for must be 'grossly inadequate' for a trustee's sale to be set aside on those grounds alone. In *Cox* [Citation, 1985], the property was worth between \$200,000 and \$300,000, and was sold to the beneficiary for \$11,873. The Court held that amount to be grossly inadequate. In *Steward* [Citation, 1988] the property had been purchased for approximately \$64,000, and then was sold to a third party at a foreclosure sale for \$4,870. This court held that \$4,870 was not grossly inadequate. In *Miebach* [Citation] (1984), the Court noted that a sale for less than two percent of the property's fair market value was grossly inadequate. The Court in *Miebach* also noted prior cases where the sale had been voided due to grossly inadequate purchase price; the properties in those cases had been sold for less than four percent of the value and less than three percent of the value. In addition, the Restatement indicates that gross inadequacy only exists when the sale price is less than 20 percent of the fair market value—without other defects, sale prices over 20 percent will not be set aside. [Citation.] The Property was sold for between 40 and 48 percent of its value. These facts do not support a grossly inadequate purchase price.

Alpha cites *Miebach* for the proposition that 'where the inadequacy of price is great the sale will be set aside with slight indications of fraud or unfairness,' arguing that such indications existed here. However, the cases cited by the Court in *Miebach* to support this proposition involved properties sold for less than three and four percent of their value. Alpha has not demonstrated the slightest indication of fraud, nor shown that a property that sold for 40 to 48 percent of its value sold for a greatly inadequate price.

### **Duty to a Junior Lienholder**

Alpha claims that Currin owed a duty to Alpha, the junior lienholder. Alpha cites no case law for this proposition, and, indeed, there is none—Division Two specifically declined to decide this issue in *Country Express* [Citation]. Alpha acknowledges the

lack of language in RCW 61.24 (the deed of trust statute) regarding fiduciary duties of trustees to junior lienholders. But Alpha argues that since RCW 61.24 requires that the trustee follow certain procedures in conducting the sale, and allows for sales to be restrained by anyone with an interest, a substantive duty from the trustee to a junior lienholder can be inferred.

Alpha's arguments are unavailing. The procedural requirements in RCW 61.24 do not create implied substantive duties. The structure of the deed of trust sale illustrates that no duty is owed to the junior lienholder. The trustee and the junior lienholder have no relationship with each other. The sale is pursuant to a contract between the grantor, the beneficiary and the trustee. The junior lienholder is not a party to that contract. The case law indicates only that the trustee owes a fiduciary duty to the debtor and beneficiary: "a trustee of a deed of trust is a fiduciary for both the mortgagee and mortgagor and must act impartially between them." Cox [Citation]. The fact that a sale in accordance with that contract can extinguish the junior lienholder's interest further shows that the grantor's and beneficiary's interest in the deed of trust being foreclosed is adverse to the junior lienholder. We conclude the trustee, while having duties as fiduciary for the grantor and beneficiary, does not have duties to another whose interest is adverse to the grantor or beneficiary. Thus, Alpha's claim of a special duty to a junior lienholder fails....

### **Attorney Fees**

...Defendants claim they are entitled to attorney fees for opposing a frivolous claim, pursuant to [the Washington statute]. An appeal is frivolous 'if there are no debatable issues upon which reasonable minds might differ and it is so totally devoid of merit that there was no reasonable possibility of reversal.' [Citation] Alpha has presented several issues not so clearly resolved by case law as to be frivolous, although Alpha's arguments ultimately fail. Thus, Respondents' request for attorney fees under [state law] is denied.

Affirmed.

### CASE QUESTIONS

1. Why did the plaintiff (Alpha) think the sale should have been set aside because of the location problems?
2. Why did the court decide the trustee had no duty to reopen bidding?
3. What is meant by “chilling bidding”? What argument did the plaintiff make to support its contention that bidding was chilled?
4. The court notes precedent to the effect that a “grossly inadequate” bid price has some definition. What is the definition? What percentage of the real estate’s value in this case was the winning bid?
5. A trustee is one who owes a fiduciary duty of the utmost loyalty and good faith to another, the beneficiary. Who was the beneficiary here? What duty is owed to the junior lienholder (Alpha here)—any duty?
6. Why did the defendants not get the attorneys’ fee award they wanted?

## 29.5 Summary and Exercises

### Summary

A mortgage is a means of securing a debt with real estate. The mortgagor, or borrower, gives the mortgage. The lender is the mortgagee, who holds the mortgage. On default, the mortgagee may foreclose the mortgage, converting the security interest into title. In many states, the mortgagor has a statutory right of redemption after foreclosure.

Various statutes regulate the mortgage business, including the Truth in Lending Act, the Equal Credit Opportunity Act, the Real Estate Settlement Procedures Act, and the Home Mortgage Disclosure Act, which together prescribe a code of fair practices and require various disclosures to be made before the mortgage is created.

The mortgagor signs both a note and the mortgage at the closing. Without the note, the mortgage would secure nothing. Most notes and mortgages contain an acceleration clause, which calls for the entire principal and interest to be due, at the mortgagee's option, if the debtor defaults on any payment.

In most states, mortgages must be recorded for the mortgagee to be entitled to priority over third parties who might also claim an interest in the land. The general rule is "First in time, first in right," although there are exceptions for fixture filings and nonobligatory future advances. Mortgages are terminated by repayment, novation, or foreclosure, either through judicial sale or under a power-of-sale clause.

Real estate may also be used as security under a deed of trust, which permits a trustee to sell the land automatically on default, without recourse to a court of law.

Nonconsensual liens are security interests created by law. These include court-decreed liens, such as attachment liens and judgment liens. Other liens are mechanic's liens (for labor, services, or materials furnished in connection with someone's real property), possessory liens (for artisans working with someone else's personal property), and tax liens.

## EXERCISES

1. Able bought a duplex from Carr, who had borrowed from First Bank for its purchase. Able took title subject to Carr's mortgage. Able did not make mortgage payments to First Bank; the bank foreclosed and sold the property, leaving a deficiency. Which is correct?
  - a. Carr alone is liable for the deficiency.
  - b. Able alone is liable for the deficiency because he assumed the mortgage.
  - c. First Bank may pursue either Able or Carr.
  - d. Only if Carr fails to pay will Able be liable.
2. Harry borrowed \$175,000 from Judith, giving her a note for that amount and a mortgage on his condo. Judith did not record the mortgage. After Harry defaulted on his payments, Judith began foreclosure proceedings. Harry argued that the mortgage was invalid because Judith had failed to record it. Judith counterargues that because a mortgage is not an interest in real estate, recording is not necessary. Who is correct? Explain.
3. Assume in Exercise 2 that the documents did not contain an acceleration clause and that Harry missed three consecutive payments. Could Judith foreclose? Explain.
4. Rupert, an automobile mechanic, does carpentry work on weekends. He built a detached garage for Clyde for \$20,000. While he was constructing the garage, he agreed to tune up Clyde's car for an additional \$200. When the work was completed, Clyde failed to pay him the \$20,200, and Rupert claimed a mechanic's lien on the garage and car. What problems, if any, might Rupert encounter in enforcing his lien? Explain.
5. In Exercise 4, assume that Clyde had borrowed \$50,000 from First Bank and had given the bank a mortgage on the property two weeks after Rupert commenced work on the garage but several weeks before he filed the lien. Assuming that the bank immediately recorded its mortgage and that Rupert's lien is valid, does the mortgage take priority over the lien? Why?
6. Defendant purchased a house from Seller and assumed the mortgage indebtedness to Plaintiff. All monthly payments were made on time until March 25, 1948, when no more were made. On October 8, 1948, Plaintiff sued to foreclose and accelerate the note. In February of 1948, Plaintiff asked to obtain a loan elsewhere and pay him off; he offered a discount if she would do so, three times, increasing the amount offered

each time. Plaintiff understood that Defendant was getting a loan from the Federal Housing Administration (FHA), but she was confronted with a number of requirements, including significant property improvements, which—because they were neighbors—Plaintiff knew were ongoing. While the improvements were being made, in June or July, he said to her, “Just let the payments go and we’ll settle everything up at the same time,” meaning she need not make monthly payments until the FHA was consummated, and he’d be paid from the proceeds. But then “he changed his tune” and sought foreclosure. Should the court order it?

## SELF-TEST QUESTIONS

1. The person or institution holding a mortgage is called
  - a. the mortgagor
  - b. the mortgagee
  - c. the debtor
  - d. none of the above
  
2. Mortgages are regulated by
  - a. the Truth in Lending Act
  - b. the Equal Credit Opportunity Act
  - c. the Real Estate Settlement Procedures Act
  - d. all of the above
  
3. At the closing, a mortgagor signs
  - a. only a mortgage
  - b. only a note
  - c. either a note or the mortgage
  - d. both a note and the mortgage
  
4. Mortgages are terminated by
  - a. repayment
  - b. novation
  - c. foreclosure
  - d. any of the above
  
5. A lien ordered against a person's property to prevent its disposal during a lawsuit is called
  - a. a judgment lien
  - b. an attachment lien
  - c. a possessory lien
  - d. none of the above

**SELF-TEST ANSWERS**

1. b
2. d
3. d
4. d
5. b



## Chapter 30

# Bankruptcy

### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. A short history of US bankruptcy law
2. An overview of key provisions of the 2005 bankruptcy act
3. The basic operation of Chapter 7 bankruptcy
4. The basic operation of Chapter 11 bankruptcy
5. The basic operation of Chapter 13 bankruptcy
6. What debtor's relief is available outside of bankruptcy

## 30.1 Introduction to Bankruptcy and Overview of the 2005 Bankruptcy Act

### LEARNING OBJECTIVES

1. Understand what law governs bankruptcy in the United States.
2. Know the key provisions of the law.

### The Purpose of Bankruptcy Law

Bankruptcy law governs the rights of creditors and insolvent debtors who cannot pay their debts. In broadest terms, bankruptcy deals with the seizure of the debtor's assets and their distribution to the debtor's various creditors. The term derives from the Renaissance custom of Italian traders, who did their trading from benches in town marketplaces. Creditors literally "broke the bench" of a merchant who failed to pay his debts. The term *banco rotta* (broken bench) thus came to apply to business failures.

In the Victorian era, many people in both England and the United States viewed someone who became bankrupt as a wicked person. In part, this attitude was prompted by the law itself, which to a greater degree in England and to a lesser degree in the United States treated the insolvent debtor as a sort of felon. Until the second half of the nineteenth century, British insolvents could be imprisoned; jail for insolvent debtors was abolished earlier in the United States. And the entire administration of bankruptcy law favored the creditor, who could with a mere filing throw the financial affairs of the alleged insolvent into complete disarray.

Today a different attitude prevails. Bankruptcy is understood as an aspect of financing, a system that permits creditors to receive an equitable distribution of the bankrupt person's assets and promises new hope to debtors facing impossible financial burdens. Without such a law, we may reasonably suppose that the level of economic activity would be far less than it is, for few would be willing to risk being personally burdened forever by crushing debt. Bankruptcy gives the honest debtor a fresh start and resolves disputes among creditors.

## History of the Bankruptcy System; Bankruptcy Courts and Judges Constitutional Basis

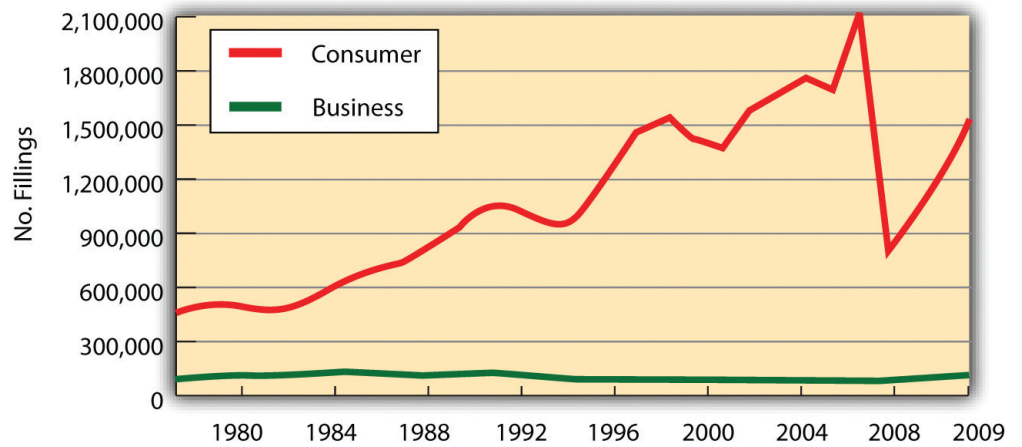
The US Constitution prohibits the states from impairing the “obligation of a contract.” This means that no state can directly provide a means for discharging a debtor unless the debt has been entirely paid. But the Constitution in Article I, Section 8, does give the federal government such a power by providing that Congress may enact a uniform bankruptcy law.

### Bankruptcy Statutes

Congress passed bankruptcy laws in 1800, 1841, and 1867. These lasted only a few years each. In 1898, Congress enacted the Bankruptcy Act, which together with the Chandler Act amendments in 1938, lasted until 1978. In 1978, Congress passed the Bankruptcy Reform Act, and in 2005, it adopted the current law, the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). This law is the subject of our chapter.

At the beginning of the twentieth century, bankruptcies averaged fewer than 20,000 per year. Even in 1935, at the height of the Great Depression, bankruptcy filings in federal court climbed only to 69,000. At the end of World War II, in 1945, they stood at 13,000. From 1950 on, the statistics show a steep increase. During the decade before the 1978 changes, bankruptcy filings in court averaged 181,000 a year—reaching a high of 254,000 in 1975. They soared to over 450,000 filings per year in the 1980s and mostly maintained that pace until just before the 2005 law took effect (see [Figure 30.1 "US Bankruptcies, 1980–2009"](#)). The 2005 act—preceded by “massive lobbying largely by banks and credit card companies” CCH Bankruptcy Reform Act Briefing, “Bankruptcy Abuse Prevention and Consumer Protection Act of 2005,” April 2005, [http://www.cch.com/bankruptcy/bankruptcy\\_04-21.pdf](http://www.cch.com/bankruptcy/bankruptcy_04-21.pdf).—was intended by its promoters to restore personal responsibility and integrity in the bankruptcy system. The law’s critics said it was simply a way for the credit card industry to extract more money from consumers before their debts were wiped away.

Figure 30.1 US Bankruptcies, 1980–2009



Bankruptcy Action.com, <http://www.bankruptcyaction.com/USbankstats.htm>, statistics from Administrative Office of the Courts.

### Bankruptcy Courts, Judges, and Costs

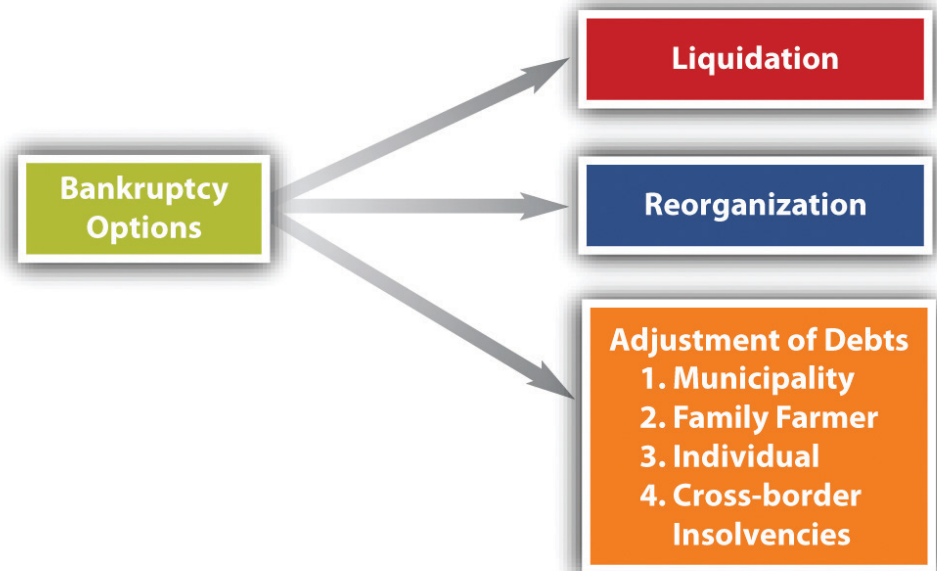
Each federal judicial district has a US Bankruptcy Court, whose judges are appointed by US Courts of Appeal. Unless both sides agree otherwise, bankruptcy judges are to hear only bankruptcy matters (called core proceedings). Bankruptcy trustees are government lawyers appointed by the US Attorney General. They have administrative responsibilities in overseeing the proceedings.

The filing fee for a bankruptcy is about \$200, depending upon the type of bankruptcy, and the typical lawyer's fee for uncomplicated cases is about \$1,200–\$1,400.

### Overview of Bankruptcy Provisions

The BAPCPA provides for six different kinds of bankruptcy proceedings. Each is covered by its own chapter in the act and is usually referred to by its chapter number (see [Figure 30.2 "Bankruptcy Options"](#)).

Figure 30.2 Bankruptcy Options



The bankruptcy statute (as opposed to case law interpreting it) is usually referred to as the bankruptcy *code*. The types of bankruptcies are as follows:

- Chapter 7, Liquidation: applies to all debtors except railroads, insurance companies, most banks and credit unions, and homestead associations.<sup>11</sup> United States Code, Section 109(b). A liquidation is a “straight” bankruptcy proceeding. It entails selling the debtor’s nonexempt assets for cash and distributing the cash to the creditors, thereby discharging the insolvent person or business from any further liability for the debt. About 70 percent of all bankruptcy filings are Chapter 7.
- Chapter 9, Adjustment of debts of a municipality: applies to municipalities that are insolvent and want to adjust their debts.<sup>11</sup> United States Code, Section 109(c). (The law does not suppose that a town, city, or county will go out of existence in the wake of insolvency.)
- Chapter 11, Reorganization: applies to anybody who could file Chapter 7, plus railroads. It is the means by which a financially troubled company can continue to operate while its financial affairs are put on a sounder basis. A business might liquidate following reorganization but will probably take on new life after negotiations with creditors on how the old debt is to be paid off. A company may voluntarily decide to seek

Chapter 11 protection in court, or it may be forced involuntarily into a Chapter 11 proceeding.

- Chapter 12, Adjustment of debts of a family farmer or fisherman with regular annual income.11 United States Code, Section 109(f). Many family farmers cannot qualify for reorganization under Chapter 13 because of the low debt ceiling, and under Chapter 11, the proceeding is often complicated and expensive. As a result, Congress created Chapter 12, which applies only to farmers whose total debts do not exceed \$1.5 million.
- Chapter 13, Adjustment of debts of an individual with regular income: applies only to individuals (no corporations or partnerships) with debt not exceeding about \$1.3 million.11 United States Code, Section 109(e). This chapter permits an individual with regular income to establish a repayment plan, usually either a composition (an agreement among creditors, discussed in [Section 30.5 "Alternatives to Bankruptcy"](#), “Alternatives to Bankruptcy”) or an extension (a stretch-out of the time for paying the entire debt).
- Chapter 15, Ancillary and other cross-border cases: incorporates the United Nations’ Model Law on Cross-Border Insolvency to promote cooperation among nations involved in cross-border cases and is intended to create legal certainty for trade and investment. “Ancillary” refers to the possibility that a US debtor might have assets or obligations in a foreign country; those non-US aspects of the case are “ancillary” to the US bankruptcy case.

The BAPCPA includes three chapters that set forth the procedures to be applied to the various proceedings. Chapter 1, “General Provisions,” establishes who is eligible for relief under the act. Chapter 3, “Case Administration,” spells out the powers of the various officials involved in the bankruptcy proceedings and establishes the methods for instituting bankruptcy cases. Chapter 5, “Creditors, the Debtor, and the Estate,” deals with the debtor’s “estate”—his or her assets. It lays down ground rules for determining which property is to be included in the estate, sets out the powers of the bankruptcy trustee to “avoid” (invalidate) transactions by which the debtor sought to remove property from the estate, orders the distribution of property to creditors, and sets forth the duties and benefits that accrue to the debtor under the act.

To illustrate how these procedural chapters (especially Chapter 3 and Chapter 5) apply, we focus on the most common proceeding: liquidation (Chapter 7). Most of the principles of bankruptcy law discussed in connection with liquidation apply to the other types of proceedings as well. However, some principles vary, and we conclude the chapter by noting special features of two other important proceedings—Chapter 13 and Chapter 11.

### KEY TAKEAWAY

Bankruptcy law's purpose is to give the honest debtor a fresh start and to resolve disputes among creditors. The most recent amendments to the law were effective in 2005. Bankruptcy law provides relief to six kinds of debtors: (1) Chapter 7, straight bankruptcy—liquidation—applies to most debtors (except banks and railroads); (2) Chapter 9 applies to municipalities; (3) Chapter 11 is business reorganization; (4) Chapter 12 applies to farmers; (5) Chapter 13 is for wage earners; and (6) Chapter 15 applies to cross-border bankruptcies. The bankruptcy statutes also have several chapters that cover procedures of bankruptcy proceedings.

### EXERCISES

1. Why is bankruptcy law required in a modern capitalistic society?
2. Who does the bankruptcy trustee represent?
3. The three most commonly filed bankruptcies are Chapter 7, 11, and 13. Who gets relief under those chapters?

## 30.2 Case Administration; Creditors' Claims; Debtors' Exemptions and Dischargeable Debts; Debtor's Estate

### LEARNING OBJECTIVES

1. Understand the basic procedures involved in administering a bankruptcy case.
2. Recognize the basic elements of creditors' rights under the bankruptcy code.
3. Understand the fundamentals of what property is included in the debtor's estate.
4. Identify some of the debtor's exemptions—what property can be kept by the debtor.
5. Know some of the debts that cannot be discharged in bankruptcy.
6. Know how an estate is liquidated under Chapter 7.

### Case Administration (Chapter 3 of the Bankruptcy Code)

Recall that the purpose of liquidation is to convert the debtor's assets—except those exempt under the law—into cash for distribution to the creditors and thereafter to discharge the debtor from further liability. With certain exceptions, any person may voluntarily file a petition to liquidate under Chapter 7. A “person” is defined as any individual, partnership, or corporation. The exceptions are railroads and insurance companies, banks, savings and loan associations, credit unions, and the like.

For a Chapter 7 liquidation proceeding, as for bankruptcy proceedings in general, the various aspects of case administration are covered by the bankruptcy code's Chapter 3. These include the rules governing commencement of the proceedings, the effect of the petition in bankruptcy, the first meeting of the creditors, and the duties and powers of trustees.

#### Commencement

The bankruptcy begins with the filing of a petition in bankruptcy with the bankruptcy court.



## Voluntary and Involuntary Petitions

The individual, partnership, or corporation may file a voluntary petition in bankruptcy; 99 percent of bankruptcies are voluntary petitions filed by the debtor. But involuntary bankruptcy is possible, too, under Chapter 7 or Chapter 11. To put anyone into bankruptcy involuntarily, the petitioning creditors must meet three conditions: (1) they must have claims for unsecured debt amounting to at least \$13,475; (2) three creditors must join in the petition whenever twelve or more creditors have claims against the particular debtor—otherwise, one creditor may file an involuntary petition, as long as his claim is for at least \$13,475; (3) there must be no bona fide dispute about the debt owing. If there is a dispute, the debtor can resist the involuntary filing, and if she wins the dispute, the creditors who pushed for the involuntary petition have to pay the associated costs. Persons owing less than \$13,475, farmers, and charitable organizations cannot be forced into bankruptcy.

## The Automatic Stay

The petition—voluntary or otherwise—operates as a **stay**<sup>1</sup> against suits or other actions against the debtor to recover claims, enforce judgments, or create liens (but not alimony collection). In other words, once the petition is filed, the debtor is freed from worry over other proceedings affecting her finances or property. No more debt collection calls! Anyone with a claim, secured or unsecured, must seek relief in the bankruptcy court. This provision in the act can have dramatic consequences. Beset by tens of thousands of products-liability suits for damages caused by asbestos, UNR Industries and Manville Corporation, the nation's largest asbestos producers, filed (separate) voluntary bankruptcy petitions in 1982; those filings automatically stayed all pending lawsuits.

## First Meeting of Creditors

Once a petition in bankruptcy is filed, the court issues an **order of relief**<sup>2</sup>, which determines that the debtor's property is subject to bankruptcy court control and creates the stay. The Chapter 7 case may be dismissed by the court if, after a notice and hearing, it finds that among other things (e.g., delay, nonpayment of required bankruptcy fees), the debts are primarily consumer debts and the debtor could pay them off—that's the 2005 act's famous "means test," discussed in [Section 30.3 "Chapter 7 Liquidation"](#).

Assuming that the order of relief has been properly issued, the creditors must meet within a reasonable time. The debtor is obligated to appear at the meeting and submit to examination under oath. The judge does not preside and, indeed, is not even entitled to attend the meeting.

1. Upon filing the bankruptcy, an automatic injunction that halts actions by creditors to collect debts.
2. The court's order determining the debtor's property to be under the control of the bankruptcy court.

When the judge issues an order for relief, an interim trustee is appointed who is authorized initially to take control of the debtor's assets. The trustee is required to collect the property, liquidate the debtor's estate, and distribute the proceeds to the creditors. The trustee may sue and be sued in the name of the estate. Under every chapter except Chapter 7, the court has sole discretion to name the trustee. Under Chapter 7, the creditors may select their own trustee as long as they do it at the first meeting of creditors and follow the procedures laid down in the act.

### **Trustee's Powers and Duties**

The act empowers the trustee to use, sell, or lease the debtor's property in the ordinary course of business or, after notice and a hearing, even if not in the ordinary course of business. In all cases, the trustee must protect any security interests in the property. As long as the court has authorized the debtor's business to continue, the trustee may also obtain credit in the ordinary course of business. She may invest money in the estate to yield the maximum, but reasonably safe, return. Subject to the court's approval, she may employ various professionals, such as attorneys, accountants, and appraisers, and may, with some exceptions, assume or reject executory contracts and unexpired leases that the debtor has made. The trustee also has the power to avoid many prebankruptcy transactions in order to recover property of the debtor to be included in the liquidation.

### **Creditors' Claims, the Debtor, and the Estate (Chapter 5 of the Bankruptcy Code)**

We now turn to the major matters covered in Chapter 5 of the bankruptcy act: creditors' claims, debtors' exemptions and discharge, and the property to be included in the estate. We begin with the rules governing proof of claims by creditors and the priority of their claims.

#### **Claims and Creditors**

A claim is defined as a right to payment, whether or not it is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured. A creditor is defined as a person or entity with a claim that arose no later than when the court issues the order for relief. These are very broad definitions, intended to give the debtor the broadest possible relief when finally discharged.

## Proof of Claims

Before the trustee can distribute proceeds of the estate, unsecured creditors must file a **proof of claim**<sup>3</sup>, prima facie evidence that they are owed some amount of money. They must do so within six months after the first date set for the first meeting of creditors. A creditor's claim is disallowed, even though it is valid, if it is not filed in a timely manner. A party in interest, such as the trustee or creditor, may object to a proof of claim, in which case the court must determine whether to allow it. In the absence of objection, the claim is "deemed allowed." The court will not allow some claims. These include unenforceable claims, claims for unmaturing interest, claims that may be offset by debts the creditor owes the debtor, and unreasonable charges by an insider or an attorney. If it's a "no asset" bankruptcy—most are—creditors are in effect told by the court not to waste their time filing proof of claim.

## Claims with Priority

The bankruptcy act sets out categories of claimants and establishes priorities among them. The law is complex because it sets up different orders of priorities.

First, *secured creditors* get their security interests before anyone else is satisfied, because the security interest is not part of the property that the trustee is entitled to bring into the estate. This is why being a secured creditor is important (as discussed in [Chapter 28 "Secured Transactions and Suretyship"](#) and [Chapter 29 "Mortgages and Nonconsensual Liens"](#)). To the extent that secured creditors have claims in excess of their collateral, they are considered unsecured or general creditors and are lumped in with general creditors of the appropriate class.

Second, of the six classes of claimants (see [Figure 30.3 "Distribution of the Estate"](#)), the first is known as that of "*priority claims*." It is subdivided into ten categories ranked in order of priority. The highest-priority class within the general class of priority claims must be paid off in full before the next class can share in a distribution from the estate, and so on. Within each class, members will share pro rata if there are not enough assets to satisfy everyone fully. The priority classes, from highest to lowest, are set out in the bankruptcy code (11 USC Section 507) as follows:

(1) *Domestic support obligations* ("DSO"), which are claims for support due to the spouse, former spouse, child, or child's representative, and at a lower priority within this class are any claims by a governmental unit that has rendered support assistance to the debtor's family obligations.

3. The form used to file a claim by a creditor.

(2) *Administrative expenses* that are required to administer the bankruptcy case itself. Under former law, administrative expenses had the highest priority, but Congress elevated domestic support obligations above administrative expenses with the passage of the BAPCPA. Actually, though, administrative expenses have a de facto priority over domestic support obligations, because such expenses are deducted before they are paid to DSO recipients. Since trustees are paid from the bankruptcy estate, the courts have allowed de facto top priority for administrative expenses because no trustee is going to administer a bankruptcy case for nothing (and no lawyer will work for long without getting paid, either).

(3) *Gap creditors*. Claims made by **gap creditors**<sup>4</sup> in an involuntary bankruptcy petition under Chapter 7 or Chapter 11 are those that arise between the filing of an involuntary bankruptcy petition and the order for relief issued by the court. These claims are given priority because otherwise creditors would not deal with the debtor, usually a business, when the business has declared bankruptcy but no trustee has been appointed and no order of relief issued.

(4) *Employee wages* up to \$10,950 for each worker, for the 180 days previous to either the bankruptcy filing or when the business ceased operations, whichever is earlier (180-day period).

(5) *Unpaid contributions to employee benefit plans* during the 180-day period, but limited by what was already paid by the employer under subsection (4) above plus what was paid on behalf of the employees by the bankruptcy estate for any employment benefit plan.

(6) *Any claims for grain from a grain producer or fish from a fisherman* for up to \$5,400 each against a storage or processing facility.

(7) *Consumer layaway deposits* of up to \$2,425 each.

(8) *Taxes owing to federal, state, and local governments* for income, property, employment and excise taxes. Outside of bankruptcy, taxes usually have a higher priority than this, which is why many times creditors—not tax creditors—file an involuntary bankruptcy petition against the debtor so that they have a higher priority in bankruptcy than they would outside it.

(9) *Allowed claims based on any commitment by the debtor to a federal depository institution* to maintain the capital of an insured depository institution.

4. Creditors giving credit, or lending money to a debtor, in the period between the filing of an involuntary bankruptcy petition and the entry of the order for relief.

(10) *Claims for death or personal injury from a motor vehicle or vessel that occurred while the debtor was legally intoxicated.*

Third through sixth (after secured creditors and priority claimants), other claimants are attended to, but not immediately. The bankruptcy code (perhaps somewhat awkwardly) deals with who gets paid when in more than one place. Chapter 5 sets out priority *claims* as just noted; that order applies to *all* bankruptcies. Chapter 7, dealing with liquidation (as opposed to Chapter 11 and Chapter 13, wherein the debtor pays most of her debt), then lists the order of *distribution*. Section 726 of 11 United States Code provides: “Distribution of property of the estate. (1) First, in payment of claims of the kind specified in, and in the order specified in section 507...” (again, the priority of claims just set out). Following the order specified in the bankruptcy code, our discussion of the order of distribution is taken up in [Section 30.3 "Chapter 7 Liquidation"](#).

### **Debtor's Duties and Exemptions**

The act imposes certain duties on the debtor, and it exempts some property that the trustee can accumulate and distribute from the estate.

#### **Debtor's Duties**

The debtor, reasonably enough, is supposed to file a list of creditors, assets, liabilities, and current income, and a statement of financial affairs. The debtor must cooperate with the trustee and be an “honest debtor” in general; the failure to abide by these duties is grounds for a denial of discharge.

The individual debtor (not including partnerships or corporations) also must show evidence that he or she attended an approved nonprofit budget and counseling agency within 180 days before the filing. The counseling may be “an individual or group briefing (including a briefing conducted by telephone or on the Internet) that outline[s] the opportunities for available credit counseling and assisted such individual in performing a related budget analysis.”<sup>11</sup> United States Code, Section 109(h). In Section 111, the 2005 act describes who can perform this counseling, and a host of regulations and enforcement mechanisms are instituted, generally applying to persons who provide goods or services related to bankruptcy work for consumer debtors whose nonexempt assets are less than \$150,000, in order to improve the professionalism of attorneys and others who work with debtors in, or contemplating, bankruptcy. A debtor who is incapacitated, disabled, or on active duty in a military zone doesn't have to go through the counseling.

## Debtor's Exemptions

The bankruptcy act exempts certain property of the estate of an individual debtor so that he or she will not be impoverished upon discharge. Exactly what is exempt depends on state law.

Notwithstanding the Constitution's mandate that Congress establish "uniform laws on the subject of bankruptcies," bankruptcy law is in fact not uniform because the states persuaded Congress to allow nonuniform exemptions. The concept makes sense: what is necessary for a debtor in Maine to live a nonimpoverished postbankruptcy life might not be the same as what is necessary in southern California. The bankruptcy code describes how a person's residence is determined for claiming state exemptions: basically, where the debtor lived for 730 days immediately before filing or where she lived for 180 days immediately preceding the 730-day period. For example, if the debtor resided in the same state, without interruption, in the two years leading up to the bankruptcy, he can use that state's exemptions. If not, the location where he resided for a majority of the half-year preceding the initial two years will be used. The point here is to reduce "exemption shopping"—to reduce the incidences in which a person moves to a generous exemption state only to declare bankruptcy there.

Unless the state has opted out of the federal exemptions (a majority have), a debtor can choose which exemptions to claim. These are the states that allow residents to choose either federal or state exemptions (the other states mandate the use of state exemptions only): Arkansas, Connecticut, District of Columbia, Hawaii, Kentucky, Massachusetts, Michigan, Minnesota, New Hampshire, New Jersey, New Mexico, Pennsylvania, Rhode Island, Texas, Vermont, Washington, and Wisconsin. There are also some exemptions not included in the bankruptcy code: veteran's, Social Security, unemployment, and disability benefits are outside the code, and alimony payments are also exempt under federal law. The federal exemptions can be doubled by a married couple filing together.

Here are the federal exemptions: 11 United States Code, Section 522.

Homestead:

- Real property, including mobile homes and co-ops, or burial plots up to \$20,200. Unused portion of homestead, up to \$10,125, may be used for other property.

Personal Property:

- Motor vehicle up to \$3,225.
- Animals, crops, clothing, appliances and furnishings, books, household goods, and musical instruments up to \$525 per item, and up to \$10,775 total.
- Jewelry up to \$1,350.
- \$1,075 of any property, and unused portion of homestead up to \$10,125.
- Health aids.
- Wrongful death recovery for person you depended upon.
- Personal injury recovery up to \$20,200 except for pain and suffering or for pecuniary loss.
- Lost earnings payments.

Pensions:

- Tax exempt retirement accounts; IRAs and Roth IRAs up to \$1,095,000 per person.

Public Benefits:

- Public assistance, Social Security, Veteran's benefits, Unemployment Compensation.
- Crime victim's compensation.

Tools of Trade:

- Implements, books, and tools of trade, up to \$2,025.

Alimony and Child Support:

- Alimony and child support needed for support.

Insurance:

- Unmatured life insurance policy except credit insurance.
- Life insurance policy with loan value up to \$10,775.
- Disability, unemployment, or illness benefits.
- Life insurance payments for a person you depended on, which you need for support.

In the run-up to the 2005 changes in the bankruptcy law, there was concern that some states—especially Florida—had gone too far in giving debtors’ exemptions. The Florida homestead exemption is “[r]eal or personal property, including mobile or modular home and condominium, to unlimited value. Property cannot exceed: 1/2 acre in a municipality, or 160 acres elsewhere.” The 2005 act limits the state homestead exemptions, as noted. The BAPCPA amended Section 522 to limit the amount of equity a debtor can exempt, even in a state with unlimited homestead exemptions, in certain circumstances. (Section 522(o) and (p) set out the law’s changes.)

### **Secured Property**

As already noted, secured creditors generally have priority, even above the priority claims. That’s why banks and lending institutions almost always secure the debtor’s obligations. But despite the general rule, the debtor can avoid certain types of security interests. Liens that attach to assets that the debtor is entitled to claim as exempt can be avoided to the extent the lien impairs the value of the exemption in both Chapter 13 and Chapter 7. To be avoidable, the lien must be a judicial lien (like a judgment or a garnishment), or a nonpossessory, non-purchase-money security interest in household goods or tools of the trade.

Tax liens (which are statutory liens, not judicial liens) aren’t avoidable in Chapter 7 even if they impair exemptions; tax liens can be avoided in Chapter 13 to the extent the lien is greater than the asset’s value.

### **Dischargeable and Nondischargeable Debts**

The whole point of bankruptcy, of course, is for debtors to get relief from the press of debt that they cannot reasonably pay.

#### **Dischargeable Debts**

Once discharged, the debtor is no longer legally liable to pay any remaining unpaid debts (except nondischargeable debts) that arose before the court issued the order of relief. The discharge operates to void any money judgments already rendered against the debtor and to bar the judgment creditor from seeking to recover the judgment.



## Nondischargeable Debts

Some debts are not dischargeable in bankruptcy. A bankruptcy discharge varies, depending on the type of bankruptcy the debtor files (Chapter 7, 11, 12, or 13). The most common nondischargeable debts listed in Section 523 include the following:

- All debts not listed in the bankruptcy petition
- Student loans—unless it would be an undue hardship to repay them (see [Section 30.6 "Cases"](#), *In re Zygarzewicz*)
- Taxes—federal, state, and municipal
- Fines for violating the law, including criminal fines and traffic tickets
- Alimony and child support, divorce, and other property settlements
- Debts for personal injury caused by driving, boating, or operating an aircraft while intoxicated
- Consumer debts owed to a single creditor and aggregating more than \$550 for luxury goods or services incurred within ninety days before the order of relief
- Cash advances aggregating more than \$825 obtained by an individual debtor within ninety days before the order for relief
- Debts incurred because of fraud or securities law violations
- Debts for willful injury to another's person or his or her property
- Debts from embezzlement

This is not an exhaustive list, and as noted in [Section 30.3 "Chapter 7 Liquidation"](#), there are some circumstances in which it is not just certain debts that aren't dischargeable: sometimes a discharge is denied entirely.

## Reaffirmation

A debtor may reaffirm a debt that was discharged. Section 524 of the bankruptcy code provides important protection to the debtor intent on doing so. No **reaffirmation**<sup>5</sup> is binding unless the reaffirmation was made *prior* to the granting of the discharge; the reaffirmation agreement must contain a clear and conspicuous statement that advises the debtor that the agreement is not required by bankruptcy or nonbankruptcy law and that the agreement may be rescinded by giving notice of rescission to the holder of such claim at any time prior to discharge or within sixty days after the agreement is filed with the court, whichever is later.

A written agreement to reaffirm a debt must be filed with the bankruptcy court. The attorney for the debtor must file an affidavit certifying that the agreement represents a fully informed and voluntary agreement, that the agreement does not impose an undue hardship on the debtor or a dependent of the debtor, and that the

5. To confirm again the validity of a promise that was discharged, as in bankruptcy.

attorney has fully advised the debtor of the legal consequences of the agreement and of a default under the agreement. Where the debtor is an individual who was not represented by an attorney during the course of negotiating the agreement, the reaffirmation agreement must be approved by the court, after disclosures to the debtor, and after the court finds that it is in the best interest of the debtor and does not cause an undue hardship on the debtor or a dependent.

### Property Included in the Estate

When a bankruptcy petition is filed, a **debtor's estate**<sup>6</sup> is created consisting of all the debtor's then-existing property interests, whether legal or equitable. In addition, the estate includes any bequests, inheritances, and certain other distributions of property that the debtor receives within the next 180 days. It also includes property recovered by the trustee under certain powers granted by the law. What is not exempt property will be distributed to the creditors.

The bankruptcy code confers on the trustee certain powers to recover property for the estate that the debtor transferred before bankruptcy.

One such power (in Section 544) is to act as a **hypothetical lien creditor**<sup>7</sup>. This power is best explained by an example. Suppose Dennis Debtor purchases equipment on credit from Acme Supply Company. Acme fails to perfect its security interest, and a few weeks later Debtor files a bankruptcy petition. By virtue of the section conferring on the trustee the status of a hypothetical lien creditor, the trustee can act as though she had a lien on the equipment, with priority over Acme's unperfected security interest. Thus the trustee can avoid Acme's security interest, with the result that Acme would be treated as an unsecured creditor.

Another power is to avoid transactions known as **voidable preferences**<sup>8</sup>—transactions highly favorable to particular creditors.<sup>11</sup> United States Code, Section 547. A transfer of property is voidable if it was made (1) to a creditor or for his benefit, (2) on account of a debt owed before the transfer was made, (3) while the debtor was insolvent, (4) on or within ninety days before the filing of the petition, and (5) to enable a creditor to receive more than he would have under Chapter 7. If the creditor was an "insider"—one who had a special relationship with the debtor, such as a relative or general partner of the debtor or a corporation that the debtor controls or serves in as director or officer—then the trustee may void the transaction if it was made within one year of the filing of the petition, assuming that the debtor was insolvent at the time the transaction was made.

Some prebankruptcy transfers that seem to fall within these provisions do not. The most important exceptions are (1) transfers made for new value (the debtor buys a

6. The intangible entity containing all the debtor's nonexempt property and liabilities.

7. The trustee acts as if he or she were a lien creditor with power to defeat any unperfected security interests.

8. Transfer of assets by a debtor filing a voluntary bankruptcy petition in favor of one creditor at the expense of other secured creditors.

refrigerator for cash one week before filing a petition; this is an exchange for new value and the trustee may not void it); (2) a transfer that creates a purchase-money security interest securing new value if the secured party perfects within ten days after the debtor receives the goods; (3) payment of a debt incurred in the ordinary course of business, on ordinary business terms; (4) transfers totaling less than \$600 by an individual whose debts are primarily consumer debts; (5) transfers totaling less than \$5,475 by a debtor whose debts are not primarily consumer debts; and (6) transfers to the extent the transfer was a bona fide domestic support obligation.

A third power of the trustee is to avoid **fraudulent transfers**<sup>9</sup> made within two years before the date that the bankruptcy petition was filed.<sup>11</sup> United States Code, Section 548. This provision contemplates various types of fraud. For example, while insolvent, the debtor might transfer property to a relative for less than it was worth, intending to recover it after discharge. This situation should be distinguished from the voidable preference just discussed, in which the debtor pays a favored creditor what he actually owes but in so doing cannot then pay other creditors.

#### KEY TAKEAWAY

A bankruptcy commences with the filing of a petition of bankruptcy. Creditors file proofs of claim and are entitled to certain priorities: domestic support obligations and the costs of administration are first. The debtor has an obligation to file full and truthful schedules and to attend a credit counseling session, if applicable. The debtor has a right to claim exemptions, federal or state, that leave her with assets sufficient to make a fresh start: some home equity, an automobile, and clothing and personal effects, among others. The honest debtor is discharged of many debts, but some are nondischargeable, among them taxes, debt from illegal behavior (embezzlement, drunk driving), fines, student loans, and certain consumer debt. A debtor may, after proper counseling, reaffirm debt, but only before filing. The bankruptcy trustee takes over the nonexempt property of the debtor; he may act as a hypothetical lien creditor (avoiding unperfected security interests) and avoid preferential and fraudulent transfers that unfairly diminish the property of the estate.

9. The transfer of an asset for less than its fair value.

## EXERCISES

1. What is the automatic stay, and when does it arise?
2. Why are the expenses of claimants administering the bankruptcy given top priority (notwithstanding the nominal top priority of domestic support obligations)?
3. Why are debtor's exemptions not uniform? What sorts of things are exempt from being taken by the bankruptcy trustee, and why are such exemptions allowed?
4. Some debts are nondischargeable; give three examples. What is the rationale for disallowing some debts from discharge?
5. How does the law take care that the debtor is fully informed of the right *not* to reaffirm debts, and why is such care taken?
6. What is a hypothetical lien creditor? What is the difference between a preferential transfer and a fraudulent one? Why is it relevant to discuss these three things in the same paragraph?

## 30.3 Chapter 7 Liquidation

### LEARNING OBJECTIVES

1. Recognize the grounds for a Chapter 7 case to be dismissed.
2. Be familiar with the BAPCPA's means-testing requirements before Chapter 7 discharge is granted.
3. Know under what circumstances a debtor will be denied discharge.
4. Understand the order of distribution of the debtor's estate under Chapter 7.

### Trustee's Duties under Chapter 7; Grounds for Dismissal: The Means Test

Except as noted, the provisions discussed up until now apply to each type of bankruptcy proceeding. The following discussion is limited to certain provisions under Chapter 7.

#### Trustee's Duties

In addition to the duties already noted, the trustee has other duties under Chapter 7. He must sell the property for money, close up the estate "as expeditiously as is compatible with the best interests of parties in interest," investigate the debtor's financial affairs, examine proofs of claims, reject improper ones, oppose the discharge of the debtor where doing so is advisable in the trustee's opinion, furnish a creditor with information about the estate and his administration (unless the court orders otherwise), file tax reports if the business continues to be operated, and make a final report and file it with the court.

#### Conversion

Under Section 706 of the bankruptcy code, the debtor may convert a Chapter 7 case to Chapter 11, 12, or 13 at any time. The court may order a **conversion**<sup>10</sup> to Chapter 11 at any time upon request of a party in interest and after notice and hearing. And, as discussed next, a case may be converted from Chapter 7 to Chapter 13 if the debtor agrees, or be dismissed if he does not, in those cases where the debtor makes too much money to be discharged without it being an "abuse" under the 2005 act.

10. In bankruptcy, changing the chapter number filed from one to another.

## Dismissal

The court may dismiss a case for three general reasons.

The first reason is “for cause,” after notice and a hearing for cause, including (1) unreasonable delay by the debtor that prejudices creditors, (2) nonpayment of any fees required, (3) failure to file required documents and schedules.

The second reason for dismissal (or, with the debtor’s permission, conversion to Chapter 11 or 13) applies to debtors whose debt is primarily consumer debt: the court may—after notice and a hearing—dismiss a case if granting relief would be “an abuse of the provisions” of the bankruptcy code.

The third reason for dismissal is really the crux of the 2005 law: under it, the court will find that granting relief under Chapter 7 to a debtor whose debt is primarily consumer debt is “an abuse” if the debtor makes too much money. The debtor must pass a means test: If he’s poor enough, he can go Chapter 7. If he is not poor enough (or if they are not, in case of a married couple), Chapter 13—making payments to creditors—is the way to go. Here is one practitioner’s explanation of the means test:

To apply the means test, the courts will look at the debtor’s average income for the 6 months prior to filing [not the debtor’s income at the time of filing, when—say—she just lost her job] and compare it to the median income for that state. For example, the median annual income for a single wage-earner in California is \$42,012. If the income is below the median, then Chapter 7 remains open as an option. If the income exceeds the median, the remaining parts of the means test will be applied.

The next step in the calculation takes monthly income less reasonable living expenses [“reasonable living expenses” are strictly calculated based on IRS standards; the figure excludes payments on the debts included in the bankruptcy], and multiplies that figure times 60. This represents the amount of income available over a 5-year period for repayment of the debt obligations.

If the income available for debt repayment over that 5-year period is \$10,000 or more, then Chapter 13 will be required. In other words, anyone earning above the state median, and with at least \$166.67 per month (\$10,000 divided by 60) of available income, will automatically be denied Chapter 7. So for example, if the court determines that you have \$200 per month income above living expenses, \$200 times 60 is \$12,000. Since \$12,000 is above \$10,000, you’re stuck with Chapter 13.

What happens if you are above the median income but do NOT have at least \$166.67 per month to pay toward your debts? Then the final part of the means test is applied. If the available income is less than \$100 per month, then Chapter 7 again becomes an option. If the available income is between \$100 and \$166.66, then it is measured against the debt as a percentage, with 25% being the benchmark.

In other words, let's say your income is above the median, your debt is \$50,000, and you only have \$125 of available monthly income. We take \$125 times 60 months (5 years), which equals \$7,500 total. Since \$7,500 is less than 25% of your \$50,000 debt, Chapter 7 is still a possible option for you. If your debt was only \$25,000, then your \$7,500 of available income would exceed 25% of your debt and you would be required to file under Chapter 13.

To sum up, first figure out whether you are above or below the median income for your state—median income figures are available at <http://www.new-bankruptcy-law-info.com>. Be sure to account for your spouse's income if you are a two-income family. Next, deduct your average monthly living expenses from your monthly income and multiply by 60. If the result is above \$10,000, you're stuck with Chapter 13. If the result is below \$6,000, you may still be able to file Chapter 7. If the result is between \$6,000 and \$10,000, compare it to 25% of your debt. Above 25%, you're looking at Chapter 13 for sure. Charles Phelan, "The New Bankruptcy Means Test Explained in Plain English," *Buzzle.com*, <http://www.buzzle.com/editorials/1-10-2006-85999.asp>.

The law also requires that attorneys sign the petition (as well as the debtor); the attorney's signature certifies that the petition is well-grounded in fact and that the attorney has no knowledge after reasonable inquiry that the schedules and calculations are incorrect. Attorneys thus have an incentive to err in favor of filing Chapter 13 instead of Chapter 7 (perhaps that was part of Congress's purpose in this section of the law).

If there's been a **dismissal**<sup>11</sup>, the debtor and creditors have the same rights and remedies as they had prior to the case being commenced—as if the case had never been filed (almost). The debtor can refile immediately, unless the court orders a 120-day penalty (for failure to appear). In most cases, a debtor can file instantly for a Chapter 13 following a Chapter 7 dismissal.

### **Distribution of the Estate and Discharge; Denying Discharge** **Distribution of the Estate**

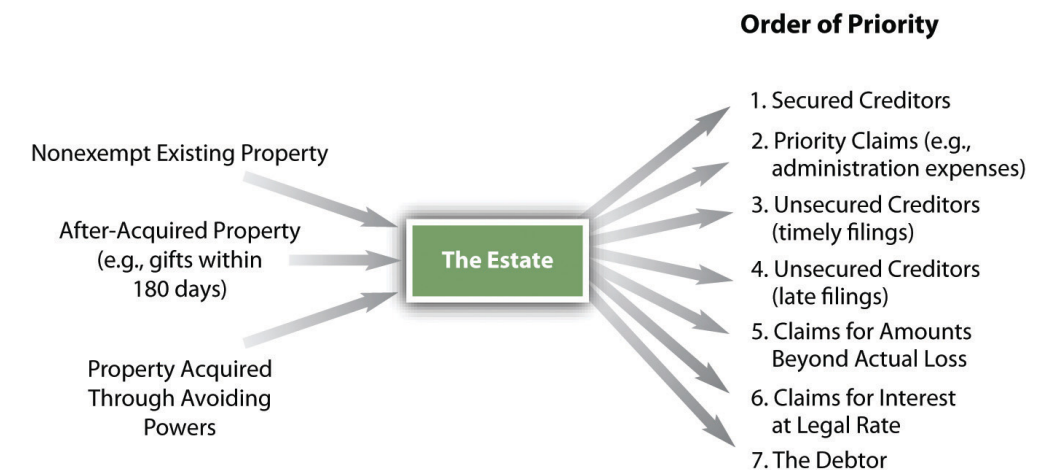
11. An order terminating a case before its normal end.

The estate includes all his or her assets or all their assets (in the case of a married couple) broadly defined. From the estate, the debtor removes property claimed

exempt; the trustee may recapture some assets improperly removed from the estate (preferential and fraudulent transfers), and what's left is the distributable estate. It is important to note that the vast majority of Chapter 7 bankruptcies are **no-asset cases**<sup>12</sup>—90–95 percent of them, according to one longtime bankruptcy trustee. Eugene Crane, Hearing before the Subcommittee on Commercial and Administrative Law of the Committee on the Judiciary, House of Representatives, One Hundred Tenth Congress, Second Session, *Statement to the House Judiciary Subcommittee*, September 16, 2008; <http://judiciary.house.gov/hearings/printers/110th/44493.PDF>. That means creditors get nothing. But in those cases where there are assets, the trustee must distribute the estate to the remaining classes of claimants in this order:

1. Secured creditors, paid on their security interests
2. Claims with priority
3. Unsecured creditors who filed their claims on time
4. Unsecured creditors who were tardy in filing, if they had no notice of the bankruptcy
5. Unsecured creditors who were tardy and had notice, real or constructive
6. Claims by creditors for fines, penalties, and exemplary or punitive damages
7. Interest for all creditors at the legal rate
8. The debtor

Figure 30.3 *Distribution of the Estate*



12. A bankruptcy case with no nonexempt property.



## Discharge

Once the estate is distributed, the court will order the debtor discharged (except for nondischargeable debts) unless one of the following overall exceptions applies for denying **discharge**<sup>13</sup> (i.e., relief from the debt). This list is not exhaustive:

1. The debtor is not an individual. In a Chapter 7 case, a corporation or partnership does not receive a bankruptcy discharge; instead, the entity is dissolved and its assets liquidated. The debts remain theoretically valid but uncollectible until the statute of limitations on them has run. Only an individual can receive a Chapter 7 discharge.<sup>11</sup> United States Code, Section 727(a)(1).
2. The debtor has concealed or destroyed property with intent to defraud, hinder, or delay within twelve months preceding filing of the petition.
3. The debtor has concealed, destroyed, or falsified books and records
4. The debtor has lied under oath, knowingly given a false account, presented or used a false claim, given or received bribes, refused to obey court orders.
5. The debtor has failed to explain satisfactorily any loss of assets.
6. The debtor has declared Chapter 7 or Chapter 11 bankruptcy within eight years, or Chapter 13 within six years (with some exceptions).
7. The debtor failed to participate in “an instructional course concerning personal financial management” (unless that’s excused).
8. An individual debtor has “abused” the bankruptcy process. A preferential transfer is not an “abuse,” but it will be set aside. Making too much money to file Chapter 7 is “an abuse” that will deny discharge.

A discharge may be revoked if the debtor committed fraud during the bankruptcy proceedings, but the trustee or a creditor must apply for revocation within one year of the discharge.

Having the **discharge denied**<sup>14</sup> does not affect the administration of the bankruptcy case. The trustee can (and will) continue to liquidate any nonexempt assets of the debtor and pay the creditors, but the debtor still has to pay the debts left over.

13. The determination that debts are no longer owing.

14. Refusal of a bankruptcy court to allow discharge, usually because the debtor has acted in bad faith.

As to any consequence of discharge, bankruptcy law prohibits governmental units from discriminating against a person who has gone through bankruptcy. Debtors are also protected from discrimination by private employers; for example, a private

employer may not fire a debtor because of the bankruptcy. Certainly, however, the debtor's credit rating will be affected by the bankruptcy.

### KEY TAKEAWAY

A Chapter 7 bankruptcy case may be dismissed for cause or because the debtor has abused the system. The debtor is automatically considered to have abused the system if he makes too much money. With the debtor's permission, the Chapter 7 may be converted to Chapter 11, 12, or 13. The law requires that the debtor pass a means test to qualify for Chapter 7. Assuming the debtor does qualify for Chapter 7, her nonexempt assets (if there are any) are sold by the trustee and distributed to creditors according to a priority set out in the law. A discharge may be denied, in general because the debtor has behaved dishonestly or—again—has abused the system.

### EXERCISES

1. What is the difference between denial of a discharge for cause and denial for abuse?
2. What is the difference between a dismissal and a denial of discharge?
3. Which creditors get satisfied first in a Chapter 7 bankruptcy?

## 30.4 Chapter 11 and Chapter 13 Bankruptcies

### LEARNING OBJECTIVES

1. Understand the basic concepts of Chapter 11 bankruptcies.
2. Understand the basic concepts of Chapter 13 bankruptcies.

### Reorganization: Chapter 11 Bankruptcy

#### Overview

Chapter 11 provides a means by which corporations, partnerships, and other businesses, including sole proprietorships, can rehabilitate themselves and continue to operate free from the burden of debts that they cannot pay.

It is simple enough to apply for the protection of the court in Chapter 11 proceeding, and for many years, large financially ailing companies have sought shelter in Chapter 11. Well-known examples include General Motors, Texaco, K-Mart, Delta Airlines, and Northwest Airlines. An increasing number of corporations have turned to Chapter 11 even though, by conventional terms, they were solvent. Doing so enables them to negotiate with creditors to reduce debt. It also may even permit courts to snuff out lawsuits that have not yet been filed. Chapters 3 and 5, discussed in [Section 30.2 "Case Administration; Creditors' Claims; Debtors' Exemptions and Dischargeable Debts; Debtor's Estate"](#), apply to Chapter 11 proceedings also. Our discussion, therefore, is limited to special features of Chapter 11.

#### How It Works

##### Eligibility

Any person eligible for discharge in Chapter 7 proceeding (plus railroads) is eligible for a Chapter 11 proceeding, except stockbrokers and commodity brokers. Individuals filing Chapter 11 must take credit counseling; businesses do not. A company may voluntarily enter Chapter 11 or may be put there involuntarily by creditors. Individuals can file Chapter 11 particularly if they have too much debt to qualify for Chapter 13 and make too much money to qualify for Chapter 7; under the 2005 act, individuals must commit future wages to creditors, just as in Chapter 13.11 United States Code, Sections 1115, 1123(a)(8), and 1129(a)(15).

### **Operation of Business**

Unless a trustee is appointed, the debtor will retain possession of the business and may continue to operate with its own management. The court may appoint a trustee on request of any party in interest after notice and a hearing. The appointment may be made for cause—such as dishonesty, incompetence, or gross mismanagement—or if it is otherwise in the best interests of the creditors. Frequently, the same incompetent management that got the business into bankruptcy is left running it—that’s a criticism of Chapter 11.

### **Creditors’ Committee**

The court must appoint a committee of unsecured creditors as soon as practicable after issuing the order for relief. The committee must consist of creditors willing to serve who have the seven largest claims, unless the court decides to continue a committee formed before the filing, if the committee was fairly chosen and adequately represents the various claims. The committee has several duties, including these: (1) to investigate the debtor’s financial affairs, (2) to determine whether to seek appointment of a trustee or to let the business continue to operate, and (3) to consult with the debtor or trustee throughout the case.

### **The Reorganization Plan**

The debtor may always file its own plan, whether in a voluntary or involuntary case. If the court leaves the debtor in possession without appointing a trustee, the debtor has the exclusive right to file a reorganization plan during the first 120 days. If it does file, it will then have another 60 days to obtain the creditors’ acceptances. Although its exclusivity expires at the end of 180 days, the court may lengthen or shorten the period for good cause. At the end of the exclusive period, the creditors’ committee, a single creditor, or a holder of equity in the debtor’s property may file a plan. If the court does appoint a trustee, any party in interest may file a plan at any time.

The Bankruptcy Reform Act specifies certain features of the plan and permits others to be included. Among other things, the plan must (1) designate classes of claims and ownership interests; (2) specify which classes or interests are impaired—a claim or ownership interest is impaired if the creditor’s legal, equitable, contractual rights are altered under the plan; (3) specify the treatment of any class of claims or interests that is impaired under the plan; (4) provide the same treatment of each claim or interests of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment; and (5) provide adequate means for carrying out the plan. Basically, what the plan does is provide a process for rehabilitating the company’s faltering business by relieving it from

repaying part of its debt and initiating reforms so that the company can try to get back on its feet.

### **Acceptance of the Plan**

The act requires the plan to be accepted by certain proportions of each impaired class of claims and interests. A class of claims accepts the plan if creditors representing at least two-thirds of the dollar amount of claims and more than one-half the number of allowed claims vote in favor. A class of property interests accepts the plan if creditors representing two-thirds of the dollar amount of the allowed ownership interests vote in favor. Unimpaired classes of claims and interest are deemed to have accepted the plan; it is unnecessary to solicit their acceptance.

### **Confirmation of the Plan**

The final act necessary under Chapter 11 is confirmation by the court. Once the court confirms the plan, the plan is binding on all creditors. The rules governing confirmation are complex, but in essence, they include the following requirements:

1. The plan must have been proposed in good faith. Companies must also make a good-faith attempt to negotiate modifications in their collective bargaining agreements (labor union contracts).
2. All provisions of the act must have been complied with.
3. The court must have determined that the reorganized business will be likely to succeed and be unlikely to require further financial reorganization in the foreseeable future.
4. Impaired classes of claims and interests must have accepted the plan, unless the plan treats them in a “fair and equitable” manner, in which case consent is not required. This is sometimes referred to as the cram-down provision.
5. All members of every class must have received no less value than they would have in Chapter 7 liquidation.

### **Discharge, Conversion**

The debtor gets discharged when all payments under the plan are completed. A Chapter 11 bankruptcy may be converted to Chapter 7, with some restrictions, if it turns out the debtor cannot make the plan work.

## **Adjustment of Debts of an Individual with Regular Income: Chapter 13 Bankruptcy In General**

Anyone with a steady income who is having difficulty paying off accumulated debts may seek the protection of a bankruptcy court in Chapter 13 proceeding (often called the wage earner's plan). Under this chapter, the individual debtor presents a payment plan to creditors, and the court appoints a trustee. If the creditors wind up with more under the plan presented than they would receive in Chapter 7 proceeding, then the court is likely to approve it. In general, a Chapter 13 repayment plan extends the time to pay the debt and may reduce it so that the debtor need not pay it all. Typically, the debtor will pay a fixed sum monthly to the trustee, who will distribute it to the creditors. The previously discussed provisions of Chapters 3 and 5 apply also to this chapter; therefore, the discussion that follows focuses on some unique features of Chapter 13.

People seek Chapter 13 discharges instead of Chapter 7 for various reasons: they make too much money to pass the Chapter 7 means test; they are behind on their mortgage or car payments and want to make them up over time and reinstate the original agreement; they have debts that can't be discharged in Chapter 7; they have nonexempt property they want to keep; they have codebtors on a personal debt who would be liable if the debtor went Chapter 7; they have a real desire to pay their debts but cannot do so without getting the creditors to give them some breathing room. Chapter 7 cases may always be converted to Chapter 13.

### **How It Works Eligibility**

Chapter 13 is voluntary only. Anyone—sole proprietorships included—who has a regular income, unsecured debts of less than \$336,000, and secured debts of less than \$1,010,650 is eligible to seek its protection. The debts must be unpaid and owing at the time the debtor applies for relief. If the person has more debt than that, she will have to file Chapter 11. The debtor must attend a credit-counseling class, as in Chapter 7.

### **The Plan**

Plans are typically extensions or compositions—that is, they extend the time to pay what is owing, or they are agreements among creditors each to accept something less than the full amount owed (so that all get something). Under Chapter 13, the stretch-out period is three to five years. The plan must provide for payments of all future income or a sufficient portion of it to the trustee. Priority creditors are entitled to be paid in full, although they may be paid later than required under the

original indebtedness. As long as the plan is being carried out, the debtor may enjoin any creditors from suing to collect the original debt.

### **Confirmation**

Under Section 1325 of the bankruptcy code, the court must approve the plan if it meets certain requirements. These include (1) distribution of property to unsecured creditors whose claims are allowed in an amount no less than that which they would have received had the estate been liquidated under Chapter 7; (2) acceptance by secured creditors, with some exceptions, such as when the debtor surrenders the secured property to the creditor; and (3) proposal of the plan “in good faith.” If the trustee or an unsecured creditor objects to confirmation, the plan must meet additional tests. For example, a plan will be approved if all of the debtor’s disposable income (as defined in Section 1325) over the commitment period (three to five years) will be used to make payments under the plan.

### **Discharge**

Once a debtor has made all payments called for in the plan, the court will discharge him from all remaining debts except certain long-term debts and obligations to pay alimony, maintenance, and support. Under former law, Chapter 13 was so broad that it permitted the court to discharge the debtor from many debts considered nondischargeable under Chapter 7, but 1994 amendments and the 2005 act made Chapter 13 less expansive. Debts dischargeable in Chapter 13, but not in Chapter 7, include debts for willful and malicious injury to property, debts incurred to pay nondischargeable tax obligations, and debts arising from property settlements in divorce or separation proceedings. (See [Section 30.6 "Cases"](#), *In re Ryan*, for a discussion of what debts are dischargeable under Chapter 13 as compared with Chapter 7.)

Although a Chapter 13 debtor generally receives a discharge only after completing all payments required by the court-approved (i.e., “confirmed”) repayment plan, there are some limited circumstances under which the debtor may request the court to grant a “hardship discharge” even though the debtor has failed to complete plan payments. Such a discharge is available only to a debtor whose failure to complete plan payments is due to circumstances beyond the debtor’s control. A Chapter 13 discharge stays on the credit record for up to ten years.

A discharge may be denied if the debtor previously went through a bankruptcy too soon before filing Chapter 13, failed to act in good faith, or—with some exceptions—failed to complete a personal financial management course.

### KEY TAKEAWAY

Chapter 11—frequently referred to as “corporate reorganization”—is most often used by businesses whose value as a going concern is greater than it would be if liquidated, but, with some exceptions, anyone eligible to file Chapter 7 can file Chapter 11. The business owners, or in some cases the trustee or creditors, develop a plan to pay the firm’s debts over a three- to five-year period; the plan must be approved by creditors and the court. Chapter 13—frequently called the wage-earner’s plan—is a similar mechanism by which a person can discharge some debt and have longer to pay debts off than originally scheduled. Under Chapter 13, people can get certain relief from creditors that they cannot get in Chapter 7.

### EXERCISES

1. David Debtor is a freelance artist with significant debt that he feels a moral obligation to pay. Why is Chapter 11 his best choice of bankruptcy chapters to file under?
2. What is the practical difference between debts arising from property settlements in divorce or separation proceedings—which can be discharged under Chapter 13—and debts owing for alimony (maintenance) and child support—which cannot be discharged under Chapter 13?
3. Why would a person want to go through the long grind of Chapter 13 instead of just declaring straight bankruptcy (Chapter 7) and being done with it?



## 30.5 Alternatives to Bankruptcy

### LEARNING OBJECTIVES

1. Understand that there are nonbankruptcy alternatives for debtors who cannot pay their bills in a timely way: assignment for benefit of creditors, compositions, and receiverships.
2. Recognize the reasons why these alternatives might not work.

### Alternatives to Bankruptcy: Overview

Bankruptcy is a necessary thing in a capitalist economic system. As already noted, without it, few people would be willing to take business risks, and the economy would necessarily operate at a lower level (something some people might not think so bad overall). But bankruptcy, however “enlightened” society may have become about it since Victorian days, still carries a stigma. Bankruptcy filings are public information; the lists of people and businesses who declare bankruptcy are regularly published in monthly business journals. Bankruptcy is expensive, too, and both debtors and creditors become enmeshed in significantly complex federal law. For these reasons, among others, both parties frequently determine it is in their best interest to find an alternative to bankruptcy. Here we take up briefly three common alternatives.

In other parts of this book, other nonbankruptcy creditors’ rights are discussed: under the Uniform Commercial Code (UCC), creditors have rights to reclaim goods sold and delivered but not paid for; under the UCC, too, creditors have a right to repossess personal property that has been put up as collateral for the debtor’s loan or extension of credit; and mortgagees have the right to repossess real estate without judicial assistance in many circumstances. These nonbankruptcy remedies are governed mostly by state law.

The nonbankruptcy alternatives discussed here are governed by state law also.

### Assignment for Benefit of Creditors; Compositions; Receivership Assignment for Benefit of Creditors

Under a common-law **assignment for the benefit of creditors**<sup>15</sup>, the debtor transfers some or all of his assets to a trustee—usually someone appointed by the adjustment bureau of a local credit managers’ association—who sells the assets and

15. The debtor assigns property to a trustee to sell for creditors.

apportions the proceeds in some agreed manner, usually pro rata, to the creditors. Of course, not every creditor need agree with such a distribution. Strictly speaking, the common-law assignment does not discharge the balance of the debt. Many state statutes attempt to address this problem either by prohibiting creditors who accept a partial payment of debt under an assignment from claiming the balance or by permitting debtors to demand a release from creditors who accept partial payment.

### Composition

A **composition**<sup>16</sup> is simply an agreement by creditors to accept less than the full amount of the debt and to discharge the debtor from further liability. As a contract, composition requires consideration; the mutual agreement among creditors to accept a pro rata share of the proceeds is held to be sufficient consideration to support the discharge. The essential difference between assignment and composition lies in the creditors' agreement: an assignment implies no agreement among the creditors, whereas a composition does. Not all creditors of the particular debtor need agree to the composition for it to be valid. A creditor who does not agree to the composition remains free to attempt to collect the full sum owed; in particular, a creditor not inclined to compose the debt could attach the debtor's assets while other creditors are bargaining over the details of the composition agreement.

One advantage of the assignment over the composition is that in the former the debtor's assets—having been assigned—are protected from attachment by hungry creditors. Also, the assignment does not require creditors' consent. However, an advantage to the debtor of the assignment (compared with the composition) is that in the composition creditors cannot go after the debtor for any deficiency (because they agreed not to).

### Receivership

A creditor may petition the court to appoint a receiver; **receivership**<sup>17</sup> is a long-established procedure in equity whereby the receiver takes over the debtor's property under instructions from the court. The receiver may liquidate the property, continue to operate the business, or preserve the assets without operating the business until the court finally determines how to dispose of the debtor's property.

The difficulty with most of the alternatives to bankruptcy lies in their voluntary character: a creditor who refuses to go along with an agreement to discharge the debtor can usually manage to thwart the debtor and her fellow creditors because, at the end of the day, the US Constitution forbids the states from impairing private

16. Creditors' agreement to accept less than the face amount owing.

17. A court action placing the debtor's property under control of a custodian so that it can be preserved or distributed for the benefit of all creditors.

citizens' contractual obligations. The only final protection, therefore, is to be found in the federal bankruptcy law.

#### KEY TAKEAWAY

Bankruptcy is expensive and frequently convoluted. Nonbankruptcy alternatives include assignment for the benefit of creditors (the debtor's assets are assigned to a trustee who manages or disposes of them for creditors), compositions (agreements by creditors to accept less than they are owed and to discharge the debtor from further liability), and receivership (a type of court-supervised assignment).

#### EXERCISES

1. What is an assignment for benefit of creditors?
2. What is a composition?
3. What is a receivership?
4. Why are these alternatives to bankruptcy often unsatisfactory?

## 30.6 Cases

### Dischargeability of Student Loans under Chapter 7

In re Zygarewicz

423 B.R. 909 (Bkrtcy.E.D.Cal. 2010)

MCMANUS, BANKRUPTCY JUDGE.

Angela Zygarewicz, a chapter 7 debtor and the plaintiff in this adversary proceeding, borrowed 16 government-guaranteed student [sic] loans totaling \$81,429. The loans have been assigned to Educational Credit Management Corporation (“ECMC”). By September 2009, the accrual of interest on these student loans had caused the debt to balloon to more than \$146,000. The debtor asks the court to declare that these student loans were discharged in bankruptcy.

The Bankruptcy Code provides financially distressed debtors with a fresh start by discharging most of their pre-petition debts....However, under 11 U.S.C. § 523(a)(8), there is a presumption that educational loans extended by or with the aid of a governmental unit or nonprofit institution are nondischargeable unless the debtor can demonstrate that their repayment would be an undue hardship. See [Citation]. This exception to a bankruptcy discharge ensures that student loans, which are typically extended solely on the basis of the student’s future earnings potential, cannot be discharged by recent graduates who then pocket all of the future benefits derived from their education. See [Citation].

The debtor bears the burden of proving by a preponderance of the evidence that she is entitled to a discharge of the student loan. See [Citation]. That is, the debtor must prove that repayment of student loans will cause an undue hardship.

The Bankruptcy Code does not define “the undue hardship.” Courts interpreting section 523(a)(8), however, have concluded that undue hardship [and] is something more than “garden-variety hardship.” [Citation.] Only cases involving “real and substantial” hardship merit discharges. See [Citation.]

The Ninth Circuit has adopted a three-part test to guide courts in their attempts to determine whether a debtor will suffer an undue hardship is required to repay a student loan:

- First, the debtor must establish “that she cannot maintain, based on current income and expenses, a ‘minimal’ standard of living for herself and her dependents if forced to repay the loans.”...
- Second, the debtor must show “that additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans.”...
- The third prong requires “that the debtor has made good faith efforts to repay the loans....”

(*Pena*, citing *Brunner v. N.Y. State Higher Educ. Servs. Corp.*, [Citation]).

Debtor must satisfy all three parts of the *Brunner* test before her student loans can be discharged. Failure to prove any of the three prongs will defeat a debtor’s case.

When this bankruptcy case was filed in September 2005, the debtor was a single woman and had no dependents. She is 39 years old.

Schedule I reported that the debtor was unemployed. The debtor’s responses to the Statement of Financial Affairs revealed that she had received \$5,500 in income during 2005 prior to the filing of the petition. Evidence at trial indicated that after the petition was filed, the debtor found work and earned a total of \$9,424 in 2005. In 2004 and 2003, she earned \$13,994 and \$17,339, respectively.

Despite this modest income, the debtor did not immediately file an adversary proceeding to determine the dischargeability of her student loans. It was almost three years after the entry of her chapter 7 discharge ‘on January 3, 2006 that the debtor reopened her chapter 7 case in order to pursue this adversary proceeding.’

In her complaint, the debtor admits that after she received a discharge, she found part-time work with a church and later took a full-time job as a speech therapist. During 2006, the debtor earned \$20,009 and in 2007 she earned \$37,314. Hence, while it is clear the debtor’s income was very modest in the time period immediately prior to her bankruptcy petition, her financial situation improved during her bankruptcy case.

The court cannot conclude based on the evidence of the debtor’s financial circumstances up to the date of the discharge, that she was unable to maintain a minimal standard of living if she was required to repay her students [sic] loans.

However, in January 2007, the debtor was injured in an automobile accident. Her injuries eventually halted the financial progress she had been making and eventually prevented her from working. She now subsists on social security disability payments.

The circumstance creating the debtor's hardship, the automobile accident, occurred after her chapter 7 petition was filed, indeed, approximately one year after her discharge was entered. The debtor is maintaining that this post-petition, post-discharge circumstance warrants a declaration that her student loans were discharged effective from the petition date.

When must the circumstances creating a debtor's hardship arise: before the bankruptcy case is filed; after the case is filed but prior to the entry of a discharge; or at anytime, including after the entry of a discharge?

The court concludes that the circumstances causing a chapter 7 debtor's financial hardship must arise prior to the entry of the discharge. If the circumstances causing a debtor's hardship arise after the entry of a discharge, those circumstances cannot form the basis of a determination that repayment of a student loan will be an undue hardship....

[T]here is nothing in the Bankruptcy Code requiring that a complaint under section 523(a)(8) [to discharge student loans] be filed at any particular point in a bankruptcy case, whether it is filed under chapter 7 or 13. [Relevant Federal Rules of Bankruptcy Procedure] permits such dischargeability complaints to be brought at any time, including after the entry of a discharge and the closing of the bankruptcy case....

While a debtor's decision to file an action to determine the dischargeability of a student loan is not temporally constrained, this does not mean that a debtor's financial hardship may arise after a discharge has been entered.

[The] *Coleman* [case, cited by debtor] deals with the ripeness of a dispute concerning the dischargeability of a student loan. [The Ninth Circuit held that it] is ripe for adjudication at any point during the case. The Ninth Circuit did not conclude, however, that a debtor could rely upon post-discharge circumstances to establish undue hardship. In fact, the court in *Coleman* made clear that the debtor could take a snapshot of the hardship warranting a discharge of a student loan any time *prior* to discharge. [*Coleman* was a Chapter 13 case.]

Here, the debtor was injured in an automobile accident on January 17, 2007, almost exactly one year after her January 3, 2006 chapter 7 discharge. Because the accident had no causal link to the misfortune prompting the debtor to seek bankruptcy relief in the first instance, the accident cannot be relied on to justify the discharge of the student loans because repayment would be an undue hardship.

To hold otherwise would mean that a bankruptcy discharge is a perpetual license to discharge student loans based on events that occur years after the bankruptcy discharge is granted. If a discharged debtor suffers later financial misfortune, that debtor must consider seeking another discharge subject to the limitations imposed by [the sections of the code stipulating how often a person can petition for bankruptcy]. In the context of a second case, the debtor could then ask that the student loan be declared dischargeable under section 523(a)(8).

In this instance, the debtor is now eligible for a discharge in a chapter 13 case. Her chapter 7 petition was filed on September 19, 2005. Section 1328(f)(1) bars a chapter 13 discharge when the debtor has received a chapter 7 discharge in a case commenced in the prior four years. She would not be eligible for a chapter 7 discharge until September 19, 2013.

This is not to say that post-discharge events are irrelevant. The second and third prongs of the *Pena* test require the court to consider whether the circumstances preventing a debtor from repaying a student loan are likely to persist, and whether the debtor has made good faith efforts to repay the student loan. Post-discharge events are relevant to these determinations because they require the court to look into the debtor's financial future.

Unfortunately for the debtor, it is unnecessary to consider the second and third prongs because she cannot satisfy the first prong.

## CASE QUESTIONS

1. What is the rationale for making the bankruptcy discharge of student loans very difficult?
2. Petitioner argued that she should be able to use a postdischarge event (the auto accident) as a basis for establishing that she could not maintain a “minimal” standard of living, and thus she should get a retroactive discharge of her student loans. What benefit is there to her if she could successfully make the argument, given that she could—as the court noted—file for Chapter 13?
3. The court cites the *Coleman* case. That was a Chapter 13 proceeding. Here were the facts: Debtor had not yet completed her payments under her five-year repayment plan, and no discharge order had yet been entered; one year into the plan, she was laid off work. She had been trying to repay her student loans for several years, and she claimed she would suffer hardship in committing to the five-year repayment plan without any guarantee that her student loan obligations would be discharged, since she was required to commit all of her disposable income to payments under the plan and would likely be forced to pursue undue hardship issue pro se upon completion of the plan.” In *Coleman*, the court held that Debtor could, postfiling but pre-discharge—one year into the five-year plan—bring up the hardship issue.

Now, in the case here, after the auto accident, the petitioner “subsists” on Social Security disability payments, and she has almost \$150,000 in debt, yet the court prohibited her from claiming a hardship discharge of student loans. Does this result really make sense? Is the court’s concern that allowing this postdischarge relief would mean “that a bankruptcy discharge is a perpetual license to discharge student loans based on events that occur years after the bankruptcy discharge is granted” well founded? Suppose it is scheduled to take thirty years to pay off student loans; in year 4, the student-borrower, now Debtor, declares Chapter 7 bankruptcy, student loans not being discharged; in year 6, the person is rendered disabled. What public policy is offended if the person is allowed to “reopen” the bankruptcy and use the postbankruptcy event as a basis for claiming a hardship discharge of student loans?



4. The court suggests she file for Chapter 13. What if—because of timing—the petitioner was not eligible for Chapter 13? What would happen then?

## Chapter 11 Bankruptcy

In re Johns-Manville Corp.

36 B.R. 727 (Bkrtcy. N.Y. 1984)

Lifland, Bankruptcy Judge.

Whether an industrial enterprise in the United States is highly successful is often gauged by its “membership” in what has come to be known as the “Fortune 500”. Having attained this measure of financial achievement, Johns-Manville Corp. and its affiliated companies (collectively referred to as “Manville”) were deemed a paradigm of success in corporate America by the financial community. Thus, Manville’s filing for protection under Chapter 11 of Title 11 of the United States Code (“the Code or the Bankruptcy Code”) on August 26, 1982 (“the filing date”) was greeted with great surprise and consternation on the part of some of its creditors and other corporations that were being sued along with Manville for injuries caused by asbestos exposure. As discussed at length herein, Manville submits that the sole factor necessitating its filing is the mammoth problem of uncontrolled proliferation of asbestos health suits brought against it because of its substantial use for many years of products containing asbestos which injured those who came into contact with the dust of this lethal substance. According to Manville, this current problem of approximately 16,000 lawsuits pending as of the filing date is compounded by the crushing economic burden to be suffered by Manville over the next 20–30 years by the filing of an even more staggering number of suits by those who had been exposed but who will not manifest the asbestos-related diseases until some time during this future period (“the future asbestos claimants”). Indeed, approximately 6,000 asbestos health claims are estimated to have arisen in only the first 16 months since the filing date. This burden is further compounded by the insurance industry’s general disavowal of liability to Manville on policies written for this very purpose.

It is the propriety of the filing by Manville which is the subject of the instant decision. Four separate motions to dismiss the petition pursuant to Section 1112(b) of the Code have been lodged before this Court....

Preliminarily, it must be stated that there is no question that Manville is eligible to be a debtor under the Code's statutory requirements. Moreover, it should also be noted that neither Section 109 nor any other provision relating to voluntary petitions by companies contains any insolvency requirement....Accordingly, it is abundantly clear that Manville has met all of the threshold eligibility requirements for filing a voluntary petition under the Code....

A "principal goal" of the Bankruptcy Code is to provide "open access" to the "bankruptcy process." [Citation.] The rationale behind this "open access" policy is to provide access to bankruptcy relief which is as "open" as "access to the credit economy." Thus, Congress intended that "there should be no legal barrier to voluntary petitions." Another major goal of the Code, that of "rehabilitation of debtors," requires that relief for debtors must be "timely." Congress declared that it is essential to both the "open access" and "rehabilitation" goals that

[i]nitiating relief should not be a death knell. The process should encourage resort to it, by debtors and creditors, that cuts short the dissipation of assets and the accumulation of debts. Belated commencement of a case may kill an opportunity for reorganization or arrangement.

Accordingly, the drafters of the Code envisioned that a financially beleaguered debtor with real debt and real creditors should not be required to wait until the economic situation is beyond repair in order to file a reorganization petition. The "Congressional purpose" in enacting the Code was to encourage resort to the bankruptcy process. This philosophy not only comports with the elimination of an insolvency requirement, but also is a corollary of the key aim of Chapter 11 of the Code, that of avoidance of liquidation. The drafters of the Code announced this goal, declaring that reorganization is more efficient than liquidation because "assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap." [Citation.] Moreover, reorganization also fosters the goals of preservation of jobs in the threatened entity. [Citation.]

In the instant case, not only would liquidation be wasteful and inefficient in destroying the utility of valuable assets of the companies as well as jobs, but, more importantly, liquidation would preclude just compensation of some present asbestos victims and all future asbestos claimants. This unassailable reality represents all the more reason for this Court to adhere to this basic potential liquidation avoidance aim of Chapter 11 and deny the motions to dismiss. Manville must not be required to wait until its economic picture has deteriorated beyond salvation to file for reorganization.

Clearly, none of the justifications for declaring an abuse of the jurisdiction of the bankruptcy court announced by these courts [in various cases cited] are present in the *Manville* case. In *Manville*, it is undeniable that there has been no sham or hoax perpetrated on the Court in that *Manville* is a real business with real creditors in pressing need of economic reorganization. Indeed, the Asbestos Committee has belied its own contention that *Manville* has no debt and no real creditors by quantifying a benchmark settlement demand approaching one billion dollars for compensation of approximately 15,500 pre-petition asbestos claimants, during the course of negotiations pitched toward achieving a consensual plan. This huge asserted liability does not even take into account the estimated 6,000 new asbestos health claims which have arisen in only the first 16 months since the filing date. The number of post-filing claims increases each day as “future claims back into the present.” ...

In short, *Manville*'s filing did not in the appropriate sense abuse the jurisdiction of this Court and it is indeed, like the debtor in [Citation], a “once viable business supporting employees and unsecured creditors [that] has more recently been burdened with judgments [and suits] that threaten to put it out of existence.” Thus, its petition must be sustained....

In sum, *Manville* is a financially besieged enterprise in desperate need of reorganization of its crushing real debt, both present and future. The reorganization provisions of the Code were drafted with the aim of liquidation avoidance by great access to Chapter 11. Accordingly, *Manville*'s filing does not abuse the jurisdictional integrity of this Court, but rather presents the same kinds of reasons that were present in [Citation], for awaiting the determination of *Manville*'s good faith until it is considered...as a prerequisite to confirmation or as a part of the cadre of motions before me which are scheduled to be heard subsequently.

[A]ll four of the motions to dismiss the *Manville* petition are denied in their entirety.

## CASE QUESTIONS

1. What did Manville want to do here, and why?
2. How does this case demonstrate the fundamental purpose of Chapter 11 as opposed to Chapter 7 filings?
3. The historical background here is that Manville knew from at least 1930 that asbestos—used in many industrial applications—was a deadly carcinogen, and it worked diligently for decades to conceal and obfuscate the fact. What “good faith” argument was raised by the movants in this case?

### Chapter 13: What Debts Are Dischargeable?

In re Ryan

389 B.R. 710 9th Cir. BAP, (Idaho, 2008)

On July 13, 1995, Ryan was convicted of possession of an unregistered firearm under 26 U.S.C. § 5861(d) in the United States District Court for the District of Alaska. Ryan was sentenced to fifty-seven months in prison followed by three years of supervised release. In addition, Ryan was ordered to pay a fine of \$7,500..., costs of prosecution in the amount of \$83,420, and a special assessment of \$50.00. Ryan served his sentence. He also paid the \$7,500 fine. The district court, following an appellate mandate, ultimately eliminated the restitution obligation.

On April 25, 2003, Ryan filed a petition for bankruptcy relief under chapter 7 in the District of Idaho. He received his chapter 7 discharge on August 11, 2003. Shortly thereafter, Ryan filed a case under chapter 13, listing as his only obligation the amount of unpaid costs of prosecution owed to the United States (“Government”)....

Ryan completed payments under the plan, and an “Order of Discharge” was entered on October 5, 2006. The chapter 13 trustee’s final report reflected that the Government received \$2,774.89 from payments made by Ryan under his plan, but a balance of \$77,088.34 on the Government’s costs of prosecution claim remained unpaid. Ryan then renewed his request for determination of dischargeability. The bankruptcy court held that the unpaid portion of the Government’s claim for costs of prosecution was excepted from discharge by § 1328(a)(3). Ryan appealed.

Section 1328(a)(3) provides an exception to discharge in chapter 13 for “restitution, or a criminal fine.” It states, in pertinent part:

[A]s soon as practicable after the completion by the debtor of all payments under the plan, the court shall grant the debtor a discharge of all debts provided for by the plan or disallowed under section 502 of this title except any debt...

(3) for restitution, or a *criminal fine*, included in a sentence on the debtor's conviction of a crime [...] [emphasis added].

The essential question, then, is whether these costs of prosecution constitute a "criminal fine."

Statutory interpretation begins with a review of the particular language used by Congress in the relevant version of the law. [Citation.]

The term "criminal fine" is not defined in [Chapter 13] or anywhere else in the Bankruptcy Code. However, its use in § 1328(a)(3) implicates two important policies embedded in the Bankruptcy Code. First, in light of the objective to provide a fresh start for debtors overburdened by debts that they cannot pay, exceptions to discharge are interpreted strictly against objecting creditors and in favor of debtors. *See, e.g.* [Citations]. In chapter 13, this principle is particularly important because Congress adopted the liberal "superdischarge" provisions of § 1328 as an incentive to debtors to commit to a plan to pay their creditors all of their disposable income over a period of years rather than simply discharging their debts in a chapter 7 liquidation.

"[T]he dischargeability of debts in chapter 13 that are not dischargeable in chapter 7 represents a policy judgment that [it] is preferable for debtors to attempt to pay such debts to the best of their abilities over three years rather than for those debtors to have those debts hanging over their heads indefinitely, perhaps for the rest of their lives." [Citations.]

A second, countervailing policy consideration is a historic deference, both in the Bankruptcy Code and in the administration of prior bankruptcy law, to excepting criminal sanctions from discharge in bankruptcy. Application of this policy is consistent with a general recognition that, "[t]he principal purpose of the Bankruptcy Code is to grant a 'fresh start' to the 'honest but unfortunate debtor.'" [Citation] (emphasis added [in original]).

The legislative history is clear that [in its 1994 amendments to the bankruptcy law] Congress intended to overrule the result in [of a 1990 Supreme Court case so that]... "[N]o debtor with criminal restitution obligations will be able to discharge them through any bankruptcy proceeding."...

The imposition on a defendant of the costs of a special prosecutor is different from ordering a defendant to pay criminal fines. Costs are paid to the entity incurring the costs; criminal fines are generally paid to a special fund for victims' compensation and assistance in the U.S. Treasury....

To honor the principle that exceptions to discharge are to be construed narrowly in favor of debtors, particularly in chapter 13, where a broad discharge was provided by Congress as an incentive for debtors to opt for relief under that chapter rather than under chapter 7, it is not appropriate to expand the scope of the [Chapter 13] exception beyond the terms of the statute. Congress could have adopted an exception to discharge in chapter 13 that mirrored [the one in Chapter 7]. It did not do so. In contrast, under [the 2005] BAPCPA, when Congress wanted to limit the chapter 13 "superdischarge," it incorporated exceptions to discharge from [Chapter 7] wholesale....

As a bottom line matter, Ryan served his time and paid in full the criminal fine that was imposed as part of his sentence for conviction of possession of an unregistered firearm. The restitution obligation that was included as part of his sentence was voided. Ryan paid the Government a total of \$6,331.66 to be applied to the costs of prosecution awarded as part of his criminal judgment, including \$2,774.89 paid under his chapter 13 plan, leaving a balance of \$77,088.34. We determine that the unpaid balance of the costs of prosecution award was covered by Ryan's chapter 13 discharge.

Based on the foregoing analysis, we conclude that the exception to discharge included in [Chapter 13] for "restitution, or a criminal fine, included in a sentence on the debtor's conviction of a crime" does not cover costs of prosecution included in such a sentence, and we REVERSE.

### CASE QUESTIONS

1. What is the rationale for making some things dischargeable under Chapter 13 that are not dischargeable under Chapter 7?
2. What is the difference between "criminal restitution" (which in 1994 Congress said could not get discharged at all) and "the costs of prosecution"?
3. Why did the court decide that Ryan's obligation to pay "costs of prosecution" was not precluded by the limits on Chapter 13 bankruptcies imposed by Congress?

### 30.7 Summary and Exercises

## Summary

The Constitution gives Congress the power to legislate on bankruptcy. The current law is the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which provides for six types of proceedings: (1) liquidation, Chapter 7; (2) adjustment of debts of a municipality, Chapter 9; (3) reorganization, Chapter 11; (4) family farmers with regular income, Chapter 12; (5) individuals with regular income, Chapter 13; and (6) cross-border bankruptcies, Chapter 15.

With some exceptions, any individual, partnership, or corporation seeking liquidation may file a voluntary petition in bankruptcy. An involuntary petition is also possible; creditors petitioning for that must meet certain criteria.

A petition operates as a stay against the debtor for lawsuits to recover claims or enforce judgments or liens. A judge will issue an order of relief and appoint a trustee, who takes over the debtor's property and preserves security interests. To recover monies owed, creditors must file proof of claims. The trustee has certain powers to recover property for the estate that the debtor transferred before bankruptcy. These include the power to act as a hypothetical lien creditor, to avoid fraudulent transfers and voidable preferences.

The bankruptcy act sets out categories of claimants and establishes priority among them. After secured parties take their security, the priorities are (1) domestic support obligations, (2) administrative expenses, (3) gap creditor claims, (4) employees' wages, salaries, commissions, (5) contributions to employee benefit plans, (6) grain or fish producers' claims against a storage facility, (7) consumer deposits, (8) taxes owed to governments, (9) allowed claims for personal injury or death resulting from debtor's driving or operating a vessel while intoxicated. After these priority claims are paid, the trustee must distribute the estate in this order: (a) unsecured creditors who filed timely, (b) unsecured creditors who filed late, (c) persons claiming fines and the like, (d) all other creditors, (e) the debtor. Most bankruptcies are no-asset, so creditors get nothing.

Under Chapter 7's 2005 amendments, debtors must pass a means test to be eligible for relief; if they make too much money, they must file Chapter 13.

Certain property is exempt from the estate of an individual debtor. States may opt out of the federal list of exemptions and substitute their own; most have.

Once discharged, the debtor is no longer legally liable for most debts. However, some debts are not dischargeable, and bad faith by the debtor may preclude discharge. Under some circumstances, a debtor may reaffirm a discharged debt. A Chapter 7 case may be converted to Chapter 11 or 13 voluntarily, or to Chapter 11 involuntarily.



Chapter 11 provides for reorganization. Any person eligible for discharge in Chapter 7 is eligible for Chapter 11, except stockbrokers and commodity brokers; those who have too much debt to file Chapter 13 and surpass the means test for Chapter 7 file Chapter 11. Under Chapter 11, the debtor retains possession of the business and may continue to operate it with its own management unless the court appoints a trustee. The court may do so either for cause or if it is in the best interests of the creditors. The court must appoint a committee of unsecured creditors, who remain active throughout the proceeding. The debtor may file its own reorganization plan and has the exclusive right to do so within 120 days if it remains in possession. The plan must be accepted by certain proportions of each impaired class of claims and interests. It is binding on all creditors, and the debtor is discharged from all debts once the court confirms the plan.

Chapter 13 is for any individual with regular income who has difficulty paying debts; it is voluntary only; the debtor must get credit counseling. The debtor presents a payment plan to creditors, and the court appoints a trustee. The plan extends the time to pay and may reduce the size of the debt. If the creditors wind up with more in this proceeding than they would have in Chapter 7, the court is likely to approve the plan. The court may approve a stretch-out of five years. Some debts not dischargeable under Chapter 7 may be under Chapter 13.

Alternatives to bankruptcy are (1) composition (agreement by creditors to accept less than the face amount of the debt), (2) assignment for benefit of creditors (transfer of debtor's property to a trustee, who uses it to pay debts), and (3) receivership (a disinterested person is appointed by the court to preserve assets and distribute them at the court's direction). Because these are voluntary procedures, they are ineffective if all parties do not agree to them.

## EXERCISES

1. David has debts of \$18,000 and few assets. Because his debts are less than \$25,000, he decides to file for bankruptcy using the state court system rather than the federal system. Briefly describe the procedure he should follow to file for bankruptcy at the state level.
2. Assume that David in Exercise 1 is irregularly employed and has developed a plan for paying off his creditors. What type of bankruptcy should he use, Chapter 7, 11, or 13? Why?
3. Assume that David owns the following unsecured property: a \$3,000 oboe, a \$1,000 piano, a \$2,000 car, and a life insurance policy with a cash surrender value of \$8,000. How much of this property is available for distribution to his creditors in a bankruptcy? Explain.
4. If David owes his ex-wife alimony (maintenance) payments and is obligated to pay \$12,000 for an educational loan, what effect will his discharge have on these obligations?
5. Assume that David owns a corporation that he wants to liquidate under Chapter 7. After the corporate assets are distributed to creditors, there is still money owing to many of them. What obstacle does David face in obtaining a discharge for the corporation?
6. The famous retired professional football player—with a pension from the NFL—Orenthal James “O.J.” Simpson was convicted of wrongful death in a celebrated Santa Monica, California, trial in 1997 and ordered to pay \$33.5 million in damages to the families of the deceased. Mr. Simpson sold his California house, moved to Florida, and, from occasional appearances in the press, seemed to be living a high-style life with a big house, nice cars, and sharp clothing. He has never declared bankruptcy. Why hasn’t he been forced into an involuntary Chapter 7 bankruptcy by his creditors?
7.
  - a. A debtor has an automobile worth \$5,000. The federal exemption applicable to her is \$3,225. The trustee sells the car and gives the debtor the amount of the exemption. The debtor, exhausted by the bankruptcy proceedings, takes the \$3,225 and spends it on a six-week vacation in Baja California. Is this an “abuse” of the bankruptcy system?
  - b. A debtor has \$500 in cash beyond what is exempt in bankruptcy. She takes the cash and buys new tires for her car, which is worth about \$2,000. Is this an “abuse” of the bankruptcy system?

## SELF-TEST QUESTIONS

1. Alternatives to bankruptcy include
  - a. an assignment
  - b. a composition
  - c. receivership
  - d. all of the above
  
2. A composition is
  - a. a procedure where a receiver takes over the debtor's property
  - b. an agreement by creditors to take less than the face value of their debt
  - c. basically the same as an assignment
  - d. none of these
  
3. The highest-priority class set out by the 2005 act is for
  - a. employees' wages
  - b. administrative expenses
  - c. property settlements arising from divorce
  - d. domestic support obligations
  
4. Darlene Debtor did the following within ninety days of filing for bankruptcy. Which could be set aside as a preferential payment?
  - a. paid water and electricity bills
  - b. made a gift to the Humane Society
  - c. prepaid an installment loan on inventory
  - d. borrowed money from a bank secured by a mortgage on business property
  
5. Donald Debtor sold his 1957 Chevrolet to his brother for one-fifth its value sixty days before filing for bankruptcy. The trustee wishes to avoid the transaction on the basis that it was
  - a. a hypothetical lien
  - b. a lease disguised as a sale

- c. a preferential payment
  - d. a voidable preference
6. Acme Co. filed for bankruptcy with the following debts; which is their correct priority from highest to lowest?
- i. wages of \$15,000 owed to employees
  - ii. unpaid federal taxes
  - iii. balance owed to a creditor who claimed its security with a \$5,000 deficiency owing
- a. i, ii, iii
  - b. ii, iii, i
  - c. iii, ii, i
  - d. i, iii, ii

#### SELF-TEST ANSWERS

- 1. d
- 2. b
- 3. d
- 4. c
- 5. d
- 6. a