



# **The Legal Environment and Advanced Business Law**

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v. 1.0

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## About the Authors

### Don Mayer

Don Mayer teaches law, ethics, public policy, and sustainability at the Daniels College of Business, University of Denver, where he is professor in residence. His research focuses on the role of business in creating a more just, sustainable, peaceful, and productive world. With James O'Toole, Professor Mayer has coedited and contributed content to *Good Business: Exercising Effective and Ethical Leadership* (Routledge, 2010). He is also coauthor of *International Business Law: Cases and Materials*, which is in its fifth edition with Pearson Publishing Company. He recently served as the first Arsht Visiting Ethics Scholar at the University of Miami.



After earning a philosophy degree from Kenyon College and a law degree from Duke University Law School, Professor Mayer served as a Judge Advocate General's (JAG) Corps officer in the United States Air Force during the Vietnam conflict and went into private practice in North Carolina. In 1985, he earned his LLM in international and comparative law at the Georgetown University Law Center. Later that year, he began his academic career at Western Carolina University and proceeded to become a full professor at Oakland University in Rochester, Michigan, where he taught for many years before moving to the University of Denver. He has taught as a visitor at California State Polytechnic University, the University of Michigan, the Manchester Business School Worldwide, and Antwerp Management School.

Professor Mayer has won numerous awards from the Academy of Legal Studies in Business, including the Hoeber Award for best article in the *American Business Law Journal*, the Maurer Award for best article on business ethics (twice), and the Ralph Bunche Award for best article on international business law (three times). His work has been published in many journals and law reviews but most often in *American Business Law Journal*, the *Journal of Business Ethics*, and the *Business Ethics Quarterly*.

## Daniel M. Warner

Daniel Warner is a magna cum laude graduate of the University of Washington, where—following military service—he also attended law school. In 1978, after several years of civil practice, he joined the faculty at the College of Business and Economics at Western Washington University, where he is now a professor of business legal studies in the Accounting Department. He has published extensively, exploring the intersection of popular culture and the law, and has received the College of Business Dean’s Research Award five times for “distinguished contributions in published research.”



Professor Warner served on the Whatcom County Council for eight years (two years as its chair). He has served on the Faculty Senate and on various university and college committees, including as chairman of the University Master Plan Committee. Professor Warner has also been active in state bar association committee work and in local politics, where he has served on numerous boards and commissions for over thirty years.

## George J. Siedel

George J. Siedel’s research addresses legal issues that relate to international business law, negotiation, and dispute resolution. Recent publications focus on proactive law and the use of law to gain competitive advantage. His work in progress includes research on the impact of litigation on large corporations and the use of electronic communication as evidence in litigation.



Professor Siedel has been admitted to practice before the United States Supreme Court and in Michigan, Ohio, and Florida. Following graduation from law school, he worked as an attorney in a professional corporation. He has also served on several boards of directors and as associate dean of the University of Michigan Business School.

The author of numerous books and articles, Professor Siedel has received several research awards, including the Faculty Recognition Award from the University of Michigan and the following awards from the Academy of Legal Studies in Business: the Hoeber Award, the Ralph Bunche Award, and the Maurer Award. The Center for

International Business Education and Research selected a case written by Professor Siedel for its annual International Case Writing Award. His research has been cited by appellate courts in the United States and abroad, including the High Court of Australia.

Professor Siedel has served as visiting professor of business law at Stanford University, visiting professor of business administration at Harvard University, and Parsons fellow at the University of Sydney. He has been elected a visiting fellow at Cambridge University's Wolfson College and a life fellow of the Michigan State Bar Foundation. As a Fulbright scholar, Professor Siedel held a distinguished chair in the humanities and social sciences.

### **Jethro K. Lieberman**

Jethro K. Lieberman is professor of law and vice president for academic publishing at New York Law School, where he has taught for more than twenty-five years. He earned his BA in politics and economics from Yale University, his JD from Harvard Law School, and his PhD in political science from Columbia University. He began his teaching career at Fordham University School of Law. Before that, he was vice president at what is now the International Institute for Conflict Prevention and Resolution (CPR). For nearly ten years, he was legal affairs editor of *Business Week* magazine. He practiced antitrust and trade regulation law at a large Washington law firm and was on active duty as a member of the Navy's Judge Advocate General's (JAG) Corps during the Vietnam era. He is the author of *The Litigious Society* (Basic Books), the winner of the American Bar Association's top literary prize, the Silver Gavel, and the author of *A Practical Companion to the Constitution: How the Supreme Court Has Ruled on Issues from Abortion to Zoning* (University of California Press), among many other books. He is a long-time letterpress printer and proprietor of The Press at James Pond, a private press, and owner of the historic Kelmscott-Goudy Press, an Albion handpress that was used to print the Kelmscott Press edition of Geoffrey Chaucer's *Canterbury Tales* in the 1890s.



### **Alyssa Rose Martina (Contributing Author)**

Alyssa Rose Martina is an entrepreneur, businesswoman, professional writer, and educator. She started her first company, *Metro Parent Magazine*, in 1986, after serving for five years as legal counsel for Wayne County Circuit Court, one of the

nation's largest state judicial circuits. As a dedicated entrepreneur, she saw an opportunity to fill a void for parents and established a family magazine. Today, more than 263,000 readers rely on *Metro Parent* as their "parenting bible." Alyssa's company, Metro Parent Publishing Group, also produces several ancillary publications: *Metro Baby*, a biannual pregnancy resource guide; *Going Places*, a biannual guide to family fun in Southeast Michigan; *Party Book*, an event planning resource guide; and *Special Edition*, a resource for parents regarding children with special needs. To offer support and resources to African American families, Alyssa saw an opportunity to establish a second publishing company catered to the African American market. In 1999, the company was launched and today, *BLAC Magazine*, which covers "Black Life, Arts and Culture," reaches over sixty thousand readers in the Detroit region. This monthly lifestyle publication explores and celebrates the rich cultural fabric of African American life in southeast Michigan, under the guidance of African American community leaders and educators and a distinguished panel of advisors who form an advisory council.

Alyssa presents lectures and workshops to various business and community groups around the country on topics such as innovation, strategy, entrepreneurship, and next-level thinking. She also serves as a consultant on events marketing for several of her sister publications throughout the country. In April 2010, Alyssa received her MBA with highest distinction from the University of Michigan's Ross School of Business. She has guest-lectured on entrepreneurial/legal issues at Ross and has also served as a teaching assistant. She has written a number of parenting articles and a children's book, and she was a weekly columnist for the *Detroit News*. Alyssa has served as an editor and reviewer for several business law articles and manuscripts. Alyssa teaches at Walsh School of Business as an adjunct professor. Her course is focused on legal issues in business for MBA students.



# Acknowledgments

The authors would like to thank the following colleagues who have reviewed the text and provided comprehensive feedback and suggestions for improving the material:

- Jennifer Barger Johnson, University of Central Oklahoma
- Dawn M. Bradanini, Lincoln College
- Larry Bumgardner, Pepperdine University
- Michael Edward Chaplin, California State University–Northridge
- Nigel Cohen, University of Texas–Pan American
- Mark Edison, North Central College
- Mark Gideon, University of Maryland
- Henry J. Hastings, Eastern Michigan University
- Henry Lowenstein, Coastal Carolina University
- Tanya Marcum, Bradley University
- Harry McCracken, California Lutheran University
- Robert Miller, Dominican University
- Leon Moerson, George Washington University
- Tonia Hat Murphy, University of Notre Dame
- Bart Pachino, California State University–Northridge
- Kimber J. Palmer, Texas A&M University–International
- Lawrence Price, Saint Mary’s University of Minnesota
- Kurt Saunders, California State University–Northridge
- Ron Washburn, Bryant University
- Ruth Weatherly, Simpson College
- Eric Yordy, Northern Arizona University

# 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 Business Law and Legal Environment 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://smallbusiness.findlaw.com/employment-employer/employment-employer-hiring/employment-employer-hiring-contract-samples.html>.
- 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 [\(Reference mayer 1.0-ch08 not found in Book\)](#)). 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. For the Islamic and Middle Eastern law, see <http://www.soas.ac.uk/library/subjects/law/region/islamic>.

### 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*

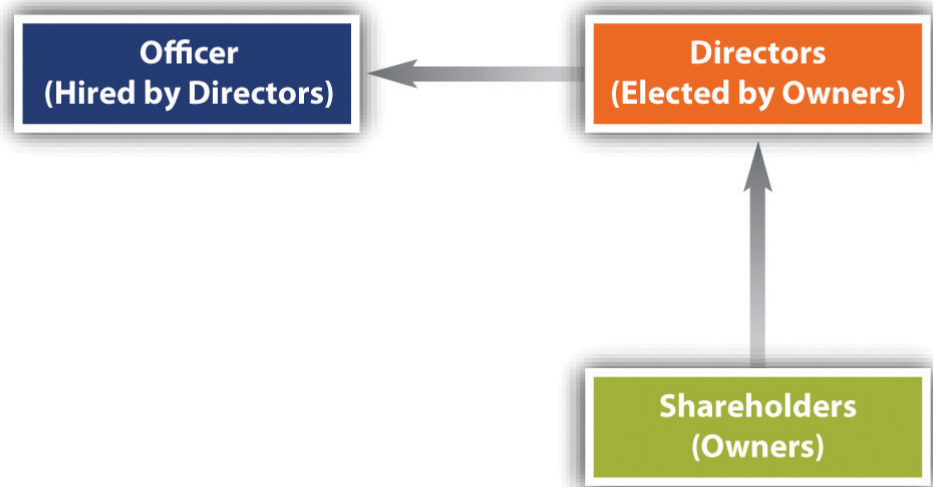


Figure 2.1 "Corporate Legal Structure", though somewhat oversimplified, shows the basic legal structure of a corporation under Delaware law and the laws of most other states in the United States. Shareholders elect directors, who then hire officers to manage the company. From this structure, some very 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, <http://www.ou.edu/deptcomm/dodjcc/groups/02C2/Johnson%20&20Johnson.htm>. 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.

### 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

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.

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**

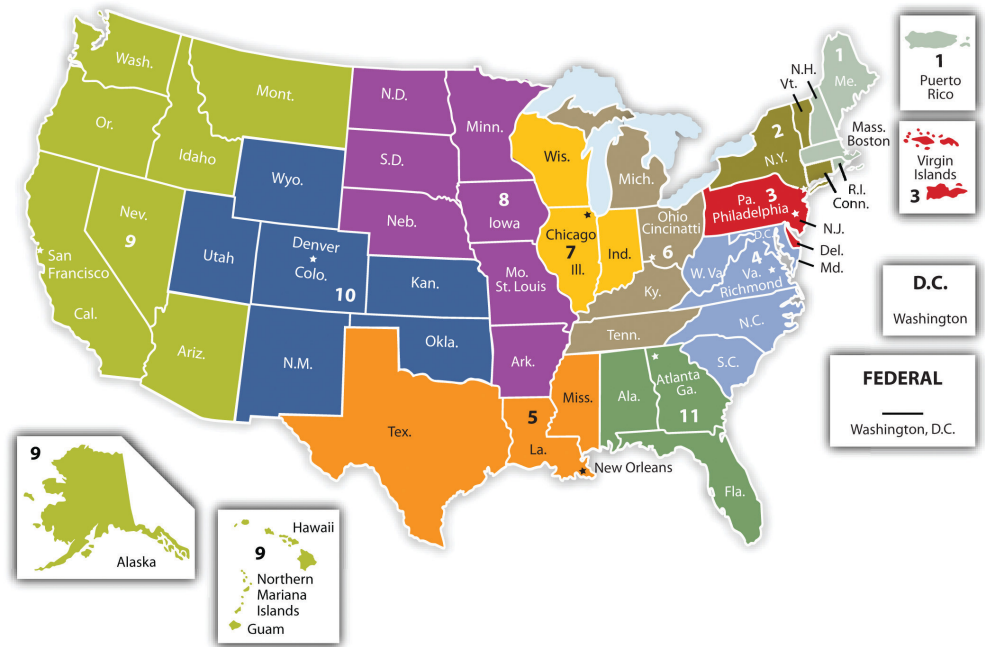
Cases from the district courts can then be appealed to the circuit courts of appeal, of which there are thirteen ([Figure 3.1 "The Federal Judicial Circuits"](#)). Each circuit oversees the work of the district courts in several states. For example, the US Court of Appeals for the Second Circuit hears 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?

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.

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.

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 ((Reference mayer 1.0-ch48 not found in Book)) and discriminatory attitudes toward certain individuals and groups ((Reference mayer 1.0-ch50 not found in Book)) 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

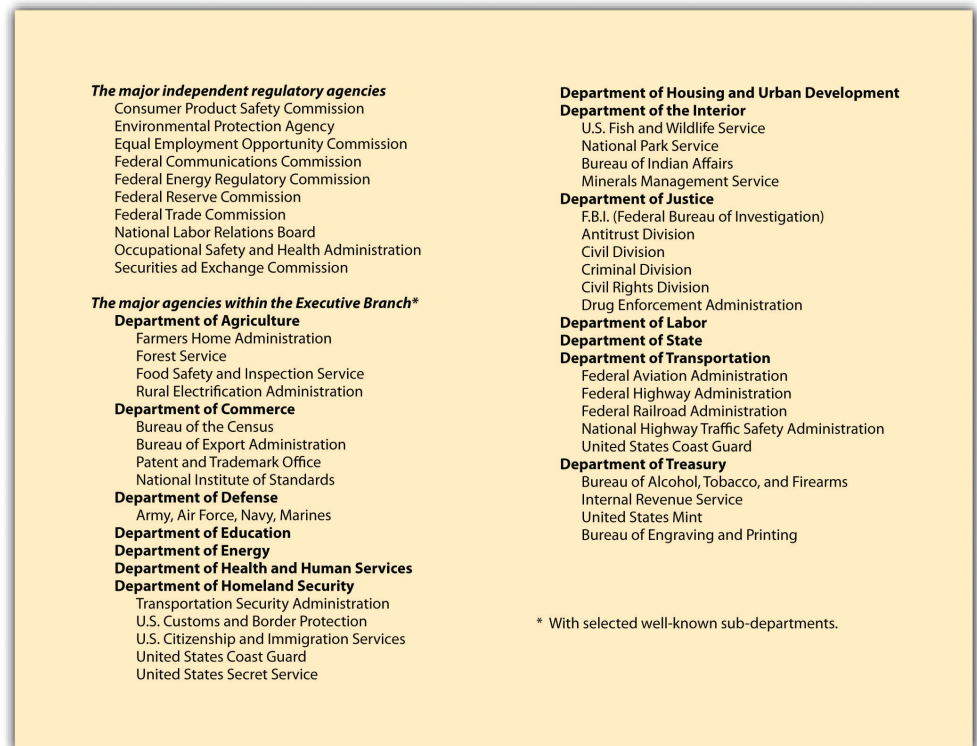
### LEARNING OBJECTIVES

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 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 Antitrust Law

In [\(Reference mayer 1.0-ch43 not found in Book\)](#), [\(Reference mayer 1.0-ch44 not found in Book\)](#), and [\(Reference mayer 1.0-ch45 not found in Book\)](#), we consider the fundamentals of antitrust law, which for the most part affects the business enterprise civilly. But violations of Section 1 of the Sherman Act, which condemns activities in “restraint of trade” (including price fixing), are also crimes.

18. Any number of crimes, usually involving a business context; any illegal act committed by nonviolent means to obtain a personal or business advantage.

### **Violations of the Food and Drug Act**

The federal Food, Drug, and Cosmetic Act prohibits any person or corporation from sending into interstate commerce any adulterated or misbranded food, drug, cosmetics, or related device. For example, in a 2010 case, Allergen had to pay a criminal fine for marketing Botox as a headache or pain reliever, a use that had not been approved by the Food and Drug Administration. Unlike most criminal statutes, willfulness or deliberate misconduct is not an element of the act. As the *United States v. Park* case ([Section 6.7 "Cases"](#)) shows, an executive can be held criminally liable even though he may have had no personal knowledge of the violation.

### **Environmental Crimes**

Many federal environmental statutes have criminal provisions. These include the Federal Water Pollution Control Act (commonly called the Clean Water Act); the Rivers and Harbors Act of 1899 (the Refuse Act); the Clean Air Act; the Federal Insecticide, Fungicide, and Rodenticide Act (FIFRA); the Toxic Substances Control Act (TSCA); and the Resource Conservation and Recovery Act (RCRA). Under the Clean Water Act, for example, wrongful discharge of pollutants into navigable waters carries a fine ranging from \$2,500 to \$25,000 per day and imprisonment for up to one year. “Responsible corporate officers” are specifically included as potential defendants in criminal prosecutions under the act. They can include officers who have responsibility over a project where subcontractors and their employees actually caused the discharge. *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**

**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, or use public goods such as the mails or the Internet to commit fraud, violate antitrust laws, or commit other white-collar crimes).

19. Any crime (usually theft of some sort, or sabotage) committed with the aid of a computer.

## 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 reprosecuted for the same crime.

### **Self-Incrimination**

The Fifth Amendment is also the source of a person's right against self-incrimination (no person "shall be compelled in any criminal case to be a witness against himself"). The debate over the limits of this right has given rise to an immense literature. In broadest outline, the right against self-incrimination means that the prosecutor may not call a defendant to the witness stand during trial and may not comment to the jury on the defendant's failure to take the stand. Moreover, a defendant's confession must be excluded from evidence if it was not voluntarily made (e.g., if the police beat the person into giving a confession). In *Miranda v. Arizona*, the Supreme Court ruled that no confession is admissible if the police have not first advised a suspect of his constitutional rights, including the right to have a lawyer present to advise him during the questioning. *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

## 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**

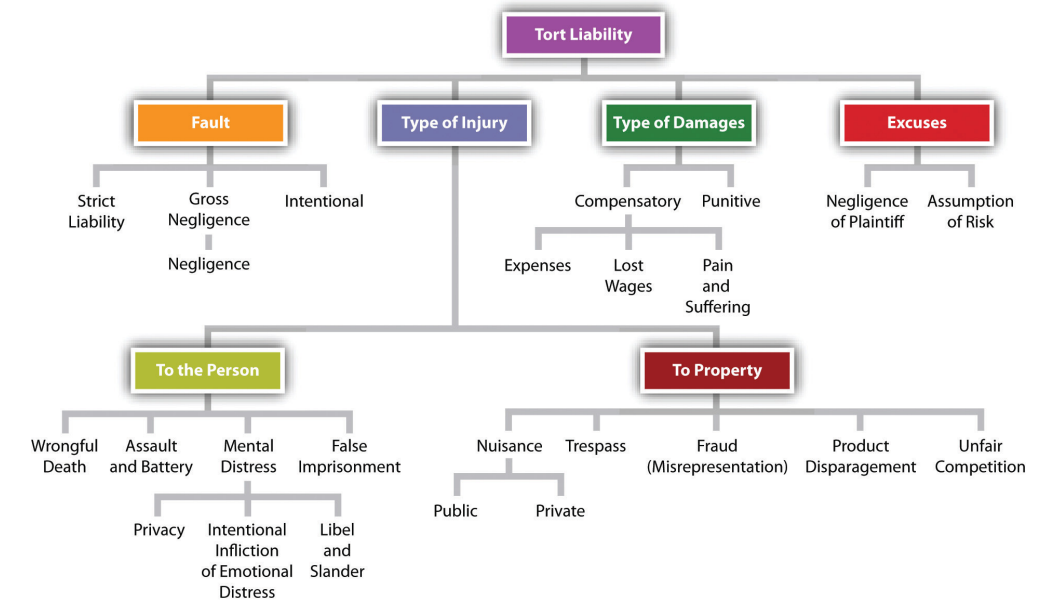
There are three kinds of torts: intentional torts, negligent torts, and strict liability torts. Intentional torts arise from intentional acts, whereas unintentional torts often result from carelessness (e.g., when a surgical team fails to remove a clamp from a patient's abdomen when the operation is 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 11 "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 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

## 8.1 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 [\(Reference mayer 1.0-ch08 not found in Book\)](#) 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 9 "Title and Risk of Loss" and Chapter 10 "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 12 "Bailments and the Storage, Shipment, and Leasing of Goods".

In Chapter 13 "Nature and Form of Commercial Paper", Chapter 14 "Negotiation of Commercial Paper", Chapter 15 "Holder in Due Course and Defenses", and Chapter 16 "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 19 "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 20 "Mortgages and Nonconsensual Liens". Chapter 18 "Consumer Credit Transactions" covers consumer credit transactions and Chapter 21 "Bankruptcy" covers bankruptcy law; these topics are important for all creditors, even those lacking some form of security.

Finally, the specialized topic of Article 8, investment securities (e.g., corporate stocks and bonds), is treated in (Reference mayer 1.0-ch43 not found in Book).

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?

## 8.2 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 8.1 "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 8.1 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 8.5.1 "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 (Reference mayer 1.0-ch08 not found in Book). 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?

## 8.3 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 9 "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 [\(Reference mayer 1.0-ch08 not found in Book\)](#)). 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 [\(Reference mayer 1.0-ch13 not found in Book\)](#). 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.

## 8.4 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.* ((Reference mayer 1.0-ch12 s05 s03 not found in Book), set out in (Reference mayer 1.0-ch12 not found in Book)), 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 8.5.2 ““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?

## 8.5 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 (Reference mayer 1.0-ch15 not found in Book) 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 [concurrs 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?

## 8.6 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 9

### 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.

## 9.1 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 crops 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?

## 9.2 Title from Nonowners

### LEARNING OBJECTIVE

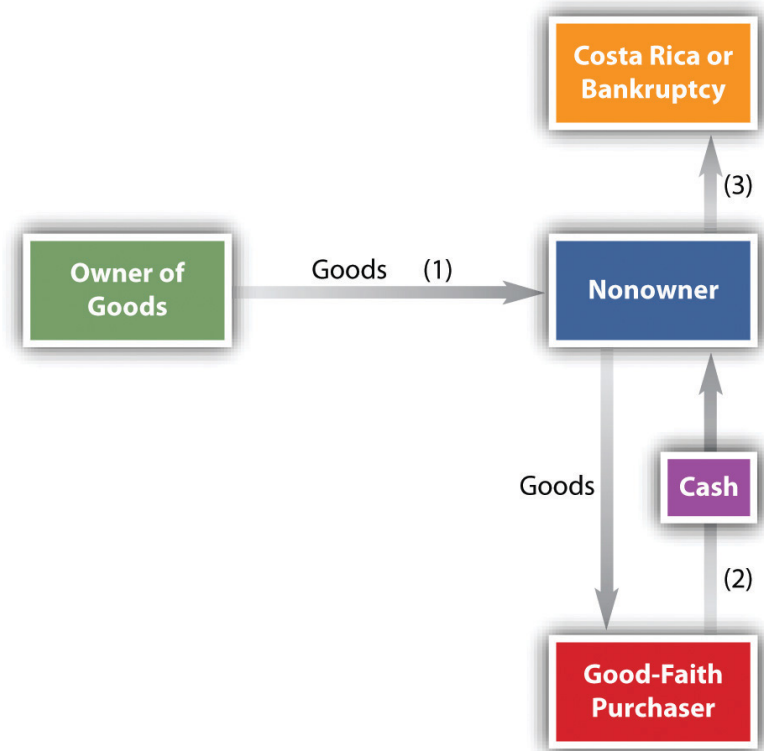
1. Understand when and why a nonowner can nevertheless pass title on to a purchaser.

### 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 9.1 "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 9.1 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 15 "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 19 "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**

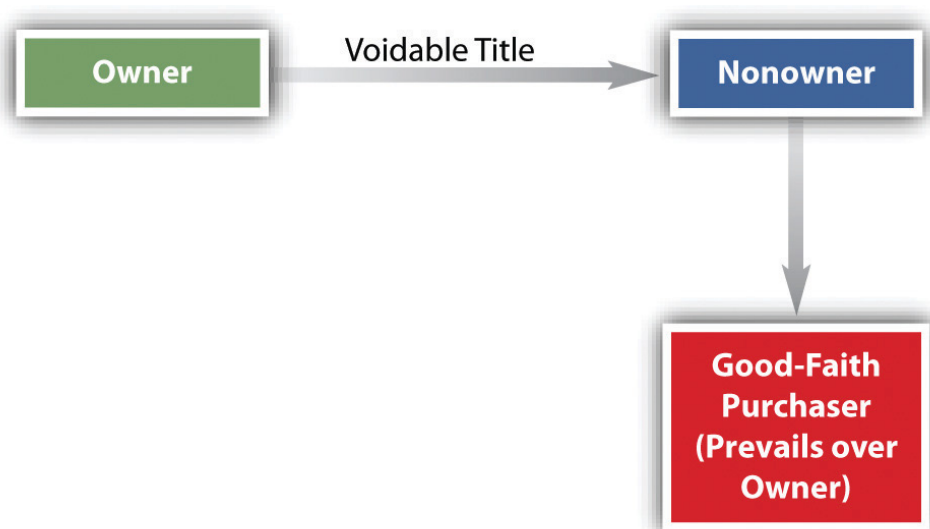
As noted, there are exceptions to the law governing the sale of goods.

#### **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 9.2 "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 [\(Reference mayer 1.0-ch09 not found in Book\)](#) 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 9.4.2 "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 9.2 *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).

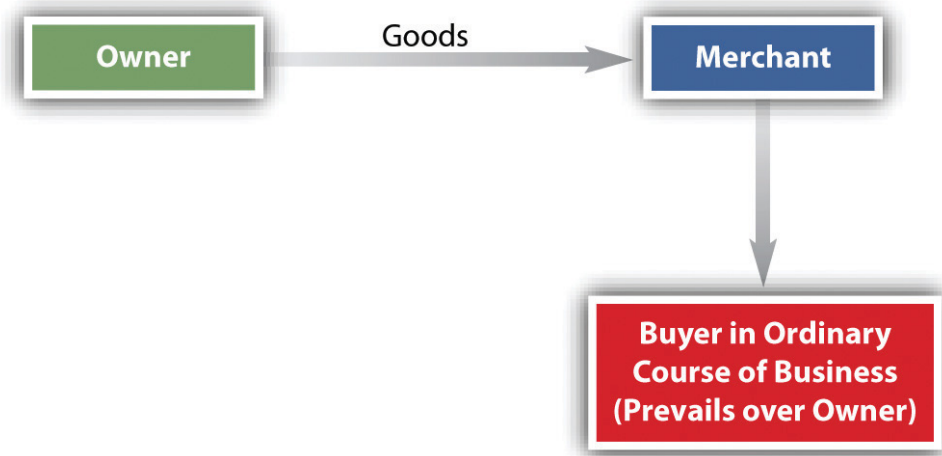
### Entrustment

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 9.3 "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 9.3 *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?

## 9.3 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 9.4.3 "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 9.1.2 "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?



## 9.4 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?

## 9.5 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 10

## 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.



## 10.1 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 9 "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.

## 10.2 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?

## 10.3 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 renege 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?

## 10.4 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 [\(Reference mayer 1.0-ch15 not found in Book\)](#), 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?

## 10.5 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?

## 10.6 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 11

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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

## 11.1 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, <http://news.findlaw.com/legalnews/us/pl>.
- 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.

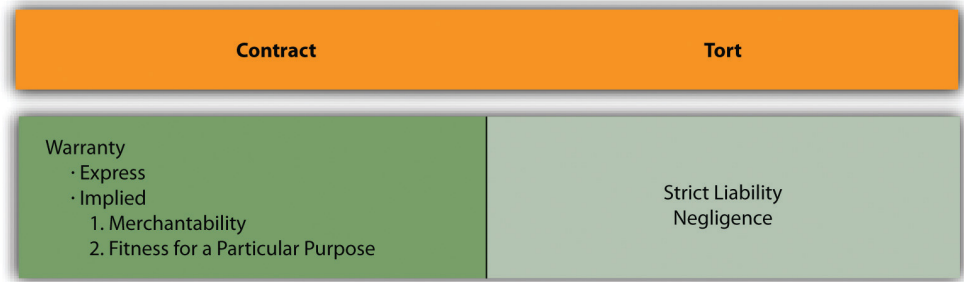
## Current State of the Law

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 11.1 "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 11.1 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?

## 11.2 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 Reference mayer\_1.0-ch12 not found in Book.)

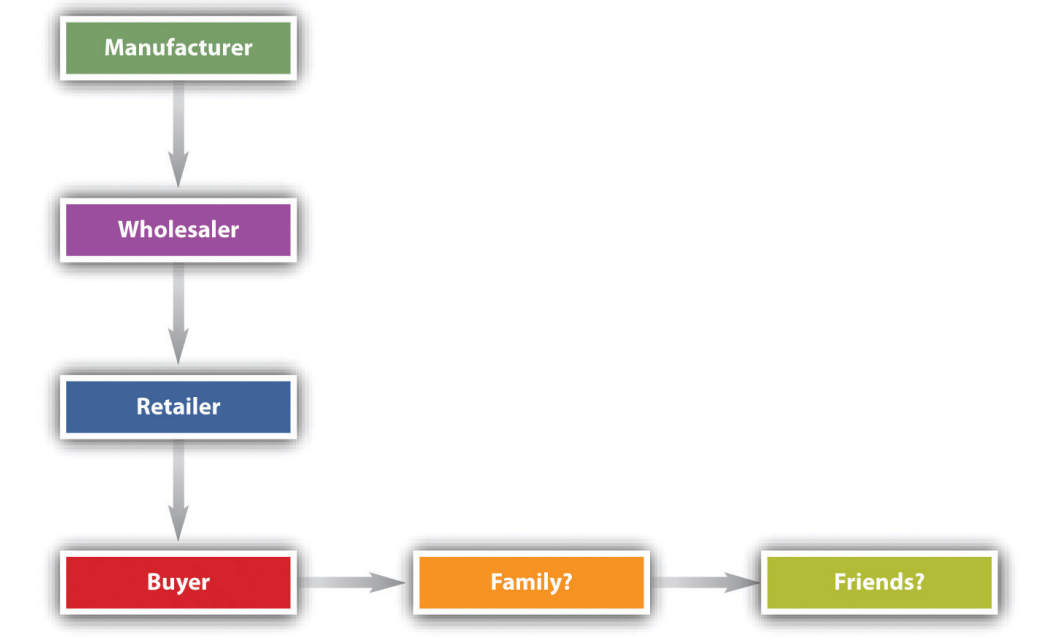
9. Under the Magnuson-Moss Act, a less-than-full warranty.

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 11.2 "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 11.2 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 11.2 "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?



## 11.3 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 11.3 "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 11.3 *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 11.6.3 "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?

## 11.4 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 11.4 "Major Difference between Warranty and Strict Liability"](#).

Figure 11.4 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 [\(Reference mayer 1.0-ch11 not found in Book\)](#) 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?

## 11.5 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?

## 11.6 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 manufactures and sellers changed the instructions as a result of this case?

## **11.7 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 12

# 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

## 12.1 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?

## 12.2 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 12.1 "Duty of Care"](#)).

Figure 12.1 *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 11 "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. This liability is discussed in (Reference mayer 1.0-ch38 not found in Book), which covers agency law.

## **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

4. An encumbrance upon property to secure payment.

5. A claim allowed to one who furnishes labor, services, or materials to improve property.



than a century and a half old. As the rule is usually stated, the common law confers 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?

## 12.3 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 warehouseman, which his or her authorized agent may make
8. The warehouseman’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 warehouseman claims a lien or security interest

### **General Duty of Care**

The warehouseman’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 warehouseman. Nor does the section invalidate contractual limitations otherwise permissible under Article 7. The warehouseman’s duty of care under this section is considerably weaker than the carrier’s duty. Determining when a warehouseman becomes a carrier, if the warehouseman is to act as shipper, can become an important issue.

### **Limitation of Liability**

The warehouseman 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 warehouseman cannot force the bailor to accept this limitation: the bailor may demand in writing increased liability, in which event the warehouseman may charge more for the storage. If the warehouseman 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 12.2 "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.

Figure 12.2 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 \_\_\_\_\_  
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 \_\_\_\_\_ Agent \_\_\_\_\_  
Per \_\_\_\_\_ per \_\_\_\_\_  
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 9 "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?

## 12.4 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 8 "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 14 "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?

## 12.5 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?

## **12.6 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 13

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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.

## 13.1 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.

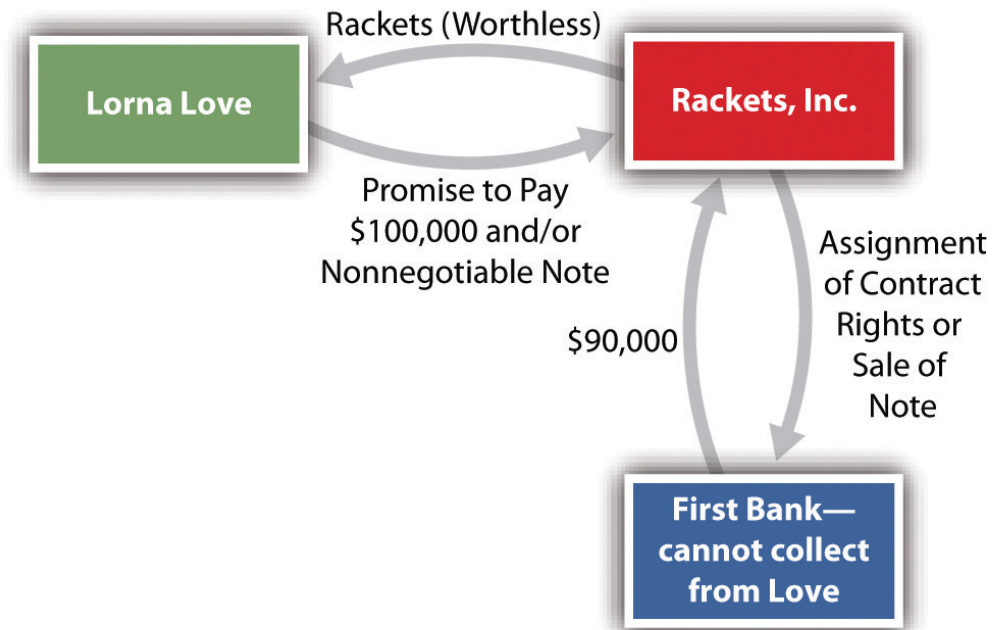
### The Central Role of Commercial Paper

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 13.1 "Assignment of Contract Rights"](#)). Unfortunately, the rackets that arrive at Love's are warped and thus commercially worthless. Rackets files for bankruptcy.

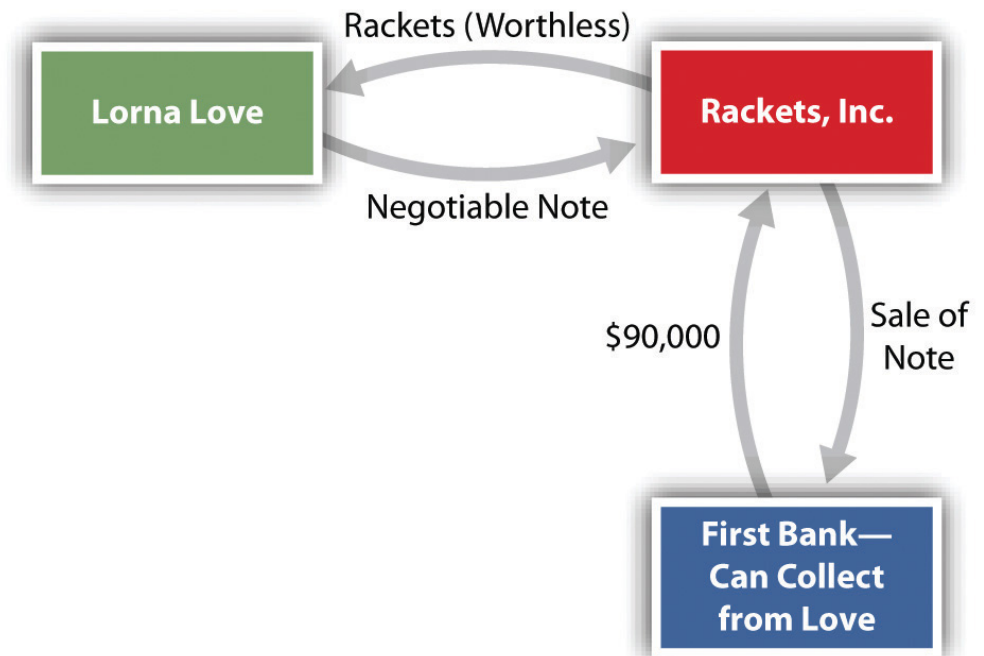
Figure 13.1 Assignment of Contract Rights



May the bank collect from Love \$100,000, the value of the contract rights it purchased? No. Under the contract rule discussed in (Reference mayer 1.0-ch13 not found in Book), 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 13.3 "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 13.2 "Sale of Negotiable Note").

Figure 13.2 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 14 "Negotiation of Commercial Paper"](#).
3. Is the purchaser of the paper a holder in due course? See [Chapter 15 "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 15 "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 16 "Liability and Discharge"](#).

Finally, in [Chapter 17 "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 17 "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?

## 13.2 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 13.1 "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.

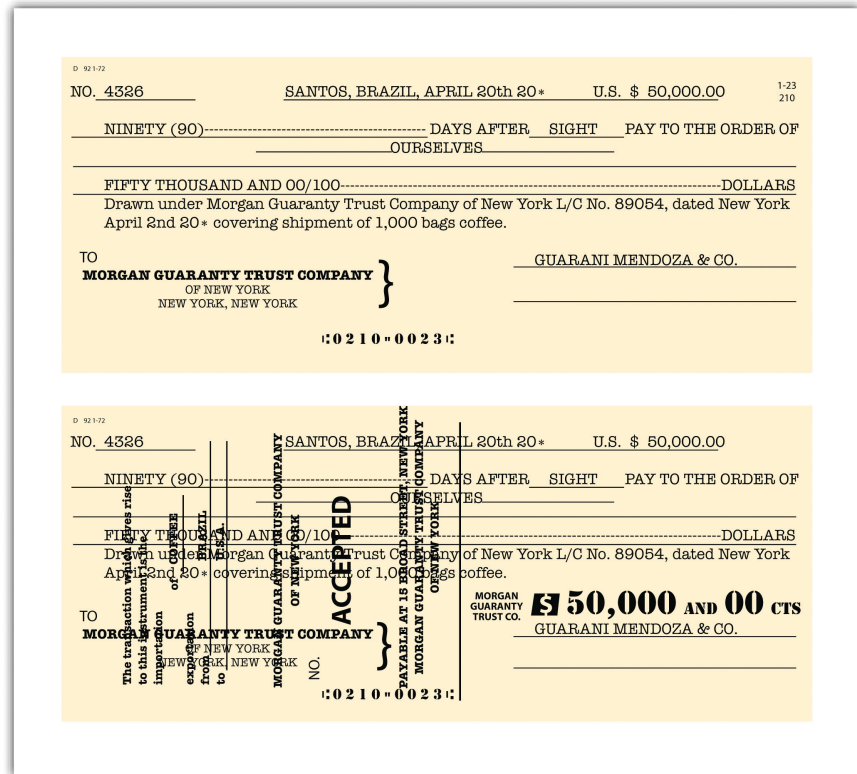
5. A drawee who accepts a draft, agreeing to be primarily responsible for paying it.

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 13.3 "A Time Draft"](#).

Figure 13.3 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.

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.

- 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.

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 13.3 "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.

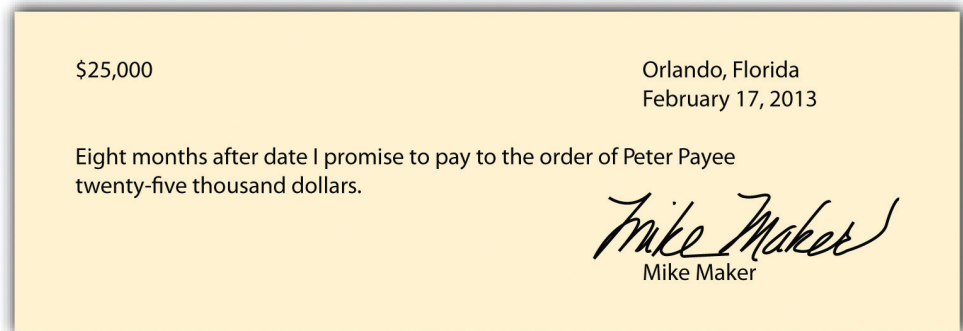
12. The acceptance by a drawee of a check or draft.

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 13.4 "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 13.4 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 15 "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 17 "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?

## 13.3 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 16 "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 13.4 "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 13.4 "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 13.4 "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?



## 13.4 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

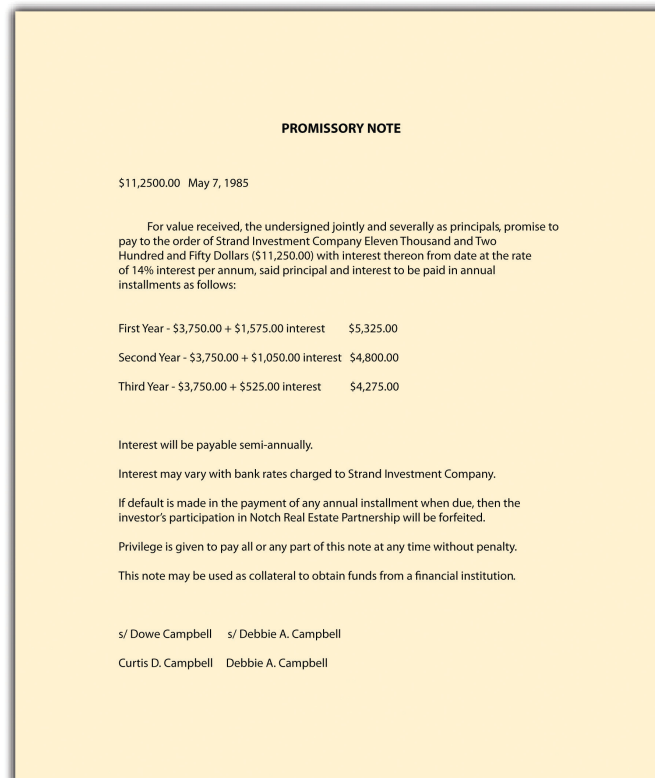
Centerre Bank of Branson v. Campbell

744 S.W.2d 490 (Mo. App. 1988)

Crow, J.

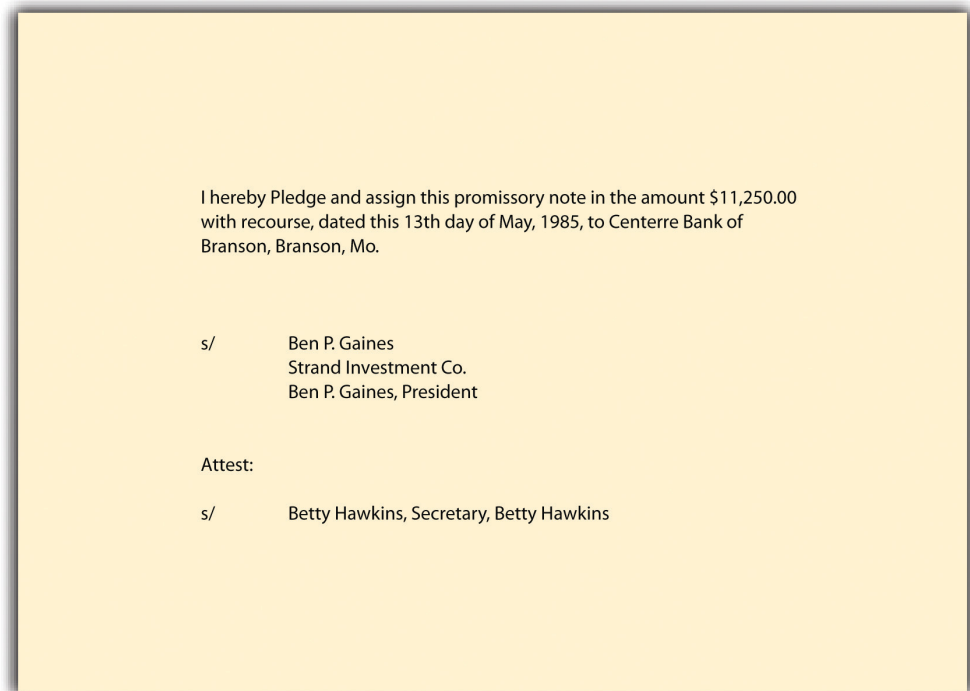
On or about May 7, 1985, appellants (“the Campbells”) signed the following document:

Figure 13.5



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 13.5] document:

Figure 13.6



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?

## 13.5 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.

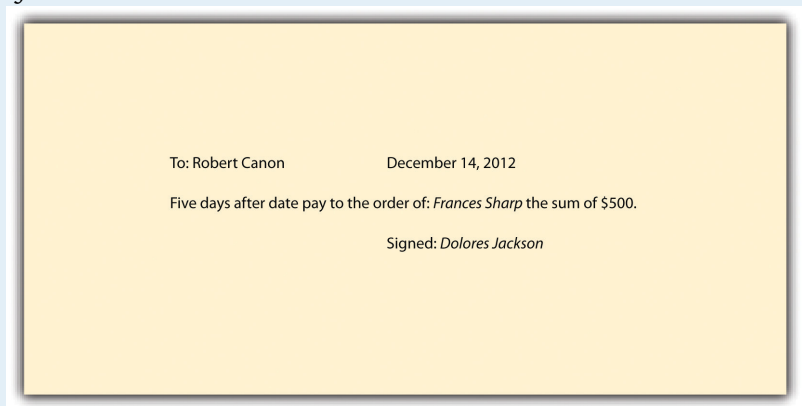
In addition to drawers, makers, drawees, and payees, one can deal with commercial paper in five other capacities: as indorsers, indorsees, holders, holders in due course, and accommodation parties.

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 13.7



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 14

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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.



## 14.1 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 16 "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 16 "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 15 "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 14.1 "Negotiation of Bearer Paper"](#); recall that “Lorna Love” is the proprietor of a tennis club introduced in [Chapter 13 "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 14.4 "Cases"](#)) deals with issues involving bearer paper.

Figure 14.1 *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 13 "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 14.2 "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 14.2 "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 14.2 *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?

## 14.2 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

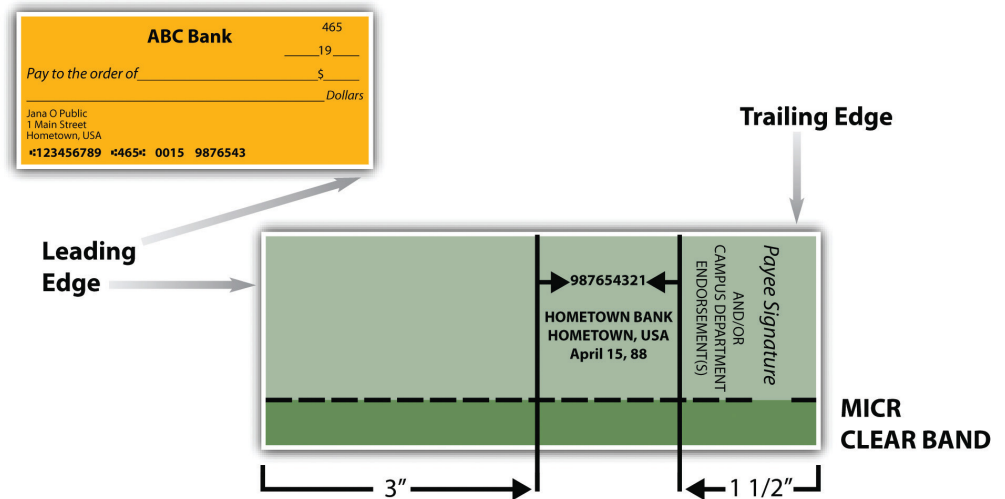
*Indorse* (or *endorse*) literally means “on the back of,” as fish, say, have dorsal fins—fins on their backs. Usually indorsements are on the back of the instrument, but an indorsement could be on a piece of paper affixed to the instrument. Such an attachment is called an **allonge**<sup>7</sup>—it 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 14.3 "Indorsement Standard"](#).

Figure 14.3 *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 14.3 "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 14.4 "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 14.4 *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 14.4 "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 14.4 "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 14.4 "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 14.4 "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 depositary bank are not affected by the restriction unless they have knowledge that Attorney dealt with the check in breach of trust (adapted from UCC, Section 3-206, Official Comment 4). (Of course Attorney should not indorse in blank; she should indorse "Tina Attorney, in trust for Carlene Creditor" and deposit the check in her trust account.)

The dichotomy here between restrictive and unrestrictive indorsements is the indorser's way of showing to what use the instrument may be put.

### Conditional Indorsement

An indorser might want to condition the negotiation of an instrument upon some event, such as "Pay Carla Green if she finishes painting my house by July 15." Such a **conditional indorsement**<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?

## 14.3 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 14.4 "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 14.2 "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 depository 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 depository 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 depository bank without indorsement (UCC, Section 4-205(a)). Under Section 4-205(c), deposit in a depository 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 14.4 "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?

## 14.4 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?

## 14.5 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 15

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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?



## 15.1 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 13 "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 15.3 "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

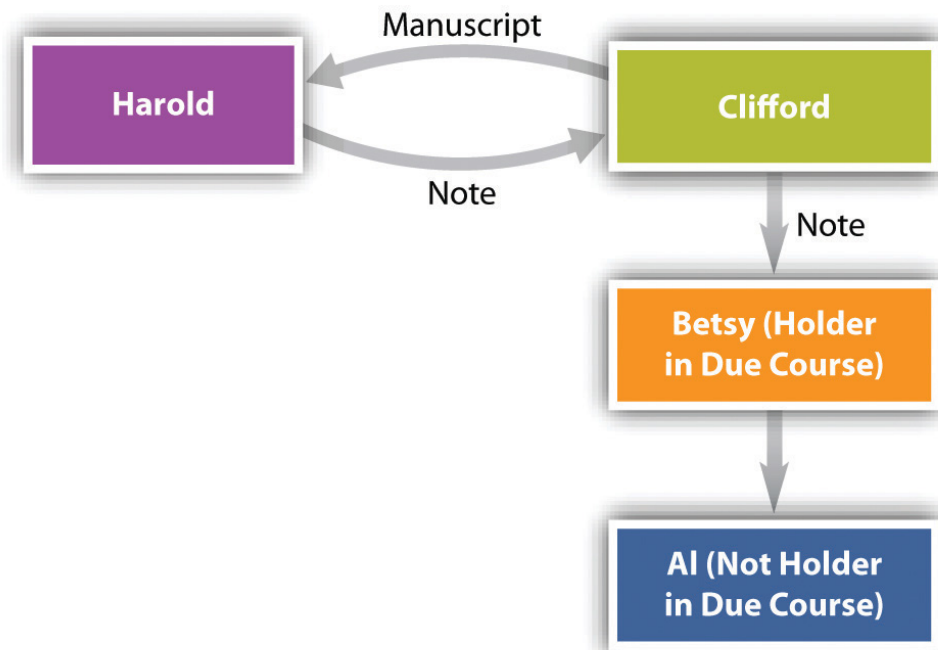
The payee can be an HDC, but in the usual circumstances, a payee would have knowledge of claims or defenses because the payee would be one of the original parties to the instrument. Nevertheless, a payee may be an HDC if all the prerequisites are met. For instance, Blackstone fraudulently convinces Whitestone 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 15.1 "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 15.1 *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?



## 15.2 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 15.1 "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.

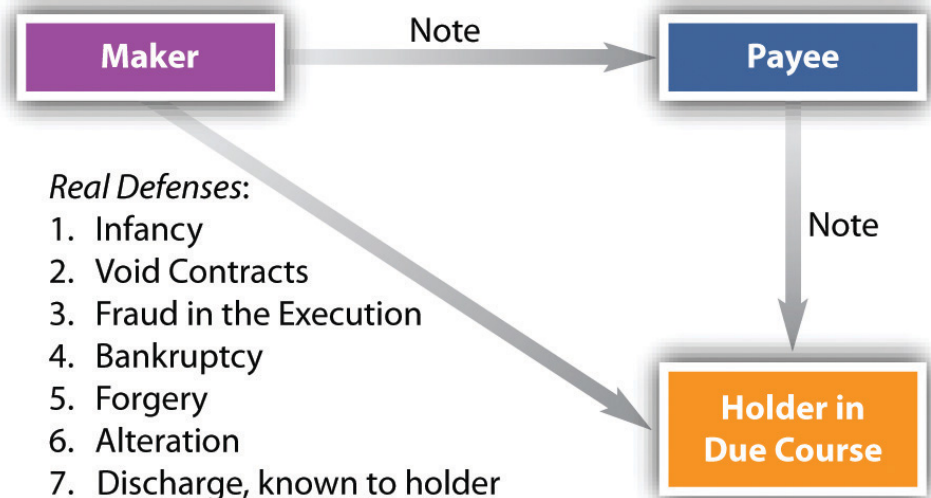
### Holder in Due Course Is Subject to Real Defenses

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 15.2 "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 15.2 *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 15.3 "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 15.3 "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 15.3 *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?

## 15.3 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, <http://www.parascript.com/objects/0707TransactionDirectory.pdf>.

## 15.4 Summary and Exercises

### Summary

A holder is a holder in due course (HDC) if he takes the instrument without reason to question its authenticity on account of obvious facial irregularities, for value, in good faith, and without notice that it is overdue or has been dishonored, or that it contains a forgery or alteration, or that that any person has any defense against it or claim to it. The HDC takes the paper free of most defenses; an ordinary holder takes the paper as an assignee, acquiring only the rights of the assignor.

Value is not the same as consideration; hence, a promise will not satisfy this criterion until it has been performed. The HDC must have given something of value other than a promise to give.

Good faith means (1) honesty in fact in the conduct or transaction concerned and (2) the observance of reasonable commercial standards of fair dealing. Honesty in fact is a subjective test, but the observance of reasonable commercial standards is objective.

Notice is not limited to receipt of an explicit statement of defenses; a holder may be given notice through inferences that should be drawn from the character of the instrument. Thus an incomplete instrument, one that bears marks of forgery, or one that indicates it is overdue may give notice on its face. Certain facts do not necessarily give notice of defense or claim: that the instrument is antedated or postdated, that the instrument was negotiated in return for an executory promise, that any party has signed for accommodation, that an incomplete instrument has been completed, that any person negotiating the instrument is or was a fiduciary, or that there has been default in payment of interest or principal.

A person who could not have become an HDC directly (e.g., because he had notice of a defense or claim) may become so if he takes as transferee from an HDC as long as he was not a party to any fraud or illegality affecting the instrument or had not previously been a holder with notice of a defense or claim. This is the shelter rule.

Holders in due course are not immune from all defenses. A real, as opposed to a personal, defense may be asserted against the HDC. Personal defenses include fraud in the inducement, failure of consideration, nonperformance of a condition precedent, and the like. Real defenses consist of infancy, acts that would make a contract void (such as duress), fraud in the execution, forgery, and discharge in bankruptcy. A 1976 trade regulation rule of the Federal Trade Commission abolishes the holder-in-due-course rule for consumer transactions.

## EXERCISES

1. Mike signed and delivered a note for \$9,000 to Paul Payee in exchange for Paul's tractor. Paul transferred the note to Hilda, who promised to pay \$7,500 for it. After Hilda had paid Paul \$5,000 of the promised \$7,500, Hilda learned that Mike had a defense: the tractor was defective. How much, if anything, can Hilda collect from Mike on the note, and why?
2. In Exercise 1, if Hilda had paid Paul \$7,500 and then learned of Mike's defense, how much—if any of the amount—could she collect from Mike?
3. Tex fraudulently sold a boat, to which he did not have title, to Sheryl for \$30,000 and received, as a deposit from her, a check in the amount of \$5,000. He deposited the check in his account at First Bank and immediately withdrew \$3,000 of the proceeds. When Sheryl discovered that Tex had no title, she called her bank (the drawee) and stopped payment on the check. Tex, in the meantime, disappeared. First Bank now wishes to collect the \$3,000 from Sheryl, but she claims it is not an HDC because it did not give value for the check in that the payment to Tex was conditional: the bank retained the right to collect from Tex if it could not collect on the check. Is Sheryl correct? Explain.
4. Corporation draws a check payable to First Bank. The check is given to an officer of Corporation (known to Bank), who is instructed to deliver it to Bank in payment of a debt owed by Corporation to Bank. Instead, the officer, intending to defraud Corporation, delivers the check to Bank in payment of his personal debt. Bank has received funds of Corporation that have been used for the personal benefit of the officer. Corporation asserts a claim to the proceeds of the check against Bank. Is Bank an HDC of the check?
5. Contractor contracted with Betty Baker to install a new furnace in Baker's business. Baker wrote a check for \$8,000 (the price quoted by Contractor) payable to Furnace Co., which Contractor delivered to Furnace Co. in payment of his own debt to it. Furnace Co. knew nothing of what went on between Contractor and Baker. When Contractor did not complete the job, Baker stopped payment on the check. Furnace Co. sued Baker, who defended by claiming failure of consideration. Is this a good defense against Furnace Co.?
6. Benson purchased a double-paned, gas-filled picture window for his house from Wonder Window, making a \$200 deposit and signing an installment contract, which is here set out in its entirety:

October 3, 2012

I promise to pay to Wonder Window or order the sum of \$1,000 in five equal installments of \$200.

[Signed] Benson

Wonder Window negotiated the installment contract to Devon, who took the instrument for value, in good faith, without notice of any claim or defense of any party, and without 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 16

### 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 13 "Nature and Form of Commercial Paper", Chapter 14 "Negotiation of Commercial Paper", and Chapter 15 "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 14 "Negotiation of Commercial Paper". We conclude the chapter by reviewing the ways in which parties are discharged from liability.

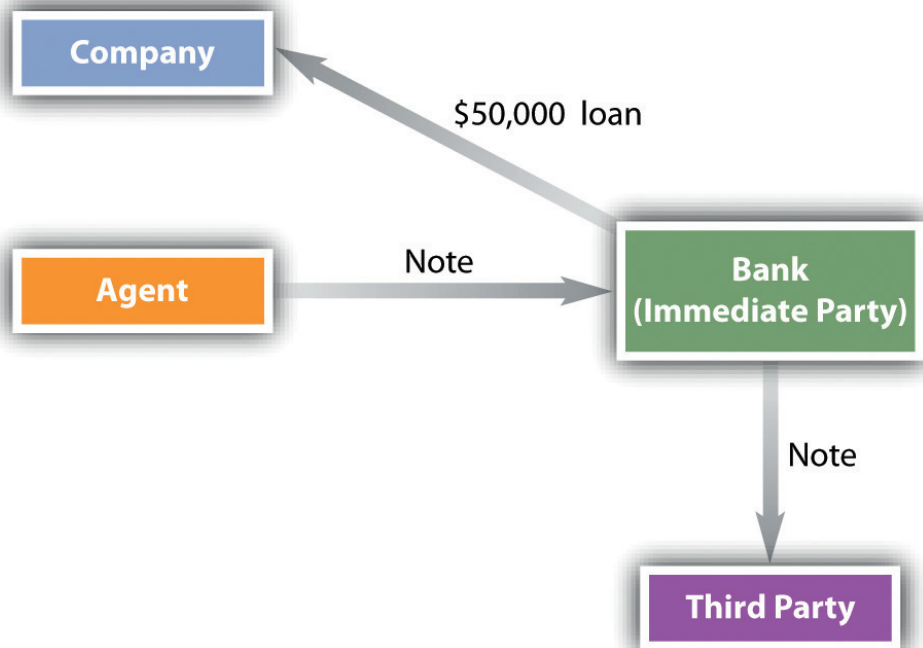
## 16.1 Liability Imposed by Signature: Agents, Authorized and Unauthorized

### 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 16.1 "Signature by Representative"](#)).

Figure 16.1 *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?

## 16.2 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 13 "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 16.2 "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 16.2 "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?

## 16.3 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?

## 16.4 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?



## 16.5 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?

## 16.6 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.

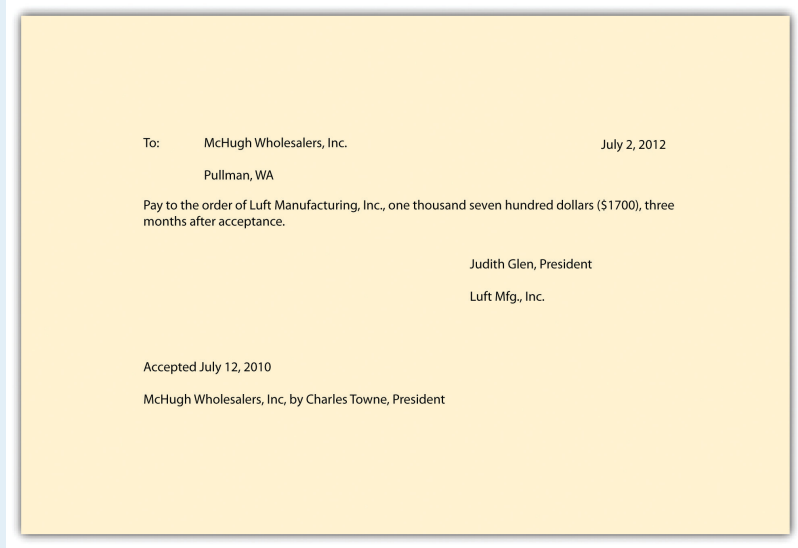
A holder on presentment makes certain warranties also: (1) entitled to enforce the instrument, (2) no knowledge that the maker's or drawer's signature is unauthorized, and (3) no material alteration.

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 16.2



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 17

### 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.



## 17.1 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.

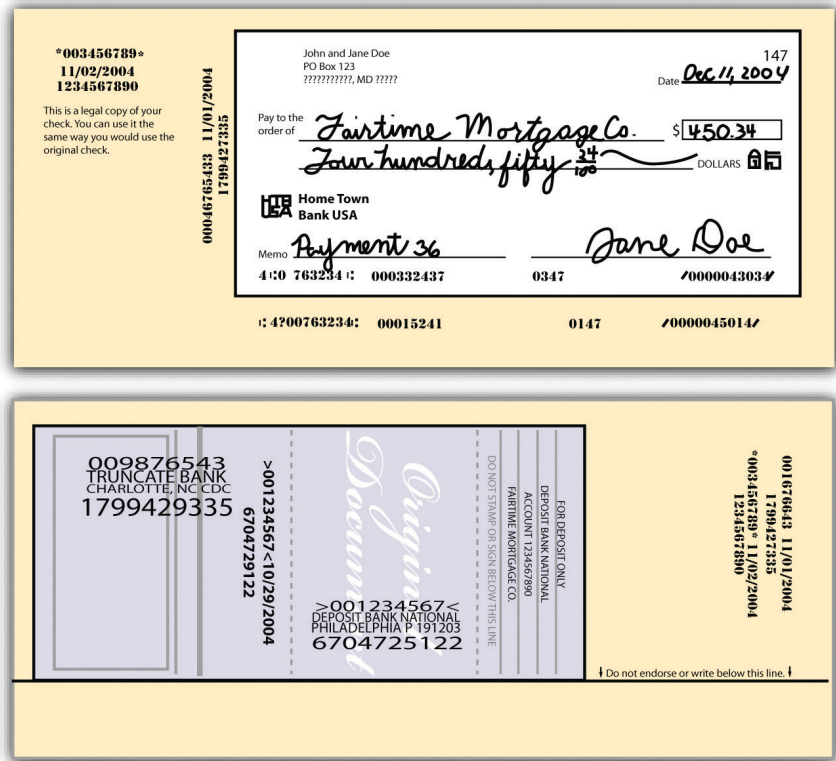
6. An office where banks exchange checks and drafts and settle accounts, owned by the member banks participating.

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 17.1 "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 17.1 *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 17.4 "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 17.4 "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?

## 17.2 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

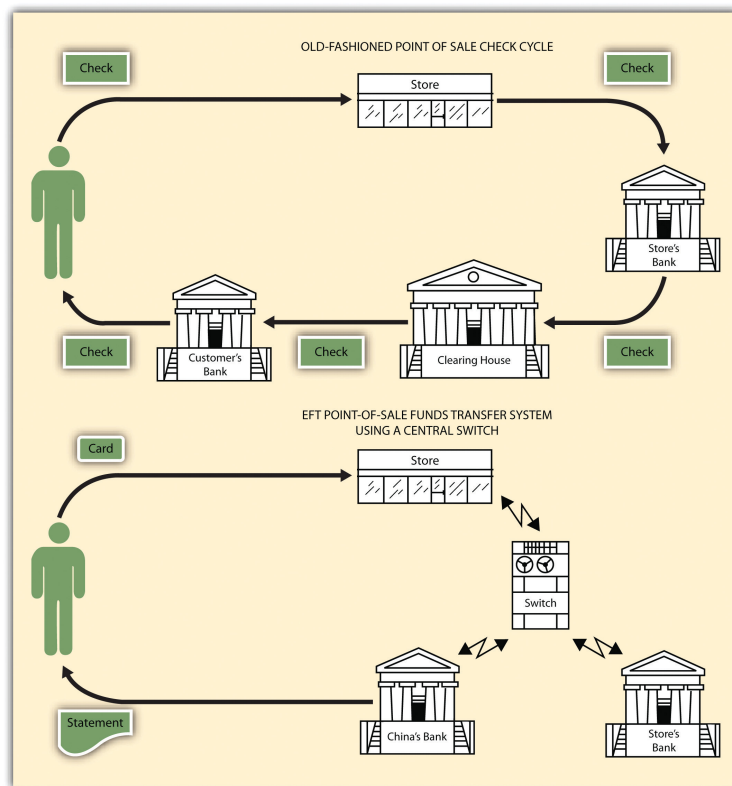
You are of course familiar with some forms of EFT:

- 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 17.2 "How EFT Replaces Checks"](#).

Figure 17.2 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 17.4 "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?

## 17.3 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 17.3 "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.

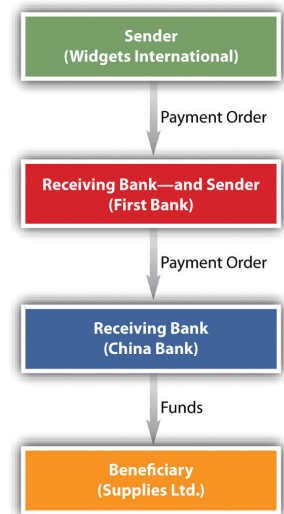
### Error by Sender

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 17.3 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 17.4 "A Letter of Credit"](#).

Figure 17.4 *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.



## 17.4 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?

## 17.5 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 18

## 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 19 "Secured Transactions and Suretyship"](#) and [Chapter 20 "Mortgages and Nonconsensual Liens"](#) explore different types of security that a creditor might require. [Chapter 21 "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*,

1. Debt owed by consumers.

July 30, 2007, <http://articles.moneycentral.msn.com/Banking/CreditCardSmarts/TheBigLieAboutCreditCardDebt.aspx>.

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.

## 18.1 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 18.3 "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 18.1 Credit Disclosure Form

Big Wheel Auto Alice Green

<b>ANNUAL PERCENTAGE RATE</b> The cost of your credit as a yearly rate	<b>FINANCE CHARGE</b> The dollar amount the credit will cost you	Amount Financed The amount of credit provided to you or on your behalf	Total of Payments The amount you will have paid after you have made all your payments as scheduled	Total Sale Price The total cost of your purchase on credit, including your down-payment of
14.84%	\$1496.80	\$6107.50	\$7604.30	\$1500 \$9104.30

You have the right to receive at this time an itemization of the Amount Financed  
 I want an itemization     I do not want an itemization

Your payment schedule will be:

Number of Payments	Amount of Payments	When Payments Are Due
36	\$211.23	Monthly beginning 6-1-11

**Insurance**  
Credit life insurance and credit disability insurance are not required to obtain credit, and will not be provided unless you sign and agree to pay the additional cost

Type	Premium	Signature
Credit Life	\$120	I want credit life insurance <span style="float: right;"><u>Alice Green</u></span> Signature
Credit Disability		I want credit disability insurance <span style="float: right;">_____</span> Signature
Credit Life and Disability		I want credit life and disability insurance <span style="float: right;">_____</span> Signature

Security: You are giving a security interest in:  
 the goods being purchased.  
 \_\_\_\_\_

Filing fees \$ 12.50      Nonfiling insurance \$ \_\_\_\_\_

Late Charge: If a payment is late, you will be charged \$10.

Prepayment: If you pay off early, you  
 may  will not have to pay a penalty.  
 may  will not be entitled to a refund of part of the finance charge.

See your contract documents for any additional information about nonpayment, default, any required repayment in full before the scheduled date, and prepayment refunds and penalties.

I have received a copy of this statement.  
Alice Green      6-1-11  
 Signature      Date

e means an estimate



By requiring that the finance charge and the annual percentage rate be disclosed on a uniform basis, the TILA makes understanding and comparison of loans much easier. The **finance charge**<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 18.1 "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, <http://articles.moneycentral.msn.com/Banking/YourCreditRating/weston-credit-card-lenders-go-on-a-rampage.aspx>. 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 18.3 "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 18.3 "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?

## 18.2 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?

## 18.3 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?

## 18.4 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 19

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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

## 19.1 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.

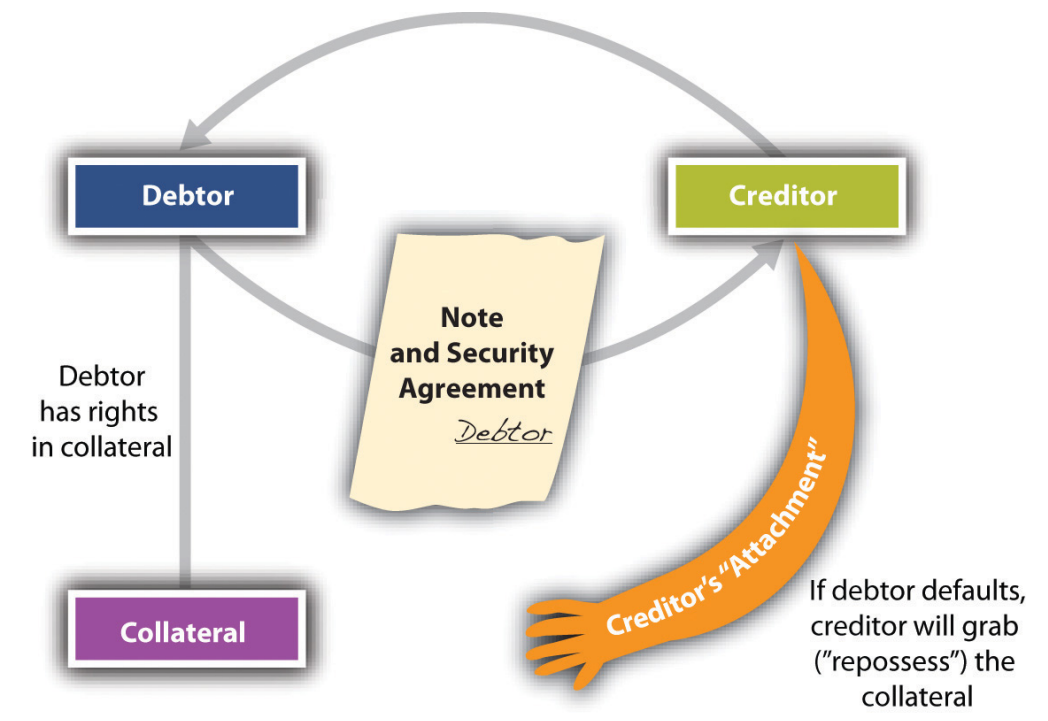
In this chapter, we take up security interests in personal property and suretyship. In the next chapter, we look at mortgages and nonconsensual liens.

## 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 19.1 "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 19.1 *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).

**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

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.

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:

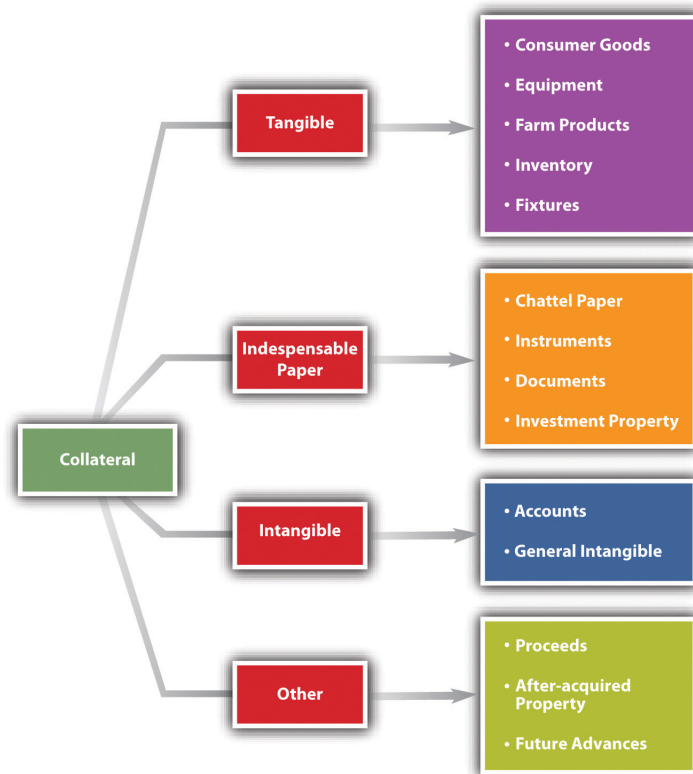
- Example 1: A debtor enters into a security agreement with a creditor that contains a future advances clause. The agreement gives the creditor a security interest in a \$700,000 inventory-picking robot to secure repayment of a loan made to the debtor. The parties contemplate that the debtor will, from 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 19.2 "Tangibles and Intangibles as Collateral"](#).

Figure 19.2 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 19.1 "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 19.1 "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 19.3 "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 19.3 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 (use first, middle name and address)  
 BUSINESS (legal business name and address)

2. FOR OFFICE USE ONLY - DO NOT WRITE IN THIS BOX

TRADE NAME, DBA, AKA:

3. SECURED PARTY(IES) (name and address)

4. ASSIGNEE(S) OF SECURED PARTY(IES) if applicable (name and address)

5. SECURED PARTY CONTACT PERSON: \_\_\_\_\_ Phone: \_\_\_\_\_

6. CHECK ONLY IF APPLICABLE: (For definitions of TRANSMITTING UTILITY AND PRODUCTS OF COLLATERAL, see instruction sheet.)  
 Debtor is a Transmitting Utility  Products of Collateral are also covered

7. THIS FINANCING STATEMENT covers the following collateral: (Attach additional 8-1/2"x 11" sheet(s) if needed)

8. RETURN ACKNOWLEDGEMENT COPY TO: (name and address)

9. FILE WITH:  
 UNIFORM COMMERCIAL CODE  
 DEPARTMENT OF LICENSING  
 P.O. BOX 9660  
 OLYMPIA, WA 98507-9660  
 (206) 753-2523

MAKE CHECKS PAYABLE TO THE DEPARTMENT OF LICENSING

10. FOR OFFICE USE ONLY - IMAGES TO BE FILMED

11. If collateral is described below, this statement may be signed by the Secured Party instead of the Debtor. Please check the appropriate box, complete the adjacent lines and 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

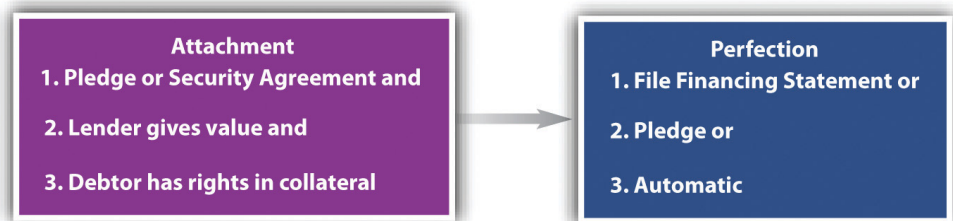
18. Mortgage arrangement in which a lender secures its loan with a lien on items stored in a warehouse or at the debtor’s place of business, with access to the items controlled by the lender, who releases goods as they are paid for by the borrower.

“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 19.4 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?

## 19.2 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 19.5 "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 financers who file properly have priority over previously perfected mortgagees. Buyers in the ordinary course of business take free of a security interest created by their seller, so long as they don't know their purchase violates a security agreement. Buyers of consumer goods perfected by mere attachment win out over the creditor who declined to file. Buyers in the ordinary course of business of farm products prevail over the farmer's creditors (under federal law, not the UCC). Lien creditors who become such before perfection win out; those who become such after perfection usually lose. Bailees in possession and material men have priority over previous perfected claimants. Bankruptcy trustees win out over unperfected security interests and over perfected ones if they are considered voidable transfers from the debtor to the secured party. Deposit accounts perfected by control prevail over previously perfected secured parties in the same deposit accounts.

### EXERCISES

1. What is the general rule regarding priorities for the right to repossess goods encumbered by a security interest when there are competing creditors clamoring for that right?
2. Why does it make good sense to allow purchase-money security creditors in (1) inventory, (2) equipment, and (3) fixtures priority over creditors who perfected before the PMSI was perfected?
3. A buyer in the ordinary course of business is usually one buying inventory. Why does it make sense that such a buyer should take free of a security interest created by his seller?

## 19.3 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 19.5 "Cases"](#).

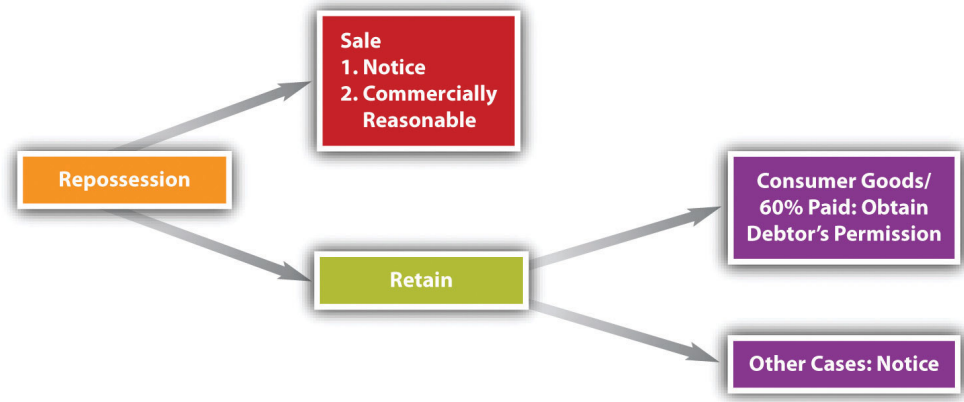
The reference in Section 9-609(a)(2) to "render equipment unusable and dispose of collateral on a debtor's premises" gets to situations involving "heavy equipment [when] the physical removal from the debtor's plant and the storage of collateral pending disposition may be impractical or unduly expensive....Of 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 19.5 "Disposition after Repossession"](#)).

Figure 19.5 *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 19.5 "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?

## 19.4 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).

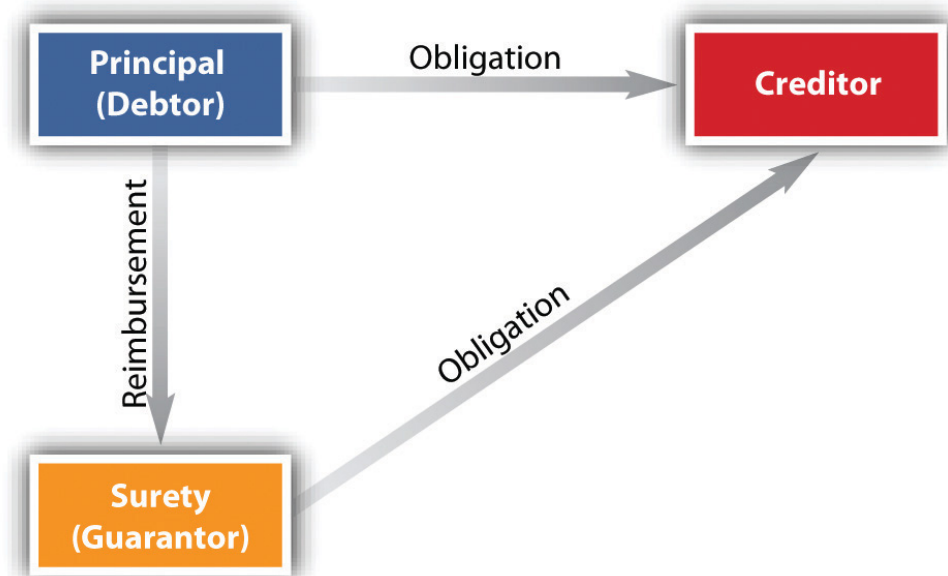
A **surety**<sup>22</sup> is one who promises to pay or perform an obligation owed by the **principal debtor**<sup>23</sup>, and, strictly speaking, the surety is primarily liable on the debt: the creditor can demand payment from the surety when the debt is due. The creditor is the person to whom the 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 19.6 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 19.5 "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 19.6 "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?

## 19.5 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?

## **19.6 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

## **19.7 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 which 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 (for example, 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 purchase money security interest 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 purchase money security interest, among them: 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. Creditors may obtain security:
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  - b. through operation of law
  - c. through both of these
  - 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?
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  - 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 May 15
  - d. Judgment lien creditor who filed the judgment on June 10
6. 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 \$5000 from Creditor, who was aware of Bank's security interest. Knittle then declared bankruptcy. Who has priority, Bank or Creditor?
7. Same facts as above, except Creditor—again aware of Bank's security interest—filed a financing statement to perfect its interest. Who has priority, Bank or Creditor?
8. 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?
9.
  - 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. Similar to facts as above, except 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?
10. 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 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?

11.
  - a. Mrs. Ace said to University Bookstore: "Sell the books to my daughter. I'll pay for them." When 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 Goodhand's defense valid?
  
12.
  - 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 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?

### Answers

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

## Chapter 20

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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

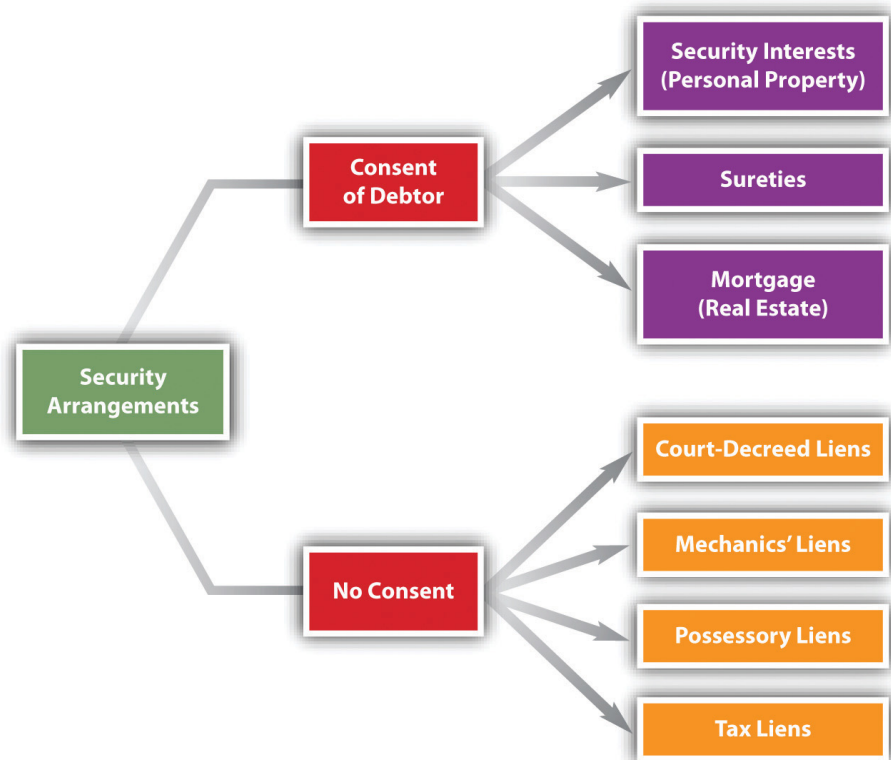
## 20.1 Uses, History, and Creation of Mortgages

### 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 19 "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 20.1 "Security Arrangements"](#)).

Figure 20.1 *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 19 "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 20.2 "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 18 "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 13 "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 20.4 "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 20.2 "Sample Mortgage Form"](#).

Figure 20.2 *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?

## 20.2 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 19 "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 19 "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

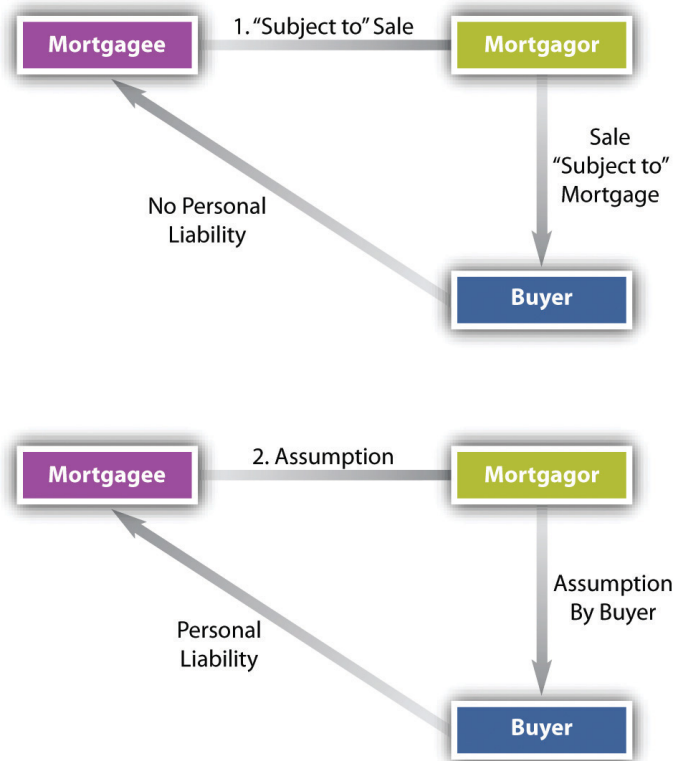
Unless they live in the home for twenty-five or thirty years, the mortgagors usually pay off the mortgage when the property is sold. Occasionally, mortgages are paid off in order to refinance. If the mortgage was taken out at a time of high interest rates and rates later drop, the homeowner might want 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 20.4 "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 20.3 "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 20.3 “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

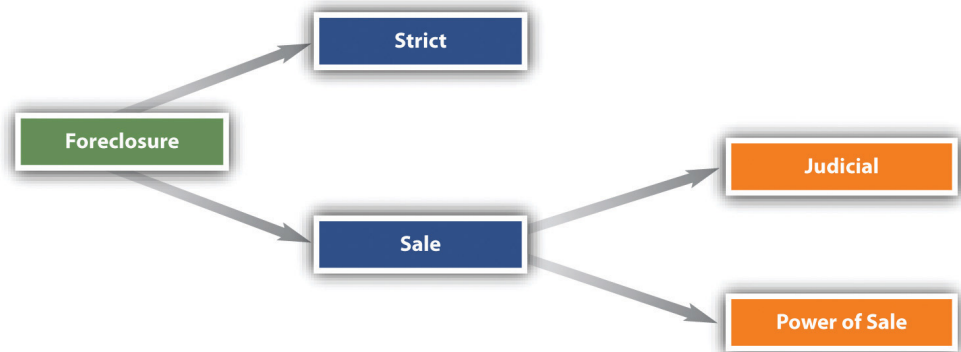
11. A contract clause requiring the entire mortgage amount be paid to the mortgagee if the property is sold; it prevents any assumption.

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

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 20.4 "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 20.4 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 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 20.4 "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?

## 20.3 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 20.3.3 "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.

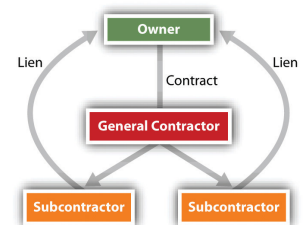
A particularly difficult problem crops up when the owner has paid the contractor, who in turn fails to pay his subcontractors. In many states, the subcontractors can file a lien on the owner's property, thus forcing the owner to pay them (see [Figure 20.5 "Subcontractors' Lien"](#))—and maybe twice. 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 20.4 "Cases"](#).

Figure 20.5 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?

## 20.4 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?



## 20.5 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, conveying 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 21

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## 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

## 21.1 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.

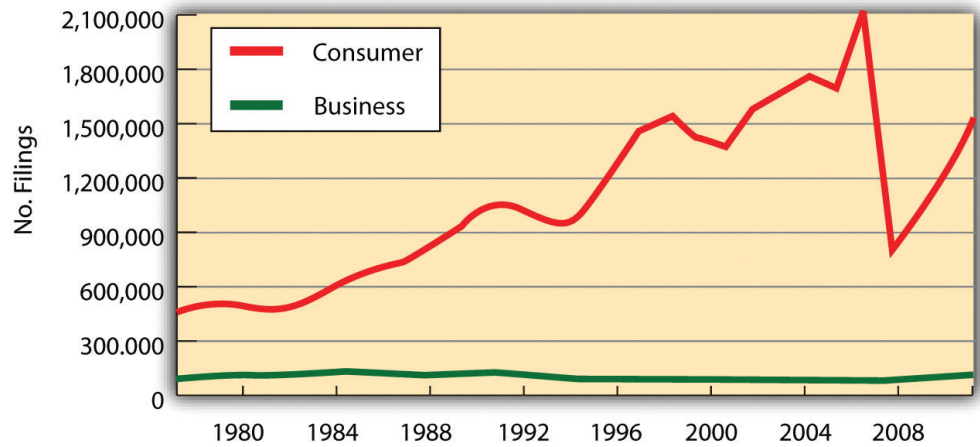
### Bankruptcy Statutes

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 21.1 "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 21.1 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

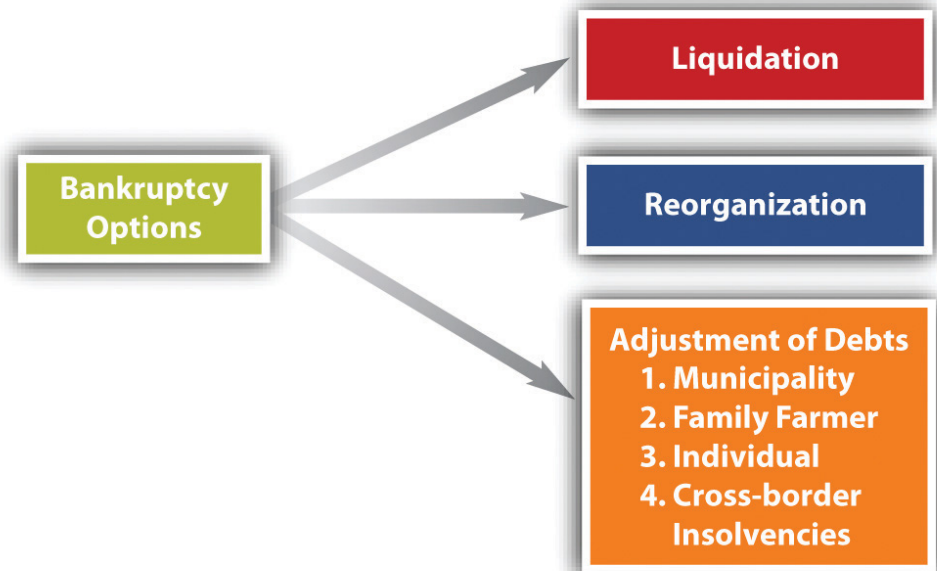
Each federal judicial district has a US Bankruptcy Court, whose judges are appointed by US Courts of Appeal. Unless both sides agree otherwise, bankruptcy judges are to hear only bankruptcy matters (called core proceedings). Bankruptcy trustees are government lawyers appointed by the US Attorney General. 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 21.2 "Bankruptcy Options"](#)).

Figure 21.2 *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.<sup>11</sup> 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.<sup>11</sup> 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 21.5 "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?

## 21.2 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 21.3 "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 19 "Secured Transactions and Suretyship"](#) and [Chapter 20 "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 21.3 "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 21.3 "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 21.6 "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 21.3 "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?

## 21.3 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**

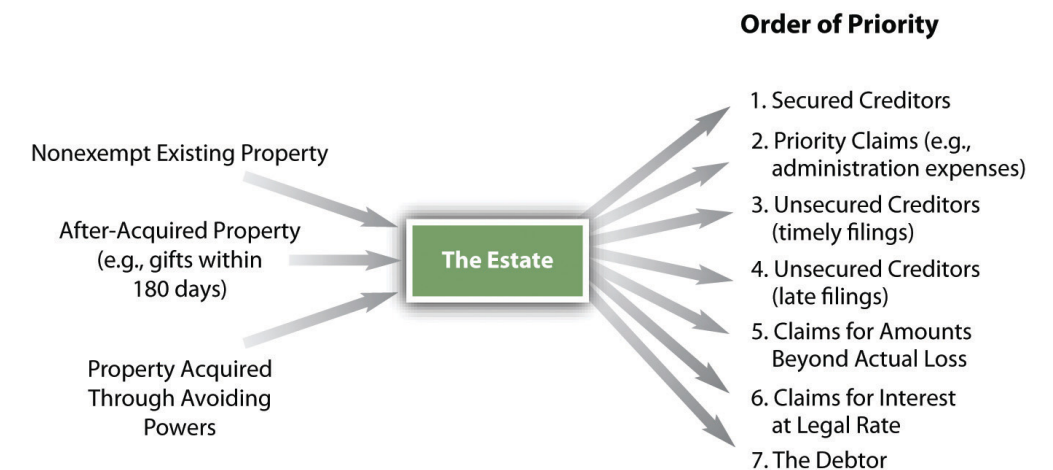
11. An order terminating a case before its normal end.

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 21.3 *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?

## 21.4 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 21.2 "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 21.6 "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?

## 21.5 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?



## 21.6 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?

## **21.7 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

## Chapter 22

### Introduction to Property: Personal Property and Fixtures

#### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The difference between personal property and other types of property
2. How rights in personal property are acquired and maintained
3. How some kinds of personal property can become real property, and how to determine who has rights in fixtures that are part of real property

In this chapter, we examine the general nature of property rights and the law relating to personal property—with special emphasis on acquisition and fixtures. In [Chapter 23 "Intellectual Property"](#), we discuss intellectual property, a kind of personal property that is increasingly profitable. In [Chapter 24 "The Nature and Regulation of Real Estate and the Environment"](#) through [Chapter 26 "Landlord and Tenant Law"](#), we focus on real property, including its nature and regulation, its acquisition by purchase (and some other methods), and its acquisition by lease (landlord and tenant law).

In [Chapter 27 "Estate Planning: Wills, Estates, and Trusts"](#) and [Chapter 28 "Insurance"](#), we discuss estate planning and insurance—two areas of the law that relate to both personal and real property.

## 22.1 The General Nature of Property Rights

### LEARNING OBJECTIVES

1. Understand the elastic and evolving boundaries of what the law recognizes as property that can be bought or sold on the market.
2. Distinguish real property from personal property.

### Definition of Property

Property, which seems like a commonsense concept, is difficult to define in an intelligible way; philosophers have been striving to define it for the past 2,500 years. To say that “property is what we own” is to beg the question—that is, to substitute a synonym for the word we are trying to define. Blackstone’s famous definition is somewhat wordy: “The right of property is that sole and despotic dominion which one man claims and exercises over the external things of the world, in total exclusion of the right of any other individual in the universe. It consists in the free use, enjoyment, and disposal of all a person’s acquisitions, without any control or diminution save only by the laws of the land.” A more concise definition, but perhaps too broad, comes from the Restatement of the Law of Property, which defines property as the “legal relationship between persons with respect to a thing.”

The Restatement’s definition makes an important point: property is a *legal relationship*, the power of one person to use objects in ways that affect others, to exclude others from the property, and to acquire and transfer property. Still, this definition does not contain a specific list of those nonhuman “objects” that could be in such a relationship. We all know that we can own personal objects like iPods and DVDs, and even more complex objects like homes and minerals under the ground. Property also embraces objects whose worth is representative or symbolic: ownership of stock in a corporation is valued not for the piece of paper called a stock certificate but for dividends, the power to vote for directors, and the right to sell the stock on the open market. Wholly intangible things or objects like copyrights and patents and bank accounts are capable of being owned as property. But the list of things that can be property is not fixed, for our concept of property continues to evolve. Collateralized debt obligations (CDOs) and structured investment vehicles (SIVs), prime players in the subprime mortgage crisis, were not on anyone’s list of possible property even fifteen years ago.

## The Economist's View

Property is not just a legal concept, of course, and different disciplines express different philosophies about the purpose of property and the nature of property rights. To the jurist, property rights should be protected because it is just to do so. To an economist, the legal protection of property rights functions to create incentives to use resources efficiently. For a truly efficient system of property rights, some economists would require universality (everything is owned), exclusivity (the owners of each thing may exclude all others from using it), and transferability (owners may exchange their property). Together, these aspects of property would lead, under an appropriate economic model, to efficient production and distribution of goods. But the law of property does not entirely conform to the economic conception of the ownership of productive property by private parties; there remain many kinds of property that are not privately owned and some parts of the earth that are considered part of “the commons.” For example, large areas of the earth’s oceans are not “owned” by any one person or nation-state, and certain land areas (e.g., Yellowstone National Park) are not in private hands.

## Classification of Property

1. That which physically exists, like a building, a popsicle stand, a hair dryer, or a steamroller.
2. Something without physical reality that entitles the owner to certain benefits; stocks, bonds, and intellectual property would be common examples.
3. That which is owned by any branch of government; private property is that which is owned by anyone else, including a corporation.
4. All property, real or personal, that is not publicly owned or part of “the commons.”
5. Land and all structures and fixtures that have legally become part of the land.
6. Any property that is not real property.

Property can be classified in various ways, including tangible versus intangible, private versus public, and personal versus real. **Tangible property**<sup>1</sup> is that which physically exists, like a building, a popsicle stand, a hair dryer, or a steamroller. **Intangible property**<sup>2</sup> is something without physical reality that entitles the owner to certain benefits; stocks, bonds, and intellectual property would be common examples. **Public property**<sup>3</sup> is that which is owned by any branch of government; **private property**<sup>4</sup> is that which is owned by anyone else, including a corporation.

Perhaps the most important distinction is between real and personal property. Essentially, **real property**<sup>5</sup> is immovable; **personal property**<sup>6</sup> is movable. At common law, personal property has been referred to as “chattels.” When chattels become affixed to real property in a certain manner, they are called fixtures and are treated as real property. (For example, a bathroom cabinet purchased at Home Depot and screwed into the bathroom wall may be converted to part of the real property when it is affixed.) Fixtures are discussed in [Section 22.3 "Fixtures"](#) of this chapter.

## Importance of the Distinction between Real and Personal Property

In our legal system, the distinction between real and personal property is significant in several ways. For example, the sale of personal property, but not real

property, is governed by Article 2 of the Uniform Commercial Code (UCC). Real estate transactions, by contrast, are governed by the general law of contracts. Suppose goods are exchanged for realty. Section 2-304 of the UCC says that the transfer of the goods and the seller's obligations with reference to them are subject to Article 2, but not the transfer of the interests in realty nor the transferor's obligations in connection with them.

The form of transfer depends on whether the property is real or personal. Real property is normally transferred by a deed, which must meet formal requirements dictated by state law. By contrast, transfer of personal property often can take place without any documents at all.

Another difference can be found in the law that governs the transfer of property on death. A person's heirs depend on the law of the state for distribution of his property if he dies intestate—that is, without a will. Who the heirs are and what their share of the property will be may depend on whether the property is real or personal. For example, widows may be entitled to a different percentage of real property than personal property when their husbands die intestate.

Tax laws also differ in their approach to real and personal property. In particular, the rules of valuation, depreciation, and enforcement depend on the character of the property. Thus real property depreciates more slowly than personal property, and real property owners generally have a longer time than personal property owners to make good unpaid taxes before the state seizes the property.

#### KEY TAKEAWAY

Property is difficult to define conclusively, and there are many different classifications of property. There can be public property as well as private property, tangible property as well as intangible property, and, most importantly, real property as well as personal property. These are important distinctions, with many legal consequences.

## EXERCISES

1. Kristen buys a parcel of land on Marion Street, a new and publicly maintained roadway. Her town's ordinances say that each property owner on a public street must also provide a sidewalk within ten feet of the curb. A year after buying the parcel, Kristen commissions a house to be built on the land, and the contractor begins by building a sidewalk in accordance with the town's ordinance. Is the sidewalk public property or private property? If it snows, and if Kristen fails to remove the snow and it melts and ices over and a pedestrian slips and falls, who is responsible for the pedestrian's injuries?
2. When can private property become public property? Does public property ever become private property?

## 22.2 Personal Property

### LEARNING OBJECTIVE

1. Explain the various ways that personal property can be acquired by means other than purchase.

Most legal issues about personal property center on its acquisition. Acquisition by purchase is the most common way we acquire personal property, but there are at least five other ways to legally acquire personal property: (1) possession, (2) finding lost or misplaced property, (3) gift, (4) accession, and (5) confusion.

### Possession

It is often said that “possession is nine-tenths of the law.” There is an element of truth to this, but it’s not the whole truth. For our purposes, the more important question is, what is meant by “possession”? Its meaning is not intuitively obvious, as a moment’s reflection will reveal. For example, you might suppose that you possess something when it is physically within your control, but what do you say when a hurricane deposits a boat onto your land? What if you are not even home when this happens? Do you possess the boat? Ordinarily, we would say that you don’t, because you don’t have physical control when you are absent. You may not even have the intention to control the boat; perhaps instead of a fancy speedboat in relatively good shape, the boat is a rust bucket badly in need of repair, and you want it removed from your front yard.

Even the element of physical domination of the object may not be necessary. Suppose you give your new class ring to a friend to examine. Is it in the friend’s possession? No: the friend has custody, not possession, and you retain the right to permit a second friend to take it from her hands. This is different from the case of a bailment, in which the bailor gives possession of an object to the bailee. For example, a garage (a bailee) entrusted with a car for the evening, and not the owner, has the right to exclude others from the car; the owner could not demand that the garage attendants refrain from moving the car around as necessary.

From these examples, we can see that possession or physical control must usually be understood as the power to exclude others from using the object. Otherwise, anomalies arise from the difficulty of physically controlling certain objects. It is more difficult to exercise control over a one-hundred-foot television antenna than

a diamond ring. Moreover, in what sense do you possess your household furniture when you are out of the house? Only, we suggest, in the power to exclude others. But this power is not purely a physical one: being absent from the house, you could not physically restrain anyone. Thus the concept of possession must inevitably be mixed with legal rules that do or could control others.

Possession confers ownership in a restricted class of cases only: when no person was the owner at the time the current owner took the object into his possession. The most obvious categories of objects to which this rule of possession applies are wild animals and abandoned goods. The rule requires that the would-be owner actually take possession of the animal or goods; the hunter who is pursuing a particular wild animal has no legal claim until he has actually captured it. Two hunters are perfectly free to pursue the same animal, and whoever actually grabs it will be the owner.

But even this simple rule is fraught with difficulties in the case of both wild animals and abandoned goods. We examine abandoned goods in [Section 22.2.2 "Lost or Misplaced Property"](#). In the case of wild game, fish in a stream, and the like, the general rule is subject to the rights of the owner of the land on which the animals are caught. Thus even if the animals caught by a hunter are wild, as long as they are on another's land, the landowner's rights are superior to the hunter's. Suppose a hunter captures a wild animal, which subsequently escapes, and a second hunter thereafter captures it. Does the first hunter have a claim to the animal? The usual rule is that he does not, for once an animal returns to the wild, ownership ceases.

### **Lost or Misplaced Property**

At common law, a technical distinction arose between lost and misplaced property. An object is lost if the owner inadvertently and unknowingly lets it out of his possession. It is merely misplaced if the owner intentionally puts it down, intending to recover it, even if he subsequently forgets to retrieve it. These definitions are important in considering the old saying "Finders keepers, losers weepers." This is a misconception that is, at best, only partially true, and more often false. The following hierarchy of ownership claims determines the rights of finders and losers.

First, the owner is entitled to the return of the property unless he has intentionally abandoned it. The finder is said to be a quasi-bailee for the true owner, and as bailee she owes the owner certain duties of care. The finder who knows the owner or has reasonable means of discovering the owner's identity commits larceny if she holds on to the object with the intent that it be hers. This rule applies only if the finder actually takes the object into her possession. For example, if you spot someone's wallet on the street you have no obligation to pick it up; but if you do pick it up and



see the owner's name in it, your legal obligation is to return it to the rightful owner. The finder who returns the object is not automatically entitled to a reward, but if the loser has offered a reward, the act of returning it constitutes performance of a unilateral contract. Moreover, if the finder has had expenses in connection with finding the owner and returning the property, she is entitled to reasonable reimbursement as a quasi-bailee. But the rights of the owner are frequently subject to specific statutes, such as the one discussed in *Bishop v. Ellsworth* in [Section 22.4.1 "Lost or Misplaced Property"](#).

Second, if the owner fails to claim the property within the time allowed by statute or has abandoned it, then the property goes to the owner of the real estate on which it was found if (1) the finder was a trespasser, (2) the goods are found in a private place (though what exactly constitutes a private place is open to question: is the aisle of a grocery store a private place? the back of the food rack? the stockroom?), (3) the goods are buried, or (4) the goods are misplaced rather than lost.

If none of these conditions apply, then the finder is the owner. These rules are considered in the *Bishop* case, (see [Section 22.4.1 "Lost or Misplaced Property"](#)).

## Gift

A **gift**<sup>7</sup> is a voluntary transfer of property without consideration or compensation. It is distinguished from a sale, which requires consideration. It is distinguished from a promise to give, which is a declaration of an intention to give in the future rather than a present transfer. It is distinguished from a testamentary disposition (will), which takes effect only upon death, not upon the preparation of the documents. Two other distinctions are worth noting. An **inter vivos**<sup>8</sup> (enter VYE vos) gift is one made between living persons without conditions attached. A **causa mortis**<sup>9</sup> (KAW zuh mor duz) gift is made by someone contemplating death in the near future.

## Requirements

7. A voluntary transfer of property without consideration or compensation.
8. A gift made between living persons.
9. A gift made by someone in contemplating death in the near future.

Figure 22.1 Gift Requirements



To make an effective gift *inter vivos* or *causa mortis*, the law imposes three requirements: (1) the donor must *deliver* a deed or object to the donee; (2) the donor must actually *intend* to make a gift, and (3) the donee must *accept* (see [Figure 22.1 "Gift Requirements"](#)).

### **Delivery**

Although it is firmly established that the object be delivered, it is not so clear what constitutes delivery. On the face of it, the requirement seems to be that the object must be transferred to the donee's possession. Suppose your friend tells you he is making a gift to you of certain books that are lying in a locked trunk. If he actually gives you the trunk so that you can carry it away, a gift has been made. Suppose, however, that he had merely given you the key, so that you could come back the next day with your car. If this were the sole key, the courts would probably construe the transfer of the key as possession of the trunk. Suppose, instead, that the books were in a bank vault and the friend made out a legal document giving both you and him the power to take from the bank vault. This would not be a valid gift, since he retained power over the goods.

### **Intent**

The intent to make a gift must be an intent to give the property at the present time, not later. For example, suppose a person has her savings account passbook put in her name and a friend's name, intending that on her death the friend will be able to draw out whatever money is left. She has not made a gift, because she did not intend to give the money when she changed the passbook. The intent requirement can sometimes be sidestepped if legal title to the object is actually transferred, postponing to the donee only the use or enjoyment of the property until later. Had the passbook been made out in the name of the donee only and delivered to a third party to hold until the death of the donor, then a valid gift may have been made. Although it is sometimes difficult to discern this distinction in practice, a more accurate statement of the rule of intent is this: Intention to give in the future does not constitute the requisite intent, whereas present gifts of future interests will be upheld.

### **Acceptance**

In the usual case, the rule requiring acceptance poses no difficulties. A friend hands you a new book and says, "I would like you to have this." Your taking the book and saying "thank-you" is enough to constitute your acceptance. But suppose that the friend had given you property without your knowing it. For example, a secret admirer puts her stock certificates jointly in your name and hers without telling you. Later, you marry someone else, and she asks you to transfer the certificates

back to her name. This is the first you have heard of the transaction. Has a gift been made? The usual answer is that even though you had not accepted the stock when the name change was made, the transaction was a gift that took effect immediately, subject to your right to repudiate when you find out about it. If you do not reject the gift, you have joint rights in the stock. But if you expressly refuse to accept a gift or indicate in some manner that you might not have accepted it, then the gift is not effective. For example, suppose you are running for office. A lobbyist whom you despise gives you a donation. If you refuse the money, no gift has been made.

### **Gifts Causa Mortis**

Even though the requirements of delivery, intent, and acceptance apply to gifts causa mortis as well as inter vivos, a gift causa mortis (one made in contemplation of death) may be distinguished from a gift inter vivos on other grounds. The difference between the two lies in the power of the donor to revoke the gift before he dies; in other words, the gift is conditional on his death. Since the law does not permit gifts that take place in the future contingent on some happening, how can it be that a gift causa mortis is effective? The answer lies in the nature of the transfer: the donee takes actual title when the gift is made; should the donor not in fact die or should he revoke the gift before he dies, then and only then will the donee lose title. The difference is subtle and amounts to the difference between saying “If I die, the watch is yours” and “The watch is yours, unless I survive.” In the former case, known as a condition precedent, there is no valid gift; in the latter case, known as a condition subsequent, the gift is valid.

### **Gifts to Minors**

Every state has adopted either the Uniform Gifts to Minors Act (UGMA) or the Uniform Transfers to Minors Act (UTMA), both of which establish the manner by which irrevocable gifts are made to minors. Under these acts, a custodian holds the gifts until the minor reaches the age of eighteen, twenty-one, or twenty-five, depending on state law. Gifts under UGMA are limited for the most part to money or securities, while UTMA allows other types of gifts as well, such as real estate or tangible personal property.

### **Gift Tax**

The federal government and many states impose gift taxes on gifts above a certain dollar amount. We discuss gift taxes in connection with estate taxes in [Chapter 27 "Estate Planning: Wills, Estates, and Trusts"](#).

## Accession

An **accession**<sup>10</sup> is something that is added to what one already possesses. In general, the rule is that the owner of the thing owns the additional thing that comes to be attached to it. For example, the owner of a cow owns her calves when she gives birth. But when one person adds value to another person's property, either through labor alone or by adding new materials, the rule must be stated somewhat differently. The general rule is this: when goods are added to goods, the owner of the principal goods becomes the owner of the enhanced product. For example, a garage uses its paint to repaint its customer's automobile. The car owner, not the painter, is the owner of the finished product.

When someone has wrongfully converted—that is, taken as her own—the property of another, the owner may sue for damages, either to recover his property or its value. But a problem arises when the converter has added to the value of that property. In general, the courts hold that when the conversion is willful, the owner is entitled to the full value of the goods as enhanced by the converter. Suppose that a carpenter enters a ten-acre forest that he knows belongs to his neighbor, cuts down one hundred trees, transports them to his shop, and cuts them up into standard lumber, thus increasing their market value. The owner is entitled to this full value, and the carpenter will get nothing for his trouble. Thus the willful converter loses the value of his labor or materials. If, on the other hand, the conversion was innocent, or at most negligent, the rule is somewhat more uncertain. Generally the courts will award the forest owner the value of the standing timber, giving the carpenter the excess attributable to his labor and transportation. A more favorable treatment of the owner is to give her the full value of the lumber as cut, remitting to the carpenter the value of his expenses.

## Confusion

In accession, the goods of one owner are transformed into a more valuable commodity or are inextricably united with the goods of another to form a constituent part. Still another type of joining is known as **confusion**<sup>11</sup>, and it occurs when goods of different owners, while maintaining their original form, are commingled. A common example is the intermingling of grain in a silo. But goods that are identifiable as belonging to a particular person—branded cattle, for instance—are not confused, no matter how difficult it may be to separate herds that have been put together.

When the goods are identical, no particular problem of division arises. Assuming that each owner can show how much he has contributed to the confused mass, he is entitled to that quantity, and it does not matter which particular grains or kernels he extracts. So if a person, seeing a container of grain sitting on the side of the road,

10. Something that is added to what one already possesses.

11. Where personal property is intermingled, negligently or intentionally, with the personal property of others.

mistakes it for his own and empties it into a larger container in his truck, the remedy is simply to restore a like quantity to the original owner. When owners of like substances consent to have those substances combined (such as in a grain silo), they are said to be tenants in common, holding a proportional share in the whole.

In the case of willful confusion of goods, many courts hold that the wrongdoer forfeits all his property unless he can identify his particular property. Other courts have modified this harsh rule by shifting the burden of proof to the wrongdoer, leaving it up to him to claim whatever he can establish was his. If he cannot establish what was his, then he will forfeit all. Likewise, when the defendant has confused the goods negligently, without intending to do so, most courts will tend to shift to the defendant the burden of proving how much of the mass belongs to him.

### KEY TAKEAWAY

Other than outright purchase of personal property, there are various ways in which to acquire legal title. Among these are possession, gift, accession, confusion, and finding property that is abandoned, lost, or mislaid, especially if the abandoned, lost, or mislaid property is found on real property that you own.

### EXERCISES

1. Dan captures a wild boar on US Forest Service land. He takes it home and puts it in a cage, but the boar escapes and runs wild for a few days before being caught by Romero, some four miles distant from Dan's house. Romero wants to keep the boar. Does he "own" it? Or does it belong to Dan, or to someone else?
2. Harriet finds a wallet in the college library, among the stacks. The wallet has \$140 in it, but no credit cards or identification. The library has a lost and found at the circulation desk, and the people at the circulation desk are honest and reliable. The wallet itself is unique enough to be identified by its owner. (a) Who owns the wallet and its contents? (b) As a matter of ethics, should Harriet keep the money if the wallet is "legally" hers?

## 22.3 Fixtures

### LEARNING OBJECTIVE

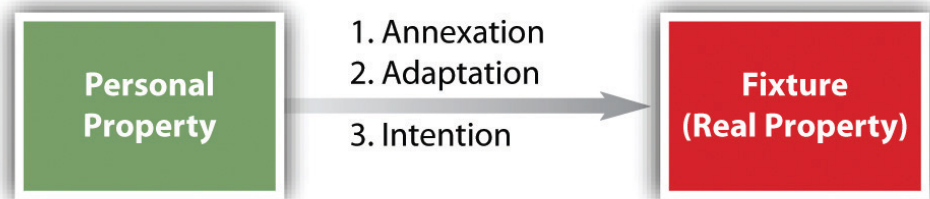
1. Know the three tests for when personal property becomes a fixture and thus becomes real property.

### Definition

A **fixture**<sup>12</sup> is an object that was once personal property but that has become so affixed to land or structures that it is considered legally a part of the real property. For example, a stove bolted to the floor of a kitchen and connected to the gas lines is usually considered a fixture, either in a contract for sale, or for testamentary transfer (by will). For tax purposes, fixtures are treated as real property.

### Tests

Figure 22.2 *Fixture Tests*



Obviously, no clear line can be drawn between what is and what is not a fixture. In general, the courts look to three tests to determine whether a particular object has become a fixture: annexation, adaptation, and intention (see [Figure 22.2 "Fixture Tests"](#)).

### Annexation

The object must be annexed or affixed to the real property. A door on a house is affixed. Suppose the door is broken and the owner has purchased a new door made to fit, but the house is sold before the new door is installed. Most courts would consider that new door a fixture under a rule of constructive annexation. Sometimes courts have said that an item is a fixture if its removal would damage

12. An object that was once personal property that has become so affixed to land or structures that it is legally a part of the real property.

the real property, but this test is not always followed. Must the object be attached with nails, screws, glue, bolts, or some other physical device? In one case, the court held that a four-ton statue was sufficiently affixed merely by its weight. *Snedeker v. Warring*, 12 N.Y. 170 (1854).

### **Adaptation**

Another test is whether the object is adapted to the use or enjoyment of the real property. Examples are home furnaces, power equipment in a mill, and computer systems in bank buildings.

### **Intention**

Recent decisions suggest that the controlling test is whether the person who actually annexes the object intends by so doing to make it a permanent part of the real estate. The intention is usually deduced from the circumstances, not from what a person might later say her intention was. If an owner installs a heating system in her house, the law will presume she intended it as a fixture because the installation was intended to benefit the house; she would not be allowed to remove the heating system when she sold the house by claiming that she had not intended to make it a fixture.

### **Fixture Disputes**

Because fixtures have a hybrid nature (once personal property, subsequently real property), they generate a large number of disputes. We have already examined two types of these disputes in other contexts: (1) disputes between mortgagees and secured parties ([Chapter 19 "Secured Transactions and Suretyship"](#)) and (2) disputes over whether the sale of property attached to real estate (such as crops or a structure) but about to be severed is a sale of goods or real estate ([Chapter 8 "Introduction to Sales and Leases"](#)). Two other types of disputes remain.

### **Transfer of Real Estate**

When a homeowner sells her house, the problem frequently crops up as to whether certain items in the home have been sold or may be removed by the seller. Is a refrigerator, which simply plugs into the wall, a fixture or an item of personal property? If a dispute arises, the courts will apply the three tests—annexation, adaptation, and intention. Of course, the simplest way of avoiding the dispute is to incorporate specific reference to questionable items in the contract for sale, indicating whether the buyer or the seller is to keep them.

### Tenant's Fixtures

Tenants frequently install fixtures in the buildings they rent or the property they occupy. A company may install tens of thousands of dollars worth of equipment; a tenant in an apartment may bolt a bookshelf into the wall or install shades over a window. Who owns the fixtures when the tenant's lease expires? The older rule was that any fixture, determined by the usual tests, must remain with the landlord. Today, however, certain types of fixtures—known as **tenant's fixtures**<sup>13</sup>—stay with the tenant. These fall into three categories: (1) trade fixtures—articles placed on the premises to enable the tenant to carry on his or her trade or business in the rented premises; (2) agricultural fixtures—devices installed to carry on farming activities (e.g., milling plants and silos); (3) domestic fixtures—items that make a tenant's personal life more comfortable (carpeting, screens, doors, washing machines, bookshelves, and the like).

The three types of tenant's fixtures remain personal property and may be removed by the tenant if the following three conditions are met: (1) They must be installed for the requisite purposes of carrying on the trade or business or the farming or agricultural pursuits or for making the home more comfortable, (2) they must be removable without causing substantial damage to the landlord's property, and (3) they must be removed before the tenant turns over possession of the premises to the landlord. Again, any debatable points can be resolved in advance by specifying them in the written lease.

#### KEY TAKEAWAY

Personal property is often converted to real property when it is affixed to real property. There are three tests that courts use to determine whether a particular object has become a fixture and thus has become real property: annexation, adaptation, and intention. Disputes over fixtures often arise in the transfer of real property and in landlord-tenant relations.

13. Fixtures added to rental property that become property of the owner.



## EXERCISES

1. Jim and Donna Stoner contract to sell their house in Rochester, Michigan, to Clem and Clara Hovenkamp. Clara thinks that the decorative chandelier in the entryway is lovely and gives the house an immediate appeal. The chandelier was a gift from Donna's mother, "to enhance the entryway" and provide "a touch of beauty" for Jim and Donna's house. Clem and Clara assume that the chandelier will stay, and nothing specific is mentioned about the chandelier in the contract for sale. Clem and Clara are shocked when they move in and find the chandelier is gone. Have Jim and Donna breached their contract of sale?
2. Blaine Goodfellow rents a house from Associated Properties in Abilene, Texas. He is there for two years, and during that time he installs a ceiling fan, custom-builds a bookcase for an alcove on the main floor, and replaces the screening on the front and back doors, saving the old screening in the furnace room. When his lease expires, he leaves, and the bookcase remains behind. Blaine does, however, take the new screening after replacing it with the old screening, and he removes the ceiling fan and puts back the light. He causes no damage to Associated Properties' house in doing any of this. Discuss who is the rightful owner of the screening, the bookcase, and the ceiling fan after the lease expires.

## 22.4 Case

### Lost or Misplaced Property

Bishop v. Ellsworth

91 Ill. App.2d 386, 234 N.E. 2d 50 (1968)

OPINION BY: STOUWER, Presiding Justice

Dwayne Bishop, plaintiff, filed a complaint alleging that on July 21, 1965, defendants, Mark and Jeff Ellsworth and David Gibson, three small boys, entered his salvage yard premises at 427 Mulberry Street in Canton, without his permission, and while there happened upon a bottle partially embedded in the loose earth on top of a landfill, wherein they discovered the sum of \$12,590 in US currency. It is further alleged that said boys delivered the money to the municipal chief of police who deposited it with defendant, Canton State Bank. The complaint also alleges defendants caused preliminary notices to be given as required by Ill. Rev. Stats., chapter 50, subsections 27 and 28 (1965), but that such statute or compliance therewith does not affect the rights of the plaintiff. [The trial court dismissed the plaintiff's complaint.]

...It is defendant's contention that the provisions of Ill Rev Stats, chapter 50, subsections 27 and 28 govern this case. The relevant portions of this statute are as follows:

"27. Lost goods...If any person or persons shall hereafter find any lost goods, money, bank notes, or other choses in action, of any description whatever, such person or persons shall inform the owner thereof, if known, and shall make restitution of the same, without any compensation whatever, except the same shall be voluntarily given on the part of the owner. If the owner be unknown, and if such property found is of the value of \$ 15 or upwards, the finder...shall, within five days after such finding...appear before some judge or magistrate...and make affidavit of the description thereof, the time and place when and where the same was found, that no alteration has been made in the appearance thereof since the finding of the same, that the owner thereof is unknown to him and that he has not secreted, withheld or disposed of any part thereof. The judge or magistrate shall enter the value of the property found as near as he can ascertain in his estray book together with the affidavit of the finder, and shall also, within ten days after the proceedings have been entered on his estray book, transmit to the county clerk a certified copy

thereof, to be by him recorded in his estray book and to file the same in his office...28. Advertisement...If the value thereof exceeds the sum of \$ 15, the county clerk, within 20 days after receiving the certified copy of the judge or magistrate's estray record shall cause an advertisement to be set up on the court house door, and in 3 other of the most public places in the county, and also a notice thereof to be published for 3 weeks successively in some public newspaper printed in this state and if the owner of such goods, money, bank notes, or other choses in action does not appear and claim the same and pay the finder's charges and expenses within one year after the advertisement thereof as aforesaid, the ownership of such property shall vest in the finder."

\* \* \*

We think it apparent that the statute to which defendants make reference provides a means of vesting title to lost property in the finder where the prescribed search for the owner proves fruitless. This statute does not purport to provide for the disposition of property deemed mislaid or abandoned nor does it purport to describe or determine the right to possession against any party other than the true owner. The plain meaning of this statute does not support plaintiff's position that common law is wholly abrogated thereby. The provisions of the statute are designed to provide a procedure whereby the discoverer of "lost" property may be vested with the ownership of said property even as against the true owner thereof, a right which theretofore did not exist at common law. In the absence of any language in the statute from which the contrary can be inferred it must be assumed that the term "lost" was used in its generally accepted legal sense and no extension of the term was intended. Thus the right to possession of discovered property still depends upon the relative rights of the discoverer and the owner of the locus in quo and the distinctions which exist between property which is abandoned, mislaid, lost or is treasure trove. The statute assumes that the discoverer is in the rightful possession of lost property and proceedings under such statute is (sic) not a bar where the issue is a claim to the contrary. There is a presumption that the owner or occupant of land or premises has custody of property found on it or actually imbedded in the land. The ownership or possession of the locus in quo is related to the right to possession of property discovered thereon or imbedded therein in two respects. First, if the premises on which the property is discovered are private it is deemed that the property discovered thereon is and always has been in the constructive possession of the owner of said premises and in a legal sense the property can be neither mislaid nor lost. *Pyle v. Springfield Marine Bank*, 330 Ill App 1, 70 NE2d 257. Second, the question of whether the property is mislaid or lost in a legal sense depends upon the intent of the true owner. The ownership or possession of the premises is an important factor in determining such intent. If the property be determined to be mislaid, the owner of the premises is entitled to the possession thereof against the discoverer. It would also appear that if the

discoverer is a trespasser such trespasser can have no claim to possession of such property even if it might otherwise be considered lost.

...The facts as alleged in substance are that the Plaintiff was the owner and in possession of real estate, that the money was discovered in a private area of said premises in a bottle partially imbedded in the soil and that such property was removed from the premises by the finders without any right or authority and in effect as trespassers. We believe the averment of facts in the complaint substantially informs the defendants of the nature of and basis for the claim and is sufficient to state a cause of action. [The trial court's dismissal of the Plaintiff's complaint is reversed and the case is remanded.]

### CASE QUESTIONS

1. What is the actual result in this case? Do the young boys get any of the money that they found? Why or why not?
2. Who is Dwayne Bishop, and why is he a plaintiff here? Was it Bishop that put the \$12,590 in US currency in a bottle in the landfill at the salvage yard? If not, then who did?
3. If Bishop is not the original owner of the currency, what are the rights of the original owner in this case? Did the original owner "lose" the currency? Did the original owner "misplace" the currency? What difference does it make whether the original owner "lost" or "misplaced" the currency? Can the original owner, after viewing the legal advertisement, have a claim superior to Dwayne Bishop's claim?

## **22.5 Summary and Exercises**

## Summary

Property is the *legal relationship* between persons with respect to things. The law spells out what can be owned and the degree to which one person can assert an interest in someone else's things. Property is classified in several ways: personal versus real, tangible versus intangible, private versus public. The first distinction, between real and personal, is the most important, for different legal principles often apply to each. Personal property is movable, whereas real property is immovable.

Among the ways personal property can be acquired are: by (1) possession, (2) finding, (3) gift, (4) accession, and (5) confusion.

Possession means the power to exclude others from using an object. Possession confers ownership only when there is no owner at the time the current owner takes possession. "Finders keepers, losers weepers" is not a universal rule; the previous owner is entitled to return of his goods if it is reasonably possible to locate him. If not, or if the owner does not claim his property, then it goes to the owner of the real estate on which it was found, if the finder was a trespasser, or the goods were buried, were in a private place, or were misplaced rather than lost. If none of these conditions applies, the property goes to the finder.

A gift is a voluntary transfer of property without consideration. Two kinds of gifts are possible: *inter vivos* and *causa mortis*. To make an effective gift, (1) the donor must make out a deed or physically deliver the object to the donee, (2) the donor must intend to make a gift, and (3) the donee must accept the gift. Delivery does not always require physical transfer; sometimes, surrender of control is sufficient. The donor must intend to give the gift now, not later.

Accession is an addition to that which is already owned—for example, the birth of calves to a cow owned by a farmer. But when someone else, through labor or by supplying material, adds value, the accession goes to the owner of the principal goods.

Confusion is the intermingling of like goods so that each, while maintaining its form, becomes a part of a larger whole, like grain mixed in a silo. As long as the goods are identical, they can easily enough be divided among their owners.

A fixture is a type of property that ceases to be personal property and becomes real property when it is annexed or affixed to land or buildings on the land and adapted to the use and enjoyment of the real property. The common-law rules governing fixtures do not employ clear-cut tests, and sellers and buyers can avoid many disputes by specifying in their contracts what goes with the land. Tenant's fixtures remain the property of the tenant if they are for the convenience of the tenant, do not cause substantial damage to the property when removed, and are removed before possession is returned to the landlord.

## EXERCISES

1. Kate owns a guitar, stock in a corporation, and an antique bookcase that is built into the wall of her apartment. How would you classify each kind of property?
2. After her last business law class, Ingrid casually throws her textbook into a trash can and mutters to herself, “I’m glad I don’t have to read that stuff anymore.” Tom immediately retrieves the book from the can. Days later, Ingrid realizes that the book will come in handy, sees Tom with it, and demands that he return the book. Tom refuses. Who is entitled to the book? Why?
3. In Exercise 2, suppose that Ingrid had accidentally left the book on a table in a restaurant. Tom finds it, and chanting “Finders keepers, losers weepers,” he refuses to return the book. Is Ingrid entitled to the book? Why?
4. In Exercise 3, if the owner of the book (Ingrid) is never found, who is entitled to the book—the owner of the restaurant or Tom? Why?
5. Matilda owned an expensive necklace. On her deathbed, Matilda handed the necklace to her best friend, Sadie, saying, “If I die, I want you to have this.” Sadie accepted the gift and placed it in her safe-deposit box. Matilda died without a will, and now her only heir, Ralph, claims the necklace. Is he entitled to it? Why or why not?

## SELF-TEST QUESTIONS

1. Personal property is defined as property that is
  - a. not a chattel
  - b. owned by an individual
  - c. movable
  - d. immovable
  
2. Personal property can be acquired by
  - a. accession
  - b. finding
  - c. gift
  - d. all of the above
  
3. A gift causa mortis is
  - a. an irrevocable gift
  - b. a gift made after death
  - c. a gift made in contemplation of death
  - d. none of the above
  
4. To make a gift effective,
  - a. the donor must intend to make a gift
  - b. the donor must either make out a deed or deliver the gift to the donee
  - c. the donee must accept the gift
  - d. all of the above are required
  
5. Tenant's fixtures
  - a. remain with the landlord in all cases
  - b. remain the property of the tenant in all cases
  - c. remain the property of the tenant if they are removable without substantial damage to the landlord's property
  - d. refer to any fixture installed by a tenant



**SELF-TEST ANSWERS**

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

## Chapter 23

# Intellectual Property

### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The principal kinds of intellectual property
2. The difference between patents and trade secrets, and why a company might choose to rely on trade secrets rather than obtain a patent
3. What copyrights are, how to obtain them, and how they differ from trademarks
4. Why some “marks” may not be eligible for trademark protection, and how to obtain trademark protection for those that are

1. Intangible personal property whose major forms are patents, copyrights, and trademarks.
2. A grant from government that gives an inventor the exclusive right to make, use, and sell an invention for a period of twenty years from the date of filing the application for a patent.
3. The legal right given “authors” to prevent others from copying the expression embodied in a protected work.
4. Defined by the federal Lanham Act of 1946 as “any word, name, symbol, or device or any combination thereof adopted and used by a manufacturer or merchant to identify his goods and distinguish them from goods manufactured or sold by others.”

Few businesses of any size could operate without being able to protect their rights to a particular type of intangible personal property: **intellectual property**<sup>1</sup>. The major forms of intellectual property are patents, copyrights, and trademarks. Unlike tangible personal property (machines, inventory) or real property (land, office buildings), intellectual property is formless. It is the product of the human intellect that is embodied in the goods and services a company offers and by which the company is known.

A **patent**<sup>2</sup> is a grant from government that gives an inventor the exclusive right to make, use, and sell an invention for a period of twenty years from the date of filing the application for a patent. A **copyright**<sup>3</sup> is the right to exclude others from using or marketing forms of expression. A **trademark**<sup>4</sup> is the right to prevent others from using a company’s product name, slogan, or identifying design. Other forms of intellectual property are trade secrets (particular kinds of information of commercial use to a company that created it) and right of publicity (the right to exploit a person’s name or image). Note that the property interest protected in each case is not the tangible copy of the invention or writing—not the machine with a particular serial number or the book lying on someone’s shelf—but the invention or words themselves. That is why intellectual property is said to be intangible: it is a right to exclude any others from gaining economic benefit from your own intellectual creation. In this chapter, we examine how Congress, the courts, and the

Patent and Trademark Office have worked to protect the major types of intellectual property.

## 23.1 Patents

### LEARNING OBJECTIVES

1. Explain why Congress would grant exclusive monopolies (patents) for certain periods of time.
2. Describe what kinds of things may be patentable and what kinds of things may not be patentable.
3. Explain the procedures for obtaining a patent, and how patent rights may be an issue where the invention is created by an employee.
4. Understand who can sue for patent infringement, on what basis, and with what potential remedies.

### Source of Authority and Duration

Patent and copyright law are federal, enacted by Congress under the power given by Article I of the Constitution “to promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries.” Under current law, a patent gives an inventor exclusive rights to make, use, or sell an invention for twenty years. (If the patent is a design patent—protecting the appearance rather than the function of an item—the period is fourteen years.) In return for this limited monopoly, the inventor must fully disclose, in papers filed in the US Patent and Trademark Office (PTO), a complete description of the invention.

5. A “means devised for the production of a given result”—for example, a process for making steel.
6. A particular apparatus for achieving a certain result or carrying out a distinct process—lathes, printing presses, motors, and the cotton gin are all examples of machines.
7. An article or product, such as a television, automobile, telephone, and lightbulb.
8. A new arrangement of elements such that the resulting compound, such as a metal alloy, is not found in nature.

### Patentability

#### What May Be Patented

The patent law says that “any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof” may be patented.<sup>35</sup> United States Code, Section 101. A **process**<sup>5</sup> is a “process, art or method, and includes a new use of a known process, machine, manufacture, composition of matter, or material.”<sup>35</sup> United States Code, Section 101. A process for making rolled steel, for example, qualifies as a patentable process under the statute. A **machine**<sup>6</sup> is a particular apparatus for achieving a certain result or carrying out a distinct process—lathes, printing presses, motors, and the cotton gin are all examples of the hundreds of thousands of machines that have received US patents since the first Patent Act in 1790. A **manufacture**<sup>7</sup> is an article or a product, such as a television, an automobile, a telephone, or a lightbulb. A **composition of matter**<sup>8</sup> is a new arrangement of elements so that the resulting compound, such as

a metal alloy, is not found in nature. In *Commissioner of Patents v. Chakrabarty*, *Commissioner of Patents v. Chakrabarty*, 444 U.S. 1028 (1980). the Supreme Court said that even living organisms—in particular, a new “genetically engineered” bacterium that could “eat” oil spills—could be patented. The *Chakrabarty* decision has spawned innovation: a variety of small biotechnology firms have attracted venture capitalists and other investors.

According to the PTO, gene sequences are patentable subject matter, provided they are isolated from their natural state and processed in a way that separates them from other molecules naturally occurring with them. Gene patenting, always controversial, generated new controversy when the PTO issued a patent to Human Genome Sciences, Inc. for a gene found to serve as a platform from which the AIDS virus can infect cells of the body. Critics faulted the PTO for allowing “ownership” of a naturally occurring human gene and for issuing patents without requiring a showing of the gene’s utility. New guidelines from the PTO followed in 2000; these focused on requiring the applicant to make a strong showing on the utility aspect of patentability and somewhat diminished the rush of biotech patent requests.

There are still other categories of patentable subjects. An improvement is an alteration of a process, machine, manufacture, or composition of matter that satisfies one of the tests for patentability given later in this section. New, original ornamental designs for articles of manufacture are patentable (e.g., the shape of a lamp); works of art are not patentable but are protected under the copyright law. New varieties of cultivated or hybridized plants are also patentable, as are genetically modified strains of soybean, corn, or other crops.

### **What May Not Be Patented**

Many things can be patented, but not (1) the laws of nature, (2) natural phenomena, and (3) abstract ideas, including algorithms (step-by-step formulas for accomplishing a specific task).

One frequently asked question is whether patents can be issued for computer software. The PTO was reluctant to do so at first, based on the notion that computer programs were not “novel”—the software program either incorporated automation of manual processes or used mathematical equations (which were not patentable). But in 1998, the Supreme Court held in *Diamond v. Diehr*, 450 U.S. 175 (1981). that patents could be obtained for a process that incorporated a computer program if the process itself was patentable.

A business process can also be patentable, as the US Court of Appeals for the Federal Circuit ruled in 1998 in *State Street Bank and Trust v. Signature Financial Group, Inc.*

*Street Bank and Trust v. Signature Financial Group, Inc.*, 149 F.3d 1368 (Fed. Cir. 1998). Signature Financial had a patent for a computerized accounting system that determined share prices through a series of mathematical calculations that would help manage mutual funds. State Street sued to challenge that patent. Signature argued that its model and process was protected, and the court of appeals upheld it as a “practical application of a mathematical, algorithm, formula, or calculation,” because it produces a “useful, concrete and tangible result.” Since *State Street*, many other firms have applied for business process patents. For example, Amazon.com obtained a business process patent for its “one-click” ordering system, a method of processing credit-card orders securely. (But see *Amazon.com v. Barnesandnoble.com*, *Amazon.com v. Barnesandnoble.com, Inc.*, 239 F.3d 1343 (Fed. Cir. 2001). in which the court of appeals rejected Amazon’s challenge to Barnesandnoble.com using its Express Land one-click ordering system.)

### Tests for Patentability

Just because an invention falls within one of the categories of patentable subjects, it is not necessarily patentable. The Patent Act and judicial interpretations have established certain tests that must first be met. To approve a patent application, the PTO (as part of the Department of Commerce) will require that the invention, discovery, or process be novel, useful, and nonobvious in light of current technology.

Perhaps the most significant test of patentability is that of obviousness. The act says that no invention may be patented “if the differences between the subject matter sought to be patented and the prior art are such that the subject matter as a whole would have been obvious at the time the invention was made to a person having ordinary skill in the art to which said subject matter pertains.” This provision of the law has produced innumerable court cases, especially over improvement patents, when those who wish to use an invention on which a patent has been issued have refused to pay royalties on the grounds that the invention was obvious to anyone who looked.

### Procedures for Obtaining a Patent

In general, the United States (unlike many other countries) grants a patent right to the first person to invent a product or process rather than to the first person to file for a patent on that product or process. As a practical matter, however, someone who invents a product or process but does not file immediately should keep detailed research notes or other evidence that would document the date of invention. An inventor who fails to apply for a patent within a year of that date would forfeit the rights granted to an inventor who had published details of the invention or offered it for sale. But until the year has passed, the PTO may not issue

a patent to X if Y has described the invention in a printed publication here or abroad or the invention has been in public use or on sale in this country.

An inventor cannot obtain a patent automatically; obtaining a patent is an expensive and time-consuming process, and the inventor will need the services of a patent attorney, a highly specialized practitioner. The attorney will help develop the required **specification**<sup>9</sup>, a description of the invention that gives enough detail so that one skilled in the art will be able to make and use the invention. After receiving an application, a PTO examiner will search the records and accept or reject the claim. Usually, the attorney will negotiate with the examiner and will rewrite and refine the application until it is accepted. A rejection may be appealed, first to the PTO's Board of Appeals and then, if that fails, to the federal district court in the District of Columbia or to the US Court of Appeals for the Federal Circuit, the successor court to the old US Court of Customs and Patent Appeals.

Once a patent application has been filed, the inventor or a company to which she has assigned the invention may put the words "patent pending" on the invention. These words have no legal effect. Anyone is free to make the invention as long as the patent has not yet been issued. But they do put others on notice that a patent has been applied for. Once the patent has been granted, infringers may be sued even if the infringer has made the product and offered it for sale before the patent was granted.

In today's global market, obtaining a US patent is important but is not usually sufficient protection. The inventor will often need to secure patent protection in other countries as well. Under the Paris Convention for the Protection of Industrial Property (1883), parties in one country can file for patent or trademark protection in any of the other member countries (172 countries as of 2011). The World Trade Organization's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) established standards for protecting intellectual property rights (patents, trademarks, and copyrights) and provides that each member nation must have laws that protect intellectual property rights with effective access to judicial systems for pursuing civil and criminal penalties for violations of such rights.

## Patent Ownership

The patent holder is entitled to make and market the invention and to exclude others from doing so. Because the patent is a species of property, it may be transferred. The inventor may assign part or all of his interest in the patent or keep the property interest and license others to manufacture or use the invention in return for payments known as royalties. The license may be exclusive with one licensee, or the inventor may license many to exploit the invention. One important

9. A description of the invention that gives enough detail so that one skilled in the art will be able to make and use the invention.

limitation on the inventor's right to the patent interest is the so-called shop right. This is a right created by state courts on equitable grounds giving employers a nonexclusive royalty-free license to use any invention made by an employee on company time and with company materials. The shop right comes into play only when a company has no express or implied understanding with its employees. Most corporate laboratories have contractual agreements with employees about who owns the invention and what royalties will be paid.

## Infringement and Invalidity Suits

Suits for patent infringement can arise in three ways: (1) the patent holder may seek damages and an injunction against the infringer in federal court, requesting damages for royalties and lost profits as well; (2) even before being sued, the accused party may take the patent holder to court under the federal Declaratory Judgment Act, seeking a court declaration that the patent is invalid; (3) the patent holder may sue a licensee for royalties claimed to be due, and the licensee may counterclaim that the patent is invalid. Such a suit, if begun in state court, may be removed to federal court.

In a federal patent infringement lawsuit, the court may grant the winning party reimbursement for attorneys' fees and costs. If the infringement is adjudged to be intentional, the court can triple the amount of damages awarded. Prior to 2006, courts were typically granting permanent injunctions to prevent future infringement. Citing *eBay, Inc. v. Merc Exchange, LLC*, *eBay, Inc. v. Merc Exchange, LLC*, 546 U.S. 388 (2006), the Supreme Court ruled that patent holders are not automatically entitled to a permanent injunction against infringement during the life of the patent. Courts have the discretion to determine whether justice requires a permanent injunction, and they may conclude that the public interest and equitable principles may be better satisfied with compensatory damages only.

Proving infringement can be a difficult task. Many companies employ engineers to "design around" a patent product—that is, to seek ways to alter the product to such an extent that the substitute product no longer consists of enough of the elements of the invention safeguarded by the patent. However, infringing products, processes, or machines need not be identical; as the Supreme Court said in *Sanitary Refrigerator Co. v. Winers*, *Sanitary Refrigerator Co. v. Winers*, 280 U.S. 30 (1929). "one device is an infringement of another...if two devices do the same work in substantially the same way, and accomplish substantially the same result...even though they differ in name, form, or shape." This is known as the **doctrine of equivalents**<sup>10</sup>. In an infringement suit, the court must choose between these two extremes: legitimate "design around" and infringement through some equivalent product.

10. The judicial doctrine that infringing products, processes, or machines need not be identical.



An infringement suit can often be dangerous because the defendant will almost always assert in its answer that the patent is invalid. The plaintiff patent holder thus runs the risk that his entire patent will be taken away from him if the court agrees. In ruling on validity, the court may consider all the tests, such as prior art and obviousness, discussed in [Section 23.1.2 "Patentability"](#) and rule on these independently of the conclusions drawn by the PTO.

### Patent Misuse

Although a patent is a monopoly granted to the inventor or his assignee or licensee, the monopoly power is legally limited. An owner who misuses the patent may find that he will lose an infringement suit. One common form of misuse is to tie the patented good to some unpatented one—for example, a patented movie projector that will not be sold unless the buyer agrees to rent films supplied only by the manufacturer of the movie projector, or a copier manufacturer that requires buyers to purchase plain paper from it. As we will see in ([Reference mayer 1.0-ch48 not found in Book](#)), various provisions of the federal antitrust laws, including, specifically, Section 3 of the Clayton Act, outlaw certain kinds of tying arrangements. Another form of patent misuse is a provision in the licensing agreement prohibiting the manufacturer from also making competing products. Although the courts have held against several other types of misuse, the general principle is that the owner may not use his patent to restrain trade in unpatented goods.

#### KEY TAKEAWAY

Many different “things” are patentable, include gene sequences, business processes, and any other “useful invention.” The US Patent and Trademark Office acts on initial applications and may grant a patent to an applicant. The patent, which allows a limited-time monopoly, is for twenty years. The categories of patentable things include processes, machines, manufactures, compositions of matter, and improvements. Ideas, mental processes, naturally occurring substances, methods of doing business, printed matter, and scientific principles cannot be patented. Patent holders may sue for infringement and royalties from an infringer user.

## EXERCISES

1. Calera, Inc. discovers a way to capture carbon dioxide emissions at a California power plant and use them to make cement. This is a win for the power company, which needs to reduce its carbon dioxide emissions, and a win for Calera. Calera decides to patent this invention. What kind of patent would this be? A machine? A composition of matter? A manufacture?
2. In your opinion, what is the benefit of allowing companies to isolate genetic material and claim a patent? What kind of patent would this be? A machine? A composition of matter? A manufacture?
3. How could a “garage inventor,” working on her own, protect a patentable invention while yet demonstrating it to a large company that could bring the invention to market?

## 23.2 Trade Secrets

### LEARNING OBJECTIVES

1. Describe the difference between trade secrets and patents, and explain why a firm might prefer keeping a trade secret rather than obtaining a patent.
2. Understand the dimensions of corporate espionage and the impact of the federal Economic Espionage Act.

### Definition of Trade Secrets

A patent is an invention publicly disclosed in return for a monopoly. A **trade secret**<sup>11</sup> is a means to a monopoly that a company hopes to maintain by preventing public disclosure. Why not always take out a patent? There are several reasons. The trade secret might be one that is not patentable, such as a customer list or an improvement that does not meet the tests of novelty or nonobviousness. A patent can be designed around; but if the trade secret is kept, its owner will be the exclusive user of it. Patents are expensive to obtain, and the process is extremely time consuming. Patent protection expires in twenty years, after which anyone is free to use the invention, but a trade secret can be maintained for as long as the secret is kept.

However, a trade secret is valuable only so long as it is kept secret. Once it is publicly revealed, by whatever means, anyone is free to use it. The critical distinction between a patent and a trade secret is this: a patent gives its owner the right to enjoin anyone who infringes it from making use of it, whereas a trade secret gives its “owner” the right to sue only the person who improperly took it or revealed it.

According to the Restatement of Torts, Section 757, Comment b, a trade secret may consist of

any formula, pattern, device or compilation of information which is used in one’s business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it. It may be a formula for a chemical compound, a process of manufacturing, treating or preserving materials, a pattern for a machine or other device, or a list of customers....A trade secret is a process or device for continuous use in the operation of a business. Generally it relates to the

11. A process, chemical formula, list, plan, or mechanism known only to an employer and those employees who need to know in order to use it in the business.

production of goods, as, for example, a machine or formula for the production of an article.

Other types of trade secrets are customer information, pricing data, marketing methods, sources of supply, and secret technical know-how.

## **Elements of Trade Secrets**

To be entitled to protection, a trade secret must be (1) original and (2) secret.

### **Originality**

The trade secret must have a certain degree of originality, although not as much as would be necessary to secure a patent. For example, a principle or technique that is common knowledge does not become a protectable trade secret merely because a particular company taught it to one of its employees who now wants to leave to work for a competitor.

### **Secrecy**

Some types of information are obviously secret, like the chemical formula that is jealously guarded through an elaborate security system within the company. But other kinds of information might not be secret, even though essential to a company's business. For instance, a list of suppliers that can be devised easily by reading through the telephone directory is not secret. Nor is a method secret simply because someone develops and uses it, if no steps are taken to guard it. A company that circulates a product description in its catalog may not claim a trade secret in the design of the product if the description permits someone to do "reverse engineering." A company that hopes to keep its processes and designs secret should affirmatively attempt to do so—for example, by requiring employees to sign a nondisclosure agreement covering the corporate trade secrets with which they work. However, a company need not go to every extreme to guard a trade secret.

Trade-secrets espionage has become a big business. To protect industrial secrets, US corporations spend billions on security arrangements. The line between competitive intelligence gathering and espionage can sometimes be difficult to draw. The problem is by no means confined to the United States; companies and nations all over the world have become concerned about theft of trade secrets to gain competitive advantage, and foreign governments are widely believed to be involved in espionage and cyberattacks.

## Economic Espionage Act

The Economic Espionage Act (EEA) of 1996 makes the theft or misappropriation of a trade secret a federal crime. The act is aimed at protecting commercial information rather than classified national defense information. Two sorts of activities are criminalized. The first section of the act Economic Espionage Act, 18 United States Code, Section 1831(a) (1996) criminalizes the misappropriation of trade secrets (including conspiracy to misappropriate trade secrets and the subsequent acquisition of such misappropriated trade secrets) with the knowledge or intent that the theft will benefit a foreign power. Penalties for violation are fines of up to US\$500,000 per offense and imprisonment of up to fifteen years for individuals, and fines of up to US\$10 million for organizations.

The second section Economic Espionage Act, 18 United States Code, Section 1832 (1996). criminalizes the misappropriation of trade secrets related to or included in a product that is produced for or placed in interstate (including international) commerce, with the knowledge or intent that the misappropriation will injure the owner of the trade secret. Penalties for violation are imprisonment for up to ten years for individuals (no fines) and fines of up to US\$5 million for organizations.

In addition to these specific penalties, the fourth section of the EEA Economic Espionage Act, 18 United States Code, Section 1834 (1996). also requires criminal forfeiture of (1) any proceeds of the crime and property derived from proceeds of the crime and (2) any property used, or intended to be used, in commission of the crime.

The EEA authorizes civil proceedings by the Department of Justice to enjoin violations of the act but does not create a private cause of action. This means that anyone believing they have been victimized must go through the US attorney general in order to obtain an injunction.

The EEA is limited to the United States and has no extraterritorial application unless (1) the offender is a US company or a citizen operating from abroad against a US company or (2) an act in furtherance of the espionage takes place in the United States. Other nations lack such legislation, and some may actively support industrial espionage using both their national intelligence services. The US Office of the National Counterintelligence Executive publishes an annual report, mandated by the US Congress, on foreign economic collection and industrial espionage, which outlines these espionage activities of many foreign nations.

## Right of Employees to Use Trade Secrets

A perennial source of lawsuits in the trade secrets arena is the employee who is hired away by a competitor, allegedly taking trade secrets along with him. Companies frequently seek to prevent piracy by requiring employees to sign confidentiality agreements. An agreement not to disclose particular trade secrets learned or developed on the job is generally enforceable. Even without an agreement, an employer can often prevent disclosure under principles of agency law. Sections 395 and 396 of the Restatement (Second) of Agency suggest that it is an actionable breach of duty to disclose to third persons information given confidentially during the course of the agency. However, every person is held to have a right to earn a living. If the rule were strictly applied, a highly skilled person who went to another company might be barred from using his knowledge and skills. The courts do not prohibit people from using elsewhere the general knowledge and skills they developed on the job. Only specific trade secrets are protected.

To get around this difficulty, some companies require their employees to sign agreements not to compete. But unless the agreements are limited in scope and duration to protect a company against only specific misuse of trade secrets, they are unenforceable.

### KEY TAKEAWAY

Trade secrets, if they can be kept, have indefinite duration and thus greater potential value than patents. Trade secrets can be any formula, pattern, device, process, or compilation of information to be used in a business. Customer information, pricing data, marketing methods, sources of supply, and technical know-how could all be trade secrets. State law has protected trade secrets, and federal law has provided criminal sanctions for theft of trade secrets. With the importance of digitized information, methods of theft now include computer hacking; theft of corporate secrets is a burgeoning global business that often involves cyberattacks.

## EXERCISES

1. Wu Dang, based in Hong Kong, hacks into the Hewlett-Packard database and “steals” plans and specifications for HP’s latest products. The HP server is located in the United States. He sells this information to a Chinese company in Shanghai. Has he violated the US Economic Espionage Act?
2. What are the advantages of keeping a formula as a trade secret rather than getting patent protection?

## 23.3 Copyright

### LEARNING OBJECTIVES

1. Describe and explain copyrights, how to obtain one, and how they differ from trademarks.
2. Explain the concept of fair use and describe its limits.

### Definition and Duration

Copyright is the legal protection given to “authors” for their “writings.” Copyright law is federal; like patent law, its source lies in the Constitution. Copyright protects the expression of ideas in some tangible form, but it does not protect the ideas themselves. Under the 1976 Copyright Act as amended, a copyright in any work created after January 1, 1978, begins when the work is fixed in tangible form—for example, when a book is written down or a picture is painted—and generally lasts for the life of the author plus 70 years after his or her death. This is similar to copyright protection in many countries, but in some countries, the length of copyright protection is the life of the author plus 50 years. For copyrights owned by publishing houses, done as works for hire, common copyright expires 95 years from the date of publication or 120 years from the date of creation, whichever is first. For works created before 1978, such as many of Walt Disney’s movies and cartoons, the US Sonny Bono Copyright Term Extension Act of 1998 provided additional protection of up to 95 years from publication date. Thus works created in 1923 by Disney would not enter the public domain until 2019 or after, unless the copyright had expired prior to 1998 or unless the Disney company released the work into the public domain. In general, after expiration of the copyright, the work enters the **public domain**<sup>12</sup>.

In 1989, the United States signed the Berne Convention, an international copyright treaty. This law eliminated the need to place the symbol © or the word *Copyright* or the abbreviation *Copr.* on the work itself. Copyrights can be registered with the US Copyright Office in Washington, DC.

### Protected Expression

The Copyright Act protects a variety of “writings,” some of which may not seem written at all. These include literary works (books, newspapers, and magazines), music, drama, choreography, films, art, sculpture, and sound recordings. Since

12. Once a copyright has expired, the material enters the public domain, meaning that no one can claim exclusive rights in the material.



copyright covers the expression and not the material or physical object, a book may be copyrighted whether it is on paper, microfilm, tape, or computer disk.

## Rights Protected by the Copyright Act

### Preventing Copying

A copyright gives its holder the right to prevent others from copying his or her work. The copyright holder has the exclusive right to reproduce the work in any medium (paper, film, sound recording), to perform it (e.g., in the case of a play), or to display it (a painting or film). A copyright also gives its holder the exclusive right to prepare derivative works based on the copyrighted work. Thus a playwright could not adapt to the stage a novelist's book without the latter's permission.

### Fair Use

One major exception to the exclusivity of copyrights is the **fair use doctrine**<sup>13</sup>. Section 107 of the Copyright Act provides as follows:

Fair use of a copyrighted work, including such use by reproduction in copies or phonorecords or by any other means specified by section 106 of the copyright, for purposes such as criticism, comment, news reporting, teaching (including multiple copies for classroom use), scholarship, or research, is not an infringement of copyright. In determining whether the use made of a work in any particular case is a fair use, the factors to be considered shall include—

- (1) the purpose and character of the use, including whether such use is of a commercial nature or is for nonprofit educational purposes;
- (2) the nature of the copyrighted work;
- (3) the amount and substantiality of the portion used in relation to the copyrighted work as a whole; and
- (4) the effect of the use upon the potential market for or value of the copyrighted work.<sup>17</sup> United States Code, Section 107.

13. Use of copyrighted material in criticism, comment, news reporting, teaching (including multiple copies for classroom use), scholarship, or research that does not significantly reduce the market for the copyrighted material.

These are broad guidelines. Accordingly, any copying could be infringement, and fair use could become a question of fact on a case-by-case basis. In determining fair use, however, courts have often considered the fourth factor (effect of the use upon the potential market for the copyrighted work) to be the most important.

Clear examples of fair use would be when book reviewers or writers quote passages from copyrighted books. Without fair use, most writing would be useless because it could not readily be discussed. But the doctrine of fair use grew more troublesome with the advent of plain-paper copiers and is now even more troublesome with electronic versions of copyrighted materials that are easily copied and distributed. The 1976 act took note of the new copier technology, listing “teaching (including multiple copies for classroom use)” as one application of fair use. The Copyright Office follows guidelines specifying just how far the copying may go—for example, multiple copies of certain works may be made for classroom use, but copies may not be used to substitute for copyrighted anthologies.

### **Infringement**

Verbatim use of a copyrighted work is easily provable. The more difficult question arises when the copyrighted work is altered in some way. As in patent law, the standard is one of substantial similarity.

### **Copyrightability Standards**

To be subject to copyright, the writing must be “fixed” in some “tangible medium of expression.” A novelist who composes a chapter of her next book in her mind and tells it to a friend before putting it on paper could not stop the friend from rushing home, writing it down, and selling it (at least the federal copyright law would offer no protection; some states might independently offer a legal remedy, however).

The work also must be creative, at least to a minimal degree. Words and phrases, such as names, titles, and slogans, are not copyrightable; nor are symbols or designs familiar to the public. But an author who contributes her own creativity—like taking a photograph of nature—may copyright the resulting work, even if the basic elements of the composition were not of her making.

Finally, the work must be “original,” which means simply that it must have originated with the author. The law does not require that it be novel or unique. This requirement was summarized pithily by Judge Learned Hand: “If by some magic a man who had never known it were to compose anew Keats’s Ode on a Grecian Urn, he would be an author, and, if he copyrighted it, others might not copy that poem, though they might of course copy Keats’s.” *Sheldon v. Metro-Goldwyn Pictures Corp.*, 81 F.2d 49 (2d Cir. 1936). Sometimes the claim is made that a composer, for example, just happened to compose a tune identical or strikingly similar to a copyrighted song; rather than assume the unlikely coincidence that Judge Hand hypothesized, the courts will look for evidence that the alleged copier had access to the copyrighted song. If he did—for example, the song was frequently played on the

air—he cannot defend the copying with the claim that it was unconscious, because the work would not then have been original.

Section 102 of the Copyright Act excludes copyright protection for any “idea, procedure, process, system, method of operation, concept, principle, or discovery, regardless of the form in which it is described, explained, illustrated, or embodied.”<sup>17</sup> United States Code, Section 102.

Einstein copyrighted books and monographs he wrote on the theory of relativity, but he could not copyright the famous formula  $E = mc^2$ , nor could he prevent others from writing about the theory. But he could protect the particular way in which his ideas were expressed. In general, facts widely known by the public are not copyrightable, and mathematical calculations are not copyrightable. Compilations of facts may be copyrightable, if the way that they are coordinated or arranged results in a work that shows some originality. For example, compiled information about yachts listed for sale may qualify for copyright protection. *BUC International Corp. v. International Yacht Council, Ltd.*, 489 F.3d 1129 (11th Cir. 2007).

One of the most troublesome recent questions concerning expression versus ideas is whether a computer program may be copyrighted. After some years of uncertainty, the courts have accepted the copyrightability of computer programs. *Apple Computer, Inc. v. Franklin Computer Corp.*, 714 F.2d 1240 (3d Cir. 1983). Now the courts are wrestling with the more difficult question of the scope of protection: what constitutes an “idea” and what constitutes its mere “expression” in a program.

How far the copyright law will protect particular software products is a hotly debated topic, sparked by a federal district court’s ruling in 1990 that the “look and feel” of Lotus 1-2-3’s menu system is copyrightable and was in fact infringed by Paperback Software’s VP-Planner, a competing spreadsheet. *Lotus Development Corp. v. Paperback Software International*, 740 F.Supp. 37 (D. Mass. 1990). The case has led some analysts to “fear that legal code, rather than software code, is emerging as the factor that will determine which companies and products will dominate the 1990s.” Peter H. Lewis, “When Computing Power Is Generated by the Lawyers,” *New York Times*, July 22 1990.

### Who May Obtain a Copyright?

With one important exception, only the author may hold the initial copyright, although the author may assign it or license any one or more of the rights conveyed by the copyright. This is a simple principle when the author has written a book or painted a picture. But the law is unclear in the case of a motion picture or a sound recording. Is the author the script writer, the producer, the performer, the director,

the engineer, or someone else? As a practical matter, all parties involved spell out their rights by contract.

The exception, which frequently covers the difficulties just enumerated, is for works for hire. Any person employed to write—a journalist or an advertising jingle writer, for example—is not the “author.” For purposes of the statute, the employer is the author and may take out the copyright. When the employee is in fact an “independent contractor” and the work in question involves any one of nine types (book, movies, etc.) spelled out in the Copyright Act, the employer and the creator must spell out their entitlement to the copyright in a written agreement. *Community for Creative Non-Violence v. Reid*, 109 S.Ct. 2166 (1989).

### Obtaining a Copyright

Until 1978, a work could not be copyrighted unless it was registered in the Copyright Office or was published and unless each copy of the work carried a copyright notice, consisting of the word *Copyright*, the abbreviation *Copr.*, or the common symbol ©, together with the date of first publication and the name of the copyright owner. Under the 1976 act, copyright became automatic whenever the work was fixed in a tangible medium of expression (e.g., words on paper, images on film or videotape, sound on tape or compact disc), even if the work remained unpublished or undistributed. However, to retain copyright protection, the notice had to be affixed once the work was “published” and copies circulated to the public. After the United States entered the Berne Convention, an international treaty governing copyrights, Congress enacted the Berne Implementation Act, declaring that, effective in 1989, notice, even after publication, was no longer required.

Notice does, however, confer certain benefits. In the absence of notice, a copyright holder loses the right to receive statutory damages (an amount stated in the Copyright Act and not required to be proved) if someone infringes the work. Also, although it is no longer required, an application and two copies of the work (for deposit in the Library of Congress) filed with the Copyright Office, in Washington, DC, will enable the copyright holder to file suit should the copyright be infringed. Unlike patent registration, which requires elaborate searching of Patent and Trademark Office (PTO) records, copyright registration does not require a reading of the work to determine whether it is an original creation or an infringement of someone else’s prior work. But copyright registration does not immunize the holder from an infringement suit. If a second work has been unlawfully copied from an earlier work, the second author’s copyright will not bar the infringed author from collecting damages and obtaining an injunction.

## Computer Downloads and the Digital Millennium Copyright Act

The ubiquity of the Internet and the availability of personal computers with large capacities have greatly impacted the music business. Sharing of music files took off in the late 1990s with Napster, which lost a legal battle on copyright and had to cease doing business. By providing the means by which individuals could copy music that had been purchased, major record labels were losing substantial profits. Grokster, a privately owned software company based in the West Indies, provided peer-to-peer file sharing from 2001 to 2005 until the US Supreme Court's decision in *MGM Studios, Inc. v. Grokster, Ltd.*, 545 U.S. 913 (2005).

For computers with the Microsoft operating system, the Court disallowed the peer-to-peer file sharing, even though Grokster claimed it did not violate any copyright laws because no files passed through its computers. (Grokster had assigned certain user computers as "root supernodes" that acted as music hubs for the company and was not directly involved in controlling any specific music-file downloads.)

Grokster had argued, based on *Sony v. Universal Studios*, 464 U.S. 417 (1984), that the sale of its copying equipment (like the Betamax videocassette recorders at issue in that case) did not constitute contributory infringement "if the product is widely used for legitimate, unobjectionable purposes." Plaintiffs successfully argued that the Sony safe-harbor concept requires proof that the noninfringing use is the primary use in terms of the product's utility.

The Digital Millennium Copyright Act (DMCA), passed into law in 1998, implements two 1996 treaties of the World Intellectual Property Organization. It criminalizes production and sale of devices or services intended to get around protective measures that control access to copyrighted works. In addition, the DMCA heightens the penalties for copyright infringement on the Internet. The DMCA amended Title 17 of the United States Code to extend the reach of copyright, while limiting the liability of the providers of online services for copyright infringement by their users.

### KEY TAKEAWAY

Copyright is the legal protection given to “authors” for their “writings.” It protects ideas in fixed, tangible form, not ideas themselves. Copyright protection can extend as long as 120 years from the date of creation or publication. Expression found in literary works, music, drama, film, art, sculpture, sound recordings, and the like may be copyrighted. The fair use doctrine limits the exclusivity of copyright in cases where scholars, critics, or teachers use only selected portions of the copyrighted material in a way that is unlikely to affect the potential market for or value of the copyrighted work.

### EXERCISES

1. Explain how a list could be copyrightable.
2. An author wrote a novel, *Brunch at Bruno's*, in 1961. She died in 1989, and her heirs now own the copyright. When do the rights of the heirs come to an end? That is, when does *Brunch at Bruno's* enter the public domain?
3. Keith Bradsher writes a series of articles on China for the *New York Times* and is paid for doing so. Suppose he wants to leave the employ of the *Times* and be a freelance writer. Can he compile his best articles into a book, *Changing Times in China*, and publish it without the *New York Times's* permission? Does it matter that he uses the word *Times* in his proposed title?
4. What kind of file sharing of music is now entirely legal? Shaunese Collins buys a Yonder Mountain String Band CD at a concert at Red Rocks in Morrison, Colorado. With her iMac, she makes a series of CDs for her friends. She does this six times. Has she committed six copyright violations?

## 23.4 Trademarks

### LEARNING OBJECTIVES

1. Understand what a trademark is and why it deserves protection.
2. Know why some “marks” may not be eligible for trademark protection, and how to obtain trademark protection for those that are.
3. Explain what “blurring” and “tarnishment” are and what remedies are available to the holder of the mark.

### Definitions of Trademarks

A trademark is defined in the federal Lanham Act of 1946 as “any word, name, symbol, or device or any combination thereof adopted and used by a manufacturer or merchant to identify his goods and distinguish them from goods manufactured or sold by others.”<sup>15</sup> United States Code, Section 1127.

Examples of well-known trademarks are Coca-Cola, Xerox, and Apple. A **service mark**<sup>14</sup> is used in the sale or advertising of services to identify the services of one person and distinguish them from the services of others. Examples of service marks are McDonald’s, BP, and Hilton. A **certification mark**<sup>15</sup> is used in connection with many products “to certify regional or other origin, material, mode of manufacture, quality, accuracy or other characteristics of such goods or services or that the work or labor on the goods or services was performed by members of a union or other organization.” Examples are the Good Housekeeping Seal of Approval and UL (Underwriters Laboratories, Inc., approval mark). Unlike other forms of trademark, the owner of the certification mark (e.g., Good Housekeeping, or the Forest Stewardship Council’s FSC mark) is not the owner of the underlying product.

### Extent of Trademark Protection

#### Kinds of Marks

Trademarks and other kinds of marks may consist of words and phrases, pictures, symbols, shapes, numerals, letters, slogans, and sounds. Trademarks are a part of our everyday world: the sounds of a radio or television network announcing itself (NBC, BBC), the shape of a whiskey bottle (Haig & Haig’s Pinch Bottle), a series of initials (GE, KPMG, IBM), or an animal’s warning growl (MGM’s lion).

14. Used in the sale or advertising of services to identify the services of one person and distinguish them from the services of others.
15. A mark placed on a product or used in connection with a service that signifies the product or service as having met the standard set by the certifying entity.

### Limitations on Marks

Although trademarks abound, the law limits the subjects that may fall into one of the defined categories. Not every word or shape or symbol will be protected in an infringement action. To qualify for protection, a trademark must be used to identify and distinguish. The courts employ a four-part test: (1) Is the mark so arbitrary and fanciful that it merits the widest protection? (2) Is it “suggestive” enough to warrant protection without proof of secondary meaning? (3) Is it “descriptive,” warranting protection if secondary meaning is proved? (4) Is the mark generic and thus unprotectable?

These tests do not have mechanical answers; they call for judgment. Some marks are wholly fanciful, clearly identify origin of goods, and distinguish them from others—Kodak, for example. Other marks may not be so arbitrary but may nevertheless be distinctive, either when adopted or as a result of advertising—for example, Crest, as the name of a toothpaste.

Marks that are merely descriptive of the product are entitled to protection only if it can be shown that the mark has acquired **secondary meaning**<sup>16</sup>. This term reflects a process of identification on the mark in the public mind with the originator of the product. Holiday Inn was initially deemed too descriptive: an inn where people might go on holiday. But over time, travelers came to identify the source of the Great Sign and the name Holiday Inn as the Holiday Inn Corporation in Memphis, and secondary meaning was granted. Holiday Inn could thus protect its mark against other innkeepers, hoteliers, and such; however, the trademark protection for the words Holiday Inn was limited to the corporation’s hotel and motel business, and no other.

Certain words and phrases may not qualify at all for trademark protection. These include generic terms like “straw broom” (for a broom made of straw) and ordinary words like “fast food.” In one case, a federal appeals court held that the word “Lite” is generic and cannot be protected by a beer manufacturer to describe a low-calorie brew. *Miller Brewing Co. v. Falstaff Brewing Corp.*, 655 F.2d 5 (1st Cir. 1981). Donald Trump’s effort to trademark “You’re fired!” and Paris Hilton’s desire to trademark “That’s hot!” were also dismissed as being generic.

Deceptive words will not be accepted for registration. Thus the US Patent and Trademark Office (PTO) denied registration to the word *Vynahyde* because it suggested that the plastic material to which it was applied came from animal skin. Geographic terms are descriptive words and may not be used as protected trademarks unless they have acquired a secondary meaning, such as Hershey when used for chocolates. (Hershey’s chocolates are made in Hershey, Pennsylvania.) A

16. A descriptive or generic word or phrase that would otherwise not qualify for trademark protection may be eligible once it acquires secondary meaning—that is, that the origin of the goods or services becomes identified with a particular source or provider and the mark makes that connection in the public’s mind.



design that reflects a common style cannot be protected in a trademark to exclude other similar designs in the same tradition. Thus the courts have ruled that a silverware pattern that is a “functional feature” of the “baroque style” does not qualify for trademark protection. Finally, the Lanham Act denies federal registration to certain marks that fall within categories of words and shapes, including the following: the flag; the name, portrait, or signature of any living person without consent, or of a deceased US president during the lifetime of his widow; and immoral, deceptive, or scandalous matter (in an earlier era, the phrase “Bubby Trap” for brassieres was denied registration).

### **Dilution, Tarnishment, and Blurring**

Under the federal Trademark Dilution Act of 1995, companies with marks that dilute the value of a senior mark may be liable for damages. The act provides that owners of marks of significant value have property rights that should not be eroded, blurred, tarnished, or diluted in any way by another. But as a plaintiff, the holder of the mark must show (1) that it is a famous mark, (2) that the use of a similar mark is commercial, and (3) that such use causes dilution of the distinctive quality of the mark. Thus a T-shirt maker who promotes a red-and-white shirt bearing the mark Buttweiser may be liable to Anheuser-Busch, or a pornographic site called Candyland could be liable to Parker Brothers, the board game company. Interesting cases have already been brought under this act, including a case brought by Victoria’s Secret against a small adult store in Kentucky called Victor’s Little Secret. Notice that unlike most prior trademark law, the purpose is not to protect the consumer from confusion as to the source or origin of the goods or services being sold; for example, no one going to the Candyland site would think that Parker Brothers was the source.

### **Acquiring Trademark Rights**

For the first time in more than forty years, Congress, in 1988, changed the way in which trademarks can be secured. Under the Lanham Act, the fundamental means of obtaining a trademark was through use. The manufacturer or distributor actually must have placed the mark on its product—or on related displays, labels, shipping containers, advertisements, and the like—and then have begun selling the product. If the product was sold in interstate commerce, the trademark was entitled to protection under the Lanham Act (or if not, to protection under the common law of the state in which the product was sold).

Under the Trademark Law Revision Act of 1988, which went into effect in 1989, trademarks can be obtained in advance by registering with the PTO an intention to use the mark within six months (the applicant can gain extensions of up to thirty more months to put the mark into use). Once obtained, the trademark will be

protected for ten years (before the 1988 revision, a federal trademark remained valid for twenty years); if after that time the mark is still being used, the registration can be renewed. Obtaining a trademark registration lies between obtaining patents and obtaining copyrights in difficulty. The PTO will not routinely register a trademark; it searches its records to ensure that the mark meets several statutory tests and does not infringe another mark. Those who feel that their own marks would be hurt by registration of a proposed mark may file an **opposition proceeding**<sup>17</sup> with the PTO. Until 1990, the office received about 77,000 applications each year. With the change in procedure, some experts predicted that applications would rise by 30 percent.

In many foreign countries, use need not be shown to obtain trademark registration. It is common for some people in these countries to register marks that they expect to be valuable so that they can sell the right to use the mark to the company that established the mark's value. Companies that expect to market abroad should register their marks early.

### Loss of Rights

Trademark owners may lose their rights if they abandon the mark, if a patent or copyright expires on which the mark is based, or if the mark becomes generic. A mark is abandoned if a company goes out of business and ceases selling the product. Some marks are based on design patents; when the patent expires, the patent holder will not be allowed to extend the patent's duration by arguing that the design or name linked with the design is a registrable trademark.

The most widespread difficulty that a trademark holder faces is the prospect of too much success: if a trademark comes to stand generically for the product itself, it may lose exclusivity in the mark. Famous examples are aspirin, escalator, and cellophane. The threat is a continual one. Trademark holders can protect themselves from their marks' becoming generic in several ways.

1. Use a descriptive term along with the trademark. Look on a jar of Vaseline and you will see that the label refers to the contents as Vaseline petroleum jelly.
2. Protest generic use of the mark in all publications by writing letters and taking out advertisements.
3. Always put the words Trademark, Registered Trademark, or the symbol ® (meaning "registered") next to the mark itself, which should be capitalized.

17. Those who feel that their own marks would be hurt by registration of a proposed mark may file an opposition proceeding in the US Patent and Trademark Office.

### KEY TAKEAWAY

Trademark protection is federal, under the Lanham Act. Branding of corporate logos, names, and products is essential to business success, and understanding trademarks is pivotal to branding. A “mark” must be distinctive, arbitrary, or fanciful to merit protection: this means that it must not be generic or descriptive. Marks can be words, symbols, pictures, slogans, sounds, phrases, and even shapes. In the United States, rights to marks are obtained by registration and intent to use in commerce and must be renewed every ten years.

### EXERCISES

1. How will Google protect its trademark, assuming that people begin using “google” as a verb substitute for “Internet search,” just like people began using the word “cellophane” for all brands of plastic wrap?
2. Do a small amount of web searching and find out what “trade dress” protection is, and how it differs from trademark protection.
3. LexisNexis is a brand for a database collection offered by Mead Data Central. Lexus is a high-end automobile. Can Lexus succeed in getting Mead Data Central to stop using “Lexis” as a mark?

## 23.5 Cases

### Fair Use in Copyright

Elvis Presley Enterprises et al. v. Passport Video et al.

349 F.3d 622 (9th Circuit Court of Appeals, 2003)

TALLMAN, CIRCUIT JUDGE:

Plaintiffs are a group of companies and individuals holding copyrights in various materials relating to Elvis Presley. For example, plaintiff SOFA Entertainment, Inc., is the registered owner of several Elvis appearances on *The Ed Sullivan Show*. Plaintiff Promenade Trust owns the copyright to two television specials featuring Elvis: *The Elvis 1968 Comeback Special* and *Elvis Aloha from Hawaii....* Many Plaintiffs are in the business of licensing their copyrights. For example, SOFA Entertainment charges \$10,000 per minute for use of Elvis' appearances on *The Ed Sullivan Show*.

Passport Entertainment and its related entities (collectively "Passport") produced and sold *The Definitive Elvis*, a 16-hour video documentary about the life of Elvis Presley. *The Definitive Elvis* sold for \$99 at retail. Plaintiffs allege that thousands of copies were sent to retail outlets and other distributors. On its box, *The Definitive Elvis* describes itself as an all-encompassing, in-depth look at the life and career of a man whose popularity is unrivaled in the history of show business and who continues to attract millions of new fans each year....

*The Definitive Elvis* uses Plaintiffs' copyrighted materials in a variety of ways. With the video footage, the documentary often uses shots of Elvis appearing on television while a narrator or interviewee talks over the film. These clips range from only a few seconds in length to portions running as long as 30 seconds. In some instances, the clips are the subject of audio commentary, while in other instances they would more properly be characterized as video "filler" because the commentator is discussing a subject different from or more general than Elvis' performance on a particular television show. But also significant is the frequency with which the copyrighted video footage is used. *The Definitive Elvis* employs these clips, in many instances, repeatedly. In total, at least 5% to 10% of *The Definitive Elvis* uses Plaintiffs' copyrighted materials.

Use of the video footage, however, is not limited to brief clips....Thirty-five percent of his appearances on *The Ed Sullivan Show* is replayed, as well as three minutes from *The 1968 Comeback Special*.

\* \* \*

Plaintiffs sued Passport for copyright infringement....Passport, however, asserts that its use of the copyrighted materials was “fair use” under 17 U.S.C. § 107. Plaintiffs moved for a preliminary injunction, which was granted by the district court after a hearing. The district court found that Passport’s use of Plaintiffs’ copyrighted materials was likely not fair use. The court enjoined Passport from selling or distributing *The Definitive Elvis*. Passport timely appeals.

\* \* \*

We first address the purpose and character of Passport’s use of Plaintiffs’ copyrighted materials. Although not controlling, the fact that a new use is commercial as opposed to non-profit weighs against a finding of fair use. *Harper & Row Publishers, Inc. v. Nation Enters.*, 471 U.S. 539, 562, 85 L. Ed. 2d 588, 105 S.Ct. 2218 (1985). And the degree to which the new user exploits the copyright for commercial gain—as opposed to incidental use as part of a commercial enterprise—affects the weight we afford commercial nature as a factor. More importantly for the first fair-use factor, however, is the “transformative” nature of the new work. Specifically, we ask “whether the new work...merely supersedes the objects of the original creation, or instead adds something new, with a further purpose or different character, altering the first with new expression, meaning, or message....” The more transformative a new work, the less significant other inquiries, such as commercialism, become.

\* \* \*

The district court below found that the purpose and character of *The Definitive Elvis* will likely weigh against a finding of fair use. We cannot say, based on this record, that the district court abused its discretion.

First, Passport’s use, while a biography, is clearly commercial in nature. But more significantly, Passport seeks to profit directly from the copyrights it uses without a license. One of the most salient selling points on the box of *The Definitive Elvis* is that “Every Film and Television Appearance is represented.” Passport is not advertising a scholarly critique or historical analysis, but instead seeks to profit at least in part from the inherent entertainment value of Elvis’ appearances on such shows as *The*

*Steve Allen Show, The Ed Sullivan Show, and The 1968 Comeback Special*. Passport's claim that this is scholarly research containing biographical comments on the life of Elvis is not dispositive of the fair use inquiry.

Second, Passport's use of Plaintiffs' copyrights is not consistently transformative. True, Passport's use of many of the television clips is transformative because the clips play for only a few seconds and are used for reference purposes while a narrator talks over them or interviewees explain their context in Elvis' career. But voice-overs do not necessarily transform a work....

It would be impossible to produce a biography of Elvis without showing some of his most famous television appearances for reference purposes. But some of the clips are played without much interruption, if any. The purpose of showing these clips likely goes beyond merely making a reference for a biography, but instead serves the same intrinsic entertainment value that is protected by Plaintiffs' copyrights.

\* \* \*

The third factor is the amount and substantiality of the portion used in relation to the copyrighted work as a whole. This factor evaluates both the quantity of the work taken and the quality and importance of the portion taken. Regarding the quantity, copying "may not be excused merely because it is insubstantial with respect to the *infringing* work." *Harper & Row*, 471 U.S. at 565 (emphasis in original). But if the amount used is substantial with respect to the infringing work, it is evidence of the value of the copy-righted work.

Passport's use of clips from television appearances, although in most cases of short duration, were repeated numerous times throughout the tapes. While using a small number of clips to reference an event for biographical purposes seems fair, using a clip over and over will likely no longer serve a biographical purpose. Additionally, some of the clips were not short in length. Passport's use of Elvis' appearance on *The Steve Allen Show* plays for over a minute and many more clips play for more than just a few seconds.

Additionally, although the clips are relatively short when compared to the entire shows that are copyrighted, they are in many instances the heart of the work. What makes these copyrighted works valuable is Elvis' appearance on the shows, in many cases singing the most familiar passages of his most popular songs. Plaintiffs are in the business of licensing these copyrights. Taking key portions extracts the most valuable part of Plaintiffs' copyrighted works. With respect to the photographs, the

entire picture is often used. The music, admittedly, is usually played only for a few seconds.

\* \* \*

The last, and “undoubtedly the single most important” of all the factors, is the effect the use will have on the potential market for and value of the copyrighted works. *Harper & Row*, 471 U.S. at 566. We must “consider not only the extent of market harm caused by the particular actions of the alleged infringer, but also whether unrestricted and widespread conduct of the sort engaged in by the defendant...would result in a substantially adverse impact on the potential market for the original.” *Campbell*, 510 U.S. at 590. The more transformative the new work, the less likely the new work’s use of copyrighted materials will affect the market for the materials. Finally, if the purpose of the new work is commercial in nature, “the likelihood [of market harm] may be presumed.” *A&M Records*, 239 F.3d at 1016 (quoting *Sony*, 464 U.S. at 451).

The district court found that Passport’s use of Plaintiffs’ copyrighted materials likely does affect the market for those materials. This conclusion was not clearly erroneous.

First, Passport’s use is commercial in nature, and thus we can assume market harm. Second, Passport has expressly advertised that *The Definitive Elvis* contains the television appearances for which Plaintiffs normally charge a licensing fee. If this type of use became wide-spread, it would likely undermine the market for selling Plaintiffs’ copyrighted material. This conclusion, however, does not apply to the music and still photographs. It seems unlikely that someone in the market for these materials would purchase *The Definitive Elvis* instead of a properly licensed product. Third, Passport’s use of the television appearances was, in some instances, not transformative, and therefore these uses are likely to affect the market because they serve the same purpose as Plaintiffs’ original works.

\* \* \*

We emphasize that our holding today is not intended to express how we would rule were we examining the case *ab initio* as district judges. Instead, we confine our review to whether the district court abused its discretion when it weighed the four statutory fair-use factors together and determined that Plaintiffs would likely succeed on the merits. Although we might view this case as closer than the district court saw it, we hold there was no abuse of discretion in the court’s decision to grant Plaintiffs’ requested relief.

AFFIRMED.

### CASE QUESTIONS

1. How would you weigh the four factors in this case? If the trial court had found fair use, would the appeals court have overturned its ruling?
2. Why do you think that the fourth factor is especially important?
3. What is the significance of the discussion on “transformative” aspects of the defendant’s product?

## Trademark Infringement and Dilution

Playboy Enterprises v. Welles

279 F.3d 796 (9th Circuit Court of Appeals, 2001)

T. G. NELSON, Circuit Judge:

Terri Welles was on the cover of Playboy in 1981 and was chosen to be the Playboy Playmate of the Year for 1981. Her use of the title “Playboy Playmate of the Year 1981,” and her use of other trademarked terms on her website are at issue in this suit. During the relevant time period, Welles’ website offered information about and free photos of Welles, advertised photos for sale, advertised memberships in her photo club, and promoted her services as a spokesperson. A biographical section described Welles’ selection as Playmate of the Year in 1981 and her years modeling for PEI. The site included a disclaimer that read as follows: “This site is neither endorsed, nor sponsored, nor affiliated with Playboy Enterprises, Inc. PLAYBOY tm PLAYMATE OF THE YEAR tm AND PLAYMATE OF THE MONTH tm are registered trademarks of Playboy Enterprises, Inc.”

Wells used (1) the terms “Playboy ”and “Playmate” in the metatags of the website; (2) the phrase “Playmate of the Year 1981” on the masthead of the website; (3) the phrases “Playboy Playmate of the Year 1981” and “Playmate of the Year 1981” on various banner ads, which may be transferred to other websites; and (4) the repeated use of the abbreviation “PMOY ’81” as the watermark on the pages of the website. PEI claimed that these uses of its marks constituted trademark infringement, dilution, false designation of origin, and unfair competition. The district court granted defendants’ motion for summary judgment. PEI appeals the grant of summary judgment on its infringement and dilution claims. We affirm in part and reverse in part.



A. Trademark Infringement

Except for the use of PEI's protected terms in the wallpaper of Welles' website, we conclude that Welles' uses of PEI's trademarks are permissible, nominative uses. They imply no current sponsorship or endorsement by PEI. Instead, they serve to identify Welles as a past PEI "Playmate of the Year."

We articulated the test for a permissible, nominative use in *New Kids On The Block v. New America Publishing, Inc.* The band, New Kids On The Block, claimed trademark infringement arising from the use of their trademarked name by several newspapers. The newspapers had conducted polls asking which member of the band New Kids On The Block was the best and most popular. The papers' use of the trademarked term did not fall within the traditional fair use doctrine. Unlike a traditional fair use scenario, the defendant newspaper was using the trademarked term to describe not its own product, but the plaintiff's. Thus, the factors used to evaluate fair use were inapplicable. The use was nonetheless permissible, we concluded, based on its nominative nature.

We adopted the following test for nominative use:

First, the product or service in question must be one not readily identifiable without use of the trademark; second, only so much of the mark or marks may be used as is reasonably necessary to identify the product or service; and third, the user must do nothing that would, in conjunction with the mark, suggest sponsorship or endorsement by the trademark holder.

We group the uses of PEI's trademarked terms into three for the purpose of applying the test for nominative use.

1. Headlines and banner advertisements.

...

The district court properly identified Welles' situation as one which must... be excepted. No descriptive substitute exists for PEI's trademarks in this context....Just as the newspapers in *New Kids* could only identify the band clearly by using its trademarked name, so can Welles only identify herself clearly by using PEI's trademarked title.

The second part of the nominative use test requires that “only so much of the mark or marks may be used as is reasonably necessary to identify the product or service[.]” *New Kids* provided the following examples to explain this element: “[A] soft drink competitor would be entitled to compare its product to Coca-Cola or Coke, but would not be entitled to use Coca-Cola’s distinctive lettering.” Similarly, in a past case, an auto shop was allowed to use the trademarked term “Volkswagen” on a sign describing the cars it repaired, in part because the shop “did not use Volkswagen’s distinctive lettering style or color scheme, nor did he display the encircled ‘VW’ emblem.” Welles’ banner advertisements and headlines satisfy this element because they use only the trademarked words, not the font or symbols associated with the trademarks.

The third element requires that the user do “nothing that would, in conjunction with the mark, suggest sponsorship or endorsement by the trademark holder.” As to this element, we conclude that aside from the wallpaper, which we address separately, Welles does nothing in conjunction with her use of the marks to suggest sponsorship or endorsement by PEI. The marks are clearly used to describe the title she received from PEI in 1981, a title that helps describe who she is. It would be unreasonable to assume that the Chicago Bulls sponsored a website of Michael Jordan’s simply because his name appeared with the appellation “former Chicago Bull.” Similarly, in this case, it would be unreasonable to assume that PEI currently sponsors or endorses someone who describes herself as a “Playboy Playmate of the Year in 1981.” The designation of the year, in our case, serves the same function as the “former” in our example. It shows that any sponsorship or endorsement occurred in the past.

For the foregoing reasons, we conclude that Welles’ use of PEI’s marks in her headlines and banner advertisements is a nominative use excepted from the law of trademark infringement.

## 2. Metatags

Welles includes the terms “playboy” and “playmate” in her metatags. Metatags describe the contents of a website using keywords. Some search engines search metatags to identify websites relevant to a search. Thus, when an internet searcher enters “playboy” or “playmate” into a search engine that uses metatags, the results will include Welles’ site. Because Welles’ metatags do not repeat the terms extensively, her site will not be at the top of the list of search results. Applying the three-factor test for nominative use, we conclude that the use of the trademarked terms in Welles’ metatags is nominative.

As we discussed above with regard to the headlines and banner advertisements, Welles has no practical way of describing herself without using trademarked terms. In the context of metatags, we conclude that she has no practical way of identifying the content of her website without referring to PEI's trademarks.

...

Precluding their use would have the unwanted effect of hindering the free flow of information on the internet, something which is certainly not a goal of trademark law. Accordingly, the use of trademarked terms in the metatags meets the first part of the test for nominative use....We conclude that the metatags satisfy the second and third elements of the test as well. The metatags use only so much of the marks as reasonably necessary and nothing is done in conjunction with them to suggest sponsorship or endorsement by the trademark holder. We note that our decision might differ if the metatags listed the trademarked term so repeatedly that Welles' site would regularly appear above PEI's in searches for one of the trademarked terms.

### 3. Wallpaper/watermark.

The background, or wallpaper, of Welles' site consists of the repeated abbreviation "PMOY '81," which stands for "Playmate of the Year 1981." Welles' name or likeness does not appear before or after "PMOY '81." The pattern created by the repeated abbreviation appears as the background of the various pages of the website. Accepting, for the purposes of this appeal, that the abbreviation "PMOY" is indeed entitled to protection, we conclude that the repeated, stylized use of this abbreviation fails the nominative use test.

The repeated depiction of "PMOY '81" is not necessary to describe Welles. "Playboy Playmate of the Year 1981" is quite adequate. Moreover, the term does not even appear to describe Welles—her name or likeness do not appear before or after each "PMOY '81." Because the use of the abbreviation fails the first prong of the nominative use test, we need not apply the next two prongs of the test.

Because the defense of nominative use fails here, and we have already determined that the doctrine of fair use does not apply, we remand to the district court. The court must determine whether trademark law protects the abbreviation "PMOY," as used in the wallpaper.

B. Trademark Dilution [At this point, the court considers and rejects PEI's claim for trademark dilution.]

### Conclusion

For the foregoing reasons, we affirm the district court's grant of summary judgment as to PEI's claims for trademark infringement and trademark dilution, with the sole exception of the use of the abbreviation "PMOY." We reverse as to the abbreviation and remand for consideration of whether it merits protection under either an infringement or a dilution theory.

### CASE QUESTIONS

1. Do you agree with the court's decision that there is no dilution here?
2. If PMOY is not a registered trademark, why does the court discuss it?
3. What does "nominative use" mean in the context of this case?
4. In business terms, why would PEI even think that it was losing money, or could lose money, based on Welles's use of its identifying marks?

## 23.6 Summary and Exercises

### Summary

The products of the human mind are at the root of all business, but they are legally protectable only to a certain degree. Inventions that are truly novel may qualify for a twenty-year patent; the inventor may then prohibit anyone from using the art (machine, process, manufacture, and the like) or license it on his own terms. A business may sue a person who improperly gives away its legitimate trade secrets, but it may not prevent others from using the unpatented trade secret once publicly disclosed. Writers or painters, sculptors, composers, and other creative artists may generally protect the expression of their ideas for the duration of their lives plus seventy years, as long as the ideas are fixed in some tangible medium. That means that they may prevent others from copying their words (or painting, etc.), but they may not prevent anyone from talking about or using their ideas. Finally, one who markets a product or service may protect its trademark or service or other mark that is distinctive or has taken on a secondary meaning, but may lose it if the mark becomes the generic term for the goods or services.

## EXERCISES

1. Samuel Morse filed claims in the US Patent Office for his invention of the telegraph and also for the “use of the motive power of the electric or galvanic current...however developed, for marking or printing intelligible characters, signs or letters at any distances.” For which claim, if any, was he entitled to a patent? Why?
2. In 1957, an inventor dreamed up and constructed a certain new kind of computer. He kept his invention a secret. Two years later, another inventor who conceived the same machine filed a patent application. The first inventor, learning of the patent application, filed for his own patent in 1963. Who is entitled to the patent, assuming that the invention was truly novel and not obvious? Why?
3. A large company discovered that a small company was infringing one of its patents. It wrote the small company and asked it to stop. The small company denied that it was infringing. Because of personnel changes in the large company, the correspondence file was lost and only rediscovered eight years later. The large company sued. What would be the result? Why?
4. Clifford Witter was a dance instructor at the Arthur Murray Dance Studios in Cleveland. As a condition of employment, he signed a contract not to work for a competitor. Subsequently, he was hired by the Fred Astaire Dancing Studios, where he taught the method that he had learned at Arthur Murray. Arthur Murray sued to enforce the noncompete contract. What would be result? What additional information, if any, would you need to know to decide the case?
5. Greenberg worked for Buckingham Wax as its chief chemist, developing chemical formulas for products by testing other companies’ formulas and modifying them. Brite Products bought Buckingham’s goods and resold them under its own name. Greenberg went to work for Brite, where he helped Brite make chemicals substantially similar to the ones it had been buying from Buckingham. Greenberg had never made any written or oral commitment to Buckingham restricting his use of the chemical formulas he developed. May Buckingham stop Greenberg from working for Brite? May it stop him from working on formulas learned while working at Buckingham? Why?

## SELF-TEST QUESTIONS

1. Which of the following cannot be protected under patent, copyright, or trademark law?
  - a. a synthesized molecule
  - b. a one-line book title
  - c. a one-line advertising jingle
  - d. a one-word company name
  
2. Which of the following does not expire by law?
  - a. a closely guarded trade secret not released to the public
  - b. a patent granted by the US Patent and Trademark Office
  - c. a copyright registered in the US Copyright Office
  - d. a federal trademark registered under the Lanham Act
  
3. A sculptor casts a marble statue of a three-winged bird. To protect against copying, the sculptor can obtain which of the following?
  - a. a patent
  - b. a trademark
  - c. a copyright
  - d. none of the above
  
4. A stock analyst discovers a new system for increasing the value of a stock portfolio. He may protect against use of his system by other people by securing
  - a. a patent
  - b. a copyright
  - c. a trademark
  - d. none of the above
  
5. A company prints up its customer list for use by its sales staff. The cover page carries a notice that says “confidential.” A rival salesman gets a copy of the list. The company can sue to recover the list because the list is

- a. patented
- b. copyrighted
- c. a trade secret
- d. none of the above

### SELF-TEST ANSWERS

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



## Chapter 24

# The Nature and Regulation of Real Estate and the Environment

### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The various kinds of interests (or “estates”) in real property
2. The various rights that come with ownership of real property
3. What easements are, how they are created, and how they function
4. How ownership of real property is regulated by tort law, by agreement, and by the public interest (through eminent domain)
5. The various ways in which environmental laws affect the ownership and use of real property

Real property is an important part of corporate as well as individual wealth. As a consequence, the role of the corporate real estate manager has become critically important within the corporation. The real estate manager must be aware not only of the value of land for purchase and sale but also of proper lease negotiation, tax policies and assessments, zoning and land development, and environmental laws.

In this chapter and in [Chapter 25 "The Transfer of Real Estate by Sale"](#) and [Chapter 26 "Landlord and Tenant Law"](#), we focus on regulation of land use and the environment (see [Figure 24.1 "Chapter Overview"](#)). We divide our discussion of the nature of real estate into three major categories: (1) estates; (2) rights that are incidental to the possession and ownership of land—for example, the right to air, water, and minerals; and (3) easements—the rights in lands of others.

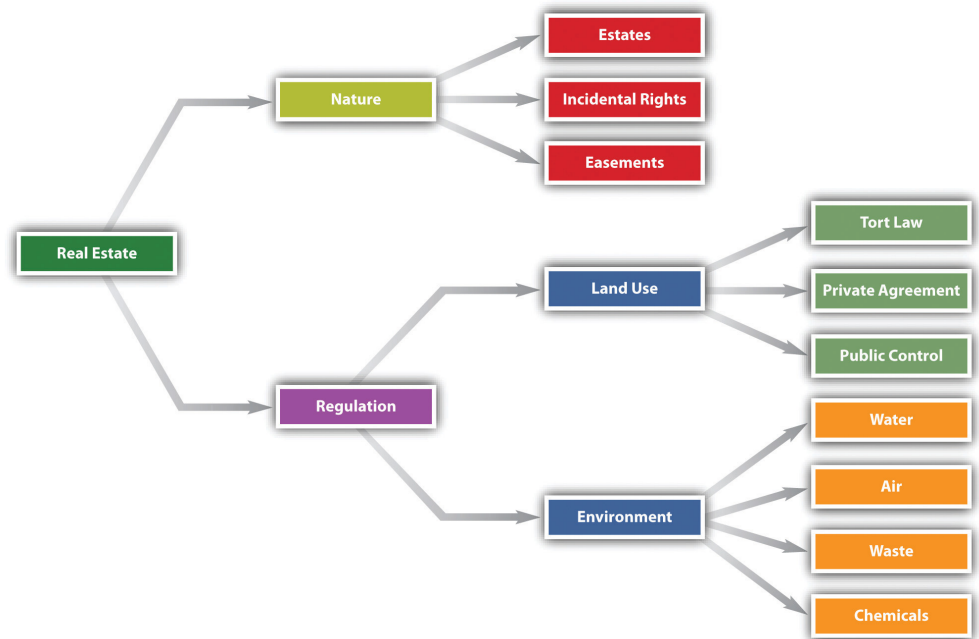
## 24.1 Estates

### LEARNING OBJECTIVE

1. Distinguish between the various kinds of estates, or interests, in real property that the law recognizes.

In property law, an estate is an interest in real property, ranging from absolute dominion and control to bare possession. Ordinarily when we think of property, we think of only one kind: absolute ownership. The owner of a car has the right to drive it where and when she wants, rebuild it, repaint it, and sell it or scrap it. The notion that the owner might lose her property when a particular event happens is foreign to our concept of personal property. Not so with real property. You would doubtless think it odd if you were sold a used car subject to the condition that you not paint it a different color—and that if you did, you would automatically be stripped of ownership. But land can be sold that way. Land and other real property can be divided into many categories of interests, as we will see. (Be careful not to confuse the various types of interests in real property with the forms of ownership, such as joint tenancy. An interest in real property that amounts to an estate is a measure of the degree to which a thing is owned; the form of ownership deals with the particular person or persons who own it.)

Figure 24.1 Chapter Overview



The common law distinguishes estates along two main axes: (1) freeholds versus leaseholds and (2) present versus future interests. A **freehold estate**<sup>1</sup> is an interest in land that has an uncertain duration. The freehold can be outright ownership—called the fee simple absolute—or it can be an interest in the land for the life of the possessor; in either case, it is impossible to say exactly how long the estate will last. In the case of one who owns property outright, her estate will last until she sells or transfers it; in the case of a life estate, it will last until the death of the owner or another specified individual. A **leasehold estate**<sup>2</sup> is one whose termination date is usually known. A one-year lease, for example, will expire precisely at the time stated in the lease agreement.

A present estate is one that is currently owned and enjoyed; a future estate is one that will come into the owner’s possession upon the occurrence of a particular event. In this chapter, we consider both present and future freehold interests; leasehold interests we save for Chapter 26 "Landlord and Tenant Law".

1. An interest in land that has an uncertain duration.
2. An estate whose termination date is usually known—a one-year lease, for example.
3. The most extensive set of rights that can be conveyed in real property.

## Present Estates (Freeholds)

### Fee Simple Absolute

The strongest form of ownership is known as the **fee simple absolute**<sup>3</sup> (or fee simple, or merely fee). This is what we think of when we say that someone “owns” the land. As one court put it, “The grant of a fee in land conveys to the grantee

complete ownership, immediately and forever, with the right of possession from boundary to boundary and from the center of the earth to the sky, together with all the lawful uses thereof.” *Magnolia Petroleum Co. v. Thompson*, 106 F.2d 217 (8th Cir. 1939). Although the fee simple may be encumbered by a mortgage (you may borrow money against the equity in your home) or an easement (you may grant someone the right to walk across your backyard), the underlying control is in the hands of the owner. Though it was once a complex matter in determining whether a person had been given a fee simple interest, today the law presumes that the estate being transferred is a fee simple, unless the conveyance expressly states to the contrary. (In her will, Lady Gaga grants her five-thousand-acre ranch “to my screen idol, Tilda Swinton.” On the death of Lady Gaga, Swinton takes ownership of the ranch outright in fee simple absolute.)

### Fee Simple Defeasible

Not every transfer of real property creates a fee simple absolute. Some transfers may limit the estate. Any transfer specifying that the ownership will terminate upon a particular happening is known as a **fee simple defeasible**<sup>4</sup>. Suppose, for example, that Mr. Warbucks conveys a tract of land “to Miss Florence Nightingale, for the purpose of operating her hospital and for no other purpose. Conveyance to be good as long as hospital remains on the property.” This grant of land will remain the property of Miss Nightingale and her heirs as long as she and they maintain a hospital. When they stop doing so, the land will automatically revert to Mr. Warbucks or his heirs, without their having to do anything to regain title. Note that the conveyance of land could be perpetual but is not absolute, because it will remain the property of Miss Nightingale only so long as she observes the conditions in the grant.

### Life Estates

An estate measured by the life of a particular person is called a **life estate**<sup>5</sup>. A conventional life estate is created privately by the parties themselves. The simplest form is that conveyed by the following words: “to Scarlett for life.” Scarlett becomes a life tenant; as such, she is the owner of the property and may occupy it for life or lease it or even sell it, but the new tenant or buyer can acquire only as much as Scarlett has to give, which is ownership for her life (i.e., all she can sell is a life estate in the land, not a fee simple absolute). If Scarlett sells the house and dies a month later, the buyer’s interest would terminate. A life estate may be based on the life of someone other than the life tenant: “to Scarlett for the life of Rhett.”

The **life tenant**<sup>6</sup> may use the property as though he were the owner in fee simple absolute with this exception: he may not act so as to diminish the value of the property that will ultimately go to the remainderman—the person who will become

4. Any transfer specifying that the ownership will terminate upon a particular happening.
5. An estate measured by the life of a particular person. A conventional life estate is created privately by the parties themselves.
6. Someone who holds an estate in land for his or her life or the life of another.

owner when the life estate terminates. The life tenant must pay the life estate for ordinary upkeep of the property, but the remainderman is responsible for extraordinary repairs.

Some life estates are created by operation of law and are known as legal life estates. The most common form is a widow's interest in the real property of her husband. In about one-third of the states, a woman is entitled to **dower**<sup>7</sup>, a right to a percentage (often one-third) of the property of her husband when he dies. Most of these states give a widower a similar interest in the property of his deceased wife. Dower is an alternative to whatever is bequeathed in the will; the widow has the right to elect the share stated in the will or the share available under dower. To prevent the dower right from upsetting the interests of remote purchasers, the right may be waived on sale by having the spouse sign the deed.

## Future Estates

To this point, we have been considering present estates. But people also can have future interests in real property. Despite the implications of its name, the future interest is owned now but is not available to be used or enjoyed now. For the most part, future interests may be bought and sold, just as land held in fee simple absolute may be bought and sold. There are several classes of future interests, but in general there are two major types: reversion and remainder.

### Reversion

A **reversion**<sup>8</sup> arises whenever the estate transferred has a duration less than that originally owned by the transferor. A typical example of a simple reversion is that which arises when a life estate is conveyed. The ownership conveyed is only for the life; when the life tenant dies, the ownership interest reverts to the grantor.

Suppose the grantor has died in the meantime. Who gets the reversion interest? Since the reversion is a class of property that is owned now, it can be inherited, and the grantor's heirs would take the reversion at the subsequent death of the life tenant.

### Remainder

The transferor need not keep the reversion interest for himself. He can give that interest to someone else, in which case it is known as a **remainder**<sup>9</sup> interest, because the remainder of the property is being transferred. Suppose the transferor conveys land with these words: "to Scarlett for life and then to Rhett." Scarlett has a life estate; the remainder goes to Rhett in fee simple absolute. Rhett is said to have a vested remainder interest, because on Scarlett's death, he or his heirs will

7. A statutory alternative to whatever is bequeathed in the will; the widow has the right to elect the share stated in the will or the share available under dower.

8. A reversion arises whenever the estate transferred has a duration less than that originally owned by the transferor.

9. The real property interest that remains after the life estate interest or other interest subject to defeasance.

automatically become owners of the property. Some remainder interests are contingent—and are therefore known as contingent remainder interests—on the happening of a certain event: “to my mother for her life, then to my sister if she marries Harold before my mother dies.” The transferor’s sister will become the owner of the property in fee simple only if she marries Harold while her mother is alive; otherwise, the property will revert to the transferor or his heirs. The number of permutations of reversions and remainders can become quite complex, far more than we have space to discuss in this text.

### KEY TAKEAWAY

An estate is an interest in real property. Estates are of many kinds, but one generic difference is between ownership estates and possessory estates. Fee simple estates and life estates are ownership estates, while leasehold interests are possessory. Among ownership estates, the principal division is between present estates and future estates. An owner of a future estate has an interest that can be bought and sold and that will ripen into present possession at the end of a period of time, at the end of the life of another, or with the happening of some contingent event.

### EXERCISES

1. Jessa owns a house and lot on 9th Avenue. She sells the house to the Hartley family, who wish to have a conveyance from her that says, “to Harriet Hartley for life, remainder to her son, Alexander Sandridge.” Alexander is married to Chloe, and they have three children, Carmen, Sarah, and Michael. Who has a future interest, and who has a present interest? What is the correct legal term for Harriet’s estate? Does Alexander, Carmen, Sarah, or Michael have any part of the estate at the time Jessa conveys to Harriet using the stated language?
2. After Harriet dies, Alexander wants to sell the property. Alexander and Chloe’s children are all eighteen years of age or older. Can he convey the property by his signature alone? Who else needs to sign?

## 24.2 Rights Incident to Possession and Ownership of Real Estate

### LEARNING OBJECTIVE

1. Understand that property owners have certain rights in the airspace above their land, in the minerals beneath their land, and even in water that adjoins their land.

### Rights to Airspace

The traditional rule was stated by Lord Coke: “Whoever owns the soil owns up to the sky.” This traditional rule remains valid today, but its application can cause problems. A simple example would be a person who builds an extension to the upper story of his house so that it hangs out over the edge of his property line and thrusts into the airspace of his neighbor. That would clearly be an encroachment on the neighbor’s property. But is it trespass when an airplane—or an earth satellite—flies over your backyard? Obviously, the courts must balance the right to travel against landowners’ rights. In *U.S. v. Causby*, *U.S. v. Causby*, 328 U.S. 256 (1946), the Court determined that flights over private land may constitute a diminution in the property value if they are so low and so frequent as to be a direct and immediate interference with the enjoyment and use of land.

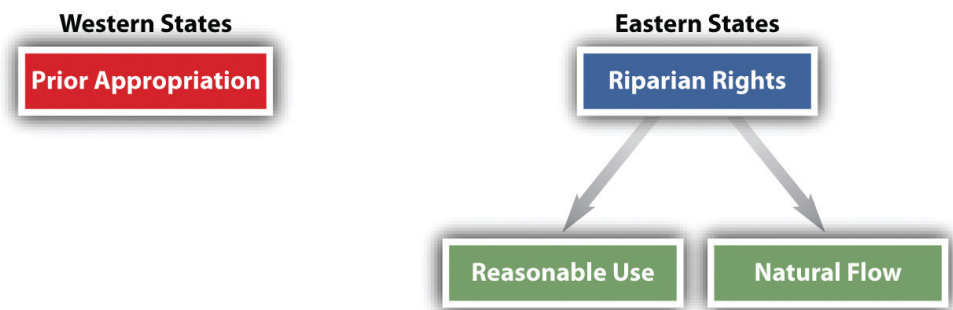
### Rights to the Depths

Lord Coke’s dictum applies to the depths as well as the sky. The owner of the surface has the right to the oil, gas, and minerals below it, although this right can be severed and sold separately. Perplexing questions may arise in the case of oil and gas, which can flow under the surface. Some states say that oil and gas can be owned by the owner of the surface land; others say that they are not owned until actually extracted—although the property owner may sell the exclusive right to extract them from his land. But states with either rule recognize that oil and gas are capable of being “captured” by drilling that causes oil or gas from under another plot of land to run toward the drilled hole. Since the possibility of capture can lead to wasteful drilling practices as everyone nearby rushes to capture the precious commodities, many states have enacted statutes requiring landowners to share the resources.

## Rights to Water

The right to determine how bodies of water will be used depends on basic property rules. Two different approaches to water use in the United States—eastern and western—have developed over time (see [Figure 24.2 "Water Rights"](#)). Eastern states, where water has historically been more plentiful, have adopted the so-called riparian rights theory, which itself can take two forms. *Riparian* refers to land that includes a part of the bed of a waterway or that borders on a public watercourse. A riparian owner is one who owns such land. What are the rights of upstream and downstream owners of riparian land regarding use of the waters? One approach is the “natural flow” doctrine: Each riparian owner is entitled to have the river or other waterway maintained in its natural state. The upstream owner may use the river for drinking water or for washing but may not divert it to irrigate his crops or to operate his mill if doing so would materially change the amount of the flow or the quality of the water. Virtually all eastern states today are not so restrictive and rely instead on a “reasonable use” doctrine, which permits the benefit to be derived from use of the waterway to be weighed against the gravity of the harm. This approach is illustrated in *Hoover v. Crane*, (see [Section 24.6.1 "Reasonable Use Doctrine"](#)). *Hoover v. Crane*, 362 Mich. 36, 106 N.W.2d 563 (1960).

Figure 24.2 *Water Rights*



In contrast to riparian rights doctrines, western states have adopted the prior appropriation doctrine. This rule looks not to equality of interests but to priority in time: first in time is first in right. The first person to use the water for a beneficial purpose has a right superior to latecomers. This rule applies even if the first user takes all the water for his own needs and even if other users are riparian owners. This rule developed in water-scarce states in which development depended on incentives to use rather than hoard water. Today, the prior appropriation doctrine has come under criticism because it gives incentives to those who already have the right to the water to continue to use it profligately, rather than to those who might develop more efficient means of using it.



### KEY TAKEAWAY

Property owners have certain rights in the airspace above their land. They also have rights in subsurface minerals, which include oil and gas. Those property owners who have bodies of water adjacent to their land will also have certain rights to withdraw or impound water for their own use. Regarding US water law, the reasonable use doctrine in the eastern states is distinctly different from the prior appropriation doctrine in western states.

### EXERCISES

1. Steve Hannaford farms in western Nebraska. The farm has passed to succeeding generations of Hannafords, who use water from the North Platte River for irrigation purposes. The headlands of the North Platte are in Colorado, but use of the water from the North Platte by Nebraskans preceded use of the water by settlers in Colorado. What theory of water rights governs Nebraska and Colorado residents? Can the state of Colorado divert and use water in such a way that less of it reaches western Nebraska and the Hannaford farm? Why or why not?
2. Jamie Stoner decides to put solar panels on the south face of his roof. Jamie lives on a block of one- and two-bedroom bungalows in South Miami, Florida. In 2009, someone purchases the house next door and within two years decides to add a second and third story. This proposed addition will significantly decrease the utility of Jamie's solar array. Does Jamie have any rights that would limit what his new neighbors can do on their own land?

## 24.3 Easements: Rights in the Lands of Others

### LEARNING OBJECTIVES

1. Explain the difference between an easement and a license.
2. Describe the ways in which easements can be created.

### Definition

An **easement**<sup>10</sup> is an interest in land created by agreement that permits one person to make use of another's estate. This interest can extend to a profit, the taking of something from the other's land. Though the common law once distinguished between an easement and profit, today the distinction has faded, and profits are treated as a type of easement. An easement must be distinguished from a mere **license**<sup>11</sup>, which is permission, revocable at the will of the owner, to make use of the owner's land. An easement is an estate; a license is personal to the grantee and is not assignable.

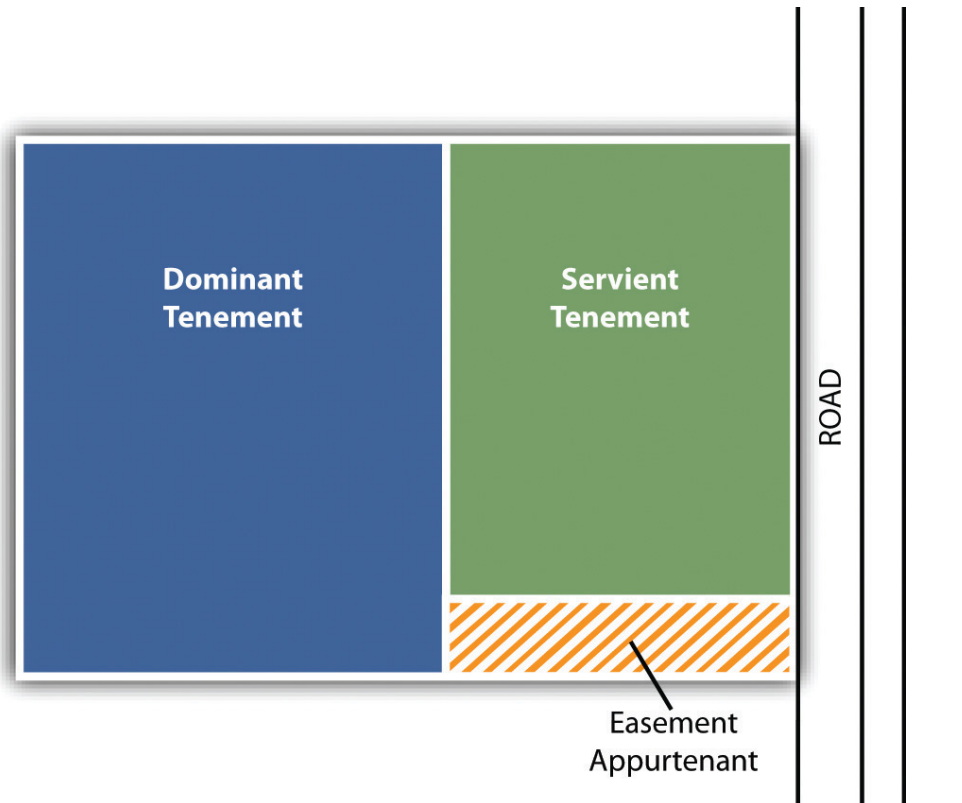
The two main types of easements are affirmative and negative. An affirmative easement gives a landowner the right to use the land of another (e.g., crossing it or using water from it), while a **negative easement**<sup>12</sup>, by contrast, prohibits the landowner from using his land in ways that would affect the holder of the easement. For example, the builder of a solar home would want to obtain negative easements from neighbors barring them from building structures on their land that would block sunlight from falling on the solar home. With the growth of solar energy, some states have begun to provide stronger protection by enacting laws that regulate one's ability to interfere with the enjoyment of sunlight. These laws range from a relatively weak statute in Colorado, which sets forth rules for obtaining easements, to the much stronger statute in California, which says in effect that the owner of a solar device has a vested right to continue to receive the sunlight.

Another important distinction is made between easements appurtenant and easements in gross. An **easement appurtenant**<sup>13</sup> benefits the owner of adjacent land. The easement is thus appurtenant to the holder's land. The benefited land is called the **dominant tenement**<sup>14</sup>, and the burdened land—that is, the land subject to the easement—is called the **servient tenement**<sup>15</sup> (see [Figure 24.3 "Easement Appurtenant"](#)). An easement in gross is granted independent of the easement holder's ownership or possession of land. It is simply an independent right—for

10. An interest in land created by agreement that permits one person to make use of another's estate.
11. As opposed to an easement, a license is personal to the grantee and is not assignable.
12. An easement that prohibits the owner of the land from using his or her land in ways that would affect the holder of the easement.
13. An easement that benefits the owner of adjacent land. The easement is thus appurtenant to the holder's land.
14. The land that benefits from an easement.
15. The burdened land—that is, the land subject to the easement.

example, the right granted to a local delivery service to drive its trucks across a private roadway to gain access to homes at the other end.

Figure 24.3 *Easement Appurtenant*



Unless it is explicitly limited to the grantee, an easement appurtenant “runs with the land.” That is, when the dominant tenement is sold or otherwise conveyed, the new owner automatically owns the easement. A commercial easement in gross may be transferred—for instance, easements to construct pipelines, telegraph and telephone lines, and railroad rights of way. However, most noncommercial easements in gross are not transferable, being deemed personal to the original owner of the easement. Rochelle sells her friend Mrs. Nanette—who does not own land adjacent to Rochelle—an easement across her country farm to operate skimobiles during the winter. The easement is personal to Mrs. Nanette; she could not sell the easement to anyone else.

### Creation

Easements may be created by express agreement, either in deeds or in wills. The owner of the dominant tenement may buy the easement from the owner of the servient tenement or may reserve the easement for himself when selling part of his

land. But courts will sometimes allow implied easements under certain circumstances. For instance, if the deed refers to an easement that bounds the premises—without describing it in any detail—a court could conclude that an easement was intended to pass with the sale of the property.

An easement can also be implied from prior use. Suppose a seller of land has two lots, with a driveway connecting both lots to the street. The only way to gain access to the street from the back lot is to use the driveway, and the seller has always done so. If the seller now sells the back lot, the buyer can establish an easement in the driveway through the front lot if the prior use was (1) apparent at the time of sale, (2) continuous, and (3) reasonably necessary for the enjoyment of the back lot. The rule of implied easements through prior use operates only when the ownership of the dominant and servient tenements was originally in the same person.

### **Use of the Easement**

The servient owner may use the easement—remember, it is on or under or above his land—as long as his use does not interfere with the rights of the easement owner. Suppose you have an easement to walk along a path in the woods owned by your neighbor and to swim in a private lake that adjoins the woods. At the time you purchased the easement, your neighbor did not use the lake. Now he proposes to swim in it himself, and you protest. You would not have a sound case, because his swimming in the lake would not interfere with your right to do so. But if he proposed to clear the woods and build a mill on it, obliterating the path you took to the lake and polluting the lake with chemical discharges, then you could obtain an injunction to bar him from interfering with your easement.

The owner of the dominant tenement is not restricted to using his land as he was at the time he became the owner of the easement. The courts will permit him to develop the land in some “normal” manner. For example, an easement on a private roadway for the benefit of a large estate up in the hills would not be lost if the large estate were ultimately subdivided and many new owners wished to use the roadway; the easement applies to the entire portion of the original dominant tenement, not merely to the part that abuts the easement itself. However, the owner of an easement appurtenant to one tract of land cannot use the easement on another tract of land, even if the two tracts are adjacent.

### KEY TAKEAWAY

An easement appurtenant runs with the land and benefits the dominant tenement, burdening the servient tenement. An easement, generally, has a specific location or description within or over the servient tenement. Easements can be created by deed, by will, or by implication.

### EXERCISE

1. Beth Delaney owns property next to Kerry Plemmons. The deed to Delaney's property notes that she has access to a well on the Plemmons property "to obtain water for household use." The well has been dry for many generations and has not been used by anyone on the Plemmons property or the Delaney property for as many generations. The well predated Plemmons's ownership of the property; as the servient tenement, the Plemmons property was burdened by this easement dating back to 1898. Plemmons hires a company to dig a very deep well near one of his outbuildings to provide water for his horses. The location is one hundred yards from the old well. Does the Delaney property have any easement to use water from the new well?

## 24.4 Regulation of Land Use

### LEARNING OBJECTIVES

1. Compare the various ways in which law limits or restricts the right to use your land in any way that you decide is best for you.
2. Distinguish between regulation by common law and regulation by public acts such as zoning or eminent domain.
3. Understand that property owners may restrict the uses of land by voluntary agreement, subject to important public policy considerations.

Land use regulation falls into three broad categories: (1) restriction on the use of land through tort law, (2) private regulation by agreement, and (3) public ownership or regulation through the powers of eminent domain and zoning.

### Regulation of Land Use by Tort Law

Tort law is used to regulate land use in two ways: (1) The owner may become liable for certain activities carried out on the real estate that affect others beyond the real estate. (2) The owner may be liable to persons who, upon entering the real estate, are injured.

#### Landowner's Activities

The two most common torts in this area are nuisance and trespass. A common-law **nuisance**<sup>16</sup> is an interference with the use and enjoyment of one's land. Examples of nuisances are excessive noise (especially late at night), polluting activities, and emissions of noxious odors. But the activity must produce substantial harm, not fleeting, minor injury, and it must produce those effects on the reasonable person, not on someone who is peculiarly allergic to the complained-of activity. A person who suffered migraine headaches at the sight of croquet being played on a neighbor's lawn would not likely win a nuisance lawsuit. While the meaning of nuisance is difficult to define with any precision, this common-law cause of action is a primary means for landowners to obtain damages for invasive environmental harms.

A **trespass**<sup>17</sup> is the wrongful physical invasion of or entry upon land possessed by another. Loud noise blaring out of speakers in the house next door might be a nuisance but could not be a trespass, because noise is not a physical invasion. But

16. A common-law nuisance is an interference with the use and enjoyment of one's land.

17. The wrongful physical invasion of or entry upon land possessed by another.

spraying pesticides on your gladiolas could constitute a trespass on your neighbor's property if the pesticide drifts across the boundary.

Nuisance and trespass are complex theories, a full explanation of which would consume far more space than we have. What is important to remember is that these torts are two-edged swords. In some situations, the landowner himself will want to use these theories to sue trespassers or persons creating a nuisance, but in other situations, the landowner will be liable under these theories for his own activities.

### **Injury to Persons Entering the Real Estate**

Traditionally, liability for injury has depended on the status of the person who enters the real estate.

#### **Trespassers**

If the person is an intruder without permission—a trespasser—the landowner owes him no duty of care unless he knows of the intruder's presence, in which case the owner must exercise reasonable care in his activities and warn of hidden dangers on his land of which he is aware. A known trespasser is someone whom the landowner actually sees on the property or whom he knows frequently intrudes on the property, as in the case of someone who habitually walks across the land. If a landowner knows that people frequently walk across his property and one day he puts a poisonous chemical on the ground to eliminate certain insects, he is obligated to warn those who continue to walk on the grounds. Intentional injury to known trespassers is not allowed, even if the trespasser is a criminal intent on robbery, for the law values human life above property rights.

#### **Children**

If the trespasser is a child, a different rule applies in most states. This is the doctrine of **attractive nuisance**<sup>18</sup>. Originally this rule was enunciated to deal with cases in which something on the land attracted the child to it, like a swimming pool. In recent years, most courts have dropped the requirement that the child must have been attracted to the danger. Instead, the following elements of proof are necessary to make out a case of attractive nuisance (Restatement of Torts, Section 339):

18. A thing or condition on land that is attractive to small children and represents a distinct hazard to their health or well-being.

1. The child must have been injured by a structure or other artificial condition.
2. The possessor of the land (not necessarily the owner) must have known or should have known that young children would be likely to trespass.

3. The possessor must have known or should have known that the artificial condition exists and that it posed an unreasonable risk of serious injury.
4. The child must have been too young to appreciate the danger that the artificial condition posed.
5. The risk to the child must have far outweighed the utility of the artificial condition to the possessor.
6. The possessor did not exercise reasonable care in protecting the child or eliminating the danger.

Old refrigerators, open gravel pits, or mechanisms that a curious child would find inviting are all examples of attractive nuisance. Suppose Farmer Brown keeps an old buggy on his front lawn, accessible from the street. A five-year-old boy clambers up the buggy one day, falls through a rotted floorboard, and breaks his leg. Is Farmer Brown liable? Probably so. The child was too young to appreciate the danger posed by the buggy, a structure. The farmer should have appreciated that young children would be likely to come onto the land when they saw the buggy and that they would be likely to climb up onto the buggy. Moreover, he should have known, if he did not know in fact, that the buggy, left outside for years without being tended, would pose an unreasonable risk. The buggy's utility as a decoration was far overbalanced by the risk that it posed to children, and the farmer failed to exercise reasonable care.

### Licenseses

A nontrespasser who comes onto the land without being invited, or if invited, comes for purposes unconnected with any business conducted on the premises, is known as a **licensee**<sup>19</sup>. This class of visitors to the land consists of (1) social guests (people you invite to your home for a party); (2) a salesman, not invited by the owner, who wishes to sell something to the owner or occupier of the property; and (3) persons visiting a building for a purpose not connected with the business on the land (e.g., students who visit a factory to see how it works). The landowner owes the same duty of care to licensees that he owes to known trespassers. That is, he must warn them against hidden dangers of which he is aware, and he must exercise reasonable care in his activities to ensure that they are not injured.

### Invitees

A final category of persons entering land is that of **invitee**<sup>20</sup>. This is one who has been invited onto the land, usually, though not necessarily, for a business purpose of potential economic benefit to the owner or occupier of the premises. This category is confusing because it sounds as though it should include social guests

19. A noninvitee to the land, such as a social guest, a salesman not invited by the owner to the property, or someone else not on the property for an invited business purpose.

20. A person who has been invited onto real property for purpose of potential economic benefit to the owner or occupier of the land.



(who clearly are invited onto the premises), but traditionally social guests are said to be licensees.

Invitees include customers of stores, users of athletic and other clubs, customers of repair shops, strollers through public parks, restaurant and theater patrons, hotel guests, and the like. From the owner's perspective, the major difference between licensees and invitees is that he is liable for injuries resulting to the latter from hidden dangers that he should have been aware of, even if he is not actually aware of the dangers. How hidden the dangers are and how broad the owner's liability is depends on the circumstances, but liability sometimes can be quite broad. Difficult questions arise in lawsuits brought by invitees (or business invitees, as they are sometimes called) when the actions of persons other than the landowner contribute to the injury.

The foregoing rules dealing with liability for persons entering the land are the traditional rules at common law. In recent years, some courts have moved away from the rigidities and sometimes perplexing differences between trespassers, licensees, and invitees. By court decision, several states have now abolished such distinctions and hold the proprietor, owner, or occupier liable for failing to maintain the premises in a reasonably safe condition. According to the California Supreme Court,

A man's life or limb does not become less worthy of protection by the law nor a loss less worthy of compensation under the law because he has come upon the land of another without permission or with permission but without a business purpose. Reasonable people do not ordinarily vary their conduct depending upon such matters, and to focus upon the status of the injured party as a trespasser, licensee, or invitee in order to determine the question whether the landowner has a duty of care, is contrary to our modern social mores and humanitarian values. Where the occupier of land is aware of a concealed condition involving in the absence of precautions an unreasonable risk of harm to those coming in contact with it and is aware that a person on the premises is about to come in contact with it, the trier of fact can reasonably conclude that a failure to warn or to repair the condition constitutes negligence. Whether or not a guest has a right to expect that his host will remedy dangerous conditions on his account, he should reasonably be entitled to rely upon a warning of the dangerous condition so that he, like the host, will be in a position to take special precautions when he comes in contact with it. *Rowland v. Christian*, 443 P.2d 561 (Cal. 1968).

## Private Regulation of Land Use by Agreement

A restrictive covenant is an agreement regarding the use of land that “runs with the land.” In effect, it is a contractual promise that becomes part of the property and that binds future owners. Violations of covenants can be redressed in court in suits for damages or injunctions but will not result in reversion of the land to the seller.

Usually, courts construe restrictive covenants narrowly—that is, in a manner most conducive to free use of the land by the ultimate owner (the person against whom enforcement of the covenant is being sought). Sometimes, even when the meaning of the covenant is clear, the courts will not enforce it. For example, when the character of a neighborhood changes, the courts may declare the covenant a nullity. Thus a restriction on a one-acre parcel to residential purposes was voided when in the intervening thirty years a host of businesses grew up around it, including a bowling alley, restaurant, poolroom, and sewage disposal plant. *Norris v. Williams*, 54 A.2d 331 (Md. 1947).

An important nullification of restrictive covenants came in 1947 when the US Supreme Court struck down as unconstitutional racially restrictive covenants, which barred blacks and other minorities from living on land so burdened. The Supreme Court reasoned that when a court enforces such a covenant, it acts in a discriminatory manner (barring blacks but not whites from living in a home burdened with the covenant) and thus violates the Fourteenth Amendment’s guarantee of equal protection of the laws. *Shelley v. Kraemer*, 334 U.S. 1 (1947).

## Public Control of Land Use through Eminent Domain

The government may take private property for public purposes. Its power to do so is known as eminent domain. The power of eminent domain is subject to constitutional limitations. Under the Fifth Amendment, the property must be put to public use, and the owner is entitled to “just compensation” for his loss. These requirements are sometimes difficult to apply.

### Public Use

The requirement of public use normally means that the property will be useful to the public once the state has taken possession—for example, private property might be condemned to construct a highway. Although not allowed in most circumstances, the government could even condemn someone’s property in order to turn around and sell it to another individual, if a legitimate public purpose could be shown. For example, a state survey in the mid-1960s showed that the government owned 49 percent of Hawaii’s land. Another 47 percent was controlled

by seventy-two private landowners. Because this concentration of land ownership (which dated back to feudal times) resulted in a critical shortage of residential land, the Hawaiian legislature enacted a law allowing the government to take land from large private estates and resell it in smaller parcels to homeowners. In 1984, the US Supreme Court upheld the law, deciding that the land was being taken for a public use because the purpose was “to attack certain perceived evils of concentrated property ownership.” *Hawaii Housing Authority v. Midkiff*, 467 U.S. 229 (1984). Although the use must be public, the courts will not inquire into the necessity of the use or whether other property might have been better suited. It is up to government authorities to determine whether and where to build a road, not the courts.

The limits of public use were amply illustrated in the Supreme Court’s 2002 decision of *Kelo v. New London*, *Kelo v. New London*, 545 U.S. 469 (2005). In which Mrs. Kelo’s house was condemned so that the city of New London, in Connecticut, could create a marina and industrial park to lease to Pfizer Corporation. The city’s motives were to create a higher tax base for property taxes. The Court, following precedent in *Midkiff* and other cases, refused to invalidate the city’s taking on constitutional grounds. Reaction from states was swift; many states passed new laws restricting the bases for state and municipal governments to use powers of eminent domain, and many of these laws also provided additional compensation to property owners whose land was taken.

### **Just Compensation**

The owner is ordinarily entitled to the fair market value of land condemned under eminent domain. This value is determined by calculating the most profitable use of the land at the time of the taking, even though it was being put to a different use. The owner will have a difficult time collecting lost profits; for instance, a grocery store will not usually be entitled to collect for the profits it might have made during the next several years, in part because it can presumably move elsewhere and continue to make profits and in part because calculating future profits is inherently speculative.

### **Taking**

The most difficult question in most modern cases is whether the government has in fact “taken” the property. This is easy to answer when the government acquires title to the property through condemnation proceedings. But more often, a government action is challenged when a law or regulation inhibits the use of private land. Suppose a town promulgates a setback ordinance, requiring owners along city sidewalks to build no closer to the sidewalk than twenty feet. If the owner of a small store had only twenty-five feet of land from the sidewalk line, the

ordinance would effectively prevent him from housing his enterprise, and the ordinance would be a taking. Challenging such ordinances can sometimes be difficult under traditional tort theories because the government is immune from suit in some of these cases. Instead, a theory of inverse condemnation has developed, in which the plaintiff private property owner asserts that the government has condemned the property, though not through the traditional mechanism of a condemnation proceeding.

## Public Control of Land Use through Zoning

**Zoning**<sup>21</sup> is a technique by which a city or other municipality regulates the type of activity to be permitted in geographical areas within its boundaries. Though originally limited to residential, commercial, and industrial uses, today's zoning ordinances are complex sets of regulations. A typical municipality might have the following zones: residential with a host of subcategories (such as for single-family and multiple-family dwellings), office, commercial, industrial, agricultural, and public lands. Zones may be exclusive, in which case office buildings would not be permitted in commercial zones, or they may be cumulative, so that a more restricted use would be allowed in a less restrictive zone. Zoning regulations do more than specify the type of use: they often also dictate minimum requirements for parking, open usable space, setbacks, lot sizes, and the like, and maximum requirements for height, length of side lots, and so on.

### Nonconforming Uses

When a zoning ordinance is enacted, it will almost always affect existing property owners, many of whom will be using their land in ways no longer permitted under the ordinance. To avoid the charge that they have thereby “taken” the property, most ordinances permit previous nonconforming uses to continue, though some ordinances limit the nonconforming uses to a specified time after becoming effective. But this permission to continue a nonconforming use is narrow; it extends only to the specific use to which the property was put before the ordinance was enacted. A manufacturer of dresses that suddenly finds itself in an area zoned residential may continue to use its sewing machines, but it could not develop a sideline in woodworking.

### Variations

Sometimes an owner may desire to use his property in ways not permitted under an existing zoning scheme and will ask the zoning board for a **variance**<sup>22</sup>—authority to carry on a nonconforming use. The board is not free to grant a variance at its whim. The courts apply three general tests to determine the validity of a variance: (1) The land must be unable to yield a reasonable return on the uses allowed by the zoning

21. A process by which a city or other municipality regulates the type of activity to be permitted.

22. Permission by zoning authorities to carry on a nonconforming use.

regulation. (2) The hardship must be unique to the property, not to property generally in the area. (3) If granted, the variance must not change the essential character of the neighborhood.

### KEY TAKEAWAY

Land use regulation can mean (1) restrictions on the use of land through tort law, (2) private regulation—by agreement, or (3) regulation through powers of eminent domain or zoning.

### EXERCISES

1. Give one example of the exercise of eminent domain. In order to exercise its power under eminent domain, must the government actually take eventual ownership of the property that is “taken”?
2. Felix Unger is an adult, trespassing for the first time on Alan Spillborghs’s property. Alan has been digging a deep grave in his backyard for his beloved Saint Bernard, Maximilian, who has just died. Alan stops working on the grave when it gets dark, intending to return to the task in the morning. He seldom sees trespassers cutting through his backyard. Felix, in the dark, after visiting the local pub, decides to take a shortcut through Alan’s yard and falls into the grave. He breaks his leg. What is the standard of care for Alan toward Felix or other infrequent trespassers? If Alan has no insurance for this accident, would the law make Alan responsible?
3. Atlantic Cement owns and operates a cement plant in New York State. Nearby residents are exposed to noise, soot, and dust and have experienced lowered property values as a result of Atlantic Cement’s operations. Is there a common-law remedy for nearby property owners for losses occasioned by Atlantic’s operations? If so, what is it called?

## 24.5 Environmental Law

### LEARNING OBJECTIVES

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

In one sense, environmental law is very old. Medieval England had smoke control laws that established the seasons when soft coal could be burned. Nuisance laws give private individuals a limited control over polluting activities of adjacent landowners. But a comprehensive set of US laws directed toward general protection of the environment is largely a product of the past quarter-century, with most of the legislative activity stemming from the late 1960s and later, when people began to perceive that the environment was systematically deteriorating from assaults by rapid population growth and greatly increased automobile driving, vast proliferation of factories that generate waste products, and a sharp rise in the production of toxic materials. Two of the most significant developments in environmental law came in 1970, when the National Environmental Policy Act took effect and the Environmental Protection Agency became the first of a number of new federal administrative agencies to be established during the decade.

### National Environmental Policy Act

Signed into law by President Nixon on January 1, 1970, the National Environmental Policy Act (NEPA) declared that it shall be the policy of the federal government, in cooperation with state and local governments, “to create and maintain conditions under which man and nature can exist in productive harmony, and fulfill the social, economic, and other requirements of present and future generations of Americans....The Congress recognizes that each person should enjoy a healthful environment and that each person has a responsibility to contribute to the preservation and enhancement of the environment.”<sup>42</sup> United States Code, Section 4321 et seq.

23. A statement mandated by the National Environmental Policy Act that is required of most federal agencies and includes an assessment of whether the agency’s actions will significantly affect environmental quality.

The most significant aspect of NEPA is its requirement that federal agencies prepare an **environmental impact statement**<sup>23</sup> in every recommendation or report on proposals for legislation and whenever undertaking a major federal action that significantly affects environmental quality. The statement must (1) detail the

environmental impact of the proposed action, (2) list any unavoidable adverse impacts should the action be taken, (3) consider alternatives to the proposed action, (4) compare short-term and long-term consequences, and (5) describe irreversible commitments of resources. Unless the impact statement is prepared, the project can be enjoined from proceeding. Note that NEPA does not apply to purely private activities but only to those proposed to be carried out in some manner by federal agencies.

## **Environmental Protection Agency**

The Environmental Protection Agency (EPA) has been in the forefront of the news since its creation in 1970. Charged with monitoring environmental practices of industry, assisting the government and private business to halt environmental deterioration, promulgating regulations consistent with federal environmental policy, and policing industry for violations of the various federal environmental statutes and regulations, the EPA has had a pervasive influence on American business. *Business Week* noted the following in 1977: “Cars rolling off Detroit’s assembly line now have antipollution devices as standard equipment. The dense black smokestack emissions that used to symbolize industrial prosperity are rare, and illegal, sights. Plants that once blithely ran discharge water out of a pipe and into a river must apply for permits that are almost impossible to get unless the plants install expensive water treatment equipment. All told, the EPA has made a sizable dent in man-made environmental filth.” “The Tricks of the Trade-off,” *Business Week*, April 4, 1977, 72.

The EPA is especially active in regulating water and air pollution and in overseeing the disposition of toxic wastes and chemicals. To these problems we now turn.

## **Water Pollution Clean Water Act**

Legislation governing the nation’s waterways goes back a long time. The first federal water pollution statute was the Rivers and Harbors Act of 1899. Congress enacted new laws in 1948, 1956, 1965, 1966, and 1970. But the centerpiece of water pollution enforcement is the Clean Water Act of 1972 (technically, the Federal Water Pollution Control Act Amendments of 1972), as amended in 1977 and by the Water Quality Act of 1987. The Clean Water Act is designed to restore and maintain the “chemical, physical, and biological integrity of the Nation’s waters.”<sup>33</sup> United States Code, Section 1251. It operates on the states, requiring them to designate the uses of every significant body of water within their borders (e.g., for drinking water, recreation, commercial fishing) and to set water quality standards to reduce pollution to levels appropriate for each use.

Congress only has power to regulate interstate commerce, and so the Clean Water Act is applicable only to “navigable waters” of the United States. This has led to disputes over whether the act can apply, say, to an abandoned gravel pit that has no visible connection to navigable waterways, even if the gravel pit provides habitat for migratory birds. In *Solid Waste Agency of Northern Cook County v. Army Corps of Engineers*, the US Supreme Court said no. *Solid Waste Agency of Northern Cook County v. Army Corps of Engineers*, 531 U.S. 159 (2001).

### **Private Industry**

The Clean Water Act also governs private industry and imposes stringent standards on the discharge of pollutants into waterways and publicly owned sewage systems. The act created an effluent permit system known as the National Pollutant Discharge Elimination System. To discharge any pollutants into navigable waters from a “point source” like a pipe, ditch, ship, or container, a company must obtain a certification that it meets specified standards, which are continually being tightened. For example, until 1983, industry had to use the “best practicable technology” currently available, but after July 1, 1984, it had to use the “best available technology” economically achievable. Companies must limit certain kinds of “conventional pollutants” (such as suspended solids and acidity) by “best conventional control technology.”

### **Other EPA Water Activities**

Federal law governs, and the EPA regulates, a number of other water control measures. Ocean dumping, for example, is the subject of the Marine Protection, Research, and Sanctuaries Act of 1972, which gives the EPA jurisdiction over wastes discharged into the oceans. The Clean Water Act gives the EPA and the US Army Corps of Engineers authority to protect waters, marshlands, and other wetlands against degradation caused by dredging and fills. The EPA also oversees state and local plans for restoring general water quality to acceptable levels in the face of a host of non-point-source pollution. The Clean Water Act controls municipal sewage systems, which must ensure that wastewater is chemically treated before being discharged from the sewage system.

Obviously, of critical importance to the nation’s health is the supply of drinking water. To ensure its continuing purity, Congress enacted the Safe Drinking Water Act of 1974, with amendments passed in 1986 and 1996. This act aims to protect water at its sources: rivers, lakes, reservoirs, springs, and groundwater wells. (The act does not regulate private wells that serve fewer than twenty-five individuals.) This law has two strategies for combating pollution of drinking water. It establishes national standards for drinking water derived from both surface reservoirs and underground aquifers. It also authorizes the EPA to regulate the injection of solid



wastes into deep wells (as happens, for instance, by leakage from underground storage tanks).

## **Air Pollution**

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

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

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

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

Concern over acid rain and other types of air pollution prompted Congress to add almost eight hundred pages of amendments to the Clean Air Act in 1990. (The original act was fifty pages long.) As a result of these amendments, the act was modernized in a manner that parallels other environmental laws. For instance, the

amendments established a permit system that is modeled after the Clean Water Act. And the amendments provide for felony convictions for willful violations, similar to penalties incorporated into other statutes.

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

## **Waste Disposal**

Though pollution of the air by highly toxic substances like benzene or vinyl chloride may seem a problem removed from that of the ordinary person, we are all in fact polluters. Every year, the United States generates approximately 230 million tons of “trash”—about 4.6 pounds per person per day. Less than one-quarter of it is recycled; the rest is incinerated or buried in landfills. But many of the country’s landfills have been closed, either because they were full or because they were contaminating groundwater. Once groundwater is contaminated, it is extremely expensive and difficult to clean it up. In the 1965 Solid Waste Disposal Act and the 1970 Resource Recovery Act, Congress sought to regulate the discharge of garbage by encouraging waste management and recycling. Federal grants were available for research and training, but the major regulatory effort was expected to come from the states and municipalities.

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

### **Resource Conservation and Recovery Act**

The RCRA expresses a “cradle-to-grave” philosophy: hazardous wastes must be regulated at every stage. The act gives the EPA power to govern their creation,

storage, transport, treatment, and disposal. Any person or company that generates hazardous waste must obtain a permit (known as a “manifest”) either to store it on its own site or ship it to an EPA-approved treatment, storage, or disposal facility. No longer can hazardous substances simply be dumped at a convenient landfill. Owners and operators of such sites must show that they can pay for damage growing out of their operations, and even after the sites are closed to further dumping, they must set aside funds to monitor and maintain the sites safely.

This philosophy can be severe. In 1986, the Supreme Court ruled that bankruptcy is not a sufficient reason for a company to abandon toxic waste dumps if state regulations reasonably require protection in the interest of public health or safety. The practical effect of the ruling is that trustees of the bankrupt company must first devote assets to cleaning up a dump site, and only from remaining assets may they satisfy creditors. *Midlantic National Bank v. New Jersey*, 474 U.S. 494 (1986). Another severity is RCRA’s imposition of criminal liability, including fines of up to \$25,000 a day and one-year prison sentences, which can be extended beyond owners to individual employees, as discussed in *U.S. v. Johnson & Towers, Inc., et al.*, (see [Section 24.6.2 "Criminal Liability of Employees under RCRA"](#)).

### **Comprehensive Environmental Response, Compensation, and Liability Act**

The CERCLA, also known as the Superfund, gives the EPA emergency powers to respond to public health or environmental dangers from faulty hazardous waste disposal, currently estimated to occur at more than seventeen thousand sites around the country. The EPA can direct immediate removal of wastes presenting imminent danger (e.g., from train wrecks, oil spills, leaking barrels, and fires). Injuries can be sudden and devastating; in 1979, for example, when a freight train derailed in Florida, ninety thousand pounds of chlorine gas escaped from a punctured tank car, leaving 8 motorists dead and 183 others injured and forcing 3,500 residents within a 7-mile radius to be evacuated. The EPA may also carry out “planned removals” when the danger is substantial, even if immediate removal is not necessary.

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

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

## **Chemical Hazards**

### **Toxic Substances Control Act**

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

The TSCA gives the EPA authority to screen for health and environmental risks by requiring companies to notify the EPA ninety days before manufacturing or importing new chemicals. The EPA may demand that the companies test the substances before marketing them and may regulate them in a number of ways, such as requiring the manufacturer to label its products, to keep records on its manufacturing and disposal processes, and to document all significant adverse reactions in people exposed to the chemicals. The EPA also has authority to ban certain especially hazardous substances, and it has banned the further production of PCBs and many uses of asbestos.

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

## **Pesticide Regulation**

The United States is a major user of pesticides, substances that eliminate troublesome insects, rodents, fungi, and bacteria, consuming more than a billion pounds a year in the form of thirty-five thousand separate chemicals. As useful as they can be, like many chemical substances, pesticides can have serious side effects on humans and plant and animal life. Beginning in the early 1970s, Congress enacted major amendments to the Federal Insecticide, Fungicide, and Rodenticide Act of 1947 and the Federal Food, Drug, and Cosmetic Act (FFDCA) of 1906.

These laws direct the EPA to determine whether pesticides properly balance effectiveness against safety. If the pesticide can carry out its intended function without causing unreasonable adverse effects on human health or the environment, it may remain on the market. Otherwise, the EPA has authority to regulate or even ban its distribution and use. To enable the EPA to carry out its functions, the laws require manufacturers to provide a wealth of data about the way individual pesticides work and their side effects. The EPA is required to inspect pesticides to ensure that they conform to their labeled purposes, content, and safety, and the agency is empowered to certify pesticides for either general or restricted use. If a pesticide is restricted, only those persons certified in approved training programs may use it. Likewise, under the Pesticide Amendment to the FFDCA, the EPA must establish specific tolerances for the residue of pesticides on feed crops and both raw and processed foods. The Food and Drug Administration (for agricultural commodities) and the US Department of Agriculture (for meat, poultry, and fish products) enforce these provisions.

## **Other Types of Environmental Controls**

### **Noise Regulation**

Under the Noise Regulation Act of 1972, Congress has attempted to combat a growing menace to US workers, residents, and consumers. People who live close to airports and major highways, workers who use certain kinds of machinery (e.g., air compressors, rock drills, bulldozers), and consumers who use certain products, such as power mowers and air conditioners, often suffer from a variety of ailments. The Noise Regulation Act delegates to the EPA power to limit “noise emissions” from these major sources of noise. Under the act, manufacturers may not sell new products that fail to conform to the noise standards the EPA sets, and users are forbidden from dismantling noise control devices installed on these products. Moreover, manufacturers must label noisy products properly. Private suits may be filed against violators, and the act also permits fines of up to \$25,000 per day and a year in jail for those who seek to avoid its terms.

### Radiation Controls

The terrifying effects of a nuclear disaster became frighteningly clear when the Soviet Union's nuclear power plant at Chernobyl exploded in early 1986, discharging vast quantities of radiation into the world's airstream and affecting people thousands of miles away. In the United States, the most notorious nuclear accident occurred at the Three Mile Island nuclear utility in Pennsylvania in 1979, crippling the facility for years because of the extreme danger and long life of the radiation. Primary responsibility for overseeing nuclear safety rests with the Nuclear Regulatory Commission, but many other agencies and several federal laws (including the Clean Air Act; the Federal Water Pollution Control Act; the Safe Drinking Water Act; the Uranium Mill Tailings Radiation Control Act; the Marine Protection, Research, and Sanctuaries Act; the Nuclear Waste Policy Act of 1982; the CERCLA; and the Ocean Dumping Act) govern the use of nuclear materials and the storage of radioactive wastes (some of which will remain severely dangerous for thousands of years). Through many of these laws, the EPA has been assigned the responsibility of setting radiation guidelines, assessing new technology, monitoring radiation in the environment, setting limits on release of radiation from nuclear utilities, developing guidance for use of X-rays in medicine, and helping to plan for radiation emergencies.

#### KEY TAKEAWAY

Laws limiting the use of one's property have been around for many years; common-law restraints (e.g., the law of nuisance) exist as causes of action against those who would use their property to adversely affect the life or health of others or the value of their neighbors' property. Since the 1960s, extensive federal laws governing the environment have been enacted. These include laws governing air, water, chemicals, pesticides, solid waste, and nuclear activities. Some laws include criminal penalties for noncompliance.

## EXERCISES

1. Who is responsible for funding CERCLA? That is, what is the source of funds for cleanups of hazardous waste?
2. Why is it necessary to have criminal penalties for noncompliance with environmental laws?
3. What is the role of states in setting standards for clean air and clean water?
4. Which federal act sets up a “cradle-to-grave” system for handling waste?
5. Why are federal environmental laws necessary? Why not let the states exclusively govern in the area of environmental protection?

## 24.6 Cases

### Reasonable Use Doctrine

Hoover v. Crane

362 Mich. 36, 106 N.W.2d 563 (1960)

EDWARDS, JUSTICE

This appeal represents a controversy between plaintiff cottage and resort owners on an inland Michigan lake and defendant, a farmer with a fruit orchard, who was using the lake water for irrigation. The chancellor who heard the matter ruled that defendant had a right to reasonable use of lake water. The decree defined such reasonable use in terms which were unsatisfactory to plaintiffs who have appealed.

The testimony taken before the chancellor pertained to the situation at Hutchins Lake, in Allegan county, during the summer of 1958. Defendant is a fruit farmer who owns a 180-acre farm abutting on the lake. Hutchins Lake has an area of 350 acres in a normal season. Seventy-five cottages and several farms, including defendant's, abut on it. Defendant's frontage is approximately 1/4 mile, or about 10% of the frontage of the lake.

Hutchins Lake is spring fed. It has no inlet but does have an outlet which drains south. Frequently in the summertime the water level falls so that the flow at the outlet ceases.

All witnesses agreed that the summer of 1958 was exceedingly dry and plaintiffs' witnesses testified that Hutchins Lake's level was the lowest it had ever been in their memory. Early in August, defendant began irrigation of his 50-acre pear orchard by pumping water out of Hutchins Lake. During that month the lake level fell 6 to 8 inches—the water line receded 50 to 60 feet and cottagers experienced severe difficulties with boating and swimming.

\* \* \*

The tenor of plaintiffs' testimony was to attribute the 6- to 8-inch drop in the Hutchins Lake level in that summer to defendant's irrigation activities. Defendant



contended that the decrease was due to natural causes, that the irrigation was of great benefit to him and contributed only slightly to plaintiff's discomfiture. He suggests to us:

One could fairly say that because plaintiffs couldn't grapple with the unknown causes that admittedly occasioned a greater part of the injury complained of, they chose to grapple mightily with the defendant because he is known and visible.

The circuit judge found it impossible to determine a normal lake level from the testimony, except that the normal summer level of the lake is lower than the level at which the lake ceases to drain into the outlet. He apparently felt that plaintiffs' problems were due much more to the abnormal weather conditions of the summer of 1958 than to defendant's irrigation activities.

His opinion concluded:

Accepting the reasonable use theory advanced by plaintiffs it appears to the court that the most equitable disposition of this case would be to allow defendant to use water from the lake until such time when his use interferes with the normal use of his neighbors. One quarter inch of water from the lake ought not to interfere with the rights and uses of defendant's neighbors and this quantity of water ought to be sufficient in time of need to service 45 acres of pears. A meter at the pump, sealed if need be, ought to be a sufficient safeguard. Pumping should not be permitted between the hours of 11 p.m. and 7 a.m. Water need be metered only at such times as there is no drainage into the outlet.

The decree in this suit may provide that the case be kept open for the submission of future petitions and proofs as the conditions permit or require.

\* \* \*

Michigan has adopted the reasonable-use rule in determining the conflicting rights of riparian owners to the use of lake water.

In 1874, Justice COOLEY said:

It is therefore not a diminution in the quantity of the water alone, or an alteration in its flow, or either or both of these circumstances combined with injury, that will give a right of action, if in view of all the circumstances, and having regard to equality of right in others, that which has been done and which causes the injury is

not unreasonable. In other words, the injury that is incidental to a reasonable enjoyment of the common right can demand no redress. *Dumont v. Kellogg*, 29 Mich 420, 425.

And in *People v. Hulbert*, the Court said:

No statement can be made as to what is such reasonable use which will, without variation or qualification, apply to the facts of every case. But in determining whether a use is reasonable we must consider what the use is for; its extent, duration, necessity, and its application; the nature and size of the stream, and the several uses to which it is put; the extent of the injury to the one proprietor and of the benefit to the other; and all other facts which may bear upon the reasonableness of the use. *Red River Roller Mills v. Wright*, 30 Minn 249, 15 NW 167, and cases cited.

The Michigan view is in general accord with 4 Restatement, Torts, §§ 851–853.

\* \* \*

We interpret the circuit judge's decree as affording defendant the total metered equivalent in pumpage of 1/4 inch of the content of Hutchins Lake to be used in any dry period in between the cessation of flow from the outlet and the date when such flow recommences. Where the decree also provides for the case to be kept open for future petitions based on changed conditions, it would seem to afford as much protection for plaintiffs as to the future as this record warrants.

Both resort use and agricultural use of the lake are entirely legitimate purposes. Neither serves to remove water from the watershed. There is, however, no doubt that the irrigation use does occasion some water loss due to increased evaporation and absorption. Indeed, extensive irrigation might constitute a threat to the very existence of the lake in which all riparian owners have a stake; and at some point the use of the water which causes loss must yield to the common good.

The question on this appeal is, of course, whether the chancellor's determination of this point was unreasonable as to plaintiffs. On this record, we cannot overrule the circuit judge's view that most of plaintiffs' 1958 plight was due to natural causes. Nor can we say, if this be the only irrigation use intended and the only water diversion sought, that use of the amount provided in the decree during the dry season is unreasonable in respect to other riparian owners.

Affirmed.

### CASE QUESTIONS

1. If the defendant has caused a diminution in water flow, an alteration of the water flow, and the plaintiff is adversely affected, why would the Supreme Court of Michigan not provide some remedy?
2. Is it possible to define an injury that is “not unreasonable”?
3. Would the case even have been brought if there had not been a drought?

### Criminal Liability of Employees under RCRA

U.S. v. Johnson & Towers, Inc., Jack W. Hopkins, and Peter Angel

741 F.2d 662 (1984)

SLOVITER, Circuit Judge

Before us is the government’s appeal from the dismissal of three counts of an indictment charging unlawful disposal of hazardous wastes under the Resource Conservation and Recovery Act. In a question of first impression regarding the statutory definition of “person,” the district court concluded that the Act’s criminal penalty provision imposing fines and imprisonment could not apply to the individual defendants. We will reverse.

The criminal prosecution in this case arose from the disposal of chemicals at a plant owned by Johnson & Towers in Mount Laurel, New Jersey. In its operations the company, which repairs and overhauls large motor vehicles, uses degreasers and other industrial chemicals that contain chemicals such as methylene chloride and trichlorethylene, classified as “hazardous wastes” under the Resource Conservation and Recovery Act (RCRA), 42 U.S.C. §§ 6901–6987 (1982) and “pollutants” under the Clean Water Act, 33 U.S.C. §§ 1251–1376 (1982). During the period relevant here, the waste chemicals from cleaning operations were drained into a holding tank and, when the tank was full, pumped into a trench. The trench flowed from the plant property into Parker’s Creek, a tributary of the Delaware River. Under RCRA, generators of such wastes must obtain a permit for disposal from the Environmental Protection Agency (E.P.A.). The E.P.A. had neither issued nor received an application for a permit for Johnson & Towers’ operations.

The indictment named as defendants Johnson & Towers and two of its employees, Jack Hopkins, a foreman, and Peter Angel, the service manager in the trucking department. According to the indictment, over a three-day period federal agents saw workers pump waste from the tank into the trench, and on the third day observed toxic chemicals flowing into the creek.

Count 1 of the indictment charged all three defendants with conspiracy under 18 U.S.C. § 371 (1982). Counts 2, 3, and 4 alleged violations under the RCRA criminal provision, 42 U.S.C. § 6928(d) (1982). Count 5 alleged a violation of the criminal provision of the Clean Water Act, 33 U.S.C. § 1319(c) (1982). Each substantive count also charged the individual defendants as aiders and abettors under 18 U.S.C. § 2 (1982).

The counts under RCRA charged that the defendants “did knowingly treat, store, and dispose of, and did cause to be treated, stored and disposed of hazardous wastes without having obtained a permit...in that the defendants discharged, deposited, injected, dumped, spilled, leaked and placed degreasers...into the trench....” The indictment alleged that both Angel and Hopkins “managed, supervised and directed a substantial portion of Johnson & Towers’ operations...including those related to the treatment, storage and disposal of the hazardous wastes and pollutants” and that the chemicals were discharged by “the defendants and others at their direction.” The indictment did not otherwise detail Hopkins’ and Angel’s activities or responsibilities.

Johnson & Towers pled guilty to the RCRA counts. Hopkins and Angel pled not guilty, and then moved to dismiss counts 2, 3, and 4. The court concluded that the RCRA criminal provision applies only to “owners and operators,” i.e., those obligated under the statute to obtain a permit. Since neither Hopkins nor Angel was an “owner” or “operator,” the district court granted the motion as to the RCRA charges but held that the individuals could be liable on these three counts under 18 U.S.C. § 2 for aiding and abetting. The court denied the government’s motion for reconsideration, and the government appealed to this court under 18 U.S.C. § 3731 (1982).

\* \* \*

The single issue in this appeal is whether the individual defendants are subject to prosecution under RCRA’s criminal provision, which applies to:

*any person who—*

....

(2) knowingly treats, stores, or disposes of any hazardous waste identified or listed under this subchapter either—

(A) without having obtained a permit under section 6925 of this title...or

(B) in knowing violation of any material condition or requirement of such permit.

42 U.S.C. § 6928(d) (emphasis added). The permit provision in section 6925, referred to in section 6928(d), requires “each person owning or operating a facility for the treatment, storage, or disposal of hazardous waste identified or listed under this subchapter to have a permit” from the E.P.A.

The parties offer contrary interpretations of section 6928(d)(2)(A). Defendants consider it an administrative enforcement mechanism, applying only to those who come within section 6925 and fail to comply; the government reads it as penalizing anyone who handles hazardous waste without a permit or in violation of a permit. Neither party has cited another case, nor have we found one, considering the application of this criminal provision to an individual other than an owner or operator.

As in any statutory analysis, we are obliged first to look to the language and then, if needed, attempt to divine Congress’ specific intent with respect to the issue.

First, “person” is defined in the statute as “an individual, trust, firm, joint stock company, corporation (including a government corporation), partnership, association, State, municipality, commission, political subdivision of a State, or any interstate body.” 42 U.S.C. § 6903(15) (1982). Had Congress meant in section 6928(d)(2)(A) to take aim more narrowly, it could have used more narrow language. Since it did not, we attribute to “any person” the definition given the term in section 6903(15).

Second, under the plain language of the statute the only explicit basis for exoneration is the existence of a permit covering the action. Nothing in the language of the statute suggests that we should infer another provision exonerating persons who knowingly treat, store or dispose of hazardous waste but are not owners or operators.

Finally, though the result may appear harsh, it is well established that criminal penalties attached to regulatory statutes intended to protect public health, in contrast to statutes based on common law crimes, are to be construed to effectuate the regulatory purpose.

\* \* \*

Congress enacted RCRA in 1976 as a “cradle-to-grave” regulatory scheme for toxic materials, providing “nationwide protection against the dangers of improper hazardous waste disposal.” H.R. Rep. No. 1491, 94th Cong., 2d Sess. 11, *reprinted in* 1976 U.S. Code Cong. & Ad. News 6238, 6249. RCRA was enacted to provide “a multifaceted approach toward solving the problems associated with the 3–4 billion tons of discarded materials generated each year, and the problems resulting from the anticipated 8% annual increase in the volume of such waste.” *Id.* at 2, 1976 U.S. Code Cong. & Ad. News at 6239. The committee reports accompanying legislative consideration of RCRA contain numerous statements evincing the Congressional view that improper disposal of toxic materials was a serious national problem.

The original statute made knowing disposal (but not treatment or storage) of such waste without a permit a misdemeanor. Amendments in 1978 and 1980 expanded the criminal provision to cover treatment and storage and made violation of section 6928 a felony. The fact that Congress amended the statute twice to broaden the scope of its substantive provisions and enhance the penalty is a strong indication of Congress’ increasing concern about the seriousness of the prohibited conduct.

We conclude that in RCRA, no less than in the Food and Drugs Act, Congress endeavored to control hazards that, “in the circumstances of modern industrialism, are largely beyond self-protection.” *United States v. Dotterweich*, 320 U.S. at 280. It would undercut the purposes of the legislation to limit the class of potential defendants to owners and operators when others also bear responsibility for handling regulated materials. The phrase “without having obtained a permit *under section 6925*” (emphasis added) merely references the section under which the permit is required and exempts from prosecution under section 6928(d)(2)(A) anyone who has obtained a permit; we conclude that it has no other limiting effect. Therefore we reject the district court’s construction limiting the substantive criminal provision by confining “any person” in section 6928(d)(2)(A) to owners and operators of facilities that store, treat or dispose of hazardous waste, as an unduly narrow view of both the statutory language and the congressional intent.

### CASE QUESTIONS

1. The district court (trial court) accepted the individual defendants' argument. What was that argument?
2. On what reasoning did the appellate court reject that argument?
3. If employees of a company that is violating the RCRA carry out disposal of hazardous substances in violation of the RCRA, they would presumably lose their jobs if they didn't. What is the moral justification for applying criminal penalties to such employees (such as Hopkins and Angel)?

## **24.7 Summary and Exercises**



## Summary

An estate is an interest in real property; it is the degree to which a thing is owned. Freehold estates are those with an uncertain duration; leaseholds are estates due to expire at a definite time. A present estate is one that is currently owned; a future estate is one that is owned now but not yet available for use.

Present estates are (1) the fee simple absolute; (2) the fee simple defeasible, which itself may be divided into three types, and (3) the life estate.

Future estates are generally of two types: reversion and remainder. A reversion arises whenever a transferred estate will endure for a shorter time than that originally owned by the transferor. A remainder interest arises when the transferor gives the reversion interest to someone else.

Use of air, earth, and water are the major rights incident to ownership of real property. Traditionally, the owner held “up to the sky” and “down to the depths,” but these rules have been modified to balance competing rights in a modern economy. The law governing water rights varies with the states; in general, the eastern states with more plentiful water have adopted either the natural flow doctrine or the reasonable use doctrine of riparian rights, giving those who live along a waterway certain rights to use the water. By contrast, western states have tended to apply the prior appropriation doctrine, which holds that first in time is first in right, even if those downstream are disadvantaged.

An easement is an interest in land—created by express agreement, prior use, or necessity—that permits one person to make use of another’s estate. An affirmative easement gives one person the right to use another’s land; a negative easement prevents the owner from using his land in a way that will affect another person’s land. In understanding easement law, the important distinctions are between easements appurtenant and in gross, and between dominant and servient owners.

The law not only defines the nature of the property interest but also regulates land use. Tort law regulates land use by imposing liability for (1) activities that affect those off the land and (2) injuries caused to people who enter it. The two most important theories relating to the former are nuisance and trespass. With respect to the latter, the common law confusingly distinguishes among trespassers, licensees, and invitees. Some states are moving away from the perplexing and rigid rules of the past and simply require owners to maintain their property in a reasonably safe condition.

Land use may also be regulated by private agreement through the restrictive covenant, an agreement that “runs with the land” and that will be binding on any subsequent owner. Land use is also regulated by the government’s power under eminent domain to take private land for public purposes (upon payment of just compensation),

through zoning laws, and through recently enacted environmental statutes, including the National Environmental Policy Act and laws governing air, water, treatment of hazardous wastes, and chemicals.

## EXERCISES

1. Dorothy deeded an acre of real estate that she owns to George for the life of Benny and then to Ernie. Describe the property interests of George, Benny, Ernie, and Dorothy.
2. In Exercise 1, assume that George moves into a house on the property. During a tornado, the roof is destroyed and a window is smashed. Who is responsible for repairing the roof and window? Why?
3. Dennis likes to spend his weekends in his backyard, shooting his rifle across his neighbor's yard. If Dennis never sets foot on his neighbor's property, and if the bullets strike neither persons nor property, has he violated the legal rights of the neighbor? Explain.
4. Dennis also drills an oil well in his backyard. He "slant drills" the well; that is, the well slants from a point on the surface in his yard to a point four hundred feet beneath the surface of his neighbor's yard. Dennis has slanted the drilling in order to capture his neighbor's oil. Can he do this legally? Explain.
5. Wanda is in charge of acquisitions for her company. Realizing that water is important to company operations, Wanda buys a plant site on a river, and the company builds a plant that uses all of the river water. Downstream owners bring suit to stop the company from using any water. What is the result? Why?
6. Sunny decides to build a solar home. Before beginning construction, she wants to establish the legal right to prevent her neighbors from constructing buildings that will block the sunlight. She has heard that the law distinguishes between licenses and easements, easements appurtenant and in gross, and affirmative and negative easements. Which of these interests would you recommend for Sunny? Why?

## SELF-TEST QUESTIONS

1. A freehold estate is defined as an estate
  - a. with an uncertain duration
  - b. due to expire at a definite time
  - c. owned now but not yet available for use
  - d. that is leased or rented
  
2. A fee simple defeasible is a type of
  - a. present estate
  - b. future estate
  - c. life estate
  - d. leasehold estate
  
3. A reversion is
  - a. a present estate that prevents transfer of land out of the family
  - b. a form of life estate
  - c. a future estate that arises when the estate transferred has a duration less than that originally owned by the transferor
  - d. identical to a remainder interest
  
4. An easement is an interest in land that may be created by
  - a. express agreement
  - b. prior use
  - c. necessity
  - d. all of the above
  
5. The prior appropriation doctrine
  - a. tends to be applied by eastern states
  - b. holds that first in time is first in right
  - c. gives those that live along a waterway special rights to use the water
  - d. all of the above

**SELF-TEST ANSWERS**

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

## Chapter 25

# The Transfer of Real Estate by Sale

### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The various forms of real estate ownership, including fee simple, tenancy in common, and joint tenancy
2. The mechanics of finding, financing, and closing a real estate transaction
3. How adverse possession may sometimes vest title in real property despite the nonconsent of the owner

This chapter follows the steps taken when real estate is transferred by sale.

1. The buyer selects a form of ownership.
2. The buyer searches for the real estate to be purchased. In doing so, the buyer will usually deal with real estate brokers.
3. After a parcel is selected, the seller and buyer will negotiate and sign a sales agreement.
4. The seller will normally be required to provide proof of title.
5. The buyer will acquire property insurance.
6. The buyer will arrange financing.
7. The sale and purchase will be completed at a closing.

During this process, the buyer and seller enter into a series of contracts with each other and with third parties such as brokers, lenders, and insurance companies. In this chapter, we focus on the unique features of these contracts, with the exception of mortgages ([Chapter 20 "Mortgages and Nonconsensual Liens"](#)) and property insurance ([Chapter 28 "Insurance"](#)). We conclude by briefly examining adverse possession—a method of acquiring property for free.

## 25.1 Forms of Ownership

### LEARNING OBJECTIVES

1. Be familiar with the various kinds of interest in real property.
2. Know the ways that two or more people can own property together.
3. Understand the effect of marriage, divorce, and death on various forms of property ownership.

### Overview

The transfer of property begins with the buyer's selection of a form of ownership. Our emphasis here is not on what is being acquired (the type of property interest) but on how the property is owned.

One form of ownership of real property is legally quite simple, although lawyers refer to it with a complicated-sounding name. This is ownership by one individual, known as ownership in **severalty**<sup>1</sup>. In purchasing real estate, however, buyers frequently complicate matters by grouping together—because of marriage, close friendship, or simply in order to finance the purchase more easily

When purchasers group together for investment purposes, they often use the various forms of organization discussed in [\(Reference mayer 1.0-ch40 not found in Book\)](#), [\(Reference mayer 1.0-ch41 not found in Book\)](#), [\(Reference mayer 1.0-ch42 not found in Book\)](#), and [\(Reference mayer 1.0-ch43 not found in Book\)](#)—corporations, partnerships, limited partnerships, joint ventures, and business trusts. The most popular of these forms of organization for owning real estate is the limited partnership. A real estate limited partnership is designed to allow investors to take substantial deductions that offset current income from the partnership and other similar investments, while at the same time protecting the investor from personal liability if the venture fails.

But you do not have to form a limited partnership or other type of business in order to acquire property with others; many other forms are available for personal or investment purposes. To these we now turn.

1. Ownership by one individual.

## Joint Tenancy

Joint tenancy is an estate in land owned by two or more persons. It is distinguished chiefly by the right of survivorship. If two people own land as joint tenants, then either becomes the sole owner when the other dies. For land to be owned jointly, four unities must coexist:

1. **Unity of time**<sup>2</sup>. The interests of the joint owners must begin at the same time.
2. **Unity of title**<sup>3</sup>. The joint tenants must acquire their title in the same conveyance—that is, the same will or deed.
3. **Unity of interest**<sup>4</sup>. Each owner must have the same interest in the property; for example, one may not hold a life estate and the other the remainder interest.
4. **Unity of possession**<sup>5</sup>. All parties must have an equal right to possession of the property (see [Figure 25.1 "Forms of Ownership and Unities"](#)).

Figure 25.1 *Forms of Ownership and Unities*

Unities	Joint Tenancy	Tenancy by Entirety	Tenancy in Common
Time	✓	✓	
Title	✓	✓	
Interest	✓	✓	
Possession	✓	✓	✓
Person		✓	

2. The interests of the joint owners must begin at the same time.
3. The joint tenants must acquire their title in the same conveyance—that is, the same will or deed.
4. Each owner must have the same interest in the property; for example, one may not hold a life estate and the other the remainder interest.
5. Where all parties have an equal right to possession of the property.

Suppose a woman owns some property and upon marriage wishes to own it jointly with her husband. She deeds it to herself and her husband “as joint tenants and not tenants in common.” Strictly speaking, the common law would deny that the resulting form of ownership was joint because the unities of title and time were missing. The wife owned the property first and originally acquired title under a different conveyance. But the modern view in most states is that an owner may convey directly to herself and another in order to create a joint estate.

When one or more of the unities is destroyed, however, the joint tenancy lapses. Fritz and Gary own a farm as joint tenants. Fritz decides to sell his interest to Jesse (or, because Fritz has gone bankrupt, the sheriff auctions off his interest at a foreclosure sale). Jesse and Gary would hold as tenants in common and not as joint tenants. Suppose Fritz had made out his will, leaving his interest in the farm to Reuben. On Fritz's death, would the unities be destroyed, leaving Gary and Reuben as tenants in common? No, because Gary, as joint tenant, would own the entire farm on Fritz's death, leaving nothing behind for Reuben to inherit.

### Tenancy by the Entirety

About half the states permit husbands and wives to hold property as **tenants by the entirety**<sup>6</sup>. This form of ownership is similar to joint tenancy, except that it is restricted to husbands and wives. This is sometimes described as the unity of person. In most of the states permitting tenancy by the entirety, acquisition by husband and wife of property as joint tenants automatically becomes a tenancy by the entirety. The fundamental importance of tenancy by the entirety is that neither spouse individually can terminate it; only a joint decision to do so will be effective. One spouse alone cannot sell or lease an interest in such property without consent of the other, and in many states a creditor of one spouse cannot seize the individual's separate interest in the property, because the interest is indivisible.

### Tenancy in Common

Two or more people can hold property as **tenants in common**<sup>7</sup> when the unity of possession is present, that is, when each is entitled to occupy the property. None of the other unities—of time, title, or interest—is necessary, though their existence does not impair the common ownership. Note that the tenants in common do not own a specific portion of the real estate; each has an undivided share in the whole, and each is entitled to occupy the whole estate. One tenant in common may sell, lease, or mortgage his undivided interest. When a tenant in common dies, his interest in the property passes to his heirs, not to the surviving tenants in common.

6. When spouses own property jointly and all unities are applicable.

7. When the unity of possession is present—that is, when each is entitled to occupy the property. None of the other unities—of time, title, or interest—is necessary, though their existence does not impair the common ownership.

Because tenancy in common does not require a unity of interest, it has become a popular form of “mingling,” by which unrelated people pool their resources to purchase a home. If they were joint tenants, each would be entitled to an equal share in the home, regardless of how much each contributed, and the survivor would become sole owner when the other owner dies. But with a tenancy-in-common arrangement, each can own a share in proportion to the amount invested.



## Community Property

In ten states—Alaska, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin—property acquired during a marriage is said to be **community property**<sup>8</sup>. There are differences among these states, but the general theory is that with certain exceptions, each spouse has an undivided equal interest in property acquired while the husband and wife are married to each other. The major exception is for property acquired by gift or inheritance during the marriage. (By definition, property owned by either spouse before the marriage is not community property.) Property acquired by gift of inheritance or owned before the marriage is known as **separate property**<sup>9</sup>. Community property states recognize other forms of ownership; specifically, husbands and wives may hold property as joint tenants, permitting the survivor to own the whole.

The consequence of community property laws is that either the husband or the wife may manage the community property, borrow against it, and dispose of community personal property. Community real estate may only be sold or encumbered by both jointly. Each spouse may bequeath only half the community property in his or her will. In the absence of a will, the one-half property interest will pass in accordance with the laws of intestate succession. If the couple divorces, the states generally provide for an equal or near-equal division of the community property, although a few permit the court in its discretion to divide in a different proportion.

## Condominiums

In popular parlance, a condominium is a kind of apartment building, but that is not its technical legal meaning. Condominium is a form of ownership, not a form of structure, and it can even apply to space—for example, to parking spaces in a garage. The word *condominium* means joint ownership or control, and it has long been used whenever land has been particularly scarce or expensive. Condominiums were popular in ancient Rome (especially near the Forum) and in the walled cities of medieval Europe.

8. There are differences among community property states, but the general theory is that, with certain exceptions, each spouse has an undivided equal interest in property acquired while the husband and wife are married to each other.

9. Property acquired by gift of inheritance or owned before the marriage.

In its modern usage, *condominium* refers to a form of housing involving two elements of ownership. The first is the living space itself, which may be held in common, in joint tenancy, or in any other form of ownership. The second is the common space in the building, including the roof, land under the structure, hallways, swimming pool, and the like. The common space is held by all purchasers as tenants in common. The living space may not be sold apart from the interest in the common space.

Two documents are necessary in a condominium sale—the master deed and the bylaws. The master deed (1) describes the condominium units, the common areas, and any restrictions that apply to them; (2) establishes the unit owner’s interest in the common area, his number of votes at owners’ association meetings, and his share of maintenance and operating expenses (sometimes unit owners have equal shares, and sometimes their share is determined by computing the ratio of living area or market price or original price of a single unit to the whole); and (3) creates a board of directors to administer the affairs of the whole condominium. The bylaws usually establish the owners’ association, set out voting procedures, list the powers and duties of the officers, and state the obligations of the owners for the use of the units and the common areas.

### **Cooperatives**

Another popular form of owning living quarters with common areas is the cooperative. Unlike the person who lives in a condominium, the tenant of a cooperative does not own a particular unit. Instead, he owns a share of the entire building. Since the building is usually owned by a corporation (a cooperative corporation, hence the name), this means that the tenant owns stock in the corporation. A tenant occupies a unit under a lease from the corporation. Together, the lease and stock in the building corporation are considered personal, not real, property.

In a condominium, an owner of a unit who defaults in paying monthly mortgage bills can face foreclosure on the unit, but neighbors in the building suffer no direct financial impact, except that the defaulter probably has not paid monthly maintenance charges either. In a cooperative, however, a tenant who fails to pay monthly charges can jeopardize the entire building, because the mortgage is on the building as a whole; consequently, the others will be required to make good the payments or face foreclosure.

### **Time-Shares**

A time-share is an arrangement by which several people can own the same property while being entitled to occupy the premises exclusively at different times on a recurring basis. In the typical vacation property, each owner has the exclusive right to use the apartment unit or cottage for a specified period of time each year—for example, Mr. and Mrs. Smith may have possession from December 15 through December 22, Mr. and Mrs. Jones from December 23 through December 30, and so on. The property is usually owned as a condominium but need not be. The sharers may own the property in fee simple, hold a joint lease, or even belong to a vacation club that sells time in the unit.

Time-share resorts have become popular in recent years. But the lure of big money has brought unscrupulous contractors and salespersons into the market. Sales practices can be unusually coercive, and as a result, most states have sets of laws specifically to regulate time-share sales. Almost all states provide a cooling-off period, or rescission period; these periods vary from state to state and provide a window where buyers can change their minds without forfeiting payments or deposits already made.

### KEY TAKEAWAY

Property is sometimes owned by one person or one entity, but more often two or more persons will share in the ownership. Various forms of joint ownership are possible, including joint tenancies, tenancy by the entirety, and tenancy in common. Married persons should be aware of whether the state they live in is a community property state; if it is, the spouse will take some interest in any property acquired during the marriage. Beyond traditional landholdings, modern real estate ownership may include interests in condominiums, cooperatives, or time-shares.

### EXERCISES

1. Miguel and Maria Ramirez own property in Albuquerque, New Mexico, as tenants by the entirety. Miguel is a named defendant in a lawsuit that alleges defamation, and an award is made for \$245,000 against Miguel. The property he owns with Maria is worth \$320,000 and is owned free of any mortgage interest. To what extent can the successful plaintiff recover damages by forcing a sale of the property?
2. Miguel and Maria Ramirez own property in Albuquerque, New Mexico, as tenants by the entirety. They divorce. At the time of the divorce, there are no new deeds signed or recorded. Are they now tenants in common or joint tenants?

## 25.2 Brokers, Contracts, Proof of Title, and Closing

### LEARNING OBJECTIVES

1. Know the duties of the real estate broker and how brokers are licensed.
2. Be able to discuss the impact of constitutional and statutory law on real estate sellers and brokers.
3. Describe the various kinds of listing contracts and their import.
4. Know the elements of a sales agreement and the various types of deeds to real estate.
5. Understand the closing process and how “good title” is obtained through the title search and insurance process.

Once the buyer (or buyers) knows what form of ownership is most desirable, the search for a suitable property can begin. This search often involves contact with a broker hired by the seller. The seller’s contract with the broker, known as the **listing agreement**<sup>10</sup>, is the first of the series of contracts in a typical real estate transaction. As you consider these contracts, it is important to keep in mind that despite the size of the transaction and the dire financial consequences should anything go awry, the typical person (buyer or seller) usually acts as his or her own attorney. An American Bar Association committee has noted the following:

It is probably safe to say that in a high percentage of cases the seller is unrepresented and signs the contracts of brokerage and sale on the basis of his faith in the broker. The buyer does not employ a lawyer. He signs the contract of sale without reading it and, once financing has been obtained, leaves all the details of title search and closing to the lender or broker. The lender or broker may employ an attorney but, where title insurance is furnished by a company maintaining its own title plant, it is possible that no lawyer, not even house counsel, will appear.

This being so, the material that follows is especially important for buyers and sellers who are not represented in the process of buying or selling real estate.

### Regulation of the Real Estate Business State Licensing

10. An agreement between the owner of real property and a real estate broker.

Real estate brokers, and the search for real estate generally, are subject to state and federal government regulation. Every state requires real estate brokers to be licensed. To obtain a license, the broker must pass an examination covering the

principles of real estate practice, transactions, and instruments. Many states additionally insist that the broker take several courses in finance, appraisal, law, and real estate practice and apprentice for two years as a salesperson in a real estate broker's office.

### **Civil Rights Act**

Two federal civil rights laws also play an important role in the modern real estate transaction. These are the Civil Rights Act of 1866 and the Civil Rights Act of 1968 (Fair Housing Act). In *Jones v. Alfred H. Mayer Co.*, 392 U.S. 409 (1968), the Supreme Court upheld the constitutionality of the 1866 law, which expressly gives all citizens of the United States the same rights to inherit, purchase, lease, sell, hold, and convey real and personal property. A minority buyer or renter who is discriminated against may sue for relief in federal court, which may award damages, stop the sale of the house, or even direct the seller to convey the property to the plaintiff.

The 1968 Fair Housing Act prohibits discrimination on the grounds of race, color, religion, sex, national origin, handicap, or family status (i.e., no discrimination against families with children) by any one of several means, including the following:

1. Refusing to sell or rent to or negotiate with any person
2. Discriminating in the terms of sale or renting
3. Discriminating in advertising
4. Denying that the housing is available when in fact it is
5. "Blockbusting" (panicking owners into selling or renting by telling them that minority groups are moving into the neighborhood)
6. Creating different terms for granting or denying home loans by commercial lenders
7. Denying anyone the use of real estate services

However, the 1968 act contains several exemptions:

1. Sale or rental of a single-family house if the seller
  - a. owns less than four such houses,
  - b. does not use a broker,
  - c. does not use discriminatory advertising,
  - d. within two years sells no more than one house in which the seller was not the most recent occupant.

- e. Rentals in a building occupied by the owner as long as it houses fewer than five families and the owner did not use discriminatory advertising
- f. Sale or rental of space in buildings or land restricted by religious organization owners to people of the same religion (assuming that the religion does not discriminate on the basis of race, color, or national origin)
- g. Private clubs, if they limit their noncommercial rentals to members

The net impact of these laws is that discrimination based on color or race is flatly prohibited and that other types of discrimination are also barred unless one of the enumerated exemptions applies.

### Hiring the Broker: The Listing Agreement

When the seller hires a real estate broker, he will sign a listing agreement. (In several states, the Statute of Frauds says that the seller must sign a written agreement; however, he should do so in all states in order to provide evidence in the event of a later dispute.) This listing agreement sets forth the broker's commission, her duties, the length of time she will serve as broker, and other terms of her agency relationship. Whether the seller will owe a commission if he or someone other than the broker finds a buyer depends on which of three types of listing agreements has been signed.

#### Exclusive Right to Sell

If the seller agrees to an **exclusive-right-to-sell**<sup>11</sup> agency, he will owe the broker the stated commission regardless of who finds the buyer. Language such as the following gives the broker an exclusive right to sell: "Should the seller or anyone acting for the seller (including his heirs) sell, lease, transfer, or otherwise dispose of the property within the time fixed for the continuance of the agency, the broker shall be entitled nevertheless to the commission as set out herein."

#### Exclusive Agency

Somewhat less onerous from the seller's perspective (and less generous from the broker's perspective) is the **exclusive agency**<sup>12</sup>. The broker has the exclusive right to sell and will be entitled to the commission if anyone other than the seller finds the buyer (i.e., the seller will owe no commission if he finds a buyer). Here is language that creates an exclusive agency: "A commission is to be paid the broker

11. If the seller agrees to an exclusive-right-to-sell agency, he will owe the broker the stated commission regardless of who finds the buyer.

12. The broker has the exclusive right to sell and will be entitled to the commission if anyone other than the seller finds the buyer (in other words, the seller will owe no commission if he finds a buyer).

whether the purchaser is secured by the broker or by any person other than the seller.”

### Open Listing

The third type of listing, relatively rarely used, is the open listing, which authorizes “the broker to act as agent in securing a purchaser for my property.” The **open listing**<sup>13</sup> calls for payment to the broker only if the broker was instrumental in finding the buyer; the broker is not entitled to her commission if anyone else, seller or otherwise, locates the buyer.

Suppose the broker finds a buyer, but the seller refuses at that point to sell. May the seller simply change his mind and avoid having to pay the broker’s commission? The usual rule is that when a broker finds a buyer who is “ready, willing, and able” to purchase or lease the property, she has earned her commission. Many courts have interpreted this to mean that even if the buyers are unable to obtain financing, the commission is owed nevertheless once the prospective buyers have signed a purchase agreement. To avoid this result, the seller should insist on either a “no deal, no commission” clause in the listing agreement (entitling the broker to payment only if the sale is actually consummated) or a clause in the purchase agreement making the purchase itself contingent on the buyer’s finding financing.

### Broker’s Duties

Once the listing agreement has been signed, the broker becomes the seller’s agent—or, as occasionally happens, the buyer’s agent, if hired by the buyer. A broker is not a general agent with broad authority. Rather, a broker is a special agent with authority only to show the property to potential buyers. Unless expressly authorized, a broker may not accept money on behalf of the seller from a prospective buyer. Suppose Eunice hires Pete’s Realty to sell her house. They sign a standard exclusive agency listing, and Pete cajoles Frank into buying the house. Frank writes out a check for \$10,000 as a down payment and offers it to Pete, who absconds with the money. Who must bear the loss? Ordinarily, Frank would have to bear the loss, because Pete was given no authority to accept money. If the listing agreement explicitly said that Pete could accept the down payment from a buyer, then the loss would fall on Eunice.

13. Calls for payment to the broker only if the broker was instrumental in finding the buyer; the broker is not entitled to her commission if anyone else, seller or otherwise, locates the buyer.

14. A fiduciary duty is a duty of the highest loyalty and trust. It means that the broker cannot buy the property for himself through an intermediary without full disclosure to the seller.

Although the broker is but a special agent, she owes the seller, her principal, a **fiduciary duty**<sup>14</sup>. (See [Reference mayer 1.0-ch38 not found in Book](#) on relations between principal and agent.) A fiduciary duty is a duty of the highest loyalty and trust. It means that the broker cannot buy the property for herself through an intermediary without full disclosure to the seller of her intentions. Nor may the

broker secretly receive a commission from the buyer or suggest to a prospective buyer that the property can be purchased for less than the asking price.

## **The Sales Agreement**

Once the buyer has selected the real estate to be acquired, an agreement of sale will be negotiated and signed. Contract law in general is discussed in (Reference mayer 1.0-ch08 not found in Book); our discussion here will focus on specific aspects of the real estate contract. The Statute of Frauds requires that contracts for sale of real estate must be in writing. The writing must contain certain information.

### **Names of Buyers and Sellers**

The agreement must contain the names of the buyers and sellers. As long as the parties sign the agreement, however, it is not necessary for the names of buyers and sellers to be included within the body of the agreement.

### **Real Estate Description**

The property must be described sufficiently for a court to identify the property without having to look for evidence outside the agreement. The proper address, including street, city, and state, is usually sufficient.

### **Price**

The price terms must be clear enough for a court to enforce. A specific cash price is always clear enough. But a problem can arise when installment payments are to be made. To say “\$50,000, payable monthly for fifteen years at 12 percent” is not sufficiently detailed, because it is impossible to determine whether the installments are to be equal each month or are to be equal principal payments with varying interest payments, declining monthly as the balance decreases.

### **Signature**

As a matter of prudence, both buyer and seller should sign the purchase agreement. However, the Statute of Frauds requires only the signature of the party against whom the agreement is to be enforced. So if the seller has signed the agreement, he cannot avoid the agreement on the grounds that the buyer has not signed it. However, if the buyer, not having signed, refuses to go to closing and take title, the seller would be unable to enforce the agreement against him.



### Easements and Restrictive Covenants

Unless the contract specifically states otherwise, the seller must deliver **marketable title**<sup>15</sup>. A marketable title is one that is clear of restrictions to which a reasonable buyer would object. Most buyers would refuse to close the deal if there were potential third-party claims to all or part of the title. But a buyer would be unreasonable if, at closing, he refused to consummate the transaction on the basis that there were utility easements for the power company or a known and visible driveway easement that served the neighboring property. As a precaution, a seller must be sure to say in the contract for sale that the property is being sold “subject to easements and restrictions of record.” A buyer who sees only such language should insist that the particular easements and restrictive covenants be spelled out in the agreement before he signs.

### Risk of Loss

Suppose the house burns down after the contract is signed but before the closing. Who bears the loss? Once the contract is signed, most states apply the rule of equitable conversion, under which the buyer’s interest (his executory right to enforce the contract to take title to the property) is regarded as real property, and the seller’s interest is regarded as personal property. The rule of equitable conversion stems from an old maxim of the equity courts: “That which ought to be done is regarded as done.” That is, the buyer ought to have the property and the seller ought to have the money. A practical consequence of this rule is that the loss of the property falls on the buyer. Because most buyers do not purchase insurance until they take title, eleven states have adopted the Uniform Vendor and Purchaser Risk Act, which reverses the equitable conversion rule and places risk of loss on the seller. The parties may themselves reverse the application of the rule; the buyer should always insist on a clause in a contract stating that risk of loss remains with the seller until a specified date, such as the closing.

### Earnest Money

As protection against the buyer’s default, the seller usually insists on a down payment known as earnest money. This is intended to cover such immediate expenses as proof of marketable title and the broker’s commission. If the buyer defaults, he forfeits the earnest money, even if the contract does not explicitly say so.

15. A marketable title is one that can be transferred to a new owner without the likelihood that claims will be made on it by another party.

### Contingencies

Performance of most real estate contracts is subject to various contingencies—that is, it is conditioned on the happening of certain events. For example, the buyer

might wish to condition his agreement to buy the house on his ability to find a mortgage or to find one at a certain rate of interest. Thus the contract for sale might read that the buyer “agrees to buy the premises for \$50,000, subject to his obtaining a \$40,000 mortgage at 5 percent.” The person protected by the contingency may waive it; if the lowest interest rate the buyer could find was 5.5 percent, he could either refuse to buy the house or waive the condition and buy it anyway.

### Times for Performance

A frequent difficulty in contracting to purchase real estate is the length of time it takes to receive an acceptance to an offer. If the acceptance is not received in a reasonable time, the offeror may treat the offer as rejected. To avoid the uncertainty, an offeror should always state in his offer that it will be held open for a definite period of time (five working days, two weeks, or whatever). The contract also ought to spell out the times by which the following should be done: (1) seller’s proof that he has title, (2) buyer’s review of the evidence of title, (3) seller’s correction of title defects, (4) closing date, and (5) possession by the buyer. The absence of explicit time provisions will not render the contract unenforceable—the courts will infer a reasonable time—but their absence creates the possibility of unnecessary disputes.

### Types of Deeds

Most real estate transactions involve two kinds of deeds, the general warranty deed and the quitclaim deed.

1. **General warranty deed.** In a warranty deed, the seller warrants to the buyer that he possesses certain types of legal rights in the property. In the **general warranty deed**<sup>16</sup>, the seller warrants that (a) he has good title to convey, (b) the property is free from any encumbrance not stated in the deed (the warranty against encumbrances), and (c) the property will not be taken by someone with a better title (the warranty of quiet enjoyment). Breach of any of these warranties exposes the seller to damages.
2. **Quitclaim deed.** The simplest form of deed is the **quitclaim deed**<sup>17</sup>, in which the seller makes no warranties. Instead, he simply transfers to the buyer whatever title he had, defects and all. A quitclaim deed should not be used in the ordinary purchase and sale transaction. It is usually reserved for removing a cloud on the title—for instance, a quitclaim deed by a widow who might have a dower interest in the property.

16. A deed in which the seller warrants that (a) he has good title to convey, (b) the property is free from any encumbrance not stated in the deed (the warranty against encumbrances), and (c) the property will not be taken by someone with a better title (the warranty of quiet enjoyment).

17. A deed in which the seller makes no warranties.

If the purchase agreement is silent about the type of deed, courts in many states will require the seller to give the buyer a quitclaim deed. In the contract, the buyer should therefore specify that the seller is to provide a warranty deed at closing.

When buyers move in after the closing, they frequently discover defects (the boiler is broken, a pipe leaks, the electrical power is inadequate). To obtain recourse against such an eventuality, the buyer could attempt to negotiate a clause in the contract under which the seller gives a warranty covering named defects. However, even without an express warranty, the law implies two warranties when a buyer purchases a new house from a builder. These are warranties that (1) the house is habitable and (2) the builder has completed the house in a workmanlike manner. Most states have refused to extend these warranties to subsequent purchasers—for example, to the buyer from a seller who had bought from the original builder. However, a few states have begun to provide limited protection to subsequent purchasers—in particular, for defects that a reasonable inspection will not reveal but that will show up only after purchase.

### **Proof of Title**

Contracts are often formed and performed simultaneously, but in real estate transactions there is more often a gap between contract formation and performance (the closing). The reason is simple: the buyer must have time to obtain financing and to determine whether the seller has marketable title. That is not always easy; at least, it is not as straightforward as looking at a piece of paper. To understand how title relates to the real estate transaction, some background on recording statutes will be useful.

### **Recording Statutes**

Suppose Slippery Sam owned Whispering Pines, a choice resort hotel on Torch Lake. On October 1, Slippery deeded Whispering Pines to Lorna for \$1,575,000. Realizing the profit potential, Slippery decided to sell it again, and did so on November 1, without bothering to tell Malvina, the new buyer to whom he gave a new deed, that he had already sold it to Lorna. He then departed for a long sailing trip to the British Virgin Islands.

When Malvina arrives on the doorstep to find Lorna already tidying up, who should prevail? At common law, the first deed prevailed over subsequent deeds. So in our simple example, if this were a pure common-law state, Lorna would have title and Malvina would be out of luck, stuck with a worthless piece of paper. Her only recourse, probably futile, would be to search out and sue Slippery Sam for fraud.

Most states, however, have enacted **recording statutes**<sup>18</sup>, which award title to the person who has complied with the requirement to place the deed in a publicly available file in a public office in the county, often called the recorder's office or the register of deeds.

### Notice Statute

Under the most common type of recording statute, called a notice statute, a deed must be recorded in order for the owner to prevail against a subsequent purchaser. Assume in our example that Lorna recorded her deed on November 2 and that Malvina recorded on November 4. In a notice-statute state, Malvina's claim to title would prevail over Lorna's because on the day that Malvina received title (November 1), Lorna had not yet recorded. For this rule to apply, Malvina must have been a bona fide purchaser, meaning that she must have (1) paid valuable consideration, (2) bought in good faith, and (3) had no notice of the earlier sale. If Lorna had recorded before Malvina took the deed, Lorna would prevail if Malvina did not in fact check the public records; she should have checked, and the recorded deed is said to put subsequent purchasers on **constructive notice**<sup>19</sup>.

### Notice-Race Statute

Another common type of recording statute is the notice-race statute. To gain priority under this statute, the subsequent bona fide purchaser must also record—that is, win the race to the recorder's office before the earlier purchaser. So in our example, in a notice-race jurisdiction, Lorna would prevail, since she recorded before Malvina did.

### Race Statute

A third, more uncommon type is the race statute, which gives title to whoever records first, even if the subsequent purchaser is not bona fide and has actual knowledge of the prior sale. Suppose that when she received the deed, Malvina knew of the earlier sale to Lorna. Malvina got to the recording office the day she got the deed, November 1, and Lorna came in the following day. In a race-statute jurisdiction, Malvina would take title.

18. Statutes that award title to the person who has complied with the requirement to place the deed in a public registry, usually a county Register of Deeds office.

19. A buyer is on constructive notice of anything put in the public records, whether or not she actually notices.

### Chain of Title

Given the recording statutes, the buyer must check the deed on record to determine (1) whether the seller ever acquired a valid deed to the property—that is, whether a chain of title can be traced from earlier owners to the seller—and (2) whether the seller has already sold the property to another purchaser, who has recorded a deed.

There are any number of potential “clouds” on the title that would defeat a fee simple conveyance: among others, there are potential judgments, liens, mortgages, and easements that might affect the value of the property. There are two ways to protect the buyer: the abstract of title and opinion, and title insurance.

### Abstract and Opinion

An abstract of title is a summary of the chain of title, listing all previous deeds, mortgages, tax liens, and other instruments recorded in the county land records office. The abstract is prepared by either an attorney or a title company. Since the list itself says nothing about whether the recorded instruments are legally valid, the buyer must also have the opinion of an attorney reviewing the abstract, or must determine by doing his own search of the public records, that the seller has valid title. The attorney’s opinion is known as a title opinion or certificate of title. The problem with this method of proving title is that the public records do not reveal hidden defects. One of the previous owners might have been a minor or an incompetent person who can still void his sale, or a previous deed might have been forged, or a previous seller might have claimed to be single when in fact he was married and his wife failed to sign away her dower rights. A search of the records would not detect these infirmities.

### Title Insurance

To overcome these difficulties, the buyer should obtain **title insurance**<sup>20</sup>. This is a one-premium policy issued by a title insurance company after a search through the same public records. When the title company is satisfied that title is valid, it will issue the insurance policy for a premium that could be as high as 1 percent of the selling price. When the buyer is taking out a mortgage, he will ordinarily purchase two policies, one to cover his investment in the property and the other to cover the mortgagee lender’s loan. In general, a title policy protects the buyer against losses that would occur if title (1) turns out to belong to someone else; (2) is subject to a lien, encumbrance, or other defect; or (3) does not give the owner access to the land. A preferred type of title policy will also insure the buyer against losses resulting from an unmarketable title.

20. A one-premium policy issued by a title insurance company after a search through the public records. Title insurance is usually provided to both the buyer and the buyer’s lender. It guarantees against defects in the title rather than any physical aspects of the property.

Note that in determining whether to issue a policy, the title company goes through the process of searching through the public records again. The title policy as such does not guarantee that title is sound. A buyer could conceivably lose part or all of the property someday to a previous rightful owner, but if he does, the title insurance company must reimburse him for his losses.

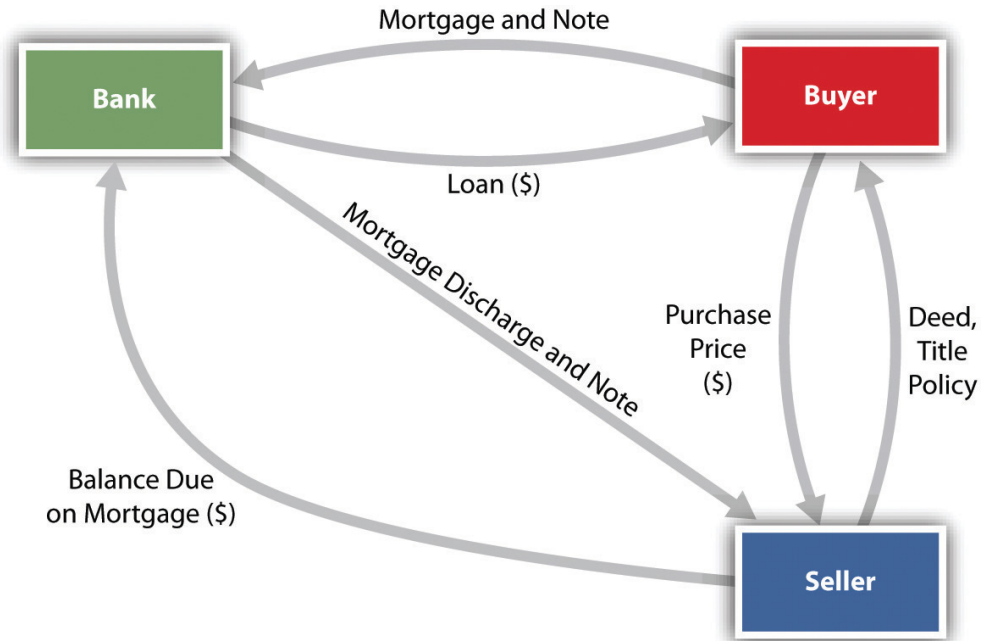
Although title insurance is usually a sound protection, most policies are subject to various exclusions and exceptions. For example, they do not provide coverage for zoning laws that restrict use of the property or for a government's taking of the property under its power of eminent domain. Nor do the policies insure against defects created by the insured or known by the insured but unknown to the company. Some companies will not provide coverage for mechanics' liens, public utility easements, and unpaid taxes. (If the accrued taxes are known, the insured will be presented with a list, and if he pays them on or before the closing, they will be covered by the final policy.) Furthermore, as demonstrated in *Title and Trust Co. of Florida v. Barrows*, (see [Section 25.4.1 "Title Insurance"](#)), title insurance covers title defects only, not physical defects in the property.

### The Closing

Closing can be a confusing process because in most instances several contracts are being performed simultaneously:

1. The seller and purchaser are performing the sales contract.
2. The seller is paying off a mortgage, while the buyer is completing arrangements to borrow money and mortgage the property.
3. Title and other insurance arrangements will be completed.
4. The seller will pay the broker.
5. If buyer and seller are represented, attorneys for each party will be paid.

Figure 25.2 Closing Process



Despite all these transactions, the critical players are the seller, the purchaser, and the bank. To place the closing process in perspective, assume that one bank holds the existing (seller's) mortgage on the property and is also financing the buyer's purchase. We can visualize the three main players sitting at a table, ready to close the transaction. The key documents and the money will flow as illustrated in [Figure 25.2 "Closing Process"](#).

### Form of the Deed

The deed must satisfy two fundamental legal requirements: it must be in the proper form, and there must be a valid delivery. Deeds are usually prepared by attorneys, who must include not only information necessary for a valid deed but also information required in order to be able to record the deed. The following information is typically required either for a valid deed or by the recording statutes.

#### Grantor

The grantor—the person who is conveying the property—must be designated in some manner. Obviously, it is best to give the grantor's full name, but it is sufficient that the person or persons conveying the deed are identifiable from the document.

Thus “the heirs of Lockewood Filmer” is sufficient identification if each of the heirs signs the deed.

### **Grantee**

Similarly, the deed should identify the grantee—the person to whom the property is being conveyed. It does not void the deed to misspell a person’s name or to omit part of a name, or even to omit the name of one of the grantees (as in “Lockewood Filmer and wife”). Although not technically necessary, the deed ought to detail the interests being conveyed to each grantee in order to avoid considerable legal difficulty later. “To Francis Lucas, a single man, and Joseph Lucas and Matilda Lucas, his wife” was a deed of unusual ambiguity. Did each party have a one-third interest? Or did Joseph and Matilda hold half as tenants by the entirety and Francis have a one-half interest as a tenant in common? Or perhaps Francis had a one-third interest as a tenant in common and Joseph and Matilda held two-thirds as tenants by the entirety? Or was there some other possible combination? The court chose the second interpretation, but considerable time and money could have been saved had the deed contained a few simple words of explanation. *Heatter v. Lucas*, 80 A.2d 749 (Pa. 1951).

### **Addresses**

Addresses of the parties should be included, although their absence will not usually invalidate the deed. However, in some states, failure to note the addresses will bar the deed from being recorded.

### **Words of Conveyance**

The deed must indicate that the grantor presently intends to convey his interest in the property to the grantee. The deed may recite that the grantor “conveys and warrants” the property (warranty deed) or “conveys and quitclaims” the property (quitclaim deed). Some deeds use the words “bargain and sell” in place of convey.

### **Description**

The deed must contain an accurate description of the land being conveyed, a description clear enough that the land can be identified without resorting to other evidence. Four general methods are used.

1. **The US government survey.** This is available west of the Mississippi (except in Texas) and in Alabama, Florida, Illinois, Indiana, Michigan, Mississippi, Ohio, and Wisconsin. With this survey, it is possible to



specify with considerable exactitude any particular plot of land in any township in these states.

2. **Metes and bounds.** The description of metes and bounds begins with a particular designated point (called a monument)—for example, a drainpipe, an old oak tree, a persimmon stump—and then defines the boundary with distances and angles until returning to the monument. As you can tell, using monuments that are biological (like trees and stumps) will have a limited utility as time goes on. Most surveyors put in stakes (iron pins), and the metes and bounds description will go from points where stakes have been put in the ground.
3. **Plats.** Many land areas have been divided into numbered lots and placed on a map called a plat. The plats are recorded. The deed, then, need only refer to the plat and lot number—for example, “Lot 17, Appledale Subdivision, record in Liber 2 of Plats, page 62, Choctaw County Records.”
4. **Informal description.** If none of the preceding methods can be used, an informal description, done precisely enough, might suffice. For instance, “my home at 31 Fernwood Street, Maplewood, Idaho” would probably pass muster.

### **Statement of Consideration**

Statutes usually require that some consideration be stated in the deed, even though a grantor may convey property as a gift. When there is a selling price, it is easy enough to state it, although the actual price need not be listed. When land is being transferred as a gift, a statement of nominal consideration—for example, one dollar—is sufficient.

### **Date**

Dates are customary, but deeds without dates will be enforced.

### **Execution**

The deed must be signed by the grantor and, in some states, witnesses, and these signatures must be acknowledged by a notary public in order to make the deed eligible for recording. If someone is signing for the grantor under a power of attorney, a written instrument authorizing one person to sign for another, the instrument must be recorded along with the deed.

## Delivery

To validly convey title to the property, the deed must not only be in proper form but also be delivered. This technical legal requirement is sometimes misunderstood. **Delivery**<sup>21</sup> entails (1) physical delivery to the grantee, (2) an intention by the grantor to convey title, and (3) acceptance of title by the grantee. Because the grantor must intend to convey title, failure to meet the other two elements during the grantor's lifetime will void title on his death (since at that point he of course cannot have an intention). Thus when a grantee is unaware of the grantor's intention to deed the property to him, an executed deed sitting in a safe-deposit box will be invalid if discovered after the grantor's death.

### Delivery to Grantee

If the deed is physically delivered to the grantee or recorded, there is a rebuttable presumption that legal delivery has been made. That is, the law presumes, in the absence of evidence to the contrary, that all three conditions have been met if delivery or recording takes place. But this presumption can be rebutted, as shown in *Havens v. Schoen*, (see [Section 25.4.2 "Delivery of a Deed"](#)).

### Delivery to Third Party (Commercial Escrow)

The grantor may deliver the deed to a third party to hold until certain conditions have been met. Thus to avoid the problem of the deed sitting in the grantor's own safe-deposit box, he could deliver it to a third party with instructions to hold it until his death and then to deliver it to the grantee. This would be an effective delivery, even though the grantee could not use the property until the grantor died. For this method to be effective, the grantor must lose all control over the deed, and the third party must be instructed to deliver the deed when the specified conditions occur.

This method is most frequently used in the commercial escrow. **Escrow**<sup>22</sup> is a method by which a third party holds a document or money or both until specified conditions have been met. A typical example would be a sale in which the buyer is afraid of liens that might be filed after the closing. A contractor that has supplied materials for the building of a house, for example, might file a lien against the property for any amounts due but unpaid under the contract. The effectiveness of the lien would relate back to the time that the materials were furnished. Thus, at closing, all potential liens might not have been filed. The buyer would prefer to pay the seller after the time for filing materialmen's liens has lapsed. But sellers ordinarily want to ensure that they will receive their money before delivering a deed. The solution is for the buyer to pay the money into escrow (e.g., to a bank) and for the seller to deliver the deed to the same escrow agent. The bank would be

21. Entails (1) physical delivery to the grantee, (2) an intention by the grantor to convey title, and (3) acceptance of title by the grantee.

22. A method by which a third party holds a document or money or both until specified conditions have been met.

instructed to hold both the money and the deed until the time for filing mechanics' liens has ended. If no materialmen's liens have been filed, then the money is paid out of escrow to the seller and the deed is released to the buyer. If a lien has been filed, then the money will not be paid until the seller removes the lien (usually by paying it off).

#### KEY TAKEAWAY

Most real estate is bought and sold through real estate brokers, who must be licensed by the state. Brokers have different kinds of agreements with clients, including exclusive right to sell, exclusive agency, and open listing. Brokers will usually arrange a sales agreement that includes standard provisions such as property description, earnest money, and various contingencies. A deed, usually a warranty deed, will be exchanged at the closing, but not before the buyer has obtained good proof of title, usually by getting an abstract and opinion and paying for title insurance. The deed will typically be delivered to the buyer and recorded at the county courthouse in the register of deeds' office.

## EXERCISES

1. Kitty Korniotis is a licensed real estate broker. Barney Woodard and his wife, Carol, sign an exclusive agency listing with Kitty to sell their house on Woodvale Avenue. At a social gathering, Carol mentions to a friend, Helen Nearing, that the house on Woodvale is for sale. The next day, Helen drives by the property and calls the number on Kitty's sign. Helen and Scott Nearing sign a contract to buy the house from the Woodards. Is Kitty entitled to the commission?
2. Deepak Abhishek, a single man, lives in a race-notice state. He contracts to buy a large parcel of land from his friend, Ron Khurana, for the sum of \$280,000. Subsequent to the contract, Khurana finds another buyer, who is willing to pay \$299,000. Khurana arranges for two closings on the same day, within two hours of each other. At 10 a.m., he sells the property to Beverly Hanks and her husband, John, for \$299,000. The Hanks are not represented by an attorney. Khurana hands them the deed at closing, but he takes it back from them and says, "I will record this at the courthouse this afternoon." The Hankses take a copy of the deed with them and are satisfied that they have bought the property; moreover, Khurana gives them a commitment from Lawyer's Title Company that the company will insure that they are receiving fee simple title from Khurana, subject to the deed's being recorded in the county register of deeds' office.

At noon, Khurana has a closing with Abhishek, who is represented by an attorney. The attorney went to the courthouse earlier, at 11:30 a.m., and saw nothing on record that would prevent Khurana from conveying fee simple title. As the deal closes, and as Khurana prepares to leave town, Abhishek's attorney goes to the courthouse and records the deed at 1:15 p.m. At 2:07 p.m., on his way out of town, Abhishek records the deed to the Hankses.

- a. Who has better claim to the property—the Hankses or Deepak Abhishek?
- b. Does it matter if the state is a notice jurisdiction or a notice-race jurisdiction?
- c. A warranty deed is given in both closings. What would be the best remedy for whichever buyer did not get the benefit of clear title from these two transactions?

## 25.3 Adverse Possession

### LEARNING OBJECTIVE

1. Explain how it is possible to own land without paying for it.

In some instances, real property can be acquired for free—or at least without paying the original owner anything. (Considerable cost may be involved in meeting the requisite conditions.) This method of acquisition—known as **adverse possession**<sup>23</sup>—is effective when five conditions are met: (1) the person claiming title by adverse possession must assert that he has a right to possession hostile to the interest of the original owner, (2) he must actually possess the property, (3) his possession must be “open and notorious,” (4) the possession must be continuous, and (5) the possession must be exclusive.

### Hostile Possession

Suppose Jean and Jacques are tenants in common of a farm. Jean announces that he no longer intends to pursue agricultural habits and leaves for the city. Jacques continues to work on the land, making improvements and paying taxes and the mortgage. Years later, Jacques files suit for title, claiming that he now owns the land outright by adverse possession. He would lose, since his possession was not hostile to Jacques. To be hostile, possession of the land must be without permission and with the intention to claim ownership. Possession by one cotenant is deemed permissive, since either or both are legally entitled to possession. Suppose, instead, that Jean and Jacques are neighboring farmers, each with title to his own acreage, and that Jean decides to fence in his property. Just to be on the safe side, he knowingly constructs the fence twenty feet over on Jacques’s side. This is adverse possession, since it is clearly hostile to Jacques’s possession of the land.

### Actual Possession

Not only must the possession be hostile but it must also be actual. The possessor must enter onto the land and make some use of it. Many state statutes define the permissible type of possession—for example, substantial enclosure or cultivation and improvement. In other states, the courts will look to the circumstances of each case to determine whether the claimant had in fact possessed the land (e.g., by grazing cattle on the land each summer).

23. Title may pass to someone who occupies the lands of another for a certain (statutorily prescribed) period of time in an open, notorious, and hostile manner.

### **Open and Notorious Possession**

The possessor must use the land in an open way, so that the original owner could determine by looking that his land was being claimed and so that people in the area would know that it was being used by the adverse possessor. In the melodramatic words of one court, the adverse possessor “must unfurl his flag on the land, and keep it flying so that the owner may see, if he will, that an enemy has invaded his domains, and planted the standard of conquest.” *Robin v. Brown*, 162 A. 161 (Pa. 1932). Construction of a building on the owner’s property would be open and notorious; development of a cave or tunnel under the owner’s property would not be.

### **Continuous Possession**

The adverse possessor must use the land continuously, not intermittently. In most states, this continuous period must last for at least twenty years. If the adverse possession is passed on to heirs or the interest is sold, the successor adverse possessors may tack on the time they claim possession to reach the twenty years. Should the original owner sell his land, the time needed to prove continuous possession will not lapse. Of course, the original owner may interrupt the period—indeed, may terminate it—by moving to eject the adverse possessor any time before the twenty years has elapsed.

### **Exclusive Possession**

The adverse possessor must claim exclusive possession of the land. Sharing the land with the owner is insufficient to ground a claim of legal entitlement based on adverse possession, since the sharing is not fully adverse or hostile. Jean finds a nice wooded lot to enjoy weekly picnics. The lot belongs to Jacques, who also uses it for picnics. This use would be insufficient to claim adverse possession because it is neither continuous nor exclusive.

If the five tests are met, then the adverse possessor is entitled to legal title. If any one of the tests is missing, the adverse possession claim will fail.

### KEY TAKEAWAY

Real property can be acquired without paying the lawful owner if five conditions of adverse possession are met: (1) the person claiming title by adverse possession must assert that he has a right to possession hostile to the interest of the original owner, (2) he must actually possess the property, (3) his possession must be “open and notorious,” (4) the possession must be continuous, and (5) the possession must be exclusive.

### EXERCISE

1. Tyler decides to camp out on a sandy beach lot near Isle of Palms, South Carolina. The owner, who had hoped to build a large house there, lived out of state. Tyler made no secret of his comings and goings, and after several weeks, when no one challenged his right to be there, he built a sturdy lean-to. After a while, he built a “micro house” and put a propane tank next to it. Although there was no running water, Tyler was plenty comfortable. His friends came often, they partied on the beach, and life was good. Five years after he first started camping out there, an agent of the owner came and told him to deconstruct his shelter and “move on.” Does Tyler have any rights in the property? Why or why not?

## 25.4 Cases

### Title Insurance

Title and Trust Co. of Florida v. Barrows

381 So.2d 1088 (Fla. App. 1979)

McCord, ACTING CHIEF JUDGE.

This appeal is from a final judgment awarding money damages to appellees (Barrows) for breach of title insurance policy. We reverse.

Through a realtor, the Barrowses purchased, for \$ 12,500, a lot surrounded on three sides by land owned by others, all of which is a part of a beach subdivision. The fourth side of their lot borders on a platted street called Viejo Street, the right-of-way for which has been dedicated to and accepted by St. Johns County. The right-of-way line opposite their lot abuts a Corps of Engineers' right-of-way in which there is a stone breakwater. The intracoastal waterway flows on the other side of the breakwater.

The realtor who sold the lot to the Barrows represented to them that the county would build a road in the right-of-way along Viejo Street when they began plans for building on their lot. There have been no street improvements in the dedicated right-of-way, and St. Johns County has no present plans for making any improvements. The "road" is merely a continuation of a sandy beach.

A year after purchasing the land the Barrowses procured a survey which disclosed that the elevation of their lot is approximately one to three feet above the mean high water mark. They later discovered that their lot, along with the Viejo Street right-of-way abutting it, is covered by high tide water during the spring and fall of each year.

At the time appellees purchased their lot, they obtained title insurance coverage from appellant. The title policy covered:

Any defect in or lien or encumbrance on the title to the estate or title covered hereby...or a lack of a right of access to and from the land....



Appellees' complaint of lack of right of access was founded on the impassable condition of the platted street. After trial without a jury, the trial court entered final judgment finding that appellees did not have access to their property and, therefore, were entitled to recover \$ 12,500 from appellant the face amount of the policy.

Appellant and Florida Land Title Association, appearing as amicus curiae, argue that appellant cannot be held liable on grounds of "lack of right of access to and from the land" since there is no defect shown by the public record as to their right of access; that the public record shows a dedicated and accepted public right-of-way abutting the lot. They contend that title insurance does not insure against defects in the physical condition of the land or against infirmities in legal right of access not shown by the public record. *See Pierson v. Bill*, 138 Fla. 104, 189 So. 679 (1939). They argue that defects in the physical condition of the land such as are involved here are not covered by title insurance. We agree. Title insurance only insures against title defects.

The Supreme Court of North Carolina in *Marriott Financial Services, Inc. v. Capitol Funds, Inc.*, 288 N.C. 122, 217 S.E.2d 551 (1975), construed "right of access" to mean the right to go to and from the public right-of-way without unreasonable restrictions. *Compare Hocking v. Title Insurance & Trust Company*, 37 Cal.2d 644, 234 P.2d 625 (1951), where, in ruling that the plaintiff failed to state a cause of action in a suit brought under her title policy, the court said:

She appears to possess fee simple title to the property for whatever it may be worth; if she has been damaged by false representations in respect to the condition and value of the land her remedy would seem to be against others than the insurers of the title she acquired.

In *Mafetone, et al., v. Forest Manor Homes, Inc., et al.*, 34 A.D.2d 566, 310 N.Y.S.2d 17 (N.Y.1970), the plaintiff brought an action against a title insurance company for damages allegedly flowing from a change in the grade of a street. There the court said:

The title company is not responsible to plaintiffs for the damages incurred by reason of the change in elevating the abutting street to its legal grade, since the provisions of the standard title insurance policy here in question are concerned with matters affecting title to property and do not concern themselves with physical conditions of the abutting property absent a specific request by the person ordering a title report and policy....

In *McDaniel v. Lawyers' Title Guaranty Fund*, 327 So.2d 852 (Fla. 2 D.C.A. 1976), our sister court of the Second District said:

The man on the street buys a title insurance policy to insure against defects in the record title. The title insurance company is in the business of guaranteeing the insured's title to the extent it is affected by the public records.

In the case here before us, there is no dispute that the public record shows a legal right of access to appellant's property via the platted Viejo Street. The title insurance policy only insured against record title defects and not against physical infirmities of the platted street.

Reversed.

### CASE QUESTIONS

1. Do you think that the seller (or the seller's agent) actually took the Barroweses to see the property when it was underwater? Why or why not?
2. Before buying, should the Barroweses have actually gone to the property to see for themselves "the lay of the land" or made inquiries of neighboring lot owners?
3. Assuming that they did not make inspection of the property or make other inquiries, do you think the seller or the seller's agent made any misrepresentations about the property that would give the Barroweses any remedies in law or equity?

## Delivery of a Deed

Havens v. Schoen

108 Mich. App. 758; 310 N.W.2d 870 (Mich. App. 1981)

[Norma Anderson Havens, the owner of certain farm property in Marlette, Michigan, in contemplation of her death executed a quit-claim deed to the property to her only daughter, Linda Karen Anderson. The deed was subsequently recorded. Subsequently, Linda Karen Anderson married and became Linda Karen Adams and died. Thereafter, Norma Anderson Havens and Norman William Scholz, a nephew of Havens who has an interest in the property as the beneficiary of a trust, brought a

suit in Sanilac Circuit Court against Ernest E. Schoen, Administrator of the estate of Linda Karen Adams, deceased, and other heirs of James W. Anderson, the ex-husband of Norma Anderson Havens, seeking to set aside the deed or to impose a constructive trust on the farm property which was the subject of the deed. Arthur E. Moore, J., found no cause of action and entered judgment for defendants. The plaintiffs appeal alleging error because there never was a delivery of the deed or an intent by Havens to then presently and unconditionally convey an interest in the property.]

PER CURIAM.

In 1962, plaintiff Dr. [Norma Anderson] Havens purchased the Scholz family farm from the estate of her twin brother, Norman Scholz. She gave a deed of trust to her other brother Earl Scholz in 1964, naming her daughter Linda Karen Adams as the principal beneficiary. In 1969, she filed suit against Earl and Inez Scholz and, in settlement of that suit, the property was conveyed to Dr. Havens and her daughter, now deceased. On August 13, 1969, Dr. Havens executed a quit-claim deed to her daughter of her remaining interest in the farm. It is this deed which Dr. Havens wishes to set aside.

The trial court found that plaintiffs failed to meet the burden of proving an invalid conveyance. Plaintiffs claim that there was never a delivery or an intent to presently and unconditionally convey an interest in the property to the daughter. The deed was recorded but defendants presented no other evidence to prove delivery. The recording of a deed raises a presumption of delivery. *Hooker v Tucker*, 335 Mich 429, 434; 56 NW2d 246 (1953). The only effect of this presumption is to cast upon the opposite party the burden of moving forward with the evidence. *Hooker v Tucker, supra*. The burden of proving delivery by a preponderance of the evidence remains with the party relying on the deed. *Camp v Guaranty Trust Co*, 262 Mich 223, 226; 247 NW 162 (1933). Acknowledging that the deed was recorded, plaintiffs presented substantial evidence showing no delivery and no intent to presently and unconditionally convey an interest in the property. The deed, after recording, was returned to Dr. Havens. She continued to manage the farm and pay all expenses for it. When asked about renting the farm, the daughter told a witness to ask her mother. Plaintiffs presented sufficient evidence to dispel the presumption. We find that the trial court erred when it stated that plaintiffs had the burden of proof on all issues. The defendants had the burden of proving delivery and requisite intent.

In *Haasjes v Woldring*, 10 Mich App 100; 158 NW2d 777 (1968), *leave denied* 381 Mich 756 (1968), two grandparents executed a deed to property to two grandchildren. The grandparents continued to live on the property, pay taxes on it and subsequent to the execution of the deed they made statements which this Court found

inconsistent with a prior transfer of property. These circumstances combined with the fact that the deed was not placed beyond the grantors' control led the *Haasjes* Court to conclude that a valid transfer of title had not been effected. The *Haasjes* Court, citing *Wandel v Wandel*, 336 Mich 126; 57 NW2d 468 (1953), and *Resh v Fox*, 365 Mich 288, 112 NW2d 486 (1961), held that in considering whether there was a present intent to pass title, courts may look to the subsequent acts of the grantor.

This Court reviews *de novo* the determinations of a trial court sitting in an equity case. *Chapman v Chapman*, 31 Mich App 576, 579; 188 NW2d 21 (1971). Having reviewed the evidence presented by the defendants to prove delivery, we find that the defendants failed to meet their burden of proof. Under the circumstances, the recording itself and the language of the deed were not persuasive proof of delivery or intent. Defendants presented no evidence of possession of the deed by anyone but the grantor and presented no evidence showing knowledge of the deed by the grantee. No evidence was presented showing that the daughter was ever aware that she owned the property. The showing made by defendants was inadequate to carry their burden of proof. The deed must be set aside.

Plaintiffs alleged none of the grounds which have traditionally been recognized as justifying the imposition of a constructive trust. See *Chapman v Chapman, supra*. A constructive trust is imposed only when it would be inequitable to do otherwise. *Arndt v Vos*, 83 Mich App 484; 268 NW2d 693 (1978). Although plaintiffs claim relief for a mutual mistake, plaintiffs have presented no facts suggesting a mistake on the part of the grantee. Creation of a constructive trust is not warranted by the facts as found by the trial court. There has been no claim that those findings are erroneous.

We remand to the trial court to enter an order setting aside the August 13, 1969, deed from Norma Anderson Havens to Linda Karen Anderson Adams purporting to convey the interest of Dr. Havens in the farm. The decision of the trial court finding no justification for imposing a trust upon the property is affirmed.

Affirmed in part, reversed in part, and remanded.

DISSENT BY:

MacKenzie, J. (*dissenting*).

I respectfully dissent. The deed was recorded with the knowledge and assent of the grantor, which creates a presumption of delivery. See *Schmidt v Jennings*, 359 Mich 376, 383; 102 NW2d 589 (1960), *Reed v Mack*, 344 Mich 391, 397; 73 NW2d 917 (1955).

Crucial evidence was conflicting and I would disagree that the trial court's findings were clearly erroneous.

In *Reed v Mack*, the Court affirmed the trial court's finding that there had been delivery where the grantor defendant, who had owned the property with her husband, recorded a deed conveying a property jointly to herself and the two other grantees, stating:

“We are in agreement with the trial court. The defendant-appellant, a grantor in the deed, caused the recording of the deed, the delivery of which she attacks. The recording of a warranty deed may, under some circumstances, be effectual to show delivery. A delivery to one of several joint grantees, in absence of proof to the contrary, is delivery to all. *Mayhew v Wilhelm*, 249 Mich 640 [229 NW 459 (1930)]. While placing a deed on record does not in itself necessarily establish delivery, the recording of a deed raises a presumption of delivery, and the whole object of delivery is to indicate an intent by the grantor to give effect to the instrument.” [Citations]

In *McMahon v Dorsey*, 353 Mich 623, 626; 91 NW2d 893 (1958), the significance of delivery was characterized as the manifestation of the grantor's intent that the instrument be a completed act.

\* \* \*

The evidence herein indicates that plaintiff Norma Anderson Havens, after she had been told she was dying from cancer, executed a quit-claim deed on August 16, 1969, to her daughter, Linda Karen Anderson. Plaintiff Havens testified that the reason she executed the deed was that she felt “if something should happen to me, at least Karen would be protected”. The deed was recorded the same day by plaintiff Havens's attorney. Plaintiff Havens either knew that the deed was recorded then or learned of the recording shortly thereafter. Although plaintiff Havens testified that she intended only a testamentary disposition, she apparently realized that the deed was effective to convey the property immediately because her testimony indicated an intention to execute a trust agreement. Linda Karen lived on the farm for five years after the deed was recorded until her death in 1974, yet plaintiff Havens did not attempt to have Linda Karen deed the farm back to her so she could replace the deed with a trust agreement or a will. Plaintiff Havens testified that she approached her attorneys regarding a trust agreement, but both attorneys denied this. The trial judge specifically found the testimony of the attorneys was convincing and he, of course, had the benefit of observing the witnesses.

*Haasjes v Woldring*, 10 Mich App 100; 158 NW2d 777 (1968), relied upon by the majority, involved unrecorded deeds which remained in a strongbox under control of the grantors until after their deaths. The grantors continued to live alone on the property and pay taxes thereon. Based on the lack of recording, I find *Haasjes* distinguishable from the present case.

In *Hooker v Tucker*, 335 Mich 429; 56 NW2d 246 (1953), delivery was held not to have occurred where the grantor handed her attorney a copy of a deed containing a legal description of property she wished included in a will to be drawn by him and he subsequently mailed the deed to the grantee without the grantor's knowledge or permission. The purported delivery by mailing being unauthorized distinguishes *Hooker* from this case where there was no indication the recording was done without the grantor's authorization.

The majority relies on the grantee's purported lack of knowledge of the conveyance but the record is not at all clear in this regard. Further, if a deed is beneficial to the grantee, its acceptance is presumed. *Tackaberry v Monteith*, 295 Mich 487, 493; 295 NW 236 (1940), see also *Holmes v McDonald*, 119 Mich 563; 78 NW 647 (1899). While the burden of proving delivery is on the person relying upon the instrument, the burden shifts upon its recordation so that the grantor must go forward with the evidence of showing nondelivery, once recordation and beneficial interest have been shown. *Hooker v Tucker, supra*, and *Tackaberry, supra*. The trial court properly found that plaintiffs failed to go forward with the evidence and found that the deed conveyed title to the farm.

Factually, this is a difficult case because plaintiff Havens executed a deed which she intended to be a valid conveyance at the time it was executed and recorded. Subsequently, when her daughter unexpectedly predeceased her, the deed created a result she had not foreseen. She seeks to eradicate the unintended *result* by this litigation.

I am reluctant to set aside an unambiguous conveyance which was on record and unchallenged for five years on the basis of the self-serving testimony of the grantor as to her intent at the time she executed the deed and authorized its recordation.

I would affirm.

**CASE QUESTION**

1. Which opinion, the majority or the dissenting opinion, do you agree with, and why?

## 25.5 Summary and Exercises

### Summary

Real property can be held in various forms of ownership. The most common forms are tenancy in common, joint tenancy, and tenancy by the entirety. Ten states recognize the community property form of ownership.

In selling real property, various common-law and statutory provisions come into play. Among the more important statutory provisions are the Civil Rights Acts of 1866 and 1968. These laws control the manner in which property may be listed and prohibit discrimination in sales. Sellers and buyers must also be mindful of contract and agency principles governing the listing agreement. Whether the real estate broker has an exclusive right to sell, an exclusive agency, or an open listing will have an important bearing on the fee to which the broker will be entitled when the property is sold.

The Statute of Frauds requires contracts for the sale of real property to be in writing. Such contracts must include the names of buyers and sellers, a description of the property, the price, and signatures. Unless the contract states otherwise, the seller must deliver marketable title, and the buyer will bear the loss if the property is damaged after the contract is signed but before the closing. The seller will usually insist on being paid earnest money, and the buyer will usually protect himself contractually against certain contingencies, such as failure to obtain financing. The contract should also specify the type of deed to be given to the buyer.

To provide protection to subsequent buyers, most states have enacted recording statutes that require buyers to record their purchases in a county office. The statutes vary: which of two purchasers will prevail depends on whether the state has a notice, notice-race, or race statute. To protect themselves, buyers usually purchase an abstract and opinion or title insurance. Although sale is the usual method of acquiring real property, it is possible to take legal title without the consent of the owner. That method is adverse possession, by which one who openly, continuously, and exclusively possesses property and asserts his right to do so in a manner hostile to the interest of the owner will take title in twenty years in most states.



## EXERCISES

1. Rufus enters into a contract to purchase the Brooklyn Bridge from Sharpy. The contract provides that Sharpy is to give Rufus a quitclaim deed at the closing. After the closing, Rufus learns that Sharpy did not own the bridge and sues him for violating the terms of the deed. What is the result? Why?
2. Pancho and Cisco decide to purchase ten acres of real estate. Pancho is to provide 75 percent of the purchase price, Cisco the other 25 percent. They want to use either a joint tenancy or tenancy in common form of ownership. What do you recommend? Why?
3. Suppose in Exercise 2 that a friend recommends that Pancho and Cisco use a tenancy by the entirety. Would this form of ownership be appropriate? Why?
4. Richard and Elizabeth, a married couple, live in a community property state. During their marriage, they save \$500,000 from Elizabeth's earnings. Richard does not work, but during the marriage, he inherits \$500,000. If Richard and Elizabeth are divorced, how will their property be divided? Why?
5. Jack wants to sell his house. He hires Walter, a real estate broker, to sell the house and signs an exclusive-right-to-sell listing agreement. Walter finds a buyer, who signs a sales contract with Jack. However, the buyer later refuses to perform the contract because he cannot obtain financing. Does Jack owe a commission to Walter? Why?
6. Suppose in Exercise 5 that Jack found the buyer, the buyer obtained financing, and the sale was completed. Does Jack owe a commission to Walter, who provided no assistance in finding the buyer and closing the deal? Why?
7. Suppose in Exercise 5 that Jack's house is destroyed by fire before the closing. Who bears the loss—Jack or the buyer? Must Jack pay a commission to Walter? Why?
8. Suppose in Exercise 5 that the buyer paid \$15,000 in earnest money when the contract was signed. Must Jack return the earnest money when the buyer learns that financing is unavailable? Why?

## SELF-TEST QUESTIONS

1. A contract for a sale of property must include
  - a. a description of the property
  - b. price
  - c. signatures of buyer and seller
  - d. all of the above
  
2. If real property is damaged after a contract for sale is signed but before closing, it is generally true that the party bearing the loss is
  - a. the seller
  - b. the buyer
  - c. both parties, who split the loss evenly
  - d. none of the above
  
3. The following deeds extend warranties to the buyer:
  - a. quitclaim and special warranty
  - b. quitclaim and general warranty
  - c. general and special warranty
  - d. all of the above
  
4. Under a notice-race statute,
  - a. whoever records first is given title, regardless of the good faith of the purchaser
  - b. whoever records first and is a bona fide purchaser is given title
  - c. either of the above may be acceptable
  - d. none of the above is acceptable
  
5. The elements of adverse possession do not include
  - a. actual possession
  - b. open and notorious use
  - c. consent of the owner
  - d. continuous possession

**SELF-TEST ANSWERS**

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

## Chapter 26

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### Landlord and Tenant Law

#### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The various types of leasehold estates
2. How leasehold states are created and extended
3. The rights and duties of landlords
4. The rights and duties of tenants
5. The potential tort liability of landlords

## 26.1 Types and Creation of Leasehold Estates

### LEARNING OBJECTIVES

1. Distinguish between the different types of leasehold estates.
2. Describe how leasehold states can be created, both orally and in writing, and the requirements for creating leases that last for more than one year.

In Chapter 24 "The Nature and Regulation of Real Estate and the Environment", we noted that real property can be divided into types of interests: freehold estates and leasehold estates. The freehold estate is characterized by indefinite duration, and the owner has title and the right to possess. The **leasehold estate**<sup>1</sup>, by contrast, lasts for a specific period. The owner of the leasehold estate—the tenant—may take possession but does not have title to the underlying real property. When the period of the leasehold ends, the right to possession reverts to the landlord—hence the landlord’s interest during the tenant’s possession is known as a **reversionary interest**. Although a leasehold estate is said to be an interest in real property, the leasehold itself is in fact personal property. The law recognizes three types of leasehold estates: the estate for years, the periodic tenancy, and the tenancy at will.

### Types of Leasehold Estates

#### Estate for Years

The **estate for years**<sup>2</sup> is characterized by a definite beginning and a definite end. When you rent an apartment for two years, beginning September 1 and ending on the second August 31, you are the owner of an estate for years. Virtually any period will do; although it is called an estate “for years,” it can last but one day or extend one thousand years or more. Some statutes declare that any estate for years longer than a specified period—one hundred years in Massachusetts, for instance—is a fee simple estate.

1. An estate whose termination date is usually known—a one-year lease, for example.
2. A leasehold in which the tenant has possession for a fixed term.
3. The agreement that creates the leasehold interest.

Unless the **lease**<sup>3</sup>—the agreement creating the leasehold interest—provides otherwise, the estate for years terminates automatically at midnight of the last day specified in the lease. The lease need not refer explicitly to calendar dates. It could provide that “the tenant may occupy the premises for six months to commence one week from the date of signing.” Suppose the landlord and tenant sign on June 23. Then the lease term begins at 12:00 a.m. on July 1 and ends just before midnight of December 31. Unless a statute provides otherwise, the landlord is not obligated to

send the tenant a notice of termination. Should the tenant die before the lease term ends, her property interest can be inherited under her will along with her other personal property or in accordance with the laws of intestate succession.

### Periodic Tenancy

As its name implies, a **periodic tenancy**<sup>4</sup> lasts for a period that is renewed automatically until either landlord or tenant notifies the other that it will end. The periodic tenancy is sometimes called an estate from year to year (or month to month, or week to week). The lease may provide explicitly for the periodic tenancy by specifying that at the expiration of, say, a one-year lease, it will be deemed renewed for another year unless one party notifies the other to the contrary within six months prior to the expiration of the term. Or the periodic tenancy may be created by implication, if the lease fails to state a term or is defective in some other way, but the tenant takes possession and pays rent. The usual method of creating a periodic tenancy occurs when the tenant remains on the premises (“holds over”) when an estate for years under a lease has ended. The landlord may either reject or accept the implied offer by the tenant to rent under a periodic tenancy. If he rejects the implied offer, the tenant may be ejected, and the landlord is entitled to rent for the holdover period. If he accepts the offer, the original lease determines the rent and length of the renewable period, except that no periodic tenancy may last longer than from year to year—that is, the renewable period may never be any longer than twelve months.

At common law, a party was required to give notice at least six months prior to the end of a year-to-year tenancy, and notice equal to the term for any other periodic tenancy. In most states today, the time period for giving notice is regulated by statute. In most instances, a year-to-year tenancy requires a month’s notice, and shorter tenancies require notice equal to the term. To illustrate the approach typically used, suppose Simone rents from Anita on a month-to-month tenancy beginning September 15. On March 30, Simone passes the orals for her doctorate and decides to leave town. How soon may she cancel her tenancy? If she calls Anita that afternoon, she will be two weeks shy of a full month’s notice for the period ending April 15, so the earliest she can finish her obligation to pay rent is May 15. Suppose her term had been from the first of each month. On April 1, she notifies Anita of her intention to leave at the end of April, but she is stuck until the end of May, because notice on the first of the month is not notice for a full month. She would have had to notify Anita by March 31 to terminate the tenancy by April 30.

4. A tenancy for a period of time that is renewed automatically until either landlord or tenant notifies the other that it will end.

5. A tenancy that will last only so long as the landlord and tenant desire.

### Tenancy at Will

If the landlord and tenant agree that the lease will last only as long as both want it to, then they have created a **tenancy at will**<sup>5</sup>. Statutes in most states require some

notice of intention to terminate. Simone comes to the university to study, and Anita gives her a room to stay in for free. The arrangement is a tenancy at will, and it will continue as long as both want it to. One Friday night, after dinner with classmates, Simone decides she would rather move in with Bob. She goes back to her apartment, packs her suitcase, and tells Anita she's leaving. The tenancy at will terminates that day.

## **Creation of Leasehold Estates**

### **Oral Leases**

Leases can be created orally, unless the term of the lease exceeds the period specified by the Statute of Frauds. In most states, that period is one year. Any oral lease for a period longer than the statutory period is invalid. Suppose that Simone, in a state with a one-year Statute of Frauds period, orally agrees with Anita to rent Anita's apartment for two years, at a monthly rent of \$250. The lease is invalid, and either could repudiate it.

### **Written Leases**

A lease required to be in writing under the Statute of Frauds must contain the following items or provisions: (1) it must identify the parties, (2) it must identify the premises, (3) it must specify the duration of the lease, (4) it must state the rent to be paid, and (5) it must be signed by the party against whom enforcement is sought (known as "the party to be charged").

The provisions need not be perfectly stated. As long as they satisfy the five requirements, they will be adequate to sustain the lease under the Statute of Frauds. For instance, the parties need not necessarily be named in the lease itself. Suppose that the prospective tenant gives the landlord a month's rent in advance and that the landlord gives the tenant a receipt listing the property and the terms of the lease but omitting the name of the tenant. The landlord subsequently refuses to let the tenant move in. Who would prevail in court? Since the tenant had the receipt in her possession, that would be sufficient to identify her as the tenant to whom the terms of the lease were meant to apply. Likewise, the lease need not specify every aspect of the premises to be enjoyed. Thus the tenant who rents an apartment in a building will be entitled to the use of the common stairway, the roof, and so on, even though the lease is silent on these points. And as long as a specific amount is ascertainable, the rent may be stated in other than absolute dollar terms. For example, it could be expressed in terms of a cost-of-living index or as a percentage of the tenant's dollar business volume.

### KEY TAKEAWAY

A leasehold estate, unlike a freehold estate, has a definite duration. The landlord's interest during the term of a leasehold estate is a reversionary interest. Leasehold estates can last for short terms or very long terms; in the case of long-term leases, a property right is created that can be passed to heirs. The usual landlord-tenant relationship is a periodic tenancy, which carries with it various common-law and statutory qualifications regarding renewal and termination. In a tenancy at will, either landlord or tenant can end the leasehold estate as soon as notice is provided by either party.

### EXERCISES

1. What is the difference between a periodic tenancy and a tenancy at will?
2. What are the essential terms that must be in a written lease?



## 26.2 Rights and Duties of Landlords and Tenants

### LEARNING OBJECTIVES

1. Itemize and explain the rights and duties of landlords.
2. List and describe the rights and duties of tenants.
3. Understand the available remedies for tenants when a landlord is in breach of his or her duties.

### Rights and Duties of Landlords

The law imposes a number of duties on the landlord and gives the tenant a number of corresponding rights. These include (1) possession, (2) habitable condition, and (3) noninterference with use.

#### Possession

The landlord must give the tenant the right of possession of the property. This duty is breached if, at the time the tenant is entitled to take possession, a third party has paramount title to the property and the assertion of this title would deprive the tenant of the use contemplated by the parties. **Paramount title**<sup>6</sup> means any legal interest in the premises that is not terminable at the will of the landlord or at the time the tenant is entitled to take possession.

If the tenant has already taken possession and then discovers the paramount title, or if the paramount title only then comes into existence, the landlord is not automatically in breach. However, if the tenant thereafter is evicted from the premises and thus deprived of the property, then the landlord is in breach. Suppose the landlord rents a house to a doctor for ten years, knowing that the doctor intends to open a medical office in part of the home and knowing also that the lot is restricted to residential uses only. The doctor moves in. The landlord is not yet in default. The landlord will be in default if a neighbor obtains an injunction against maintaining the office. But if the landlord did not know (and could not reasonably have known) that the doctor intended to use his home for an office, then the landlord would not be in default under the lease, since the property could have been put to normal—that is, residential—use without jeopardizing the tenant's right to possession.

6. Superior title.

### Warranty of Habitability

As applied to leases, the old common-law doctrine of **caveat emptor**<sup>7</sup> said that once the tenant has signed the lease, she must take the premises as she finds them. Since she could inspect them before signing the lease, she should not complain later. Moreover, if hidden defects come to light, they ought to be easy enough for the tenant herself to fix. Today this rule no longer applies, at least to residential rentals. Unless the parties specifically agree otherwise, the landlord is in breach of his lease if the conditions are unsuitable for residential use when the tenant is due to move in. The landlord is held to an **implied warranty of habitability**<sup>8</sup>.

The change in the rule is due in part to the conditions of the modern urban setting: tenants have little or no power to walk away from an available apartment in areas where housing is scarce. It is also due to modern construction and technology: few tenants are capable of fixing most types of defects. A US court of appeals has said the following:

Today's urban tenants, the vast majority of whom live in multiple dwelling houses, are interested not in the land, but solely in "a house suitable for occupation." Furthermore, today's city dweller usually has a single, specialized skill unrelated to maintenance work; he is unable to make repairs like the "jack-of-all-trades" farmer who was the common law's model of the lessee. Further, unlike his agrarian predecessor who often remained on one piece of land for his entire life, urban tenants today are more mobile than ever before. A tenant's tenure in a specific apartment will often not be sufficient to justify efforts at repairs. In addition, the increasing complexity of today's dwellings renders them much more difficult to repair than the structures of earlier times. In a multiple dwelling, repairs may require access to equipment and areas in control of the landlord. Low and middle income tenants, even if they were interested in making repairs, would be unable to obtain financing for major repairs since they have no long-term interest in the property. *Javins v. First National Realty Corp.*, 428 F.2d 1071, 1078-79 (D.C. Cir.), *cert. denied*, 400 U.S. 925 (1970).

At common law, the landlord was not responsible if the premises became unsuitable once the tenant moved in. This rule was often harshly applied, even for unsuitable conditions caused by a sudden act of God, such as a tornado. Even if the premises collapsed, the tenant would be liable to pay the rent for the duration of the lease. Today, however, many states have statutorily abolished the tenant's obligation to pay the rent if a non-man-made force renders the premises unsuitable. Moreover, most states today impose on the landlord, after the tenant has moved in, the responsibility for maintaining the premises in a safe, livable condition, consistent with the safety, health, and housing codes of the jurisdiction.

7. "Let the buyer beware." At common law, once the tenant has signed the lease, she must take the premises as she finds them.

8. The landlord's duty to provide conditions suitable for residential use.

These rules apply only in the absence of an express agreement between the parties. The landlord and tenant may allocate in the lease the responsibility for repairs and maintenance. But it is unlikely that any court would enforce a lease provision waiving the landlord's implied warranty of habitability for residential apartments, especially in areas where housing is relatively scarce.

### Noninterference with Use

In addition to maintaining the premises in a physically suitable manner, the landlord has an obligation to the tenant not to interfere with a permissible use of the premises. Suppose Simone moves into a building with several apartments. One of the other tenants consistently plays music late in the evening, causing Simone to lose sleep. She complains to the landlord, who has a provision in the lease permitting him to terminate the lease of any tenant who persists in disturbing other tenants. If the landlord does nothing after Simone has notified him of the disturbance, he will be in breach. This right to be free of interference with permissible uses is sometimes said to arise from the landlord's implied **covenant of quiet enjoyment**<sup>9</sup>.

### Tenant's Remedies

When the landlord breaches one of the foregoing duties, the tenant has a choice of three basic remedies: **termination**<sup>10</sup>, damages, or rent adjustment.

In virtually all cases where the landlord breaches, the tenant may terminate the lease, thus ending her obligation to continue to pay rent. To terminate, the tenant must (1) actually vacate the premises during the time that she is entitled to terminate and (2) either comply with lease provisions governing the method of terminating or else take reasonable steps to ensure that the landlord knows she has terminated and why.

9. An implied right in most leases—the right to be free of interference with permissible uses.

10. A remedy for a tenant, but requiring notice to the landlord and compliance with previously agreed on terms or statutory requirements for terminating the leasehold estate.

11. Conditions that interfere substantially enough with the tenant's permissible use that it is tantamount to eviction.

When the landlord physically deprives the tenant of possession, he has evicted the tenant; wrongful eviction permits the tenant to terminate the lease. Even if the landlord's conduct falls short of actual eviction, it may interfere substantially enough with the tenant's permissible use so that they are tantamount to eviction. This is known as **constructive eviction**<sup>11</sup>, and it covers a wide variety of actions by both the landlord and those whose conduct is attributable to him, as illustrated by *Fidelity Mutual Life Insurance Co. v Kaminsky*, (see [Section 26.5.1 "Constructive Eviction"](#)).

## Damages

Another traditional remedy is money damages, available whenever termination is an appropriate remedy. Damages may be sought after termination or as an alternative to termination. Suppose that after the landlord had refused Simone's request to repair the electrical system, Simone hired a contractor to do the job. The cost of the repair work would be recoverable from the landlord. Other recoverable costs can include the expense of relocating if the lease is terminated, moving costs, expenses connected with finding new premises, and any increase in rent over the period of the terminated lease for comparable new space. A business may recover the loss of anticipated business profits, but only if the extent of the loss is established with reasonable certainty. In the case of most new businesses, it would be almost impossible to prove loss of profits.

In all cases, the tenant's recovery will be limited to damages that would have been incurred by a tenant who took all reasonable steps to mitigate losses. That is, the tenant must take reasonable steps to prevent losses attributable to the landlord's breach, to find new space if terminating, to move efficiently, and so on.

## Rent Remedies

Under an old common-law rule, the landlord's obligation to provide the tenant with habitable space and the tenant's obligation to pay rent were **independent covenants**<sup>12</sup>. If the landlord breached, the tenant was still legally bound to pay the rent; her only remedies were termination and suit for damages. But these are often difficult remedies for the tenant. Termination means the aggravation of moving, assuming that new quarters can be found, and a suit for damages is time consuming, uncertain, and expensive. The obvious solution is to permit the tenant to withhold rent, or what we here call **rent adjustment**<sup>13</sup>. The modern rule, adopted in several states (but not yet in most), holds that the mutual obligations of landlord and tenant are dependent. States following this approach have developed three types of remedies: rent withholding, rent application, and rent abatement.

The simplest approach is for the tenant to withhold the rent until the landlord remedies the defect. In some states, the tenant may keep the money. In other states, the rent must be paid each month into an escrow account or to the court, and the money in the escrow account becomes payable to the landlord when the default is cured.

Several state statutes permit the tenant to apply the rent money directly to remedy the defect or otherwise satisfy the landlord's performance. Thus Simone might have

12. Under an old common-law rule, the landlord's obligation to provide the tenant with habitable space and the tenant's obligation to pay rent.

13. One remedy among several for tenants where the landlord has breached one or more duties. Rent adjustment may involve withholding the rent until the landlord complies, depositing payments in escrow, or applying withheld rent to the problem that the landlord has not fixed.

deducted from her rent the reasonable cost of hiring an electrician to repair the electrical system.

In some states, the rent may be reduced or even eliminated if the landlord fails to cure specific types of defects, such as violations of the housing code. The abatement will continue until the default is eliminated or the lease is terminated.

## Rights and Duties of Tenants

In addition to the duties of the tenant set forth in the lease itself, the common law imposes three other obligations: (1) to pay the rent reserved (stated) in the lease, (2) to refrain from committing waste (damage), and (3) not to use the premises for an illegal purpose.

### Duty to Pay Rent

What constitutes rent is not necessarily limited to the stated periodic payment usually denominated “rent.” The tenant may also be responsible for such assessments as taxes and utilities, payable to the landlord as rent. Simone’s lease calls for her to pay taxes of \$500 per year, payable in quarterly installments. She pays the rent on the first of each month and the first tax bill on January 1. On April 1, she pays the rent but defaults on the next tax bill. She has failed to pay the rent reserved in the lease.

The landlord in the majority of states is not obligated to mitigate his losses should the tenant abandon the property and fail thereafter to pay the rent. As a practical matter, this means that the landlord need not try to rent out the property but instead can let it sit vacant and sue the defaulting tenant for the balance of the rent as it becomes due. However, the tenant might notify the landlord that she has abandoned the property or is about to abandon it and offer to surrender it. If the landlord accepts the surrender, the lease then terminates. Unless the lease specifically provides for it, a landlord who accepts the surrender will not be able to recover from the tenant the difference between the amount of her rent obligation and the new tenant’s rent obligation.

Many leases require the tenant to make a **security deposit**<sup>14</sup>—a payment of a specific sum of money to secure the tenant’s performance of duties under the lease. If the tenant fails to pay the rent or otherwise defaults, the landlord may use the money to make good the tenant’s performance. Whatever portion of the money is not used to satisfy the tenant’s obligations must be repaid to the tenant at the end of the lease. In the absence of an agreement to the contrary, the landlord must pay

14. A payment of a specific sum of money to secure the tenant’s performance of duties under the lease.

interest on the security deposit when he returns the sum to the tenant at the end of the lease.

### Alteration and Restoration of the Premises

In the absence of a specific agreement in the lease, the tenant is entitled to physically change the premises in order to make the best possible permissible use of the property, but she may not make structural alterations or damage (waste) the property. A residential tenant may add telephone lines, put up pictures, and affix bookshelves to the walls, but she may not remove a wall in order to enlarge a room.

The tenant must restore the property to its original condition when the lease ends, but this requirement does not include normal wear and tear. Simone rents an apartment with newly polished wooden floors. Because she likes the look of oak, she decides against covering the floors with rugs. In a few months' time, the floors lose their polish and become scuffed. Simone is not obligated to refinish the floors, because the scuffing came from normal walking, which is ordinary wear and tear.

### Use of the Property for an Illegal Purpose

It is a breach of the tenant's obligation to use the property for an illegal purpose. A landlord who found a tenant running a numbers racket, for example, or making and selling moonshine whisky could rightfully evict her.

### Landlord's Remedies

In general, when the tenant breaches any of the three duties imposed by the common law, the landlord may terminate the lease and seek damages. One common situation deserves special mention: the holdover tenant. When a tenant improperly overstays her lease, she is said to be a **tenant at sufferance**<sup>15</sup>, meaning that she is liable to eviction. Some cultures, like the Japanese, exhibit a considerable bias toward the tenant, making it exceedingly difficult to move out holdover tenants who decide to stay. But in the United States, landlords may remove tenants through summary (speedy) proceedings available in every state or, in some cases, through **self-help**<sup>16</sup>. Self-help is a statutory remedy for landlords or incoming tenants in some states and involves the peaceful removal of a holdover tenant's belongings. If a state has a statute providing a summary procedure for removing a holdover tenant, neither the landlord nor the incoming tenant may resort to self-help, unless the statute specifically allows it. A provision in the lease permitting self-help in the absence of statutory authority is unenforceable. Self-help must be peaceful, must not cause physical harm or even the expectation of harm to the tenant or anyone on the premises with his permission, and must not result in unreasonable damage

15. When a tenant improperly overstays his or her lease.
16. Entering the premises to regain possession and remove a holdover tenant's belongings—must be peaceful, must not cause physical harm or even convey the expectation of harm to the tenant or anyone on the premises with the tenant's permission, and must not result in unreasonable damage to the tenant's property.

to the tenant's property. Any clause in the lease attempting to waive these conditions is void.

Self-help can be risky, because some summary proceeding statutes declare it to be a criminal act and because it can subject the landlord to tort liability. Suppose that Simone improperly holds over in her apartment. With a new tenant scheduled to arrive in two days, the landlord knocks on her door the evening after her lease expires. When Simone opens the door, she sees the landlord standing between two 450-pound Sumo wrestlers with menacing expressions. He demands that she leave immediately. Fearing for her safety, she departs instantly. Since she had a reasonable expectation of harm had she not complied with the landlord's demand, Simone would be entitled to recover damages in a tort suit against her landlord, although she would not be entitled to regain possession of the apartment.

Besides summary judicial proceedings and self-help, the landlord has another possible remedy against the holdover tenant: to impose another rental term. In order to extend the lease in this manner, the landlord need simply notify the holdover tenant that she is being held to another term, usually measured by the periodic nature of the rent payment. For example, if rent was paid each month, then imposition of a new term results in a month-to-month tenancy. One year is the maximum tenancy that the landlord can create by electing to hold the tenant to another term.

#### KEY TAKEAWAY

Both landlords and tenants have rights and duties. The primary duty of a landlord is to meet the implied warranty of habitability: that the premises are in a safe, livable condition. The tenant has various remedies available if the landlord fails to meet that duty, or if the landlord fails to meet the implied covenant of quiet enjoyment. These include termination, damages, and withholding of rent. The tenant has duties as well: to pay the rent, refrain from committing waste, and not use the property for an illegal purpose.

## EXERCISES

1. Consistent with the landlord's implied warranty of habitability, can the landlord and tenant agree in a lease that the tenant bear any and all expenses to repair the refrigerator, the stove, and the microwave?
2. Under what conditions is it proper for a tenant to withhold rent from the landlord?



## 26.3 Transfer of Landlord's or Tenant's Interest

### LEARNING OBJECTIVES

1. Explain how the landlord's reversionary interest works and how it may be assigned.
2. Describe the two ways in which a tenant's leasehold interest may be transferred to another party.

### General Rule

At common law, the interests of the landlord and tenant may be transferred freely unless (1) the tenancy is at will; (2) the lease requires either party to perform significant personal services, which would be substantially less likely to be performed if the interest was transferred; or (3) the parties agree that the interest may not be transferred.

### Landlord's Interest

When the landlord sells his interest, the purchaser takes subject to the lease. If there are tenants with leases in an apartment building, the new landlord may not evict them simply because he has taken title. The landlord may divide his interest as he sees fit, transferring all or only part of his entire interest in the property. He may assign his right to the rent or sell his reversionary interest in the premises. For instance, Simone takes a three-year lease on an apartment near the university. Simone's landlord gives his aged uncle his reversionary interest for life. This means that Simone's landlord is now the uncle, and she must pay him rent and look to him for repairs and other performances owed under the lease. When Simone's lease terminates, the uncle will be entitled to rent the premises. He does so, leasing to another student for three years. One year later, the uncle dies. His nephew (Simone's original landlord) has the reversionary interest and so once again becomes the landlord. He must perform the lease that the uncle agreed to with the new student, but when that lease expires, he will be free to rent the premises as he sees fit.

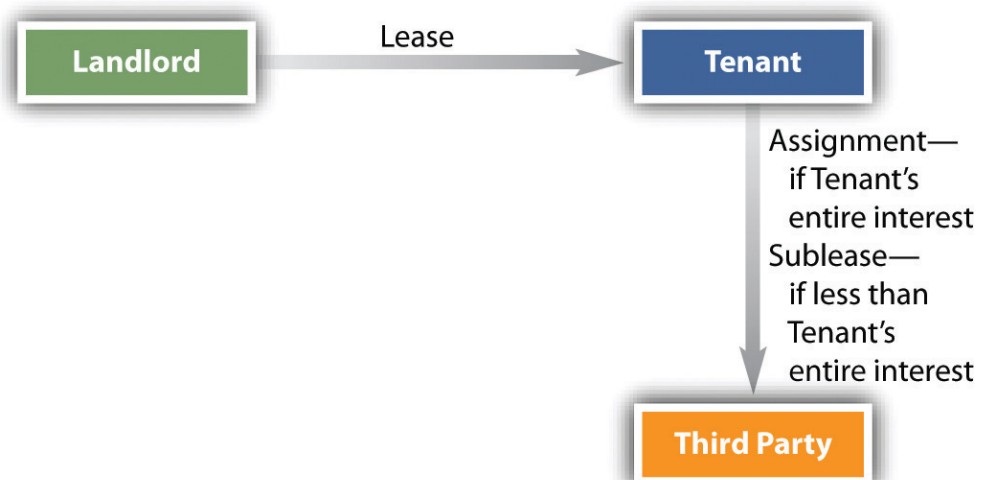
### Tenant's Interest

Why would a tenant be interested in transferring her leasehold interest? For at least two reasons: she might need to move before her lease expired, or she might be

able to make money on the leasehold itself. In recent years, many companies in New York have discovered that their present leases were worth far more to them by moving out than staying in. They had signed long-term leases years ago when the real estate market was glutted and were paying far less than current market prices. By subletting the premises and moving to cheaper quarters, they could pocket the difference between their lease rate and the market rate they charged their subtenants.

The tenant can transfer her interest in the lease by assigning or by subletting. In an **assignment**<sup>17</sup>, the tenant transfers all interest in the premises and all obligations. Thus the assignee-tenant is duty bound to pay the landlord the periodic rental and to perform all other provisions in the lease. If the assignee defaulted, however, the original tenant would remain liable to the landlord. In short, with an assignment, both assignor and assignee are liable under the lease unless the landlord releases the assignor. By contrast, a **sublease**<sup>18</sup> is a transfer of something less than the entire leasehold interest (see [Figure 26.1 "Assignment vs. Sublease"](#)). For instance, the tenant might have five years remaining on her lease and sublet the premises for two years, or she might sublet the ground floor of a four-story building. Unlike an assignee, the subtenant does not step into the shoes of the tenant and is not liable to the landlord for performance of the tenant's duties. The subtenant's only obligations are to the tenant. What distinguishes the assignment from the sublease is not the name but whether or not the entire leasehold interest has been transferred. If not, the transfer is a sublease.

Figure 26.1 Assignment vs. Sublease



17. The tenant transfers all interest in the premises, along with all obligations.

18. A transfer of something less than the entire leasehold interest.

Many landlords include clauses in their leases prohibiting assignments or subleases, and these clauses are generally upheld. But the courts construe them strictly, so that a provision barring subleases will not be interpreted to bar assignments.

#### KEY TAKEAWAY

The interests of landlords and tenants can be freely transferred unless the parties agree otherwise or unless there is a tenancy at will. If the tenant assigns her leasehold interest, she remains liable under the lease unless the landlord releases her. If less than the entire leasehold interest is transferred, it is a sublease rather than an assignment. But the original lease may prohibit either or both.

#### EXERCISES

1. What is the difference between an assignment and a sublease?
2. Are the duties of the tenant any different if the reversionary interest is assigned? Suppose that Simone is in year one of a three-year lease and that Harry is the landlord. If Harry assigns his reversionary interest to Louise, can Louise raise the rent for the next two years beyond what is stated in the original lease?

## 26.4 Landlord's Tort Liability

### LEARNING OBJECTIVES

1. State the general common-law rule as to the liability of the landlord for injuries occurring on the leased premises.
2. State the exceptions to the general rule, and explain the modern trend toward increased liability of the landlord.

In Chapter 24 "The Nature and Regulation of Real Estate and the Environment", we discussed the tort liability of the owner or occupier of real estate to persons injured on the property. As a general rule, when injury occurs on premises rented to a tenant, it is the tenant—an occupier—who is liable. The reason for this rule seems clear: The landlord has given up all but a reversionary interest in the property; he has no further control over the premises. Indeed, he is not even permitted on the property without the tenant's permission. But over the years, certain exceptions have developed to the rule that the landlord is not liable. The primary reason for this change is the recognition that the landlord is better able to pay for repairs to his property than his relatively poorer tenants and that he has ultimate control over the general conditions surrounding the apartment or apartment complex.

### Exceptions to the General Rule Hidden Dangers Known to Landlord

The landlord is liable to the tenant, her family, or guests who are injured by hidden and dangerous conditions that the landlord knew about or should have known about but failed to disclose to the tenant.

### Dangers to People off the Premises

The landlord is liable to people injured outside the property by defects that existed when the lease was signed. Simone rents a dilapidated house and agrees with the landlord to keep the building repaired. She neglects to hire contractors to repair the cracked and sagging wall on the street. The building soon collapses, crushing several automobiles parked alongside. Simone can be held responsible and so can the landlord; the tenant's contractual agreement to maintain the property is not sufficient to shift the liability away from the landlord. In a few cases, the landlord has even been held liable for activities carried on by the tenant, but only because he

knew about them when the lease was signed and should have known that the injuries were probable results.

### **Premises Leased for Admitting the Public**

A landlord is responsible for injuries caused by dangerous conditions on property to be used by the public if the danger existed when the lease was made. Thus an uneven floor that might cause people to trip or a defective elevator that stops a few inches below the level of each floor would be sufficiently dangerous to pin liability on the landlord.

### **Landlord Retaining Control of Premises**

Frequently, a landlord will retain control over certain areas of the property—for example, the common hallways and stairs in an apartment building. When injuries occur as a result of faulty and careless maintenance of these areas, the landlord will be responsible. In more than half the states, the landlord is liable for failure to remove ice and snow from a common walkway and stairs at the entrance. In one case, the tenant even recovered damages for a broken hip caused when she fell in fright from seeing a mouse that jumped out of her stove; she successfully charged the landlord with negligence in failing to prevent mice from entering the dwelling in areas under his control.

### **Faulty Repair of Premises**

Landlords often have a duty to repair the premises. The duty may be statutory or may rest on an agreement in the lease. In either case, the landlord will be liable to a tenant or others for injury resulting from defects that should have been repaired. No less important, a landlord will be liable even if he has no duty to repair but negligently makes repairs that themselves turn out to be dangerous.

### KEY TAKEAWAY

At common law, injuries taking place on leased premises were the responsibility of the tenant. There were notable exceptions, including situations where hidden dangers were known to the landlord but not the tenant, where the premises' condition caused injury to people off the premises, or where faulty repairs caused the injuries. The modern trend is to adopt general negligence principles to determine landlord liability. Thus where the landlord does not use reasonable care and subjects others to an unreasonable risk of harm, there may be liability for the landlord. This varies from state to state.

### EXERCISES

1. What was the basic logic of the common law in having tenants be responsible for all injuries that took place on leased premises?
2. Does the modern trend of applying general negligence principles to landlords make more sense? Explain your answer.

## 26.5 Cases

### Constructive Eviction

Fidelity Mutual Life Insurance Co. v. Kaminsky

768 S.W.2d 818 (Tx. Ct. App. 1989)

MURPHY, JUSTICE

The issue in this landlord-tenant case is whether sufficient evidence supports the jury's findings that the landlord and appellant, Fidelity Mutual Life Insurance Company ["Fidelity"], constructively evicted the tenant, Robert P. Kaminsky, M.D., P.A. ["Dr. Kaminsky"] by breaching the express covenant of quiet enjoyment contained in the parties' lease. We affirm.

Dr. Kaminsky is a gynecologist whose practice includes performing elective abortions. In May 1983, he executed a lease contract for the rental of approximately 2,861 square feet in the Red Oak Atrium Building for a two-year term which began on June 1, 1983. The terms of the lease required Dr. Kaminsky to use the rented space solely as "an office for the practice of medicine." Fidelity owns the building and hires local companies to manage it. At some time during the lease term, Shelter Commercial Properties ["Shelter"] replaced the Horne Company as managing agents. Fidelity has not disputed either management company's capacity to act as its agent.

The parties agree that: (1) they executed a valid lease agreement; (2) Paragraph 35 of the lease contains an express covenant of quiet enjoyment conditioned on Dr. Kaminsky's paying rent when due, as he did through November 1984; Dr. Kaminsky abandoned the leased premises on or about December 3, 1984 and refused to pay additional rent; anti-abortion protestors began picketing at the building in June of 1984 and repeated and increased their demonstrations outside and inside the building until Dr. Kaminsky abandoned the premises.

When Fidelity sued for the balance due under the lease contract following Dr. Kaminsky's abandonment of the premises, he claimed that Fidelity constructively evicted him by breaching Paragraph 35 of the lease. Fidelity apparently conceded during trial that sufficient proof of the constructive eviction of Dr. Kaminsky would relieve him of his contractual liability for any remaining rent payments.

Accordingly, he assumed the burden of proof and the sole issue submitted to the jury was whether Fidelity breached Paragraph 35 of the lease, which reads as follows:

### **Quiet Enjoyment**

Lessee, on paying the said Rent, and any Additional Rental, shall and may peaceably and quietly have, hold and enjoy the Leased Premises for the said term.

A constructive eviction occurs when the tenant leaves the leased premises due to conduct by the landlord which materially interferes with the tenant's beneficial use of the premises. Texas law relieves the tenant of contractual liability for any remaining rentals due under the lease if he can establish a constructive eviction by the landlord.

The protests took place chiefly on Saturdays, the day Dr. Kaminsky generally scheduled abortions. During the protests, the singing and chanting demonstrators picketed in the building's parking lot and inner lobby and atrium area. They approached patients to speak to them, distributed literature, discouraged patients from entering the building and often accused Dr. Kaminsky of "killing babies." As the protests increased, the demonstrators often occupied the stairs leading to Dr. Kaminsky's office and prevented patients from entering the office by blocking the doorway. Occasionally they succeeded in gaining access to the office waiting room area.

Dr. Kaminsky complained to Fidelity through its managing agents and asked for help in keeping the protestors away, but became increasingly frustrated by a lack of response to his requests. The record shows that no security personnel were present on Saturdays to exclude protestors from the building, although the lease required Fidelity to provide security service on Saturdays. The record also shows that Fidelity's attorneys prepared a written statement to be handed to the protestors soon after Fidelity hired Shelter as its managing agent. The statement tracked TEX. PENAL CODE ANN. §30.05 (Vernon Supp. 1989) and generally served to inform trespassers that they risked criminal prosecution by failing to leave if asked to do so. Fidelity's attorneys instructed Shelter's representative to "have several of these letters printed up and be ready to distribute them and verbally demand that these people move on and off the property." The same representative conceded at trial that she did not distribute these notices. Yet when Dr. Kaminsky enlisted the aid of the Sheriff's office, officers refused to ask the protestors to leave without a directive from Fidelity or its agent. Indeed, an attorney had instructed the protestors to remain *unless* the landlord or its representative ordered them to leave. It appears



that Fidelity's only response to the demonstrators was to state, through its agents, that it was aware of Dr. Kaminsky's problems.

Both action and lack of action can constitute "conduct" by the landlord which amounts to a constructive eviction....

This case shows ample instances of Fidelity's failure to act in the face of repeated requests for assistance despite its having expressly covenanted Dr. Kaminsky's quiet enjoyment of the premises. These instances provided a legally sufficient basis for the jury to conclude that Dr. Kaminsky abandoned the leased premises, not because of the trespassing protestors, but because of Fidelity's lack of response to his complaints about the protestors. Under the circumstances, while it is undisputed that Fidelity did not "encourage" the demonstrators, its conduct essentially allowed them to continue to trespass.

[The trial court judgment is affirmed.]

### CASE QUESTIONS

A constructive eviction occurs when the tenant leaves the leased premises because of conduct by the landlord that materially interferes with the tenant's beneficial use of the premises.

1. At the trial, who concluded that Fidelity's "conduct" constituted constructive eviction? Is this a question of fact, an interpretation of the contract, or both?
2. How can failure to act constitute "conduct"? What could explain Fidelity's apparent reluctance to give notice to protestors that they might be arrested for trespass?

### Landlord's Tort Liability

Stephens v. Stearns

106 Idaho 249; 678 P.2d 41 (Idaho Sup. Ct. 1984)

Donaldson, Chief Justice

Plaintiff-appellant Stephens filed this suit on October 2, 1978, for personal injuries she sustained on July 15, 1977, from a fall on an interior stairway of her apartment. Plaintiff's apartment, located in a Boise apartment complex, was a "townhouse" consisting of two separate floors connected by an internal stairway.

The apartments were built by defendant Koch and sold to defendant Stearns soon after completion in 1973. Defendant Stearns was plaintiff's landlord from the time she moved into the apartment in 1973 through the time of plaintiff's fall on July 15, 1977. Defendant Albanese was the architect who designed and later inspected the apartment complex.

\* \* \*

When viewed in the light most favorable to appellant, the facts are as follows: On the evening of July 15, 1977, Mrs. Stephens went to visit friends. While there she had two drinks. She returned to her apartment a little past 10:00 p.m. Mrs. Stephens turned on the television in the living room and went upstairs to change clothes. After changing her clothes, she attempted to go downstairs to watch television. As Mrs. Stephens reached the top of the stairway, she either slipped or fell forward. She testified that she "grabbed" in order to catch herself. However, Mrs. Stephens was unable to catch herself and she fell to the bottom of the stairs. As a result of the fall, she suffered serious injury. The evidence further showed that the stairway was approximately thirty-six inches wide and did not have a handrail although required by a Boise ordinance.

\* \* \*

In granting defendant Stearns' motion for directed verdict, the trial judge concluded that there was "an absolute lack of evidence" and that "to find a proximate cause between the absence of the handrail and the fall suffered by the plaintiff would be absolutely conjecture and speculation." (Although the trial judge's conclusion referred to "proximate cause," it is apparent that he was referring to factual or actual cause. *See Munson v. State, Department of Highways*, 96 Idaho 529, 531 P.2d 1174 (1975).) We disagree with the conclusion of the trial judge.

We have considered the facts set out above in conjunction with the testimony of Chester Shawver, a Boise architect called as an expert in the field of architecture, that the primary purpose of a handrail is for user safety. We are left with the firm conviction that there is sufficient evidence from which reasonable jurors could have concluded that the absence of a handrail was the actual cause of plaintiff's

injuries; *i.e.*, that plaintiff would not have fallen, or at least would have been able to catch herself, had there been a handrail available for her to grab.

In addition, we do not believe that the jury would have had to rely on conjecture and speculation to find that the absence of the handrail was the actual cause. To the contrary, we believe that reasonable jurors could have drawn legitimate inferences from the evidence presented to determine the issue. This comports with the general rule that the factual issue of causation is for the jury to decide. *McKinley v. Fanning*, 100 Idaho 189, 595 P.2d 1084 (1979); *Munson v. State, Department of Highways, supra*. In addition, courts in several other jurisdictions, when faced with similar factual settings, have held that this issue is a question for the jury.

\* \* \*

Rather than attempt to squeeze the facts of this case into one of the common-law exceptions, plaintiff instead has brought to our attention the modern trend of the law in this area. Under the modern trend, landlords are simply under a duty to exercise reasonable care under the circumstances. The Tennessee Supreme Court had the foresight to grasp this concept many years ago when it stated: "The ground of liability upon the part of a landlord when he demises dangerous property has nothing special to do with the relation of landlord and tenant. It is the ordinary case of liability for personal misfeasance, which runs through all the relations of individuals to each other." *Wilcox v. Hines*, 100 Tenn. 538, 46 S.W. 297, 299 (1898). Seventy-five years later, the Supreme Court of New Hampshire followed the lead of *Wilcox*. *Sargent v. Ross*, 113 N.H. 388, 308 A.2d 528 (1973). The *Sargent* court abrogated the common-law rule and its exceptions, and adopted the reasonable care standard by stating:

We thus bring up to date the other half of landlord-tenant law. Henceforth, landlords as other persons must exercise reasonable care not to subject others to an unreasonable risk of harm....A landlord must act as a reasonable person under all of the circumstances including the likelihood of injury to others, the probable seriousness of such injuries, and the burden of reducing or avoiding the risk.

*Id.* at 534 [Citations]

Tennessee and New Hampshire are not alone in adopting this rule. As of this date, several other states have also judicially adopted a reasonable care standard for landlords.

\* \* \*

In commenting on the common-law rule, A. James Casner, Reporter of Restatement (Second) of Property—Landlord and Tenant, has stated: “While continuing to pay lip service to the general rule, the courts have expended considerable energy and exercised great ingenuity in attempting to fit various factual settings into the recognized exceptions.” Restatement (Second) of Property—Landlord and Tenant ch. 17 Reporter’s Note to Introductory Note (1977). We believe that the energies of the courts of Idaho should be used in a more productive manner. Therefore, after examining both the common-law rule and the modern trend, we today decide to leave the common-law rule and its exceptions behind, and we adopt the rule that a landlord is under a duty to exercise reasonable care in light of all the circumstances.

We stress that adoption of this rule is not tantamount to making the landlord an insurer for all injury occurring on the premises, but merely constitutes our removal of the landlord’s common-law cloak of immunity. Those questions of hidden danger, public use, control, and duty to repair, which under the common-law were prerequisites to the consideration of the landlord’s negligence, will now be relevant only inasmuch as they pertain to the elements of negligence, such as foreseeability and unreasonableness of the risk. We hold that defendant Stearns did owe a duty to plaintiff Stephens to exercise reasonable care in light of all the circumstances, and that it is for a jury to decide whether that duty was breached. Therefore, we reverse the directed verdict in favor of defendant Stearns and remand for a new trial of plaintiff’s negligence action against defendant Stearns.

### CASE QUESTIONS

1. Why should actual cause be a jury question rather than a question that the trial judge decides on her own?
2. Could this case have fit one of the standard exceptions to the common-law rule that injuries on the premises are the responsibility of the tenant?
3. Does it mean anything at all to say, as the court does, that persons (including landlords) must “exercise reasonable care not to subject others to an unreasonable risk of harm?” Is this a rule that gives very much direction to landlords who may wonder what the limit of their liabilities might be?

## **26.6 Summary and Exercises**

## Summary

A leasehold is an interest in real property that terminates on a certain date. The leasehold itself is personal property and has three major forms: (1) the estate for years, (2) the periodic tenancy, and (3) the tenancy at will. The estate for years has a definite beginning and end; it need not be measured in years. A periodic tenancy—sometimes known as an estate from year to year or month to month—is renewed automatically until either landlord or tenant notifies the other that it will end. A tenancy at will lasts only as long as both landlord and tenant desire. Oral leases are subject to the Statute of Frauds. In most states, leases to last longer than a year must be in writing, and the lease must identify the parties and the premises, specify the duration, state the rent, and be signed by the party to be charged.

The law imposes on the landlord certain duties toward the tenant and gives the tenant corresponding rights, including the right of possession, habitable condition, and noninterference with use. The right of possession is breached if a third party has paramount title at the time the tenant is due to take possession. In most states, a landlord is obligated to provide the tenant with habitable premises not only when the tenant moves in but also during the entire period of the lease. The landlord must also refrain from interfering with a tenant's permissible use of the premises.

If the landlord breaches an obligation, the tenant has several remedies. He may terminate the lease, recover damages, or (in several states) use a rent-related remedy (by withholding rent, by applying it to remedy the defect, or by abatement).

The tenant has duties also. The tenant must pay the rent. If she abandons the property and fails to pay, most states do not require the landlord to mitigate damages, but several states are moving away from this general rule. The tenant may physically change the property to use it to her best advantage, but she may not make structural alterations or commit waste. The tenant must restore the property to its original condition when the lease ends. This rule does not include normal wear and tear.

Should the tenant breach any of her duties, the landlord may terminate the lease and seek damages. In the case of a holdover tenant, the landlord may elect to hold the tenant to another rental term.

The interest of either landlord or tenant may be transferred freely unless the tenancy is at will, the lease requires either party to perform significant personal services that would be substantially less likely to be performed, or the parties agree that the interest may not be transferred.

Despite the general rule that the tenant is responsible for injuries caused on the premises to outsiders, the landlord may have significant tort liability if (1) there are hidden dangers he knows about, (2) defects that existed at the time the lease was signed injure people off the premises, (3) the premises are rented for public

purposes, (4) the landlord retains control of the premises, or (5) the landlord repairs the premises in a faulty manner.

## EXERCISES

1. Lanny orally agrees to rent his house to Tenny for fifteen months, at a monthly rent of \$1,000. Tenny moves in and pays the first month's rent. Lanny now wants to cancel the lease. May he? Why?
2. Suppose in Exercise 1 that Tenny had an option to cancel after one year. Could Lanny cancel before the end of the year? Why?
3. Suppose in Exercise 1 that Lanny himself is a tenant and has leased the house for six months. He subleases the house to Tenny for one year. The day before Tenny is to move into the house, he learns of Lanny's six-month lease and attempts to terminate his one-year lease. May he? Why?
4. Suppose in Exercise 3 that Tenny learned of Lanny's lease the day after he moved into the house. May he terminate? Why?
5. Simon owns a four-story building and rents the top floor to a college student. Simon is in the habit of burning refuse in the backyard, and the smoke from the refuse is so noxious that it causes the student's eyes to water and his throat to become raw. Has Simon breached a duty to the student? Explain.
6. In Exercise 5, if other tenants (but not Simon) were burning refuse in the backyard, would Simon be in breach? Why?
7. Assume in Exercise 5 that Simon was in breach. Could the student move out of the apartment and terminate the lease? What effect would this have on the student's duty to pay rent? Explain.

## SELF-TEST QUESTIONS

1. An estate for years
  - a. has a definite beginning and end
  - b. is a leasehold estate
  - c. usually terminates automatically at midnight of the last day specified in the lease
  - d. includes all of the above
  
2. Not included among the rights given to a tenant is
  - a. paramount title
  - b. possession
  - c. habitable condition
  - d. noninterference with use
  
3. The interest of either landlord or tenant may be transferred freely
  - a. unless the tenancy is at will
  - b. unless the lease requires significant personal services unlikely to be performed by someone else
  - c. unless either of the above apply
  - d. under no circumstances
  
4. When injuries are caused on the premises to outsiders,
  - a. the tenant is always liable
  - b. the landlord is always liable
  - c. the landlord may be liable if there are hidden dangers the landlord knows about
  - d. they have no cause of action against the landlord or tenant since they have no direct contractual relationship with either party
  
5. Legally a tenant may
  - a. commit waste
  - b. make some structural alterations to the property



- c. abandon the property at any time
- d. physically change the property to suit it to her best advantage, as long as no structural alterations are made

#### SELF-TEST ANSWERS

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

## Chapter 27

### Estate Planning: Wills, Estates, and Trusts

#### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

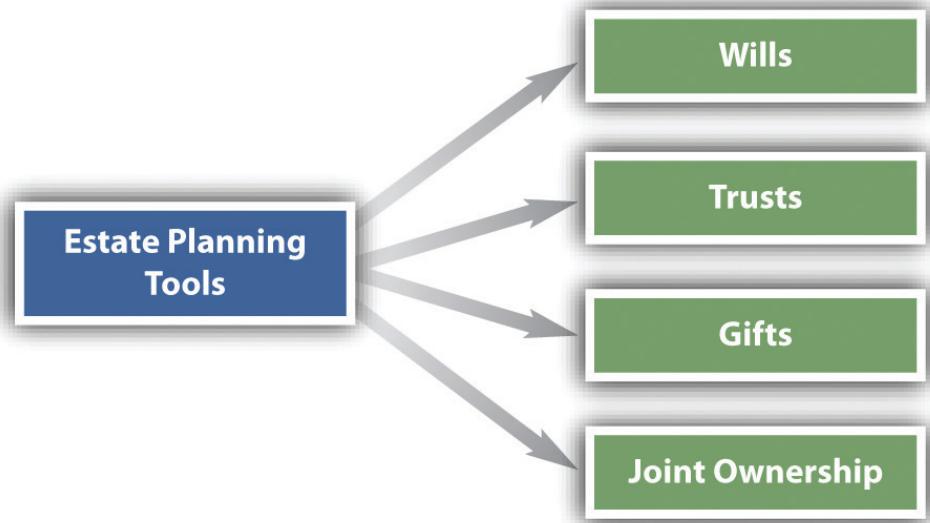
1. How property, both real and personal, can be devised and bequeathed to named heirs in a will
2. What happens to property of a decedent when there is no will
3. The requirements for “testamentary capacity”—what it takes to make a valid will that can be admitted to probate
4. The steps in the probate and administration of a will
5. How a will is distinguished from a trust, and how a trust is created, how it functions, and how it may come to an end
6. The various kinds of trusts, as well as factors that affect both estates and trusts

Broadly defined, **estate planning**<sup>1</sup> is the process by which someone decides how his assets are to be passed on to others at his death. Estate planning has two general objectives: to ensure that the assets are transferred according to the owner’s wishes and to minimize state and federal taxes.

People have at their disposal four basic estate planning tools: (1) wills, (2) trusts, (3) gifts, and (4) joint ownership (see [Figure 27.1 "Estate Planning"](#)). The rules governing gifts are discussed in [Chapter 22 "Introduction to Property: Personal Property and Fixtures"](#), and joint ownership is treated in [Chapter 24 "The Nature and Regulation of Real Estate and the Environment"](#). Consequently, we focus on the first two tools here. In addition to these tools, certain assets, such as insurance (discussed in [Chapter 28 "Insurance"](#)), are useful in estate planning.

1. The process by which an owner over the course of his life decides how his assets are to be passed on to others at his death.

Figure 27.1 *Estate Planning*



Estate planning not only provides for the spouses and children, other relatives and friends, the children's education, payoff of the mortgage, and so on, but also serves as the principal means by which liquidity can be guaranteed for taxes, expenses for administering the estate, and the like, while preserving the assets of the estate. And whenever a business is formed, estate planning consequences should always be considered, because the form and structure of the business can have important tax ramifications for the individual owners.

## 27.1 Wills and Estate Administration

### LEARNING OBJECTIVES

1. Describe how property, both real and personal, can be devised and bequeathed to named heirs in a will.
2. Understand what happens to property of a decedent when there is no will.
3. Explain the requirements for “testamentary capacity”—what it takes to make a valid will that can be admitted to probate.
4. Describe the steps in the probate and administration of a will.

### Definition

A **will**<sup>2</sup> is the declaration of a person’s wishes about the disposition of his assets on his death. Normally a written document, the will names the persons who are to receive specific items of real and personal property. Unlike a contract or a deed, a will is not binding as long as the person making the will lives. He may revoke it at any time. Wills have served their present function for virtually all of recorded history. The earliest known will is from 1800 BC (see [Figure 27.2 "An Ancient Will"](#)). Even if somewhat different in form, it served the same basic function as a modern will.

2. The declaration of a person’s wishes (the testator) about the disposition of his assets on his death.

Figure 27.2 *An Ancient Will*

[Will of Uah] "I, Uah, devise to my wife Sheftu, the woman of Gesab called Teta, daughter of Sat Sepdu, all properties given to me by my brother Ankh-ren. She shall give it to whomsoever she may see fit of her issue born to me.

"I devise to her the Eastern slaves, 4 persons, that my brother Ankh-ren gave me. She shall give them to whomsoever she may see fit of her children.

"As to my tomb, let me be buried in it with my wife alone.

"Moreover, as to the house built for me by my brother Ankh-ren, my wife shall dwell therein and shall not be evicted by any person.

"The deputy Sebu shall act as guardian of my son. Done in the presence of these witnesses:

"Kemen, Decorator of Columns,  
"Apu, Doorkeeper of the Temple,  
"Senb, son of Senb, Doorkeeper of the Temple."

Source: John H. Wigmore, *A Panorama of the World's Legal Systems*, vol. 1, p. 22.

Although most wills are written in a standardized form, some special types of wills are enforceable in many states.

1. A *nuncupative will* is one that is declared orally in front of witnesses. In states where allowed, the statutes permit it to be used only when the testator is dying as he declares his will. (A testator is one who dies with a will.)
2. A *holographic will* is one written entirely by the testator's hand and not witnessed. At common law, a holographic will was invalid if any part of the paper on which it was written contained printing. Modern statutes tend to validate holographic wills, even with printing, as long as the testator who signs it puts down material provisions in his own hand.
3. *Soldiers' and sailors' wills* are usually enforceable, no matter how informal the document, if made while the soldier is on service or the sailor is at sea (although they cannot usually transfer real property without observing certain formalities).
4. A *conditional will* is one that will take effect only on the happening of a particular named event. For example, a man intending to marry might

write, “This will is contingent on my marrying Alexa Jansey.” If he and Ms. Jansey do not marry, the will can have no operational effect.

5. A *joint will* is one in which two (or more) people use the same instrument to dispose of their assets. It must be signed by each person whose assets it is to govern.
6. *Mutual or reciprocal wills* are two or more instruments with reciprocal terms, each written by a person who intends to dispose of his or her assets in favor of the others.

## The Uniform Probate Code

**Probate**<sup>3</sup> is the process by which a deceased’s estate is managed under the supervision of a court. In most states, the court supervising this process is a specialized one and is often called the probate court. Probate practices vary widely from state to state, although they follow a general pattern in which the assets of an estate are located, added up, and disbursed according to the terms of the will or, if there is no will, according to the law of intestate succession. To attempt to bring uniformity into the conflicting sets of state laws the National Conference of Commissioners on Uniform State Laws issued the Uniform Probate Code (UPC) in 1969, and by 2011 it had been adopted in its entirety in sixteen states. Several other states have adopted significant parts of the UPC, which was revised in 2006. Our discussion of wills and estate administration is drawn primarily from the UPC, but you should note that there are variations among the states in some of the procedures standardized in the UPC.

## Will Requirements and Interpretation Capacity

Any person who is over eighteen and of “sound mind” may make a will. One who is insane may not make an enforceable will, although the degree of mental capacity necessary to sustain a will is generally said to be a “modest level of competence” and is lower than the degree of capacity people must possess to manage their own affairs during their life. In other words, a court might order a guardian to manage the affairs of one who is mentally deficient but will uphold a will that the person has written. Insanity is not the only type of mental deficiency that will disqualify a will; medication of a person for serious physical pain might lead to the conclusion that the person’s mind was dulled and he did not understand what he was doing when writing his will. The case *Estate of Seymour M. Rosen*, (see [Section 27.4.1 "Testamentary Capacity"](#)), considers just such a situation.

3. The process by which a deceased’s estate is managed under the supervision of a court.

## Writing

Under the UPC, wills must be in writing. The will is not confined to the specific piece of paper called “will” and signed by the testator. It may incorporate by reference any other writing in existence when the will is made, as long as the will sufficiently identifies the other writing and manifests an intent to incorporate it. Although lawyers prepare neatly typed wills, the document can be written in pencil or pen and on any kind of paper or even on the back of an envelope. Typically, the written will has the following provisions: (1) a “publication clause,” listing the testator’s name and his or her intention to make a will; (2) a “revocation clause,” revoking all previously made wills; (3) burial instructions; (4) debt payments, listing specific assets to be used; (5) **bequests**<sup>4</sup>, which are gifts of personal property by will; (6) **devises**<sup>5</sup>, which are gifts of real property by will; (7) a “residuary clause,” disposing of all property not covered by a specific bequest or devise; (8) a “penalty clause,” stating a penalty for anyone named in the will who contests the will; (9) the name of minor children’s guardian; and (10) the name of the executor. The executor’s job is to bring in all the assets of an estate, pay all just claims, and make distribution to beneficiaries in accord with the testator’s wishes. Beginning with California in 1983, several states have adopted statutory wills—simple fill-in-the-blank will forms that can be completed without consulting an attorney.

## Signature

The testator must sign the will, and the proper place for the signature is at the end of the entire document. The testator need not sign his full name, although that is preferable; his initials or some other mark in his own hand, intended as an execution of the document, will suffice. The UPC permits someone else to sign for the testator as long as the signing is done in the testator’s presence and by his or her direction.

## Witnesses

Most states require two or three witnesses to sign the will. The UPC requires two witnesses. The witnesses should observe the testator sign the will and then sign it themselves in the presence of each other. Since the witnesses might be asked to attest in court to the testator’s signature, it is sound practice to avoid witnesses who are unduly elderly and to use an extra witness or two. Most states forbid a person who has an interest in the will—that is, one who is a beneficiary under the will—from witnessing.

4. Gift of personal property by will.

5. Gift of real property by will.

In some states, a beneficiary who serves as a witness will lose his or her right to a bequest or devise. The UPC differs from the usual rule: no will or any provision of a

will is invalid because an interested party witnesses it, nor does the interested witness forfeit a bequest or devise.

### Revocation and Modification

Since wills are generally effective only at death, the testator may always revoke or amend a will during his lifetime. He may do so by tearing, burning, obliterating, or otherwise destroying it. A subsequent will has the effect of revoking an inconsistent prior will, and most wills expressly state that they are intended to revoke all prior wills. A written modification of or supplement to a prior will is called a **codicil**<sup>6</sup>. The codicil is often necessary, because circumstances are constantly changing. The testator may have moved to a new state where he must meet different formal requirements for executing the will; one of his beneficiaries may have died; his property may have changed. Or the law, especially the tax law, may have changed.

One exception to the rule that wills are effective only at death is the so-called **living will**<sup>7</sup>. Beginning with California in 1976, most states have adopted legislation permitting people to declare that they refuse further treatment should they become terminally ill and unable to tell physicians not to prolong their lives if they can survive only by being hooked up to life-preserving machines. This living will takes effect during the patient's life and must be honored by physicians unless the patient has revoked it. The patient may revoke at any time, even as he sees the doctor moving to disconnect the plug.

In most states, a later marriage revokes a prior will, but divorce does not. Under the UPC, however, a divorce or annulment revokes any disposition of property bequeathed or devised to the former spouse under a will executed prior to the divorce or annulment. A will is at least partially revoked if children are born after it is executed, unless it has either provided for subsequently born children or stated the testator's intention to disinherit such children.

### Abatement

6. A written modification of or supplement to a prior will.
7. A will that takes effect during life in cases of terminal illness, directing that physicians and others take no life-prolonging measures.
8. A proportional reduction of the amount payable under a will when the funds are no longer available to pay in full.

Specific bequests listed in a will might not be available in the estate when the testator or testatrix dies. **Abatement**<sup>8</sup> of a bequest happens when there are insufficient assets to pay the bequest. Suppose the testatrix leaves \$10,000 each to "my four roommates," but when she dies, her estate is worth only \$20,000. The gift to each of the roommates is said to have abated, and each will take only \$5,000.

Abatement can pose a serious problem in wills not carefully drafted. Since circumstances can always change, a general provision in a father's will, providing "my dear daughter with all the rest, residue, and remainder of my estate," will do



her little good if business reverses mean that the \$10,000 bequest to the local hospital exhausts the estate of its assets—even though at the time the will was made, the testator had assets of \$1 million and supposed his daughter would be getting the bulk of it. Since specific gifts must be paid out ahead of general bequests or devises, abatement can cause the residual legatee (the person taking all assets not specifically distributed to named individuals) to suffer.

### Ademption

Suppose that a testator bequeathed her 1923 Rolls Royce to “my faithful secretary,” but that the car had been sold and she owned only a 1980 Volkswagen when she died. Since the Rolls was not part of the estate, it is said to have adeemed (to have been taken away). **Ademption**<sup>9</sup> of a gift in a will means that the intended legatee (the person named in the will) forfeits the object because it no longer exists. An object used as a substitute by the testator will not pass to the legatee unless it is clear that she intended the legatee to have it.

### Intestacy

**Intestacy**<sup>10</sup> means dying without a will. Intestacy happens all too frequently; even those who know the consequences for their heirs often put off making a will until it is too late—Abraham Lincoln, for one, who as an experienced lawyer knew very well the hazards to heirs of dying intestate. On his death, Lincoln’s property was divided, with one-third going to his widow, one-third to a grown son, and one-third to a twelve-year-old son. Statistics show that in New York, about one-third of the people who die with estates of \$5,000 or more die without wills. In every state, statutes provide for the disposition of property of decedents dying without wills. If you die without a will, the state in effect has made one for you. Although the rules vary by statute from state to state, a common distribution pattern prevails.

### Unmarried Decedent

At common law, parents of an intestate decedent could not inherit his property. Today, however, many states provide that parents will share in the property. If the parents have already died, then the estate will pass to collateral heirs (siblings, nieces, nephews, aunts, and uncles). If there are no collateral heirs, most state laws provide that the next surviving kin of equal degree will share the property equally (e.g., first cousins). If there are no surviving kin, the estate **escheats**<sup>11</sup> (es CHEETS) to the state, which is then the sole owner of the assets of the estate.

9. Revocation or cancellation of a legatee’s rights under a will by the actions of the testator during his life, often by his having given away assets that the will says are to go to the legatee.

10. Dying without a will.

11. Property of decedents that have no known heirs will “escheat” to the state.

### Married with No Children

In some states, the surviving spouse without children will inherit the entire estate. In other states, the spouse must share the property with the decedent's parents or, if they are deceased, with the collateral heirs.

### Married with Children

In general, the surviving spouse will be entitled to one-third of the estate, and the remainder will pass in equal shares to living children of the decedent. The share of any child who died before the decedent will be divided equally among that child's offspring. These grandchildren of the decedent are said to take **per stirpes**<sup>12</sup> (per STIR peas), meaning that they stand in the shoes of their parent. Suppose that the decedent left a wife, three children, and eight grandchildren (two children each of the three surviving children and two children of a fourth child who predeceased the decedent), and that the estate was worth \$300,000. Under a typical intestate succession law, the widow would receive property worth \$100,000. The balance of the property would be divided into four equal parts, one for each of the four children. The three surviving children would each receive \$50,000. The two children of the fourth child would each receive \$25,000. The other grandchildren would receive nothing.

A system of distribution in which all living descendants share equally, regardless of generation, is said to be a distribution **per capita**<sup>13</sup>. In the preceding example, after the widow took her share, the remaining sum would be divided into eleven parts, three for the surviving children and eight for the surviving grandchildren.

### Unmarried with Children

If the decedent was a widow or widower with children, then the surviving children generally will take the entire estate.

### Estate Administration

To carry on the administration of an estate, a particular person must be responsible for locating the estate property and carrying out the decedent's instructions. If named in the will, this person is called an **executor**<sup>14</sup>. When a woman serves, she is still known in many jurisdictions as an **executrix**<sup>15</sup>. If the decedent died intestate, the court will appoint an administrator (or administratrix, if a woman), usually a close member of the family. The UPC refers to the person performing the function of executor or administrator as a personal representative. Unless excused by the

12. By representation; in a distribution per stirpes, each class of individuals takes the share to which their deceased would have been entitled.

13. According to the number of individuals, share and share alike; in a distribution per capita, each person named will receive an equal share.

14. The administrator of an estate, named in the will by the testator.

15. The female administrator of an estate, named in the will by the testator.

will from doing so, the personal representative must post a bond, usually in an amount that exceeds the value of the decedent's personal property.

The personal representative must immediately become familiar with the decedent's business, preserve the assets, examine the books and records, check on insurance, and notify the appropriate banks.

When confirmed by the court (if necessary), the personal representative must offer the will in probate—that is, file the will with the court, prove its authenticity through witnesses, and defend it against any challenges. Once the court accepts the will, it will enter a formal decree admitting the will to probate.

Traditionally, a widow could make certain elections against the will; for example, she could choose dower and homestead rights. The right of **dower**<sup>16</sup> entitled the widow to a life estate in one-third of the husband's inheritable land, while a **homestead right**<sup>17</sup> is the right to the family home as measured by an amount of land (e.g., 160 acres of rural land or 1 acre of urban land in Kansas) or a specific dollar amount. In some states, this amount is quite low (e.g., \$4,000 in Kansas) where the legislature has not upwardly adjusted the dollar amount for many years.

Today, most states have eliminated traditional dower rights. These states give the surviving spouse (widow or widower) the right to reject provisions made in a will and to take a share of the decedent's estate instead.

Once the will is admitted to probate, the personal representative must assemble and inventory all assets. This task requires the personal representative to collect debts and rent due, supervise the decedent's business, inspect the real estate, store personal and household effects, prove the death and collect proceeds of life insurance policies, take securities into custody, and ascertain whether the decedent held property in other states. Next, the assets must be appraised as of the date of death. When inventory and appraisal are completed, the personal representative must decide how and when to dispose of the assets by answering the following sorts of questions: Should a business be liquidated, sold, or allowed to continue to operate? Should securities be sold, and if so, when? Should the real estate be kept intact under the will or sold? To whom must the personal effects be given?

16. A right given to a widow to a life estate in one-third of the husband's inheritable land.

17. The right to the family home (as measured by an amount of land or a specific dollar amount) to be free of all claims of creditors.

The personal representative must also handle claims against the estate. If the decedent had unpaid debts while alive, the estate will be responsible for paying them. In most states, the personal representative is required to advertise that the estate is in probate. When all claims have been gathered and authenticated, the personal representative must pay just claims in order of priority. In general

(though by no means in every state), the order of priority is as follows: (1) funeral expenses, (2) administration expenses (cost of bond, advertising expenses, filing fees, lawsuit costs, etc.), (3) family allowance, (4) claims of the federal government, (5) hospital and other expenses associated with the decedent's last illness, (6) claims of state and local governments, (7) wage claims, (8) lien claims, (9) all other debts. If the estate is too small to cover all these claims, every claim in the first category must be satisfied before the claims in the second category may be paid, and so on.

Before the estate can be distributed, the personal representative must take care of all taxes owed by the estate. She will have to file returns for both estate and income taxes and pay from assets of the estate the taxes due. (She may have to sell some assets to obtain sufficient cash to do so.) **Estate taxes**<sup>18</sup>—imposed by the federal government and based on the value of the estate—are nearly as old as the Republic; they date back to 1797. They were instituted originally to raise revenue, but in our time they serve also to break up large estates.

As of 2011, the first \$1 million of an estate is exempt from taxation, lowering the threshold from an earlier standard. The Tax Policy Institute of the Brookings Institution estimates that 108,200 estates of people dying in 2011 will file estate tax returns, and 44,200 of those estates will pay taxes totaling \$34.4 billion.

Although a unified tax is imposed on gifts during life and transfers at death, everyone is permitted to give away \$13,000 per donee each year without paying any tax on the gift. A tax on sizable gifts is imposed to prevent people with large estates from giving away during their lives portions of their estate in order to escape estate taxes. Thus two grandparents with two married children and four grandchildren may give away \$26,000 (\$13,000 from each grandparent) to their eight descendants (children, spouses, grandchildren) each year, for a total of \$208,000, without paying any tax.

State governments also impose taxes at death. In many states, these are known as **inheritance taxes**<sup>19</sup> and are taxes on the heir's right to receive the property. The tax rate depends on the relationship to the decedent: the closer the relation, the smaller the tax. Thus a child will pay less than a nephew or niece, and either of them will pay less than an unrelated friend who is named in the will.

18. Taxes imposed by the federal government on large estates.

19. State taxes on an heir's right to receive the property.

20. Done by the executor to close out an estate in probate. After taxes and debts are paid, an accounting must be prepared, showing the remaining principal, income, and disbursements to beneficiaries.

Once the taxes are paid, a **final accounting**<sup>20</sup> must be prepared, showing the remaining principal, income, and disbursements. Only at this point may the personal representative actually distribute the assets of the estate according to the will.

### KEY TAKEAWAY

Any person with the requisite capacity may make a will and bequeath personal property to named heirs. A will can also devise real property. Throughout the United States, there are fairly common requirements to be met for a will to qualify for probate.

Intestacy statutes will govern where there is no will, and an administrator will be appointed by the probate court. Intestacy statutes will dictate which relatives will get what portion of the decedent's estate, portions that are likely to differ from what the decedent would have done had he or she left a valid will. Where there are no heirs, the decedent's property escheats to the state.

An executor (or executrix) is the person named in the will to administer the estate and render a final accounting. Estate and inheritance taxes may be owed if the estate is large enough.

### EXERCISES

1. Donald Trump is married to Ivanna Trump, but they divorce. Donald neglects to change his will, which leaves everything to Ivanna. If he were to die before remarrying, would the will still be valid?
2. Tom Tyler, married to Tina Tyler, dies without a will. If his legal state of residence is California, how will his estate be distributed? (This will require a small amount of Internet browsing.)
3. Suppose Tom Tyler is very wealthy. When he dies at age sixty-three, there are two wills: one leaves everything to his wife and family, and the other leaves everything to his alma mater, the University of Colorado. The family wishes to dispute the validity of the second (later in time) will. What, in general, are the bases on which a will can be challenged so that it does not enter into probate?

## 27.2 Trusts

### LEARNING OBJECTIVES

1. Distinguish a will from a trust, and describe how a trust is created, how it functions, and how it may come to an end.
2. Compare the various kinds of trusts, as well as factors that affect both estates and trusts.

### Definitions

When the legal title to certain property is held by one person while another has the use and benefit of it, a relationship known as a **trust**<sup>21</sup> has been created. The trust developed centuries ago to get around various nuances and complexities, including taxes, of English real property law. The trustee has legal title and the beneficiary has “equitable title,” since the courts of equity would enforce the obligations of the trustee to honor the terms by which the property was conveyed to him. A typical trust might provide for the trustee to manage an estate for the grantor’s children, paying out income to the children until they are, say, twenty-one, at which time they would become legal owners of the property.

Trusts may be created by bequest in a will, by agreement of the parties, or by a court decree. However created, the trust is governed by a set of rules that grew out of the courts of equity. Every trust involves specific property, known as the *res* (*rees*; Latin for “thing”), and three parties, though the parties may be the same person.

### Settlor or Grantor

Anyone who has legal capacity to make a contract may create a trust. The creator is known as the **settlor**<sup>22</sup> or grantor. Trusts are created for many reasons; for example, so that a minor can have the use of assets without being able to dissipate them or so that a person can have a professional manage his money.

### Trustee

The trustee is the person or legal entity that holds the legal title to the *res*. Banks do considerable business as trustees. If the settlor should neglect to name a trustee, the court may name one. The trustee is a fiduciary of the trust beneficiary and will

21. The holding of legal title by one party for the benefit of another.

22. Grantor; the one who creates a trust.

be held to the highest standard of loyalty. Not even an appearance of impropriety toward the trust property will be permitted. Thus a trustee may not loan trust property to friends, to a corporation of which he is a principal, or to himself, even if he is scrupulous to account for every penny and pays the principal back with interest. The trustee must act prudently in administering the trust.

### Beneficiary

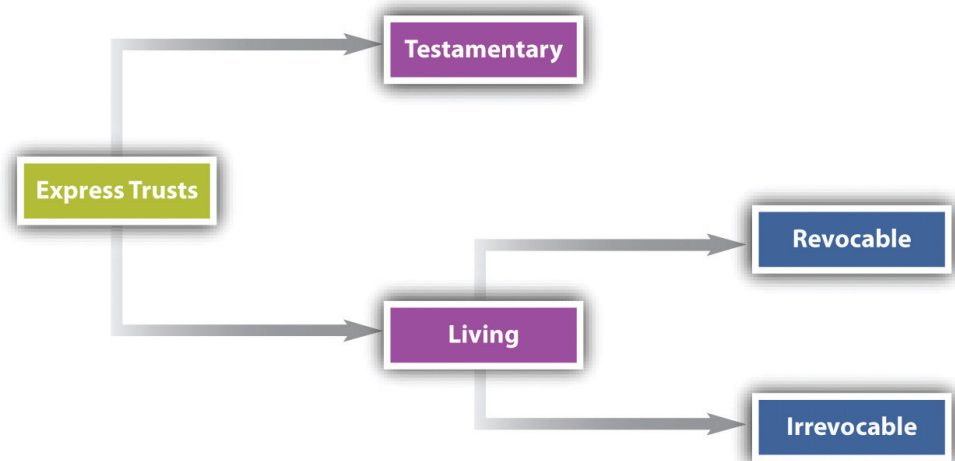
The beneficiary is the person, institution, or other thing for which the trust has been created. Beneficiaries are not limited to one's children or close friends; an institution, a corporation, or some other organization, such as a charity, can be a beneficiary of a trust, as can one's pet dogs, cats, and the like. The beneficiary may usually sell or otherwise dispose of his interest in a trust, and that interest likewise can usually be reached by creditors. Note that the settlor may create a trust of which he is the beneficiary, just as he may create a trust of which he is the trustee.

*Continental Bank & Trust Co. v. Country Club Mobile Estates, Ltd.*, (see [Section 27.4.2 "Settlor's Limited Power over the Trust"](#)), considers a basic element of trust law: the settlor's power over the property once he has created the trust.

### Express Trusts

Trusts are divided into two main categories: express and implied. Express trusts include **testamentary trusts**<sup>23</sup> and **inter vivos (or living) trusts**<sup>24</sup>. The testamentary trust is one created by will. It becomes effective on the testator's death. The inter vivos trust is one created during the lifetime of the grantor. It can be revocable or irrevocable (see [Figure 27.3 "Express Trusts"](#)).

Figure 27.3 Express Trusts



23. A trust made during the settlor's life that takes effect on his death.

24. A trust that takes effect during the life of the settlor.

A **revocable trust**<sup>25</sup> is one that the settlor can terminate at his option. On termination, legal title to the trust assets returns to the settlor. Because the settlor can reassert control over the assets whenever he wishes, the income they generate is taxed to him.

By contrast, an **irrevocable trust**<sup>26</sup> is permanent, and the settlor may not revoke or modify its terms. All income to the trust must be accumulated in the trust or be paid to the beneficiaries in accordance with the trust agreement. Because income does not go to the settlor, the irrevocable trust has important income tax advantages, even though it means permanent loss of control over the assets (beyond the instructions for its use and disposition that the settlor may lay out in the trust agreement). A hybrid form is the reversionary trust: until the end of a fixed period, the trust is irrevocable and the settlor may not modify its terms, but thereafter the trust assets revert to the settlor. The reversionary trust combines tax advantages with ultimate possession of the assets.

Of the possible types of express trusts, five are worth examining briefly: (1) Totten trusts, (2), blind trusts, (3) Clifford trusts, (4) charitable trusts, and (5) spendthrift trusts. The use of express trusts in business will also be noted.

### Totten Trust

The Totten trust, which gets its name from a New York case, *In re Totten*, 71 N.E. 748 (N.Y. 1904), is a tentative trust created when someone deposits funds in a bank as trustee for another person as beneficiary. (Usually, the account will be named in the following form: “Mary, in trust for Ed.”) During the beneficiary’s lifetime, the grantor-depositor may withdraw funds at his discretion or revoke the trust altogether. But if the grantor-depositor dies before the beneficiary and had not revoked the trust, then the beneficiary is entitled to whatever remains in the account at the time of the depositor’s death.

### Blind Trust

In a blind trust, the grantor transfers assets—usually stocks and bonds—to trustees who hold and manage them for the grantor as beneficiary. The trustees are not permitted to tell the grantor how they are managing the portfolio. The blind trust is used by high government officials who are required by the Ethics in Government Act of 1978 to put their assets in blind trusts or abstain from making decisions that affect any companies in which they have a financial stake. Once the trust is created, the grantor-beneficiary is forbidden from discussing financial matters with the trustees or even to give the trustees advice. All that the grantor-beneficiary sees is a

25. A trust that the settlor can terminate at his option.

26. A trust that the settlor cannot terminate at his option.



quarterly statement indicating by how much the trust net worth has increased or decreased.

### **Clifford Trust**

The Clifford trust, named after the settlor in a Supreme Court case, *Helvering v. Clifford*, *Helvering v. Clifford*, 309 U.S. 331 (1940). is reversionary: the grantor establishes a trust irrevocable for at least ten years and a day. By so doing, the grantor shifts the tax burden to the beneficiary. So a person in a higher bracket can save considerable money by establishing a Clifford trust to benefit, say, his or her children. The tax savings will apply as long as the income from the trust is not devoted to needs of the children that the grantor is legally required to supply. At the expiration of the express period in the trust, legal title to the res reverts to the grantor. However, the Tax Reform Act of 1986 removed the tax advantages for Clifford trusts established after March 1986. As a result, all income from such trusts is taxed to the grantor. Existing Clifford trusts were not affected by the 1986 tax law.

### **Charitable Trust**

A charitable trust is one devoted to any public purpose. The definition is broad; it can encompass funds for research to conquer disease, to aid battered wives, to add to museum collections, or to permit a group to proselytize on behalf of a particular political or religious doctrine. The law in all states recognizes the benefits to be derived from encouraging charitable trusts, and states use the cy pres (see press; “as near as possible”) doctrine to further the intent of the grantor. The most common type of trust is the charitable remainder trust. You would donate property—usually intangible property such as stock—in trust to an approved charitable organization, usually one that has tax-exempt 501(c)(3) status from the IRS. The organization serves as trustee during your life and provides you or someone you designate with a specified level of income from the property that you donated. This could be for a number of years or for your lifetime. After your death or the period that you set, the trust ends and the charitable organization owns the assets that were in the trust.

There are important tax reasons why people set up charitable trusts. The trustor gets five years' worth of tax deductions for the value of the assets in the charitable trust. Capital gains are treated favorably, as well: charitable trusts are irrevocable, which means that the person setting up the trust (the “trustor”) permanently gives up control of the assets to the charitable organization. Thus, the charitable organization could sell an asset in the trust that would ordinarily incur significant capital gains taxes, but since the trustor no longer owns the asset, there is no

capital gains tax: as a tax-exempt organization, the charity will not pay capital gains, either.

### Spendthrift Trust

A spendthrift trust is established when the settlor believes that the beneficiary is not to be trusted with whatever rights she might possess to assign the income or assets of the trust. By express provision in a trust instrument, the settlor may ensure that the trustees are legally obligated to pay only income to the beneficiary; no assignment of the assets may be made, either voluntarily by the beneficiary or involuntarily by operation of law. Hence the spendthrift beneficiary cannot gamble away the trust assets nor can they be reached by creditors to pay her gambling (or other) debts.

### Express Trusts in Business

In addition to their use in estate planning, express trusts are also created for business purposes. The business trust was popular late in the nineteenth century as a way of getting around state limitations on the corporate form and is still used today. By giving their shares to a voting trust, shareholders can ensure that their agreement to vote as a bloc will be carried out. But voting trusts can be dangerous. As discussed in (Reference mayer 1.0-ch48 not found in Book) agreements that result in price fixing or other restraints of trade violate the antitrust laws; for example, companies are in violation when they act collusively to fix prices by pooling voting stock under a trust agreement, as happened frequently at the turn of the century.

### Implied Trusts

Trusts can be created by courts without any intent by a settlor to do so. For various reasons, a court will declare that particular property is to be held by its owner in trust for someone else. Such trusts are implied trusts and are usually divided into two types: **constructive trusts**<sup>27</sup> and **resulting trusts**<sup>28</sup>. A constructive trust is one created usually to redress a fraud or to prevent unjust enrichment. Suppose you give \$1 to an agent to purchase a lottery ticket for you, but the agent buys the ticket in his own name instead and wins \$1,000,000, payable into an account in amounts of \$50,000 per year for twenty years. Since the agent had violated his fiduciary obligation and unjustly enriched himself, the court would impose a constructive trust on the account, and the agent would find himself holding the funds as trustee for you as beneficiary. By contrast, a resulting trust is one imposed to carry out the supposed intent of the parties. You give an agent \$100,000 to purchase a house for you. Title is put in your agent's name at the closing, although it is clear that since she was paid for her services, you did not intend to give the house to her as a gift.

27. Created by courts to redress fraud or prevent unjust enrichment.

28. Created by courts to give effect to the intent of the parties.

The court would declare that the house was to be held by the agent as trustee for you during the time that it takes to have the title put in your name.

### KEY TAKEAWAY

A trust can be created during the life of the settlor of the trust. A named trustee and beneficiary are required, as well as some assets that the trustee will administer. The trustee has a fiduciary duty to administer the trust with the utmost care. Inter vivos trusts can be revocable or irrevocable. Testamentary trusts are, by definition, not revocable, as they take effect on the death of the settlor.

### EXERCISES

1. Karen Vreeland establishes a testamentary trust for her son, Brian, who has a gambling addiction. What kind of trust should she have established?
2. A group of ten coworkers “invests” in the Colorado Lottery when the jackpot reaches \$200 million. Each puts in \$10 for five tickets. Dan Connelly purchases fifty Colorado Lottery tickets on behalf of the group and holds them. As luck would have it, one of the tickets is a winner. Dan takes the ticket, claims the \$200 million, quits his job, and refuses to share. Do the coworkers have any legal recourse? Was a trust created in this situation?
3. Laura Sarazen has two sisters, Lana and Linda. Laura deposits \$50,000 at the Bank of America and creates an account that names her sister, Linda, in the following form: “Laura Sarazen, in trust for Linda Sarazen.” Laura dies two years later and has not withdrawn funds from the bank. The executrix, Lana Sarazen, wants to include those funds in the estate. Linda wants to claim the \$50,000 plus accumulated interest in addition to whatever share she gets in the will. Can she?

## 27.3 Factors Affecting Estates and Trusts

### LEARNING OBJECTIVES

1. Know how principal and income are distinguished in administering a trust.
2. Explain how estates and trusts are taxed, and the utility of powers of appointment.

### Principal and Income

Often, one person is to receive income from a trust or an estate and another person, the remainderman, is to receive the remaining property when the trust or estate is terminated. In thirty-six states, a uniform act, the Uniform Principal and Income Act (UPIA), defines principal and income and specifies how expenses are to be paid. If the trust agreement expressly gives the trustee power to determine what is income and what is principal, then his decision is usually unreviewable. If the agreement is silent, the trustee is bound by the provisions of the UPIA.

The general rule is that ordinary receipts are income, whereas extraordinary receipts are additions to principal. Ordinary receipts are defined as the return of money or property derived from the use of the principal, including rent, interest, and cash dividends. Extraordinary receipts include stock dividends, revenues or other proceeds from the sale or exchange of trust assets, proceeds from insurance on assets, all income accrued at the testator's death, proceeds from the sale or redemption of bonds, and awards or judgments received in satisfaction of injuries to the trust property. Expenses or obligations incurred in producing or preserving income—including ordinary repairs and ordinary taxes—are chargeable to income. Expenses incurred in making permanent improvements to the property, in investing the assets, and in selling or purchasing trust property are chargeable to principal, as are all obligations incurred before the decedent's death.

### Taxation

Estates and trusts are taxable entities under the federal income tax statute. The general rule is that all income paid out to the beneficiaries is taxable to the beneficiaries and may be deducted from the trust's or estate's gross income in arriving at its net taxable income. The trust or estate is then taxed on the balance

left over—that is, on any amounts accumulated. This is known as the conduit rule, because the trust or estate is seen as a conduit for the income.

## **Power of Appointment**

A power of appointment is the authority given by one person (the donor) to another (the donee) to dispose of the donor's property according to whatever instructions the donor provides. A power of appointment can be created in a will, in a trust, or in some other writing. The writing may imply the power of appointment rather than specifically calling it a power of appointment. For example, a devise or bequest of property to a person that allows that person to receive it or transfer it gives that person a power of appointment. The person giving the power is the donor, and the person receiving it is the donee.

There are three classes of powers of appointment. General powers of appointment give donees the power to dispose of the property in any way they see fit. Limited powers of appointment, also known as special powers of appointment, give donees the power to transfer the property to a specified class of persons identified in the instrument creating the power. Testamentary powers of appointment are powers of appointment that typically are created by wills.

If properly used, the power of appointment is an important tool, because it permits the donee to react flexibly to circumstances that the donor could not have foreseen. Suppose you desire to benefit your children when they are thirty-five or forty according to whether they are wealthy or poor. The poorer children will be given more from the estate or trust than the wealthier ones. Since you will not know when you write the will or establish the trust which children will be poorer, a donee with a power of appointment will be able to make judgments impossible for the donor to make years or decades before.

### KEY TAKEAWAY

Administering either an estate or a trust requires knowing the distinction between principal and income in a variety of situations. For example, knowing which receipts are ordinary and which are extraordinary is essential to knowing whether to allocate the receipts as income or as an addition to principal. Knowing which expenses are chargeable to principal and which are chargeable to income is also important. Both estates and trusts are taxable entities, subject to federal and state laws on estate and trust taxation. Powers of appointment can be used in both trusts and estates in order to give flexibility to named donees.

### EXERCISES

1. In his will, Hagrid leaves his pet dragon, Norberta, to Ron Weasley as donee with power of appointment. He intends to restrict Ron's power as donee to give or sell Norberta only to wizards or witches. What kind of power of appointment should Hagrid use?
2. In a testamentary trust, Baxter Black leaves Hilda Garde both real and personal property to administer as she sees fit as trustee "for the benefit of the Michigan Militia." Hilda intends to sell the house, but meanwhile she rents it out at \$1,200 a month and incurs repairs to the property to prepare it for sale in the amount of \$4,328.45. Is the expense chargeable to income or principal? Is the rent to be characterized as ordinary receipts or extraordinary receipts?

## 27.4 Cases

### Testamentary Capacity

Estate of Seymour M. Rosen

Supreme Judicial Court of Maine

447 A.2d 1220 (1982)

GODFREY, JUSTICE

Phoebe Rosen and Jeffrey Rosen, widow and son of the decedent, Seymour M. Rosen, appeal from an order of the Knox County Probate Court admitting the decedent's will to probate. Appellants argue that the decedent lacked the testamentary capacity necessary to execute a valid will and that the Probate Court's finding that he did have the necessary capacity is clearly erroneous. On direct appeal from the Probate Court pursuant to section 1-308 of the Probate Code (18-A M.R.S.A. § 1-308), this Court reviews for clear error the findings of fact by the Probate Court. *Estate of Mitchell, Me.*, 443 A.2d 961 (1982). We affirm the judgment.

Decedent, a certified public accountant, had an accounting practice in New York City, where he had been married to Phoebe for about thirty years. Their son, Jeffrey, works in New York City. In 1973, the decedent was diagnosed as having chronic lymphatic leukemia, a disease that, as it progresses, seriously impairs the body's ability to fight infection. From 1973 on, he understood that he might die within six months. In June, 1978, he left his home and practice and moved to Maine with his secretary of two months, Robin Gordon, the appellee. He set up an accounting practice in Camden.

The leukemia progressed. The decedent was on medication and was periodically hospitalized for infections, sometimes involving septic shock, a condition described by the treating physician as akin to blood poisoning. The infections were treated with antibiotics with varying degrees of success. Despite his medical problems, the decedent continued his accounting practice, working usually three days a week, until about two months before his death on December 4, 1980. Robin Gordon lived with him and attended him until his death.

While living in New York, the decedent had executed a will leaving everything to his wife or, if she should not survive him, to his son. In November, 1979, decedent employed the services of Steven Peterson, a lawyer whose office was in the same building as decedent's, to execute a codicil to the New York will leaving all his Maine property to Robin. At about this time, decedent negotiated a property settlement with his wife, who is now living in Florida. He executed the will at issue in this proceeding on July 25, 1980, shortly after a stay in the hospital with a number of infections, and shortly before a hospitalization that marked the beginning of the decedent's final decline. This will, which revoked all earlier wills and codicils, left all his property, wherever located, to Robin, or to Jeffrey if Robin did not survive him.

The court admitted the 1980 will to probate over the objections of Phoebe and son, making extensive findings to support its conclusion that "the decedent clearly had testamentary capacity when he executed his Will."

The Probate Court applied the standard heretofore declared by this Court for determining whether a decedent had the mental competence necessary to execute a valid will:

A 'disposing mind' involves the exercise of so much mind and memory as would enable a person to transact common and simple kinds of business with that intelligence which belongs to the weakest class of sound minds; and a disposing memory exists when one can recall the general nature, condition and extent of his property, and his relations to those to whom he gives, and also to those from whom he excludes, his bounty. He must have active memory enough to bring to his mind the nature and particulars of the business to be transacted, and mental power enough to appreciate them, and act with sense and judgment in regard to them. He must have sufficient capacity to comprehend the condition of his property, his relations to the persons who were or should have been the objects of his bounty, and the scope and bearing of the provisions of his will. He must have sufficient active memory to collect in his mind, without prompting, the particulars or elements of the business to be transacted, and to hold them in his mind a sufficient length of time to perceive at least their obvious relations to each other, and be able to form some rational judgment in relation to them.

*In re Leonard*, Me., 321 A.2d 486, 488-89 (1974), quoting *Hall v. Perry*, 87 Me. 569, 572, 33 A. 160, 161 (1895).

Appellants portray the decedent as "a man ravaged by cancer and dulled by medication," and it is true that some evidence in the record tends to support this characterization. However, the law as set out in *In re Leonard* requires only a modest



level of competence (“the weakest class of sound minds”), and there is considerable evidence of record that the decedent had at least that level of mental ability and probably more:

1. The three women who witnessed the will all testified that decedent was of sound mind. They worked in the same building as the decedent, knew him, and saw him regularly. Such testimony is admissible to show testamentary capacity. *In re Leonard*, 321 A.2d at 489.
2. Lawyer Peterson, who saw the decedent daily, testified that he was of sound mind. Peterson used the decedent as a tax adviser, and the decedent did accounting work for Peterson’s clients. Peterson had confidence in the decedent’s tax abilities and left the tax aspects of the will to the decedent’s own consideration.
3. Dr. Weaver, the treating physician, testified that although the decedent would be mentally deadened for a day or two while in shock in the hospital, he would then regain “normal mental function.” Though on medication, the decedent was able to conduct his business until soon before his death. Dr. Weaver testified without objection that on one occasion he had offered a written opinion that the decedent was of sound mind.

Appellants’ principal objection to the will is that the decedent lacked the necessary knowledge of “the general nature, condition and extent of his property.” *In re Leonard*, 321 A.2d at 488. The record contains testimony of Robin Gordon and lawyer Peterson that decedent did not know what his assets were or their value. However, there is other evidence, chiefly Peterson’s testimony about his discussions with the decedent preliminary to the drafting of the 1980 will and, earlier, when the 1979 codicil to the New York will was being prepared, that the decedent did have knowledge of the contents of his estate. He knew that he had had a Florida condominium, although he was unsure whether this had been turned over to his wife as part of the recent property settlement; he knew that he had an interest in an oil partnership, and, although he was unable to place a value on that interest, he knew the name of an individual who could supply further information about it; he knew he had stocks and bonds, two motor vehicles, an account at the Camden National Bank, and accounts receivable from his accounting practice.

The law does not require that a testator’s knowledge of his estate be highly specific in order for him to execute a valid will. It requires only that the decedent be able to recall “the general nature, condition and extent of his property.” *In re Leonard*, 321 A.2d at 488. Such knowledge of one’s property is an aspect of mental soundness, not an independent legal requirement as the appellants seem to suggest. Here, there was competent evidence that the decedent had a general knowledge of his estate. The Probate Court was justified in concluding that, in the circumstances, the

decedent's ignorance of the precise extent of his property did not establish his mental incompetence. The decedent's uncertainty about his property was understandable in view of the fact that some of his property had been transferred to his wife in the recent property negotiations in circumstances rendering it possible that the decedent might have wanted to put the matter out of his mind. Also, there was evidence from which the court could have inferred that much of the property was of uncertain or changing value.

On the evidence of record, this Court cannot hold that the findings of the Probate Court were clearly erroneous. Where, as here, there is a choice between two permissible views of the weight of the evidence, the findings of the Probate Court must stand. *Estate of Mitchell*, Me., 443 A.2d 961 (1982).

### CASE QUESTIONS

1. Based on what is written in this opinion, did the decedent's widow get nothing as a result of her husband's death? What did she get, and how?
2. If Phoebe Rosen's appeal had resulted in a reversal of the probate court, what would happen?
3. Is it possible that Seymour Rosen lacked testamentary capacity? Could the probate court have ruled that he did and refuse to admit the will to probate? If so, what would happen, using the court's language and cited opinions?

### Settlor's Limited Power over the Trust

Continental Bank & Trust Co. v. Country Club Mobile Estates, Ltd.

632 P.2d 869 (Utah 1981)

Oaks, Justice

The issue in this appeal is whether a settlor who has created a trust by conveying property that is subject to an option to sell can thereafter extend the period of the option without the participation or consent of the trustee. We hold that he cannot. For ease of reference, this opinion will refer to the plaintiff-appellant, Continental Bank & Trust Co., as the "trustee," to defendant-respondent, Country Club Mobile Estates, Ltd., as the "lessee-optionee," and to Marshall E. Huffaker, deceased, as the "settlor."

The sequence of events is critical. On September 29, 1965, the settlor gave the lessee-optionee a fifty-year lease and an option to purchase, during the sixth year of the lease, the 31 acres of land at issue in this litigation. On March 1, 1971, the settlor granted the lessee-optionee a five-year extension of its option, to September 29, 1976. On December 6, 1973, the settlor conveyed the subject property to the trustee in trust for various members of his family, signing a trust agreement and conveying the property to the trustee by a warranty deed, which was promptly recorded. The lessee-optionee had actual as well as constructive notice of the creation of this trust by at least April, 1975, when it began making its monthly lease payments directly to the trustee. On March 1, 1976, the settlor signed an instrument purporting to grant the lessee-optionee another five-year extension of its option, to September 29, 1981. The trustee was unaware of this action and did not participate in it. On October 30, 1978, approximately one week after the settlor's death, the trustee learned of the March 1, 1976, attempted extension and demanded and obtained a copy of the instrument.

On July 3, 1979, the trustee brought this action against the lessee-optionee and other interested parties to quiet title to the 31 acres of trust property and to determine the validity of the attempted extension of the option. Both parties moved for summary judgment on the issue of the validity of the extended option. The district court denied the trustee's motion and granted the lessee-optionee's motion, and the trustee appealed. We reverse.

A settlor admittedly could reserve power to extend the duration of an option on trust property, and do so without the consent or involvement of the trustee. The question is whether this settlor did so. The issue turns on the terms of the trust instrument, which, in this case, gave the trustee broad powers, including the power to grant options, but also reserved to the settlor the right to revoke the trust or to direct the trustee to sell trust property. The relevant clauses are as follows:

#### **ARTICLE IV.**

To carry out the Trust purposes of the Trust created hereby...the Trustee is vested with the following powers...:

B. To manage, control, sell, convey...; to grant options...

K....The enumeration of certain powers of the Trustee herein shall not be construed as a limitation of the Trustee's power, it being intended that the Trustee shall have all rights, powers and privileges that an absolute owner of the property would have.

## ARTICLE V.

The Trustor by an instrument in writing filed with the Trustee may modify, alter or revoke this Agreement in whole or in part, and may withdraw any property subject to the agreement;...

There is hereby reserved to the Trustor the power to direct the trustee, in writing, from time to time, to retain, sell, exchange or lease any property of the trust estate....Upon receipt of such directions, the Trustee shall comply therewith. The lessee-optionee argues, and the district court held, that in the foregoing provisions of the trust agreement the settlor reserved the power to direct the trustee in regard to the leased property, and that the effect of his executing the extension of the option on March 1, 1976, was to direct the trustee to sell the property to the lessee-optionee upon its exercise of the option. We disagree. We are unable to find an exercise of the “power to direct the trustee, in writing,” in an act that was not intended to communicate and did not in fact communicate anything to the trustee. We are likewise unable to construe the extension agreement signed by the settlor and the lessee-optionee as “an instrument in writing filed with the Trustee” to “modify, alter or revoke this Agreement....” Nor can we agree with the dissent’s argument for “liberal construction...to the reserved powers of a settlor” in a trust agreement which expressly vests **the trustee** with the power “to grant options” and explicitly states its intention that **the trustee** “shall have all rights, powers and privileges that an absolute owner of the property would have.” Article IV, quoted above. (emphases in original)

A trust is a form of ownership in which the legal title to property is vested in a trustee, who has equitable duties to hold and manage it for the benefit of the beneficiaries. *Restatement of Trusts, Second*, § 2 (1959). It is therefore axiomatic in trust law that the trustee under a valid trust deed has exclusive control of the trust property, subject only to the limitations imposed by law or the trust instrument, and that once the settlor has created the trust he is no longer the owner of the trust property and has only such ability to deal with it as is expressly reserved to him in the trust instrument. *Boone v. Davis*, 64 Miss. 133, 8 So. 202 (1886); *Marvin v. Smith*, 46 N.Y. 571 (1871). As stated in Bogert, *Trusts & Trustees*, §42 (2d ed. 1965):

After a settlor has completed the creation of a trust he is, with small exceptions noted below, and except as expressly provided otherwise by the trust instrument or by statute, not in any legal relationship with the beneficiaries or the trustee, and has no liabilities or powers with regard to the trust administration.

None of the exceptions identified by Bogert applies in this case.

This is a case where a settlor created a trust and then chose to ignore it. He could have modified or revoked the trust, or directed the trustee in writing to sell or lease the trust property, but he took neither of these actions. Instead, more than two years after the creation and recording of the trust, and without any direction or notice to the trustee, the settlor gave the lessee-optionee a signed instrument purporting to extend its option to buy the trust property for another five years. The trustee did not learn of this instrument until two and one-half years later, immediately following the death of the settlor.

An extension of the option to buy would obviously have a limiting effect on the value of the reversion owned by the trust (and thus on the rights of the trust beneficiaries), which the trustee has a duty to protect. Even a revocable trust clothes beneficiaries, for the duration of the trust, with a legally enforceable right to insist that the terms of the trust be adhered to. If we gave legal effect to the settlor's extension of this option in contravention of the existence and terms of the trust, we would prejudice the interests of the beneficiaries, blur some fundamental principles of trust law, and cast doubt upon whether it is the trustee or the settlor who is empowered to manage and dispose of the trust property in a valid revocable trust.

The judgment of the district court is reversed and the cause is remanded with instructions to enter judgment for the plaintiff. Costs to appellant.

HOWE, Justice: (Dissenting)

I dissent. The majority opinion has overlooked the cardinal principle of construction of a trust agreement which is that the settlor's intent should be followed. See *Leggroan v. Zion's Savings Bank & Trust Co.*, 120 Utah 93, 232 P.2d 746 (1951). Instead, the majority places a strict and rigid interpretation on the language of the trust agreement which defeats the settlor's intent and denies him an important power he specifically reserved to himself. All of this is done in a fact situation where there is no adverse interest asserted and no one will be prejudiced in any way by following the undisputed and obvious intent of the settlor.

Unlike the situation found with many trusts, Huffaker in establishing his trust reserved to himself broad powers in Article V.:

#### **ARTICLE V.**

The Trustor by an instrument in writing filed with the Trustee *may modify, alter or revoke this Agreement* in whole or in part, and *may withdraw any property subject to the*

*Agreement*; Provided, however, that the duties, powers and limitations of the Trustee shall not be substantially changed without its written consent, except as to revocation or withdrawal. (emphasis added)

\* \* \* \*

There is hereby reserved to the Trustor the power to *direct the trustee, in writing, from time to time, to retain, sell, exchange or lease any property of the Trust estate, to invest Trust funds, or to purchase for the Trust any property which they [sic] may designate and which is acceptable to the Trustee. Upon receipt of such directions, the Trustee shall comply therewith.* (emphasis added)

Thus while Huffaker committed the property into the management and control of the trustee, he retained the right in Article V. to direct the trustee from time to time with regard to the property, and the trustee agreed that upon receipt of any such directions it would comply. It is significant that the consent of the trustee was not required. These broad reserved powers in effect gave him greater power over the property than the trustee possessed since he had the final word.

The property in question was subject to defendant's option when it was placed in trust. The trustee took title subject to that option and subject to future directions from Huffaker. The extension granted by Huffaker to the defendant was in effect a directive that the trustee sell the property to the defendant if and when it elected to purchase the property. At that time, the defendant could deliver the directive to the trustee which held legal title and the sale could be consummated. Contrary to what is said in the majority opinion, the extension was intended to communicate and did communicate to the trustee the settlor's intention to sell to the defendant. The trustee does not claim to have any doubt as to what the settlor intended.

There was no requirement in the trust agreement as to when the directive to sell had to be delivered to the trustee nor was there any requirement that the settlor must himself deliver the direction to sell to the trustee rather than the buyer deliver it. The majority opinion concedes that Huffaker had the power to extend the option but denies him that power because he did not communicate his intention to exercise that power to the trustee at the time he extended the option. It ignores the fact that the lessee had five years to decide whether it wanted to buy the property, at which time it could deliver the direction to sell to the trustee. The majority opinion reads into the trust agreement rigidity and strictness which is unwarranted.

The majority opinion contains a quote from Bogert, *Trust and Trustees*, § 42, for authority that after a settlor has completed the creation of a trust he is not in any legal relationship with the beneficiaries or the trustee, and has no liabilities or power with regard to the trust administration. However, as will be seen in that quote, it is there recognized that those rules do not apply where it has been expressly provided otherwise by the trust instrument. Such is the case here where the settlor reserved extensive powers and was himself the primary beneficiary.

Huffaker's extension agreement apparently would not have been challenged by his trustee if he had given written directions to the trustee to extend the option instead of executing the extension with the defendant himself, and apparently would not have been challenged had he not died. Yet, although the trustee did not itself extend the option nor receive a copy of the agreement until after Huffaker's death, it had not in the meantime dealt with third parties concerning the property or made any commitments that were inconsistent with Huffaker's action. Since there were no intervening third-party rights and it is not unfair to the trust beneficiaries to require them to abide by the intention of their donor and benefactor, I see no justification for the refusal of the trustee to accept the extension agreement as a valid direction to sell the property as provided for by the terms of the trust. This is not a case where the trustee in ignorance of the action of the settlor in granting an option had also granted an option or dealt with the property in a manner inconsistent with the actions of the settlor so that there are conflicting claims of innocent third-parties presented. In such a case there would be some justification for applying a strict construction so that there can be orderliness in trust administration. After all, the reason for the provisions of the trust agreement defining the powers of the trustee and the reserved powers of the settlor was to provide for the exercise of those powers in a manner that would be orderly and without collision between the trustee and settlor. In the instant case the trustee has not even suggested how it will be prejudiced by following Huffaker's directions. The majority opinion makes reference to protecting the interest of the contingent beneficiaries but overlooks that Huffaker was not only the settlor but also the primary beneficiary both when the trust was established and when the option was extended.

The majority opinion treats the relationship between Huffaker and his trustee as an adversary relationship instead of recognizing that the trustee was Huffaker's fiduciary to assist him in managing *his* property. Therefore, there is no reason to construe the trust agreement as if it were meant to deal with a relationship between two adverse parties.

My view that a liberal construction should be given to the reserved powers of a settlor under these circumstances finds support in a decision of the Supreme Judicial Court of Massachusetts, *Trager v. Schwartz*, 345 Mass. 653, 189 N.E.2d 509

(1963). There the settlor on July 15, 1942, executed as donor a declaration of trust. The property was 65 shares of stock and 4 lots of land. In that instrument he reserved the right to alter, amend or revoke the instrument in whole or in part. However, it was specifically provided in the declaration of trust that “any such alterations, amendments or revocations of this trust shall be by an instrument in writing signed by the donor, and shall become effective only upon being recorded in the South District Registry of Deeds for Middlesex County.”

Later, on February 4, 1954, the trustor executed a document entitled “Modification and Amendment of Trust” whereby he withdrew the 65 shares of stock from the trust and sold them to his son and told him that he had arranged for the recording of that instrument by his lawyer. However, he did not record the document nor instruct his attorney to do so. On August 25, 1960, the settlor executed a document entitled “Revocation of Declaration of Trust,” in which he revoked in whole the declaration of trust of July 15, 1942. This revocation was recorded on August 26th. He thereupon directed the trustees to deliver to him the 65 shares of stock and the 4 lots of real estate. His son received notice of the revocation on August 30, 1960, and recorded the following day the modification and amendment dated February 4, 1954, by which he had obtained the 165 shares of stock.

In a suit brought by the settlor to regain ownership of the stock, he contended that the recording of his complete revocation on August 26, 1960, rendered ineffective the recording of the partial revocation on August 31, 1960. He relied upon the principle that “A valid trust once created cannot be revoked or altered except by the exercise of a reserve power to do so, which must be exercised in strict conformity to its terms.” The court upheld the earlier sale of stock stating:

The provision of the declaration of trust that amendments and revocations ‘shall become effective only upon being recorded’ shall not be interpreted, where there are no intervening rights of third-parties, as preventing the carrying out of the earlier amendment once it has been recorded. This should be the result, particularly where there was an express undertaking by one of the parties to see to the recording.

In the instant case, defendant will be greatly prejudiced, and the settlor’s intention thwarted, as a result of following the majority opinion’s interpretation of the trust terms as they relate to a written direction to the trustee to sell trust property. Defendant gave up the opportunity to purchase the property within the original option period in reliance on Huffaker’s execution of the extension agreement, a document prepared by his attorney. I am not persuaded that because defendant was making its rental payments to the trustee it was unreasonable in obtaining the extension of the option, which previously had been granted it by Huffaker, to again



deal with him and rely on him since he was the final power respecting his property, and since neither he nor his attorney who had full and complete knowledge of the trust apparently raised any question as to the propriety of what they were doing. Just as the settlor in *Trager v. Schwartz*, supra, was not permitted to gain advantage by his failure to record as required by the trust agreement, I think the settlor's beneficiaries in the instant case should not gain by Huffaker's omissions and to the extreme prejudice of defendant.

The trustee has based its arguments on cases and principles that are distinguishable or inapplicable to the instant case. It regards the trust agreement as expressly allowing only it, as trustee and holder of the legal title to the property, to sell, option, or otherwise dispose of it. But the language of the trust regarding powers retained by Huffaker is inclusive enough to encompass his action in this case, for he expressly retained the right to direct the plaintiff to sell the property, a right that is compatible with his granting of the option extension.

The trustee also asserts that the written instrument received after Huffaker's death was ineffective as a directive to the trustee. Plaintiff cites authority for the principle that a revocable trust can only be modified during the settlor's lifetime, e.g., *Chase National Bank of City of N.Y. v. Tomagno*, 172 Misc. 63, 14 N.Y.S.2d 759 (1939). We are not dealing with an attempted testamentary disposition in this case, however. The option extension agreement was executed during Huffaker's lifetime, and the fact that it was received by plaintiff only after he died does not deprive it of its effect.

I would affirm the judgment below.

### CASE QUESTIONS

1. Does the decision effectively deprive Country Club Mobile Estates, Ltd. of anything? What?
2. Why would the trustee (Continental Bank & Trust Co.) object to giving Country Club Mobile Estates, Ltd. another two and a half years on the lease?
3. Which opinion seems better reasoned—the majority or the dissent? Why do you think so?

## 27.5 Summary and Exercises

### Summary

Estate planning is the process by which an owner decides how her property is to be passed on to others. The four basic estate planning tools are wills, trusts, gifts, and joint ownership. In this chapter, we examined wills and trusts. A will is the declaration of a person's wishes about the disposition of her assets on her death. The law of each state sets forth certain formalities, such as the number of witnesses, to which written wills must adhere. Wills are managed through the probate process, which varies from state to state, although many states have now adopted the Uniform Probate Code. In general, anyone over eighteen and of sound mind may make a will. It must be signed by the testator, and two or three others must witness the signature. A will may always be modified or revoked during the testator's lifetime, either expressly through a codicil or through certain actions, such as a subsequent marriage and the birth of children, not contemplated by the will. Wills must be carefully drafted to avoid abatement and ademption. The law provides for distribution in the case of intestacy. The rules vary from state to state and depend on whether the decedent was married when she died, had children or parents who survived her, or had collateral heirs.

Once a will is admitted to probate, the personal representative must assemble and inventory all assets, have them appraised, handle claims against the estate, pay taxes, prepare a final accounting, and only then distribute the assets according to the will.

A trust is a relationship in which one person holds legal title to certain property and another person has the use and benefit of it. The settlor or grantor creates the trust, giving specific property (the res) to the trustee for the benefit of the beneficiary. Trusts may be living or testamentary, revocable or irrevocable. Express trusts come in many forms, including Totten trusts, blind trusts, Clifford trusts, charitable trusts, and spendthrift trusts. Trusts may also be imposed by law; constructive and resulting trusts are designed to redress frauds, prevent unjust enrichment, or see to it that the intent of the parties is carried out.

## EXERCISES

1. Seymour deposits \$50,000 in a bank account, ownership of which is specified as “Seymour, in trust for Fifi.” What type of trust is this? Who is the settlor? The beneficiary? The trustee? May Seymour spend the money on himself? When Seymour dies, does the property pass under the laws of intestacy, assuming he has no will?
2. Seymour, a resident of Rhode Island, signed a will in which he left all his property to his close friend, Fifi. Seymour and Fifi then moved to Alabama, where Seymour eventually died. Seymour’s wife Hildegarde, who stayed behind in Rhode Island and who was not named in the will, claimed that the will was revoked when Seymour moved from one state to another. Is she correct? Why?
3. Assume in Exercise 2 that Seymour’s Rhode Island will is valid in Alabama. Is Hildegarde entitled to a part of Seymour’s estate? Explain.
4. Assume in Exercise 2 that Seymour’s Rhode Island will is valid in Alabama. Seymour and Hildegarde own, as tenants by the entirety, a cottage on the ocean. In the will, Seymour specifically states that the cottage goes to Fifi on his death. Does Fifi or Hildegarde get the cottage? Or do they share it? Explain?
5. Assume in Exercise 2 that Seymour’s Rhode Island will is not valid. Seymour’s only relative besides Hildegarde is his nephew, Chauncey, whom Seymour detests. Who is entitled to Seymour’s property when he dies—Fifi, Hildegarde, or Chauncey? Explain.
6. Scrooge is in a high tax bracket. He has set aside in a savings account \$100,000, which he eventually wants to use to pay the college expenses of his tiny son, Tim, who is three. The account earns \$10,000 a year, of which \$5,000 goes to the government in taxes. How could Scrooge lower the tax payments while retaining control of the \$100,000?
7. Assume in Exercise 6 that Scrooge considers placing the \$100,000 in trust for Tim. But he is worried that when Tim comes of age, he might sell his interest in the trust. Could the trust be structured to avoid this possibility? Explain.
8. Assume that Scrooge has a substantial estate and no relatives. Is there any reason for him to consider a will or trust? Why? If he dies without a will, what will happen to his property?

## SELF-TEST QUESTIONS

1. A will written by the testator's hand and not witnessed is called
  - a. a conditional will
  - b. a nuncupative will
  - c. a holographic will
  - d. a reciprocal will
  
2. A written modification or supplement to a prior will is called
  - a. a revocation clause
  - b. an abatement
  - c. a codicil
  - d. none of the above
  
3. A trust created by will is called
  - a. an inter vivos trust
  - b. a reversionary trust
  - c. a Totten trust
  - d. a testamentary trust
  
4. Trustees are not permitted to tell the grantor how they are managing their portfolio of assets in
  - a. a Clifford trust
  - b. a spendthrift trust
  - c. a blind trust
  - d. a voting trust
  
5. An example of an implied trust is
  - a. a spendthrift trust
  - b. a Clifford trust
  - c. a resulting trust
  - d. none of the above

**SELF-TEST ANSWERS**

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

# Chapter 28

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## Insurance

### LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The basic terms and distinctions in the law of insurance
2. The basic types of insurance for property, liability, and life
3. The basic defenses to claims against insurance companies by the insured: representation, concealment, and warranties

We conclude our discussions about property with a focus on insurance law, not only because insurance is a means of compensating an owner for property losses but also because the insurance contract itself represents a property right. In this chapter, we begin by examining regulation of the insurance industry. We then look at legal issues relating to specific types of insurance. Finally, we examine defenses that insurance companies might raise to avoid making payments under insurance policies.

## 28.1 Definitions and Types of Insurance

### LEARNING OBJECTIVES

1. Know the basic types of insurance for individuals.
2. Name and describe the various kinds of business insurance.

Certain terms are usefully defined at the outset. **Insurance**<sup>1</sup> is a contract of reimbursement. For example, it reimburses for losses from specified perils, such as fire, hurricane, and earthquake. An **insurer**<sup>2</sup> is the company or person who promises to reimburse. The **insured**<sup>3</sup> (sometimes called the assured) is the one who receives the payment, except in the case of life insurance, where payment goes to the beneficiary named in the life insurance contract. The **premium** is the consideration paid by the insured—usually annually or semiannually—for the insurer’s promise to reimburse. The contract itself is called the **policy**<sup>4</sup>. The events insured against are known as **risks**<sup>5</sup> or **perils**<sup>6</sup>.

Regulation of insurance is left mainly in the hands of state, rather than federal, authorities. Under the McCarran-Ferguson Act, Congress exempted state-regulated insurance companies from the federal antitrust laws. Every state now has an insurance department that oversees insurance rates, policy standards, reserves, and other aspects of the industry. Over the years, these departments have come under fire in many states for being ineffective and “captives” of the industry. Moreover, large insurers operate in all states, and both they and consumers must contend with fifty different state regulatory schemes that provide very different degrees of protection. From time to time, attempts have been made to bring insurance under federal regulation, but none have been successful.

We begin with an overview of the types of insurance, from both a consumer and a business perspective. Then we examine in greater detail the three most important types of insurance: property, liability, and life.

### Public and Private Insurance

Sometimes a distinction is made between public and private insurance. Public (or social) insurance includes Social Security, Medicare, temporary disability insurance, and the like, funded through government plans. Private insurance plans, by contrast, are all types of coverage offered by private corporations or organizations. The focus of this chapter is private insurance.

1. A contract of reimbursement.
2. The entity that agrees to provide insurance for the risk of certain kinds of losses, usually life, property, health, and liability claims.
3. The person or firm insured by a contract of insurance.
4. The contract for the insurance sought by the insured.
5. Potential losses that may be covered by policies of insurance.
6. Risks that are insured against.

## Types of Insurance for the Individual

### Life Insurance

Life insurance provides for your family or some other named beneficiaries on your death. Two general types are available: **term insurance**<sup>7</sup> provides coverage only during the term of the policy and pays off only on the insured's death; **whole-life insurance**<sup>8</sup> provides savings as well as insurance and can let the insured collect before death.

### Health Insurance

Health insurance covers the cost of hospitalization, visits to the doctor's office, and prescription medicines. The most useful policies, provided by many employers, are those that cover 100 percent of the costs of being hospitalized and 80 percent of the charges for medicine and a doctor's services. Usually, the policy will contain a deductible amount; the insurer will not make payments until after the deductible amount has been reached. Twenty years ago, the deductible might have been the first \$100 or \$250 of charges; today, it is often much higher.

### Disability Insurance

A disability policy pays a certain percentage of an employee's wages (or a fixed sum) weekly or monthly if the employee becomes unable to work through illness or an accident. Premiums are lower for policies with longer waiting periods before payments must be made: a policy that begins to pay a disabled worker within thirty days might cost twice as much as one that defers payment for six months.

### Homeowner's Insurance

A homeowner's policy provides insurance for damages or losses due to fire, theft, and other named perils. No policy routinely covers all perils. The homeowner must assess his needs by looking to the likely risks in his area—earthquake, hailstorm, flooding, and so on. Homeowner's policies provide for reduced coverage if the property is not insured for at least 80 percent of its replacement costs. In inflationary times, this requirement means that the owner must adjust the policy limits upward each year or purchase a rider that automatically adjusts for inflation. Where property values have dropped substantially, the owner of a home (or a commercial building) might find savings in lowering the policy's insured amount.

7. Life insurance with a death benefit but no accumulated savings.

8. Provides savings as well as insurance and can let the insured collect before death.



### **Automobile Insurance**

Automobile insurance is perhaps the most commonly held type of insurance. Automobile policies are required in at least minimum amounts in all states. The typical automobile policy covers liability for bodily injury and property damage, medical payments, damage to or loss of the car itself, and attorneys' fees in case of a lawsuit.

### **Other Liability Insurance**

In this litigious society, a person can be sued for just about anything: a slip on the walk, a harsh and untrue word spoken in anger, an accident on the ball field. A personal liability policy covers many types of these risks and can give coverage in excess of that provided by homeowner's and automobile insurance. Such umbrella coverage is usually fairly inexpensive, perhaps \$250 a year for \$1 million in liability.

### **Types of Business Insurance**

#### **Workers' Compensation**

Almost every business in every state must insure against injury to workers on the job. Some may do this through self-insurance—that is, by setting aside certain reserves for this contingency. Most smaller businesses purchase workers' compensation policies, available through commercial insurers, trade associations, or state funds.

#### **Automobile Insurance**

Any business that uses motor vehicles should maintain at least a minimum automobile insurance policy on the vehicles, covering personal injury, property damage, and general liability.

#### **Property Insurance**

No business should take a chance of leaving unprotected its buildings, permanent fixtures, machinery, inventory, and the like. Various property policies cover damage or loss to a company's own property or to property of others stored on the premises.

#### **Malpractice Insurance**

Professionals such as doctors, lawyers, and accountants will often purchase malpractice insurance to protect against claims made by disgruntled patients or

clients. For doctors, the cost of such insurance has been rising over the past thirty years, largely because of larger jury awards against physicians who are negligent in the practice of their profession.

### **Business Interruption Insurance**

Depending on the size of the business and its vulnerability to losses resulting from damage to essential operating equipment or other property, a company may wish to purchase insurance that will cover loss of earnings if the business operations are interrupted in some way—by a strike, loss of power, loss of raw material supply, and so on.

### **Liability Insurance**

Businesses face a host of risks that could result in substantial liabilities. Many types of policies are available, including policies for owners, landlords, and tenants (covering liability incurred on the premises); for manufacturers and contractors (for liability incurred on all premises); for a company's products and completed operations (for liability that results from warranties on products or injuries caused by products); for owners and contractors (protective liability for damages caused by independent contractors engaged by the insured); and for contractual liability (for failure to abide by performances required by specific contracts).

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

#### **KEY TAKEAWAY**

Although insurance is a need for every US business, and many businesses operate in all fifty states, regulation of insurance has remained at the state level. There are several forms of public insurance (Social Security, disability, Medicare) and many forms of private insurance. Both individuals and businesses have significant needs for various types of insurance, to provide protection for health care, for their property, and for legal claims made against them by others.

## EXERCISES

1. Theresa Conley is joining the accounting firm of Hunter and Patton in Des Moines, Iowa. She is a certified public accountant. What kind of insurance will she (or the firm, on her behalf) need to buy because of her professional activities?
2. Nate Johnson has just signed a franchise agreement with Papa Luigi's Pizza and will be operating his own Papa Luigi's store in Lubbock, Texas. The franchise agreement requires that he personally contract for "all necessary insurance" for the successful operation of the franchise. He expects to have twelve employees, five full-time and seven part-time (the delivery people), at his location, which will be on a busy boulevard in Lubbock and will offer take-out only. Pizza delivery employees will be using their own automobiles to deliver orders. What kinds of insurance will be "necessary"?

## 28.2 Property Insurance, Liability Insurance, and Life Insurance

### LEARNING OBJECTIVES

1. Distinguish and define the basic types of insurance for property, liability, and life.
2. Explain the concepts of subrogation and assignment.

We turn now to a more detailed discussion of the law relating to the three most common types of insurance: property, liability, and life insurance.

### Property Insurance

It is sometimes said that property is the foundation for a system of free market capitalism. If so, then protecting property is a necessary part of being part of that system, whether as an individual or as a business entity.

### Coverage

As we have noted, property insurance provides coverage for real and personal property owned by a business or an individual. Property insurance is also part of automobile policies covering damage to the car caused by an accident (collision coverage) or by other events such as vandalism or fire (comprehensive coverage). Different levels of coverage are available. For example, many basic homeowners' policies cover damage resulting from the following types of perils only: fire and lightning, windstorm and hail, explosions, riots and civil commotions, aircraft and vehicular accidents, smoke, vandalism and malicious mischief, theft, and breakage of glass that is part of a building.

A broader policy, known as broad coverage, also includes these perils: falling objects; weight of ice, snow, and sleet; collapse of buildings; sudden and accidental damage to heating systems; accidental discharge from plumbing, heating, or air-conditioning systems; freezing of heating, plumbing, and air conditioning systems; and sudden and accidental injury from excess currents to electrical appliances and wiring. Even with the broadest form of coverage, known as comprehensive, which covers all perils except for certain named exclusions, the homeowner can be left without protection. For example, comprehensive policies do not usually cover damage resulting from flooding, earthquakes, war, or nuclear radiation. The

homeowner can purchase separate coverage for these perils but usually at a steep premium.

### Insurable Interest in Property

To purchase property insurance, the would-be insured must have an **insurable interest**<sup>9</sup> in the property. Insurable interest is a real and substantial interest in specific property such that a loss to the insured would ensue if the property were damaged. You could not, for instance, take out an insurance policy on a motel down the block with which you have no connection. If a fire destroyed it, you would suffer no economic loss. But if you helped finance the motel and had an investment interest in it, you would be permitted to place an insurance policy on it. This requirement of an insurable interest stems from the public policy against wagering. If you could insure anything, you would in effect be betting on an accident.

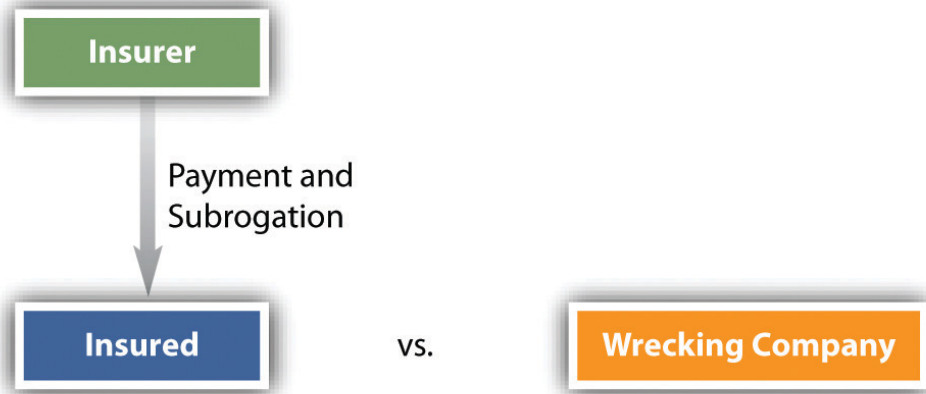
To insure property, therefore, you must have a legal interest and run the risk of a pecuniary loss. Any legal interest is sufficient: a contractual right to purchase, for instance, or the right of possession (a bailee may insure). This insurable interest must exist both at the time you take out the policy and at the time the loss occurs. Moreover, coverage is limited to the extent of the interest. As a mortgagee, you could ensure only for the amount still due.

Prior to the financial meltdown of 2008, many investment banks took insurance against possible losses from collateralized debt obligations (CDOs) and other financial products based on subprime loans. The principal insurer was American International Group, Inc. (AIG), which needed a US government bailout when the risks covered by AIG turned out to be riskier than AIG's models had projected.

9. A sufficiently substantial interest in property or someone's life to support a contract to insure it.

## Subrogation

Figure 28.1 Subrogation



**Subrogation**<sup>10</sup> is the substitution of one person for another in pursuit of a legal claim. When an insured is entitled to recover under a policy for property damage, the insurer is said to be subrogated to the insured's right to sue any third party who caused the damage. For example, a wrecking company negligently destroys an insured's home, mistaking it for the building it was hired to tear down. The insured has a cause of action against the wrecking company. If the insured chooses instead to collect against a homeowner's policy, the insurance company may sue the wrecking company in the insured's place to recover the sum it was obligated to pay out under the policy (see [Figure 28.1 "Subrogation"](#)).

## Assignment

**Assignment**<sup>11</sup> is the transfer of any property right to another. In property insurance, a distinction is made between assignment of the coverage and assignment of the proceeds. Ordinarily, the insured may not assign the policy itself without the insurer's permission—that is, he may not commit the insurer to insure someone else. But the insured may assign any claims against the insurer—for example, the proceeds not yet paid out on a claim for a house that has already burned down.

## Intentional Losses

Insurance is a means of spreading risk. It is economically feasible because not every house burns down and not every car is stolen. The number that do burn down or that are stolen can be calculated and the premium set accordingly. Events that will certainly happen, like ordinary wear and tear and the destruction of property

10. Substitution of one person for another who has a legal claim or right.

11. The transfer of any rights in a contract of insurance.

through deliberate acts such as arson, must be excluded from such calculations. The injury must result from accidental, not deliberate, causes.

### Coinsurance Clause

Most commercial property policies contain a so-called **coinsurance clause**<sup>12</sup>, which requires the insured to maintain insurance equal to a specified percentage of the property value. It is often 80 percent but may be higher or lower. If the property owner insures for less than that percentage, the recovery will be reduced. In effect, the owner becomes a coinsurer with the insurance company. The usual formula establishes the proportion that the insurer must pay by calculating the ratio of (1) the amount of insurance actually taken to (2) the coinsurance percentage multiplied by the total dollar value of the property. Suppose a fire causes \$160,000 damage to a plant worth \$1,000,000. The plant should have been insured for 80 percent (\$800,000), but the insured took out only a \$500,000 policy. He will recover only \$100,000. To see why, multiply the total damages of \$160,000 by the coinsurance proportion of five-eighths (\$500,000 of insurance on the required minimum of \$800,000). Five-eighths of \$160,000 equals \$100,000, which would be the insured's recovery where the policy has a coinsurance clause.

### Liability Insurance

Liability insurance has taken on great importance for both individuals and businesses in contemporary society. Liability insurance covers specific types of legal liabilities that a homeowner, driver, professional, business executive, or business itself might incur in the round of daily activities. A business is always at risk in sending products into the marketplace. Doctors, accountants, real estate brokers, insurance agents, and lawyers should obtain liability insurance to cover the risk of being sued for malpractice. A prudent homeowner will acquire liability insurance as part of homeowner's policy and a supplemental umbrella policy that insures for liability in excess of a limit of, say, \$100,000 in the regular homeowner's policy. And businesses, professionals, and individuals typically acquire liability insurance for driving-related activities as part of their automobile insurance. In all cases, liability policies cover not only any settlement or award that might ultimately have to be paid but also the cost of lawyers and related expenses in defending any claims.

Liability insurance is similar in several respects to property insurance and is often part of the same package policy. As with property insurance, subrogation is allowed with liability insurance, but assignment of the policy is not allowed (unless permission of the insurer is obtained), and intentional losses are not covered. For example, an accountant who willfully helps a client conceal fraud will not recover

12. In property insurance, a clause that requires the insured to maintain insurance equal to a specified percentage of the property value.

from his malpractice insurance policy if he is found guilty of participating in the fraud.

### **No-Fault Trends**

The major legal development of the century relating to liability insurance has been the elimination of liability in the two areas of greatest exposure: in the workplace and on the highway. In the next unit on agency law, we discuss the no-fault system of workers' compensation, under which a worker receives automatic benefits for workplace injuries and gives up the right to sue the employer under common-law theories of liability. Here we will look briefly at the other major type of no-fault system: recovery for damages stemming from motor vehicle accidents.

“No-fault” means that recovery for damages in an accident no longer depends on who was at fault in causing it. A motorist will file a claim to recover his actual damages (medical expenses, income loss) directly from his own insurer. The no-fault system dispenses with the costly and uncertain tort system of having to prove negligence in court. Many states have adopted one form or another of no-fault automobile insurance, but even in these states the car owner must still carry other insurance. Some no-fault systems have a dollar “threshold” above which a victim may sue for medical expenses or other losses. Other states use a “verbal threshold,” which permits suits for “serious” injury, defined variously as “disfigurement,” “fracture,” or “permanent disability.” These thresholds have prevented no-fault from working as efficiently as theory predicts. Inflation has reduced the power of dollar thresholds (in some states as low as \$200) to deter lawsuits, and the verbal thresholds have standards that can only be defined in court, so much litigation continues.

No state has adopted a “pure” no-fault system. A pure no-fault system trades away entirely the right to sue in return for the prompt payment of “first-party” insurance benefits—that is, payment by the victim’s own insurance company instead of traditional “third-party” coverage, in which the victim collects from the defendant’s insurance company.

Among the criticisms of no-fault insurance is the argument that it fails to strengthen the central purpose of the tort system: to deter unsafe conduct that causes accidents. No-fault lessens, it is said, the incentive to avoid accidents. In any event, no-fault automobile insurance has been a major development in the insurance field since 1970 and seems destined to be a permanent fixture of insurance law.



## **Life Insurance**

### **Insurable Interest**

The two types of life insurance mentioned in Section 28.1.2 "Types of Insurance for the Individual", term and whole-life policies, are important both to individuals and to businesses (insurance for key employees). As with property insurance, whoever takes out a life insurance policy on a person's life must have an insurable interest. Everyone has an insurable interest in his own life and may name whomever he pleases as beneficiary; the beneficiary need not have an insurable interest. But the requirement of insurable interest restricts those who may take out insurance on someone else's life. A spouse or children have an insurable interest in a spouse or parent. Likewise, a parent has an insurable interest in any minor child. That means that a wife, for example, may take out a life insurance policy on her husband without his consent. But she could not take out a policy on a friend or neighbor. As long as the insurable interest existed when the policy was taken out, the owner may recover when the insured dies, even if the insurable interest no longer exists. Thus a divorced wife who was married when the policy was obtained may collect when her ex-husband dies as long as she maintained the payments. Likewise, an employer has an insurable interest in his key employees and partners; such insurance policies help to pay off claims of a partner's estate and thus prevent liquidation of the business.

### **Subrogation**

Unlike property insurance, life insurance does not permit subrogation. The insurer must pay the claim when the insured dies and may not step into the shoes of anyone entitled to file a wrongful death claim against a person who caused the death. Of course, if the insured died of natural causes, there would be no one to sue anyway.

### **Change of Beneficiary and Assignment**

Unless the insured reserves the right to change beneficiaries, his or her initial designation is irrevocable. These days, however, most policies do reserve the right if certain formalities are observed, including written instructions to the insurer's home office to make the change and endorsement of the policy. The insured may assign the policy, but the beneficiary has priority to collect over the assignee if the right to change beneficiaries has not been reserved. If the policy permits beneficiaries to be changed, then the assignee will have priority over the original beneficiary.

## **Intentional Losses**

Two types of intentional losses are especially important in life insurance: suicide and murder of the insured by the beneficiary.

### **Suicide**

In a majority of states, in the absence of a suicide clause in the policy, when an insured commits suicide, the insurer need not pay out if the policy is payable to the insured's estate. However, if the policy is payable to a third person (e.g., the insured's company), payment will usually be allowed. And if an insured kills himself while insane, all states require payment, whether to the estate or a third party. Most life insurance policies today have a provision that explicitly excepts suicide from coverage for a limited period, such as two years, after the policy is issued. In other words, if the insured commits suicide within the first two years, the insurer will refund the premiums to his estate but will not pay the policy amount. After two years, suicide is treated as any other death would be.

### **Murder**

Under the law in every state, a beneficiary who kills the insured in order to collect the life insurance is barred from receiving it. But the invocation of that rule does not absolve the insurer of liability to pay the policy amount. An alternate beneficiary must be found. Sometimes the policy will name contingent beneficiaries, and many, but not all, states require the insurer to pay the contingent beneficiaries. When there are no contingent beneficiaries or the state law prohibits paying them, the insurer will pay the insured's estate. Not every killing is murder; the critical question is whether the beneficiary intended his conduct to eliminate the insured in order to collect the insurance.

The willful, unlawful, and felonious killing of the insured by the person named as beneficiary in a life policy results in the forfeiture of all rights of such person therein. It is unnecessary that there should be an express exception in the contract of insurance forbidding a recovery in favor of such a person in such an event. On considerations of public policy, the death of the insured, willfully and intentionally caused by the beneficiary of the policy, is an excepted risk so far as the person thus causing the death is concerned.

### KEY TAKEAWAY

Many kinds of insurance are available for individuals and businesses. For individuals, life insurance, homeowner's insurance, and automobile insurance are common, with health insurance considered essential but often expensive. Businesses with sufficient employees will obtain workers' compensation insurance, property insurance, and liability insurance, and auto insurance for any employees driving company vehicles. Insurance companies will often pay a claim for their insured and take over the insured's claim against a third party.

Liability insurance is important for individuals, companies, and licensed professionals. A trend toward no-fault in liability insurance is seen in claims for work-related injuries (workers' compensation) and in automobile insurance. Life insurance is common for most families and for businesses that want to protect against the loss of key employees.

### EXERCISES

1. Helen Caldicott raises a family and then begins a career as a caterer. As her business grows, she hires several employees and rents space near downtown that has a retail space, parking, and a garage for the three vehicles that bear her business's name. What kinds of insurance does Helen need for her business?
2. One of Helen's employees, Bob Zeek, is driving to a catered event when another car fails to stop at a red light and severely injures Bob and nearly totals the van Bob was driving. The police issue a ticket for careless and reckless driving to the other driver, who pleads guilty to the offense. The other driver is insured, but Helen's automobile insurance carrier goes ahead and pays for the damages to the company vehicle. What will her insurance company likely do next?
3. The health insurance provider for Helen's employees pays over \$345,000 of Bob's medical and hospitalization bills. What will Helen's insurance company likely do next?
4. Many homeowners live on floodplains but have homeowner's insurance nonetheless. Must insurance companies write such policies? Do homeowners on floodplains pay more in premiums? If insurance companies are convinced that global climate change is happening, with rising sea levels and stronger storms, can they simply avoid writing policies for homes and commercial buildings in coastal areas?

## 28.3 Insurer's Defenses

### LEARNING OBJECTIVES

1. Understand the principal defenses available to insurers when claims are made.
2. Recognize that despite these defenses, insurance companies must act in good faith.

### Types of Defenses

It is a common perception that because insurance contracts are so complex, many insureds who believe they are covered end up with uninsured losses. In other words, the large print giveth, and the small print taketh away. This perception is founded, to some extent, on the use by insurance companies of three common defenses, all of which relate to a duty of good faith on the part of the insured: (1) representation, (2) concealment, and (3) warranties.

#### Representation

A **representation**<sup>13</sup> is a statement made by someone seeking an insurance policy—for example, a statement that the applicant did (or did not) consult a doctor for any illness during the previous five years. An insurer has grounds to avoid the contract if the applicant makes a false representation. The misrepresentation must have been material; that is, a false description of a person's hair coloring should not defeat a claim under an automobile accident policy. But a false statement, even if innocent, about a material fact—for instance, that no one in the family uses the car to go to work, when unbeknownst to the applicant, his wife uses the car to commute to a part-time job she hasn't told him about—will at the insurer's option defeat a claim by the insured to collect under the policy. The accident need not have arisen out of the misrepresentation to defeat the claim. In the example given, the insurance company could refuse to pay a claim for any accident in the car, even one occurring when the car was driven by the husband to go to the movies, if the insurer discovered that the car was used in a manner in which the insured had declared it was not used. This chapter's case, *Mutual Benefit Life Insurance Co. v. JMR Electronics Corp.*, (see [Section 28.4.1 "Misrepresentation to Insurer"](#)), illustrates what happens when an insured misrepresents his smoking habits.

13. Statements made by the insured in the application process.

### Concealment

An insured is obligated to volunteer to the insurer all material facts that bear on insurability. The failure of an insured to set forth such information is a **concealment**<sup>14</sup>, which is, in effect, the mirror image of a false representation. But the insured must have had a fraudulent intent to conceal the material facts. For example, if the insured did not know that gasoline was stored in his basement, the insurer may not refuse to pay out on a fire insurance policy.

### Warranties

Many insurance policies covering commercial property will contain warranties. For example, a policy may have a warranty that the insured bank has installed or will install a particular type of burglar alarm system. Until recently, the rule was strictly enforced: any breach of a warranty voided the contract, even if the breach was not material. A nonmaterial breach might be, for example, that the bank obtained the alarm system from a manufacturer other than the one specified, even though the alarm systems are identical. In recent years, courts or legislatures have relaxed the application of this rule. But a material breach still remains absolute grounds for the insurer to avoid the contract and refuse to pay.

### Incontestable Clause

In life insurance cases, the three common defenses often are unavailable to the insurer because of the so-called **incontestable clause**<sup>15</sup>. This states that if the insured has not died during a specified period of time in which the life insurance policy has been in effect (usually two years), then the insurer may not refuse to pay even if it is later discovered that the insured committed fraud in applying for the policy. Few nonlife policies contain an incontestable clause; it is used in life insurance because the effect on many families would be catastrophic if the insurer claimed misrepresentation or concealment that would be difficult to disprove years later when the insured himself would no longer be available to give testimony about his intentions or knowledge.

### Requirement of Insurer's Good Faith

Like the insured, the insurer must act in good faith. Thus defenses may be unavailable to an insurer who has waived them or acted in such a manner as to create an estoppel. Suppose that when an insured seeks to increase the amount on his life insurance policy, the insurance company learns that he lied about his age on his original application. Nevertheless, the company accepts his application for an increase. The insured then dies, and the insurer refuses to pay his wife any sum. A court would hold that the insurer had waived its right to object, since it could have

14. The failure of an insured to set forth all the material facts in applying for insurance.

15. A clause in a life insurance policy that limits the insurance carrier's right to contest insurability after a certain number of years of premium payments on the policy.

cancelled the policy when it learned of the misrepresentation. Finally, an insurer that acts in bad faith by denying a claim that it knows it should pay may find itself open to punitive damage liability.

### KEY TAKEAWAY

Some claims by insured parties can be legally denied by insurance companies where the insured has made a material misrepresentation. Some claims can be legally denied if the insured has deliberately concealed important matters in applying for insurance coverage. Because insurance coverage is by contract, courts often strictly construe the contract language, and if the language does not cover the insured, the courts will typically not bend the language of the contract to help the insured.

### EXERCISES

1. Amir Labib gets a reduced rate from his auto insurance company because he represents in his application that he commutes less than ten miles a day to work. Three years later, he and his wife buy a new residence, farther away from work, and he begins a fifteen-mile-a-day commute. The rate would be raised if he were to mention this to his insurance company. The insurance company sees that he has a different address, because they are mailing invoices to his new home. But the rate remains the same. Amir has a serious accident on a vacation to Yellowstone National Park, and his automobile is totaled. His insurance policy is a no-fault policy as it relates to coverage for vehicle damage. Is the insurance company within its rights to deny any payment on his claim? How so, or why not?
2. In 2009, Peter Calhoun gets a life insurance policy from Northwest Mutual Life Insurance Company, and the death benefit is listed as \$250,000. The premiums are paid up when he dies in 2011 after a getaway car being chased by the police slams into his car at fifty miles per hour on a street in suburban Chicago. The life insurance company gets information that he smoked two packs of cigarettes a day, whereas in his application in 2009, he said he smoked only one pack a day. In fact, he had smoked about a pack and a half every day since 1992. Is the insurance company within its rights to deny any payment on his claim? How so, or why not?

## 28.4 Case

### Misrepresentation to Insurer

Mutual Benefit Life Insurance Co. v. JMR Electronics Corp.

848 F.2d 30 (2nd Cir. 1988)

PER CURIAM

JMR Electronics Corporation (“JMR”) appeals from a judgment of the District Court for the Southern District of New York (Robert W. Sweet, Judge) ordering rescission of a life insurance policy issued by plaintiff-appellant The Mutual Benefit Life Insurance Company (“Mutual”) and dismissing JMR’s counterclaim for the policy’s proceeds. Judge Sweet ruled that a misrepresentation made in the policy application concerning the insured’s history of cigarette smoking was material as a matter of law. Appellant contends that the misrepresentation was not material because Mutual would have provided insurance—albeit at a higher premium rate—even if the insured’s smoking history had been disclosed. We agree with the District Court that summary judgment was appropriate and therefore affirm.

The basic facts are not in dispute. On June 24, 1985, JMR submitted an application to Mutual for a \$ 250,000 “key man” life insurance policy on the life of its president, Joseph Gaon, at the non-smoker’s discounted premium rate. Mutual’s 1985 Ratebook provides: “The Non-Smoker rates are available when the proposed insured is at least 20 years old and has not smoked a cigarette for at least twelve months prior to the date of the application.” Question 13 of the application inquired about the proposed insured’s smoking history. Question 13(a) asked, “Do you smoke cigarettes? How many a day?” Gaon answered this question, “No.” Question 13(b) asked, “Did you ever smoke cigarettes?” Gaon again answered, “No.” Based on these representations, Mutual issued a policy on Gaon’s life at the non-smoker premium rate.

Gaon died on June 22, 1986, within the period of contestability contained in policy, *see* N.Y. Ins. Law § 3203 (a)(3) (McKinney 1985). Upon routine investigation of JMR’s claim for proceeds under the policy, Mutual discovered that the representations made in the insurance application concerning Gaon’s smoking history were untrue. JMR has stipulated that, at the time the application was submitted, Gaon in fact “had been smoking one-half of a pack of cigarettes per day for a continuous period of not less than 10 years.” Mutual brought this action seeking a declaration that the

policy is void. Judge Sweet granted Mutual's motion for summary judgment, dismissed JMR's counterclaim for the proceeds of the policy, and ordered rescission of the insurance policy and return of JMR's premium payments, with interest.

Under New York law, which governs this diversity suit, "it is the rule that even an innocent misrepresentation as to [the applicant's medical history], if material, is sufficient to allow the insurer to avoid the contract of insurance or defeat recovery thereunder." *Process Plants Corp. v. Beneficial National Life Insurance Co.*, 366 N.E.2d 1361 (1977). A "misrepresentation" is defined by statute as a false "statement as to past or present fact, made to the insurer...at or before the making of the insurance contract as an inducement to the making thereof." N.Y. Ins. Law § 3105(a) (McKinney 1985). A misrepresentation is "material" if "knowledge by the insurer of the facts misrepresented would have led to a refusal by the insurer to make such contract." *Id.* § 3105(b)....

In the present case JMR has stipulated that Gaon's smoking history was misrepresented in the insurance application. However, JMR disputes that this misrepresentation is material as a matter of law. JMR argues that under New York law a misrepresentation is not material unless the insurer can demonstrate that, had the applicant provided complete and accurate information, coverage either would have been refused or at the very least withheld pending a more detailed underwriting examination. In JMR's view summary judgment was inappropriate on the facts of this case because a jury could reasonably have found that even "had appellee been aware of Gaon's smoking history, a policy at the smoker's premium rate would have been issued." JMR takes the position that the appropriate remedy in this situation is to permit recovery under the policy in the amount that the premium actually paid would have purchased for a smoker.

We agree with Judge Sweet that this novel theory is without basis in New York law. The plain language of the statutory definition of "materiality," found in section 3105(b), permits avoidance of liability under the policy where "knowledge by the insurer of the facts misrepresented would have led to a refusal by the insurer to make *such contract*." (emphasis added) Moreover, numerous courts have observed that the materiality inquiry under New York law is made with respect to the particular policy issued in reliance upon the misrepresentation.

\* \* \*

There is no doubt that Mutual was induced to issue the non-smoker, discounted-premium policy to JMR precisely as a result of the misrepresentations made by Gaon concerning his smoking history. That Mutual might not have refused the risk on *any* terms had it known the undisclosed facts is irrelevant. Most risks are



insurable at some price. The purpose of the materiality inquiry is not to permit the jury to rewrite the terms of the insurance agreement to conform to the newly disclosed facts but to make certain that the risk insured was the risk covered by the policy agreed upon. If a fact is material to the risk, the insurer may avoid liability under a policy if that fact was misrepresented in an application for that policy whether or not the parties might have agreed to some other contractual arrangement had the critical fact been disclosed. As observed by Judge Sweet, a contrary result would reward the practice of misrepresenting facts critical to the underwriter's task because the unscrupulous (or merely negligent) applicant "would have everything to gain and nothing to lose" from making material misrepresentations in his application for insurance. Such a claimant could rest assured not only that he may demand full coverage should he survive the contestability period, N.Y. Ins. Law § 3203 (a)(3), but that even in the event of a contested claim, he would be entitled to the coverage that he might have contracted for had the necessary information been accurately disclosed at the outset. New York law does not permit this anomalous result. The judgment of the District Court is affirmed.

### CASE QUESTIONS

1. When you read this case, did you assume that Gaon died from lung cancer or some other smoking-related cause? Does the court actually say that?
2. Can you reasonably infer from the facts here that Gaon himself filled out the form and signed it? That is, can you know with some degree of certainty that he lied to the insurance company? Would it make any difference if he merely signed a form that his secretary filled out? Why or why not?
3. What if Gaon died of causes unrelated to smoking (e.g., he was in a fatal automobile accident), and the insurance company was looking for ways to deny the claim? Does the court's opinion and language still seem reasonable (e.g., the statement "there is no doubt that Mutual was induced to issue the non-smoker, discounted-premium policy to JMR precisely as a result of the misrepresentations made by Gaon concerning his smoking history")?
4. If Gaon had accurately disclosed his smoking history, is it clear that the insurance company would have refused to write any policy at all? Why is this question important? Do you agree with the court that the question is irrelevant?

## 28.5 Summary and Exercises

### Summary

Insurance is an inescapable cost of doing business in a modern economy and an important service for any individual with dependents or even a modest amount of property. Most readers of this book will someday purchase automobile, homeowner's, and life insurance, and many readers will deal with insurance in the course of a business career.

Most insurance questions are governed by contract law, since virtually all insurance is voluntary and entered into through written agreements. This means that the insured must pay careful attention to the wording of the policies to determine what is excluded from coverage and to ensure that he makes no warranties that he cannot keep and no misrepresentations or concealments that will void the contract. But beyond contract law, some insurance law principles—such as insurable interest and subrogation rights—are important to bear in mind. Defenses available to an insurance company may be based upon representation, concealment, or warranties, but an insurer that is overzealous in denying coverage may find itself subject to punitive damages.

## EXERCISES

1. Martin and Williams, two business partners, agreed that each would insure his life for the benefit of the other. On his application for insurance, Martin stated that he had never had any heart trouble when in fact he had had a mild heart attack some years before. Martin's policy contained a two-year incontestable clause. Three years later, after the partnership had been dissolved but while the policy was still in force, Martin's car was struck by a car being negligently driven by Peters. Although Martin's injuries were superficial, he suffered a fatal heart attack immediately after the accident—an attack, it was established, that was caused by the excitement. The insurer has refused to pay the policy proceeds to Williams. Does the insurer have a valid defense based on Martin's misrepresentation? Explain.
2. In Exercise 1, was it necessary for Williams to have an insurable interest in Martin's life to recover under the policy? Why?
3. In Exercise 1, if Williams had taken out the policy rather than Martin, could the insurer defend the claim on the ground that at the time of Martin's death, Williams had no insurable interest? Why?
4. If Williams had no insurable interest, would the incontestable clause prevent the company from asserting this defense? Why?
5. If the insurer pays Williams's claim, may it recover from Peters? Why?
6. Skidmore Trucking Company decided to expand its operations into the warehousing field. After examining several available properties, it decided to purchase a carbarn for \$100,000 from a local bus company and to convert it into a warehouse. The standard contract for a real estate purchase was signed by the parties. The contract obligated Skidmore to pay the seller on an apportioned basis for the prepaid premiums on the existing fire insurance policy (\$100,000 extended coverage). The policy expired two years and one month from the closing date. At the closing, the seller duly assigned the fire insurance policy to Skidmore in return for the payment of the apportioned amount of the prepaid premiums, but Skidmore failed to notify the insurance company of the change in ownership. Skidmore took possession of the premises and, after extensive renovation, began to use the building as a warehouse. Soon afterward, one of Skidmore's employees negligently dropped a lighted cigarette into a trash basket and started a fire that totally destroyed the building. Was the assignment of the policy to Skidmore valid? Why?
7. In Exercise 6, assuming the assignment is valid, would the insurer be obligated to pay for the loss resulting from the employee's negligence? Why?

## SELF-TEST QUESTIONS

1. The substitution of one person for another in pursuit of a legal claim is called
  - a. assignment
  - b. coinsurance
  - c. subrogation
  - d. none of the above
  
2. Most insurance questions are covered by
  - a. tort law
  - b. criminal law
  - c. constitutional law
  - d. contract law
  
3. Common defenses used by insurance companies include
  - a. concealment
  - b. false representation
  - c. breach of warranty
  - d. all of the above
  
4. A coinsurance clause
  - a. requires the insured to be insured by more than one policy
  - b. requires the insured to maintain insurance equal to a certain percentage of the property's value
  - c. allows another beneficiary to be substituted for the insured
  - d. is none of the above
  
5. Property insurance typically covers
  - a. ordinary wear and tear
  - b. damage due to theft
  - c. intentional losses
  - d. damage due to earthquakes

**SELF-TEST ANSWERS**

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